

THE PERSPECTIVE OF THE WORLD REVIEW

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Giuliano Contento de Oliveira



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The Perspective of the World Review

An international publication by the Institute for Applied Economic Research (Ipea), a body belonging to the Presidency of the Federative Republic of Brazil. It was created to promote contemporary debates emphasizing the theme of development from a South to South perspective and seeks to formulate proposals for the development of public policies, as well as to encourage international comparison with a focus on the scope of political economy.

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PRESENTATION

The *Perspective of the World Review* is an international periodical sponsored by Ipea (Institute for Applied Economic Research), a body belonging to the Presidency of the Federative Republic of Brazil through the Secretariat for Strategic Affairs (SAE).

The journal will feature versions in Portuguese and English and was designed to present and promote contemporary debates, emphasizing the theme of development from a South-South perspective. Its field of knowledge is that of political economy, with plural approaches on the essential dimensions of development such as economic, social and sustainability-related issues.

The goal is to enhance the debate in order to formulate proposals for the development of public policies and, accordingly, to encourage international comparisons and interdisciplinarity – always highlighting the role of planning. The *Perspective of the World Review* takes the ambition to formulate questions faced by contemporary civilization, which wants to enjoy comfortable living standards and dignified living conditions, but must simultaneously respect the limits of what the planet can support in terms of environmental exploitation.

It is important to point out the tribute given to Fernand Braudel through the enhancement of his formulation of the “*perspective of the world*”, which together with the “*structures of everyday life*” and the “*wheels of commerce*”, shapes his originality. Braudel always sought to address issues surrounding the dimensions of development in a historical and long-term perspective. He emphasized that a world dominated by a mode of production based on the accumulation of capital had always had to balance society, market and state. As the master taught us, in places where the task was most successful, there was prosperity, and where the difficulties were persistent, results were controversial.

This initiative is not new in Brazil – its great precursor was Celso Furtado, in *The Economic Growth of Brazil*. This seminal work was welcomed by Braudel as innovative under a methodological prism.

Editorial Board

EDITORIAL

The fifth edition of *the Perspective of the World Review*) brings to the debate institutional issues of fundamental importance for the economic and social development process of Brazil's and other developing countries. It focuses on discussions on improving and modernizing the international financial system, proposing alternatives to reduce the imbalances and inequities of the global scenario.

The international financial crisis is one of the discussed topics. In the paper by Trevor Evans, it is presented the scenario in which the crisis developed in the second half of 2008, besides the analysis of the five major approaches used to explain its emergence.

Following the theme of international crises, Edna Aparecida da Silva presents a discussion on the relationship between economics and security, by setting the concepts of national security and economic security in order to analyze the policy reforms regulating the entry of foreign investments in the USA.

María Florencia Rubiolo presents the recent changes in Chinese foreign policy, especially after the end of the Cold War, performing an analysis of the Chinese approach towards multilateral initiatives in Southeast Asia in the recent years, especially regarding to the Regional Forum Association of Southeast Asian Nations (Asean).

With regard to international trade, Vera Thorstensen argues that it comprises a broad range of activities, such as intellectual property, competition and investment, rather than export and import activities. Thus, the concept of international trade must be redesigned to comprise a broader concept, namely, the global trade.

Roberto Frenkel highlights the importance of macroeconomic policies to developing countries that aim at stimulating growth, financial stability, and robust performance in the face of external shocks, real and financial.

Finally, still on the international macroeconomic imbalances issue, Giuliano Contento de Oliveira discusses the dynamics of capital flows (Foreign direct investment, portfolio, loans and bond issues and stocks) for developing countries in the period 1990 to 2010. Thus, we propose a new theoretical framework and a new methodology for the analysis regulation of global trade.

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FIVE EXPLANATIONS FOR THE INTERNATIONAL FINANCIAL CRISIS

Trevor Evans*

ABSTRACT

This paper first briefly outlines the background to the 2007-08 international financial crisis. It then goes on to examine five of the main approaches that have been put forward to explain the crisis: the widespread presence of perverse incentives; the over-expansionary monetary policy of the US Federal Reserve; the impact of global imbalances and a so-called 'savings glut' in developing countries; the extensive deregulation of the financial system since the 1970s; and the attempt to generate an increasing return on all forms of capital and the associated pressure on wages. The paper concludes with a brief note on the policy implications which follow from each of these explanations.

RESUMO

Este artigo, primeiramente, descreve de forma breve o contexto da crise financeira internacional ocorrida em 2007-2008. Em seguida, passa a analisar cinco das principais abordagens que têm sido propostas para explicar a crise: a presença generalizada de incentivos perversos; a política monetária expansionista do Federal Reserve; o impacto dos desequilíbrios globais e o chamado "excesso de poupança" nos países em desenvolvimento; a extensa desregulamentação do sistema financeiro desde a década de 1970; e a tentativa de se gerar um retorno maior sobre todas as formas de capital e as pressões associadas sobre os salários. O artigo conclui com uma breve nota sobre as implicações políticas que decorrem de cada uma destas explicações.

INTRODUCTION

The financial crisis which began in the US in 2007, and which led to the deepest global recession since the Second World War in 2008 and 2009, is only the most recent in a long string of crises and recessions that have afflicted capitalist economies. Breakdowns in economic reproduction did also occur in pre-capitalist societies, but these were primarily due to external factors, such as wars or draughts or the plague. In capitalist economies, by contrast, crises have emerged as a result of developments *within* the economy.¹ This paper will first briefly explain the background and main features of the current crisis and then examine five of the main approaches to explaining it.

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1. For details of financial crises since the 17th century, see Charles Kindleberger, *Manias, Panics and Crashes. A History of Financial Crises*, 1978.

CAPITALISM AND CRISES

In the nineteenth century, periods of rising prosperity led to investment in expanding production and, encouraged by the profitable opportunities, banks eagerly met increased demands for borrowing. As growth picked up, wages and other prices would begin to rise and erode profits. At the same time, the price of assets (shares, land, even raw materials) would increase and encourage speculative buying, often financed by borrowing, and this would push up prices yet further. At some point the bubble in asset prices would burst and, faced with large losses, bank lending would contract dramatically causing a major downturn in production, employment and income. The recession, in turn, led to the bankruptcy of the weakest firms, making labour and other resources available to other sectors, so preparing the basis for the next period of expansion. Such crises began in Britain in the early nineteenth century, and cycles of expansion and crises then recurred at approximately 10 year intervals, spreading to include other Western European countries and the US as industrialisation was extended in the second half of the century.

As the scale of industry and finance increased, crises became ever more threatening and the state began to intervene in an attempt to ameliorate their impact. In the second half of the nineteenth century, the Bank of England developed the function of 'lender of last resort' in order to prevent problems at one bank from setting off a chain of bank failures.² This involved making loans available to banks that were basically sound but which were threatened by a sudden lack of short-term funds. Although the US was the largest capitalist economy by the turn of the 20th century, because of populist political sentiment, it did not have a central bank until the Federal Reserve System was created in 1913.³

As is well known, the most serious crisis of all began with the US stock market crash in 1929 and was followed by a wave of bank failures between 1930 and 1932 in which around one third of US banks went bankrupt. When the Roosevelt government took office in early 1933, it immediately introduced a series of measures to regulate the financial sector. The Glass-Steagall Act introduced tight controls on the banking sector, including limits on interest rates and a legal separation between commercial banks (which accept deposits and make loans) and investment banks (which advise on and conduct transactions with securities). Shortly after, the Securities and Exchange Commission was set up to regulate the securities markets.

The period that followed the introduction of these controls on the financial system was characterised by an unusual degree of financial stability. From the 1940s

2. This was first analysed in Walter Bagehot, *Lombard Street. A Description of the Money Market*, 1873, reprinted 1999.

3. This was prompted by a major crisis in 1907, when the largest private financier, J.P.Morgan, effectively took on the role of central bank, and prevented a financial collapse. For an excellent account, see Lawrence E. Mitchell, *The Speculation Economy. How Finance Triumphed Over Industry*, San Francisco, 2007.

until the early 1970s the US – and the other major capitalist countries, which also had tight regulations on their financial sectors – did not experience any serious financial crises.⁴ This period of financial stability was, furthermore, associated with a steady rise in the standard of living of the mass of the population. In the absence of serious recessions, unemployment remained exceptionally low while real wages increased and the provision of welfare services was expanded.

THE RE-EMERGENCE OF THE FINANCIAL SECTOR

After the Second World War, when US households had built up large savings, US banks initially held substantial reserves of deposits and did not experience the tight regulations as a serious constraint on their activities. By the late 1960s, however, this began to change and the banks began pushing for major changes.

First, the banks initiated a process of financial innovation, developing new instruments that were not explicitly forbidden by the existing regulations. The first of these was the creation of the Certificate of Deposit in 1966. Because this was, in legal terms, a tradable certificate and not a bank deposit, it enabled banks to attract funds by offering interest rates above the legal maximum set by the government. In subsequent years, the innovations became ever more complex, in part to get round regulations, but also to deliberately obscure the risks involved.

A second important development was the internationalisation of the US banking system. In the late 1960s, US banks began to open branches in Europe, predominantly in London, and this expanded rapidly in the course of the 1970s.⁵ The big US banks were, in part, following their big US corporate customers, who had begun to invest in Western Europe in the 1960s. But the expansion of US bank branches in London was also strongly motivated by a desire to operate outside the constraints of the US regulatory authorities, in particular to get round restrictions on capital outflows which had been tightened in the mid-1960s.⁶

The third significant development was a process of financial deregulation. Faced with the processes of innovation and internationalisation, the US authorities were faced with a stark choice: either they would have to seriously update the regulatory framework or they would have to accept that banks would increasingly circumvent the existing rules. In fact there was remarkably little discussion. With strong pressure from financial institutions, and a political and ideological climate

4. The only banking crisis during this period was in Brazil in 1962.

5. The number of US banks with overseas branches increased from 8 in 1960 to 130 in 1980 (M. Mizruchi and G. Davis, 'The globalization of American banking, 1962 to 1981', in Frank Dobbin (ed.), *The Sociology of the Economy*, New York, 2003).

6. The main measures were the Interest Equalisation Tax, introduced in 1963 to discourage foreign corporations from raising capital in the US bond market, and the Voluntary Credit Restraint Programme, introduced in 1965 to discourage banks in the US from funding the overseas investments of US corporations.

that had swung towards a belief in the self-regulating capacity of private markets, the US government embarked on a step-by-step process of eliminating the constraints on the financial sector.

FINANCE-LED CAPITALISM

From around the early 1980s, it is possible to identify a new phase of US capitalism, and because of the central role occupied by the financial sector, it often referred to as finance-led capitalism.⁷ Many of the feature of this new phase took shape around the same time in Britain under the government of Mrs Thatcher, and they followed, albeit it in a somewhat more moderate form, in France and Germany from the 1990s. The main financial developments included the following.

Firstly, as a result of the process of innovation and deregulation there was an enormous growth of the financial sector. This involved a growth of financial institutions, above all of big banks, but also of non-bank financial institutions, including pension funds and investment funds (known as mutual funds in the US), and more speculative institutions such as hedge funds and private equity funds; it involved the development of a host of new financial instruments, including complex bonds and speculative instruments such as derivatives; and it included a major expansion of financial markets.

Secondly, the strengthening of the financial sector resulted in pressure on non-financial companies in the industrial and commercial sector to give top priority to achieving the highest possible financial return for share holders – the pursuit of so-called ‘share-holder value’. If companies failed to sustain high dividend payments to shareholders, they were threatened with the risk of big institutional investors selling off their holdings. If share prices then fell significantly, the company was likely to get taken over. To guard against this, companies embarked on repeated rounds of rationalisation, outsourcing parts of the work, closing the least efficient plants, and reducing costs – especially wage costs – wherever possible.

Thirdly, non-financial firms – faced with the pressure to raise their own returns – began to engage in financial investments which appeared to offer a higher return than that obtained from investing in their previous lines of business. In this way, as non-financial companies increased their holdings of financial assets, investment in fixed capital (machinery, equipment and buildings) tended to be weaker than the earlier post-war period and, as a result, generated fewer jobs.

This new phase of capitalism appeared to be very successful for corporations in the US. From the early 1980s up until 2007, the share of corporate profits in

7. For a discussion of this new phase see the essays in Gerald Epstein (eds.), *Financialisation and the World Economy*, Cheltenham, 2005.

US national income increased steadily, rising to a level last seen in the mid-1960s.⁸ The financial sector benefited in particular, with its share of total pre-tax profits rising from around 15 per cent in the early 1980s, to some 35 per cent in the years just before the crisis broke in 2007.⁹ However, this was associated with a remorseless pressure on wages and, in practice, economic growth in the US from the early 1980s was highly dependent on the expansion of credit and the growth of speculative bubbles in asset prices. Despite the government's commitment to free market capitalism, each time the model faltered the Federal Reserve adopted a highly expansive monetary policy so as to forestall a serious recession and crisis.

In the 1980s, the most striking financial development was the extensive use of so-called junk bonds to finance a major wave of corporate takeovers. Compared with the industrial-grade bonds issued by well-known companies, there was a higher risk that these bonds would not be paid back, but they offered a more attractive rate of return and proved highly profitable for the investment banks which managed their issue. In 1989, however, after several years of over-lending, the banks abruptly curtailed the expansion of new loans and the economic expansion came to an end. The Federal Reserve managed to ameliorate the impact of the downturn by adopting an extremely expansive monetary policy and interest rates were held down for several years.

In the second half of the 1990s, the US economy experienced its next expansion which was driven by a boom in information technology. Rising profits and a strong growth of lending fuelled rising investment in new technology and led to a major bubble in share prices. Households with direct or indirect holdings of shares experienced a so-called 'wealth effect', and borrowed to finance higher consumption. This came to an end when the share-price bubble burst in early 2000, leading to a collapse in prices that was comparable with that after the famous crash in 1929. However, while this led to a recession in 2001, the Fed was again able to limit the impact of the downturn by adopting a highly expansionary monetary policy and interest rates were kept exceptionally low for several years.¹⁰

Between 2002 and 2007, the US economy registered a further expansion, this time driven primarily by a boom in house prices. Financial institutions aggressively expanded their mortgage lending, including lending targeted at low-income households through so-called sub-prime mortgages. As a result of financial deregulation, these were subject to much looser conditions than traditional mortgages although

8. See Paul Lally, Andrew Hodge and Robert Corea, 'Returns of Domestic Nonfinancial Business', *Survey of Current Business*, US Department of Commerce, May 2008.

9. US Bureau of Economic Affairs, *National Income and Product Accounts*, Table 1.14.

10. The Federal Reserve's lead interest rate was reduced in rapid steps from 6.5% in January 2001 to 1% in 2003 and 2004.

the interest rates were significantly higher.¹¹ As increased demand pushed house prices up, many households borrowed money against the increased value of their homes, and this was then used to finance increased consumption. Although wages remained virtually stagnant, the increase in consumption spending was able to drive economic growth in the US for several years. But when the bubble in house prices burst in 2007, the whole situation unravelled, detonating the most serious financial crisis since the 1930s.

SECURITISATION

The crisis was set off by the failure of financial instruments created to finance the growth of mortgage lending. In 1988, an international agreement known as the Basel Accord established that banks should hold capital reserves equal to 8 per cent of their lending.¹² This was to ensure that, if loans were not repaid, the capital reserves would provide a bank with a cushion to absorb the losses without driving it into bankruptcy. However, one effect of this regulation was to encourage a process known as securitisation, by which the banks would bundle a large number of loans (in the case of mortgages, typically several thousand), and create a security which could be sold on the capital market to a financial investor. In this way, a bank could earn fees and, by removing the loans from its own books, avoid tying up their capital for the life of the mortgages. The investor in turn received the interest and capital payments from the mortgage borrowers.¹³

Mortgage-backed securities were also created by bundling together large numbers of sub-prime mortgages but, because the repayments on these were largely dependent on low-income households, many with irregular employment, they were considered to be riskier than other forms of securities. The big New York investment banks then developed a highly lucrative business, taking the initial securities and creating new, highly complex securities known as *collateralised debt obligations* in which the rights to repayments was sliced up into *tranches*. The detail of how these instruments were constructed was extremely complicated – indeed, one aim was precisely to obscure the underlying risks involved – but the general principal was as follows. The first or senior tranche had first call on the repayments by mortgage borrowers. Because it was thought that even among low paid households a certain proportion would always meet their payments, this tranche was considered very safe, but it paid the lowest return. Once repayments to senior tranche holders had been met, holders of the second

11. While the interest rate on a standard 30-year mortgage was 5-6%, that on a sub-prime mortgage could be as much 10%. See Robert B. Avery, Kenneth P. Brevoort and Glenn B. Canner, 'The 2006 HMDA Data', *Federal Reserve Bulletin*, vol. 93, December 2007.

12. The rate was lower for some forms of lending that were considered to involve a lower risk.

13. For an account of the development of securitisation and its role in the crisis, see Gillian Tett, *Fool's Gold*, London, 2009.

or mezzanine tranche would receive repayments. These were considered a little more risky, and this tranche therefore offered a slightly higher rate of return. The lowest or equity tranche would only receive repayments when the other tranches had been serviced. If any households failed to meet their repayments, the holders of this tranche would have to carry the loss. Because this tranche carried the most risk, investors had to be offered the highest rate of return.

Securitisation was widely hailed by orthodox economists who argued that, by dispersing the risk of losses among a large number of investors, with investors able to select the level of risk they were able to cope with, the financial system as a whole had become more stable. However, many of the big banks themselves held some of the most risky securities, in part attracted by the high returns they paid. Furthermore, these holdings were often financed by borrowing short-term funds at lower rates of interest from other financial institutions. For a time, it was a highly profitable investment. In fact it was so attractive, that many European banks – including Germany's publicly owned *Landesbanken* – began to invest in US mortgage backed securities too. However, when the housing bubble burst and prices began to fall, the value of many mortgage backed securities and their complex derivatives began to fall precipitously.

THE ONSET OF THE CRISIS

The crisis broke in August 2007.¹⁴ The immediate cause was that banks did not know to what extent other banks had incurred losses from holding mortgage related securities and, in order to avoid the risk of not being repaid, banks stopped lending to each other. As a result, the inter-bank money market, where banks borrow and lend short-term funds between themselves, and which is central to the functioning of a modern capitalist banking system, dried up. This occurred almost simultaneously in the US and in Europe, and both the Federal Reserve and the European Central Bank responded by immediately pumping large amounts of money into the US and Euro-area inter-bank markets. But while this prompt response prevented a complete breakdown in the money market, inter-bank lending remained seriously curtailed and, in turn, bank credit to industrial and commercial businesses was reduced markedly. In the following months, the central banks in the US, the Euro-area, Britain and Switzerland repeatedly pumped additional funds into their banking systems, but the situation continued to deteriorate as US mortgage backed securities continued to loose value, and the scale of bank losses increased. One signal of the deteriorating situation was the failure of Bear Stearns, one of the leading New York investment banks, in March 2008.

14. For a more detailed account, see Trevor Evans, 'The 2002-2007 US Economic Expansion and the Limits of Finance-led Capitalism', *Studies in Political Economy*, vol. 83, Spring 2009.

The crisis deepened dramatically in September 2008. At the start of the month, Fannie Mae and Freddie Mac, the two most important semi-public mortgage lending agencies in the US ran into serious problems and required major financial support from the government. The key development was the collapse in mid September of the big New York investment bank, Lehman Brothers, which had been deeply involved in the construction of complex mortgage-based securities. The US authorities claimed that, because Lehman was an investment bank (which deals in securities) and not a commercial bank (which accepts deposits and is protected by the central bank), they could not legally intervene. But it is clear that the government had decided to show big financial institutions that they could not count on always being rescued. The way that they did this, however, proved to be a major error of judgement.

The collapse of Lehman Brothers set off a chain of further major financial failures, including that of American International Group, the largest insurer in the world, which had incurred huge liabilities insuring dubious mortgage backed securities. It also led to an acute sharpening of the crisis in the inter-bank money market, which resulted in an almost complete collapse in bank lending in the US, even to the most well-known companies. Finally, in early October the crisis hit international stock markets, which lost some 20 per cent of their value in the course of one week in the US, Europe and even Asia, which had been less touched up to this point.

At the end of the second week in October, amidst a wide-spread official view that the international financial system was on the edge of collapse, the governments of the US and the major European countries, including Britain, France and Germany, all announced plans to invest capital directly in banks faced with failure. This amounted, in effect, to a part nationalisation of the banking system and in the US the government became the main owner of the two biggest banks, Citibank and Bank of America. At the same time as making capital available, the governments also announced plans to provide guarantees for inter-bank lending in the hope that this would lead to a return to lending.¹⁵ However, while the co-ordinated state intervention did halt the chain of financial failures, it was unable to prevent a collapse of bank lending, either in the US or in Europe.

THE GLOBAL RECESSION

Several years of strong economic growth in the US came to an end in 2007 when households were no longer able to finance a further increase in consumer spending by borrowing against rising house prices. When bank lending dried up

15. For details, see European Central Bank, 'Measures taken by euro area governments in support of the financial sector', *Monthly Bulletin*, April 2010, pp. 75-90.

in October 2008 following the failure of Lehman Brothers, investment abruptly collapsed, and the US was hit by its most serious slump since the 1930s. In the final quarter of 2008 and the first quarter of 2009, output and employment in the US dropped abruptly, and the impact of the slump was transmitted to the rest of the world.¹⁶

The slump was transmitted to Western Europe through two main channels. Firstly, growth in Europe before the crisis had been strongly dependent on exports, largely driven either directly or indirectly by demand from the US. The slump in US demand, exacerbated by a collapse of trade credit, led to a decline of some 20 per cent in European exports and Germany, where growth had been especially dependent on exports, was particularly affected. Secondly, as in the US, the European economy was hit by a sharp reduction in the availability of bank credit as European banks struggled to deal with big losses on holdings in US securities. As a consequence, economic output in the older EU countries fell by 4.4 per cent in the final quarter of 2008 and the first quarter of 2009.¹⁷

The impact of the crisis in much of Eastern Europe and the Baltic Region was even more severe. Many countries had had large current account deficits and, prior to 2007, they had been able to finance these deficits at relatively favourable interest rates by borrowing on the international capital market. However, once the crisis broke in 2007, this financing dried up leaving the countries with a major problem. Furthermore, most of these countries did not benefit from the protection of being members of the Euro area, and were also faced with the danger of a currency crisis. In the event, Hungary and Latvia were forced to turn to the International Monetary Fund for emergency support, and were required to introduce major cuts in public expenditure, including spending on wages and pensions.¹⁸

The crisis was transmitted to Asian countries, including Japan and China, primarily through a collapse in the demand for manufactured exports, with Japan's exports falling by 50 per cent, and many smaller Asian exporters suffering from a collapse in the demand for semi-finished products.

As a result of a dramatic decline in industrial output in the US, Europe and Asia, the demand for energy and other raw materials declined sharply, leading to a notable fall in most primary commodity prices, including that of oil. Consequently, oil exporters such as Russia, the Middle Eastern countries and Venezuela

16. US real GDP fell by 3% in the last quarter of 2008 and the first quarter of 2009 (US Bureau of Economic Affairs, *National Income and Product Accounts*, Table 1.1.1).

17. See Eurostat Table tet20002 for trade and Table teina011 for growth.

18. The Baltic countries were by far the worst hit, with real GDP falling in 2009 by 18% in Latvia, 14.8% in Lithuania and 14.1% in Estonia (Eurostat, Table tsieb020).

saw a sharp fall in their income, as did the exporters of agricultural and mineral products in Latin America and Africa.

Finally, some of the very poorest in the world were affected by the crisis through a decline in the employment of migrant workers and a fall in the remittances which they were able to send back to their families. This was particularly marked for migrant workers in the US from Mexico and Central America, but it also affected many other migrant workers from elsewhere in Latin America, Asia and Africa.

GOVERNMENT RESPONSES

The sharp slump in output in the US and Europe came to an end in spring 2009. In the second half of the year output began to recover slowly, although it remained below the level reached prior to the onset of the crisis. The recovery was aided by significant government stimuli. In the US, one of the first measures of the Obama government on taking office in early 2009 was to push through a \$789 billion programme of increased expenditure and tax cuts, worth about 3 per cent of GDP in 2009 and 2010. In Europe, there were calls for a coordinated fiscal expansion, most notably by the French government. Although Germany opposed this, many countries did subsequently introduce national programmes and, in the event, the programme introduced in Germany, worth around 2.5 per cent of GDP over two years, was one of the largest.

Government programmes have compensated, at least to some extent, for a collapse of spending by private firms. However, these programmes, together with huge sums spent on supporting the financial sector and a big decline in tax revenues, have led to large budget deficits and a dramatic rise in the indebtedness of the major capitalist states. As a result, while output has been stabilised, the focus of the crisis has shifted to the ability of governments to finance their borrowing. The US government has, for some 30 years, relied on large inflows of foreign capital to help finance its budget deficits, but major holders of US debt, such as the Chinese government, have indicated they are uneasy about accumulating ever more US debt. In the Euro area, despite unprecedented peace-time indebtedness, the stronger countries are still able to finance substantial borrowing, although countries with large current account deficits in Southern Europe have faced greater difficulties. By spring 2010, Greece – although a member of the Euro area – was only able to borrow at around twice the rate of interest paid by Germany, and was forced to seek emergency support from other euro area countries and the IMF. Shortly after, the threat that similar problems could spread to other countries, in particular Portugal and Spain, obliged Euro area governments to agree to the creation of an unprecedented €440 billion fund to provide support for member

states.¹⁹ As a result of the pressure to reduce budget deficits, Ireland, Greece, Spain and Portugal have all been obliged to cut public spending, including spending on wages and pensions. At the time of writing, the ground is also being prepared for cuts in social spending in northern Europe.

Despite expectations at the height of the crisis, governments have been slow to take measures to curb the financial sector. After the threat of financial collapse receded in early 2009, the pressure to introduce major reforms abated. In fact, many of the US banks that survived the crisis began to post large profits again. The market share of the biggest banks had increased and they were able to benefit from central bank financing at exceptionally low interest rates. More generally, although the model of finance-led capitalism had seemed discredited at the height of the crisis, in both the US and Europe, governments returned to policies that were in important respects similar to those they had been pursuing before the crisis. In the US this involves striving to promote a revival of consumer spending, while in Europe – and especially Germany – governments place their hopes in a renewed expansion of exports.

The financial sector has, of course, resolutely opposed the introduction of measures that would seriously restrict their activities and in the US the big banks have spent huge sums lobbying Congress to this effect.²⁰ However, in addition to the pressure which the financial sector can bring to bear, policy responses have also been shaped by the dominant understandings of what went wrong.

THE ROLE OF INCENTIVES

One of the most widely accepted approaches to explaining the crisis emphasises the role of perverse incentives. There are numerous instances of this. Firstly, the sales personnel who went from door to door in poor neighbourhoods selling sub-prime mortgages were paid by the number of customers they could get to sign up. They offered very low initial repayment rates (so-called ‘teaser rates’ that did not even cover the cost of interest) and had no incentive to check people’s incomes or to point out that repayments would rise significantly after one or two years (who reads the small print?).

Secondly, the banks which originated the mortgages did not plan to keep these on their own books, but rather to bundle a large number of such loans together and to sell them as a security to a financial investor, such as a pension fund or an

19. This was part of a broader package totalling €750 billion, which included an additional €60 billion for an existing programme to provide EU member states with balance of payments support, and €250 billion to be made available by the International Monetary Fund.

20. See, for example, Binyamin Appelbaum and Eric Lichtblau, ‘Banks Lobbying Against Derivatives Trading Ban’, *New York Times*, 9 May 2010.

investment fund. The banks' aim was therefore to generate as many mortgages as possible, and not to carefully check whether mortgage holders would be able to meet their repayments.

Thirdly, the investment banks which took the initial mortgage backed securities and then sliced them up to create highly complex collateralised debt obligations generated huge profits from fees. The bankers who put these instruments together were rewarded with lavish bonuses – which could run into millions of dollars a year – that were generally paid in the same year that the instruments were created, irrespective of how they performed in the future.

Finally, the ratings agencies, on whose assessment of risk most investors relied when deciding whether to purchase an unfathomably complex security, were faced with a serious conflict of interest. The agencies are profit making businesses, and by the height of the housing boom a significant part of their profits were generated from rating complex mortgage based securities. In fact, only limited data was available to assess the risks (sub-prime mortgages were quite new) and the agencies had an incentive to provide a favourable assessment in order to ensure that the investment banks did not take their profitable business to another agency.

Much of the official discussion of reforms, both in the US and Europe, has been concerned with how to rectify this pattern of incentives. Bankers have been widely criticised for their greed, which did indeed assume mammoth proportions, and their bonuses have come in for particular scrutiny. However, greed is not something that is entirely new to capitalism, and the significance of individual motivations and perverse incentives can only be understood in the context of broader economic developments.

US INTEREST-RATE POLICY

A second approach to explaining the crisis, put forward by some economists and much repeated in European – and especially German – policy circles, is the argument that the US central bank kept interest rates too low and for too long between 2001 and 2004.²¹ According to this view the low interest rates were the key factor which drove the strong growth of mortgage lending and led to the bubble in house prices which, on bursting, caused the crisis.

The low interest rate in the US certainly did make mortgage borrowing more attractive – it actually enabled many poorer households to buy a house for the first

21. For a pithy statement of this view, see John B. Taylor, *Getting Off Track. How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis*, Hoover Institution Press, 2009. Taylor was architect of the influential 'Taylor Rule' which proposes a simple formula for guiding central banks' monetary policy. He served as assistant secretary of the Treasury in G. W. Bush's first government, the time when the bubble was developing.

time.²² However, the criticism of US interest-rate policy fails to recognise that the whole pattern of growth in the US since the 1980s has been repeatedly dependent on bouts of highly expansive monetary policy and that without such measures the financial sector would almost certainly have suffered more serious crises in 1990 and, most especially, in 2001.

Following massive over-lending to finance the wave of takeovers and mergers in the 1980s, the banks abruptly curtailed further credit in 1989, and the Federal Reserve under its new Chairman, Alan Greenspan, responded by dramatically lowering interest rate, which were kept low from 1990 to 1994. This relieved pressure on the major banks and, although many savings banks had to be rescued at this time, a significant financial crisis was avoided.²³ Furthermore, although the credit crunch led to a brief recession in 1990, this was remarkably mild. While employment growth was muted for several years the highly expansive monetary policy played a key role in creating the conditions for a new period of expansion.²⁴

In the second half of the 1990s, when the US economy registered its strongest growth for two decades, the stock market soared. At its peak, it was by most criteria as over-valued as in 1929, but when the bubble burst in 2000 it did not have such a devastating impact as the earlier crash and this was primarily due to the response of the central bank. By dramatically cutting interest rates from 2001 to 2003, it again relieved the pressure on key financial institutions and avoided a major financial crisis. Furthermore, although there was a recession in 2001, as in 1990, it was brief and mild. When expansion resumed in 2002, it was driven almost entirely by increased consumption and, with wages stagnant, this was primarily financed by borrowing – this time against rising house prices.

The fact that European policy makers have harked on about the supposed errors of US monetary policy also overlooks the fact that European – and above all German – economic growth in the period from 2002 to 2007 was in important respects dependent on the expansive policy in the US. In Germany, where wages were at best stagnant, economic growth was largely dependent on increasing exports, while the growth of global demand was driven, primarily, by the credit-financed increase of consumer demand in the US.

22. The proportion of black, Hispanic and female purchasers was much higher among sub-prime borrowers than among those for standard 'prime' mortgages (see Robert B. Avery, Kenneth P. Brevoort and Glenn B. Canner, 'The 2006 HMDA Data', *Federal Reserve Bulletin*, vol. 93, December 2007).

23. Many Savings and Loans Associations had made big losses on speculative investments following their deregulation in the early 1980s. Government support, estimated at around \$150 billion, was large at the time, but has since been dwarfed in the most recent crisis.

24. The main channel through which this operated was by making the US less attractive for financial investors so that the dollar weakened, making US exports significantly more competitive.

GLOBAL IMBALANCES

A third approach to analysing the crisis identifies the source of the problem not in the US but rather in developing countries, in particular, the Asian exporting countries, who have large current account surpluses.²⁵ This view has enjoyed considerable resonance in official US circles. The basis for the approach is that a so-called 'global savings glut' led to a large inflow of capital into the US, and that this contributed to the bubble in share prices in the late 1990s and, following the end of the IT boom, led to low long-term interest rates that, in turn, led to the bubble in house prices.

The US has had a current account deficit since the early 1980s. The size of the deficit increased strongly from the 1990s, and this was only possible because of large offsetting inflows of capital to the US. The ability of the US to finance such a deficit was closely related to the role of the US dollar as the principal international reserve currency. Following the Asian financial crisis in 1997-98, countries that had been forced to bow to IMF conditions consciously built up their reserves of foreign currency to avoid such a situation in the future. Meanwhile China, which has built up the largest foreign reserve holdings, has pegged its exchange rate either to the dollar, or to a basket of currencies including the dollar, in order to ensure that its export industries remain competitive, and to continue generating jobs for the stream of workers flowing into the cities from the countryside. In addition, oil exporting countries accumulated substantial surpluses for several years prior to the onset of the crisis, much of which was also invested in US financial assets.

The savings glut hypothesis emphasises the policy choices made in the developing countries. However, the ability of the Asian countries to achieve large export surpluses was strongly dependent on the demand for their exports, and the most important factor driving this was the credit-financed consumer demand from the US.²⁶ Consequently, while the large inflow of capital to the US did, at least in part, reflect policy choices by Asian governments, those countries only faced this choice because of the demand generated as a result of the strongly expansionary monetary policy in the US. Furthermore, although speculation played some role in pushing up oil prices, much of the oil-price increase was driven by the strong demand for energy when economic growth was high in both the US and Asia.

25. The notion of a 'global savings glut' was put forward before the crisis broke in a series of speeches by Ben Bernanke, Greenspan's successor as chairman of the Federal Reserve. See Ben Bernanke, 'The Global Savings Glut and the US Current Account Deficit', 10 March 2005. A more developed analysis, which broadly supports the Bernanke position, and was also written before the onset of the crisis, can be found in Martin Wolf, *Fixing Global Finance, How to Curb Financial Crises in the 21st Century*, Yale University Press, 2009.

26. This argument is developed in Richard Duncan, *The Dollar Crisis. Causes, Consequences, Cures*, John Wiley & Sons (Asia), 2003/2005.

Although the savings glut analysis is primarily applied to developing countries, it should be noted that there have also been strong inflows of capital to the US from Japan and from Europe, in particular Germany, all of which also had significant export surpluses. Indeed, it was the inflows of private capital from Europe to the US that led to European banks being hit by such large losses from investments in US mortgage backed securities.

The US's dependence on large inflows of capital to finance its current account deficit was widely seen as a problem before the crisis broke. If foreign central banks should cease to invest in dollars, it could set off a crisis of the dollar (referred to in official parlance as 'a disorderly adjustment'). The US authorities have sought to deflect attention from their responsibility for their country's deficit by focussing on China's export surplus, and by making repeated calls for the Chinese authorities to cease intervening in the foreign exchange market and to allow the renminbi to appreciate. In line with its emphasis on eliminating international imbalances, in April 2009 the US also proposed that the G20 should seek to promote more balanced current accounts, but this was opposed, for one, by Germany.

DEREGULATION

A fourth approach to explaining the crisis, and one that is much emphasised by critics of the neo-liberal model of capitalism, focuses on the role of policies to deregulate the financial sector.²⁷ An important step in the process of deregulation was the abandonment of pegged exchange rates in 1973, after which the US and the other major capitalist states largely left their exchange rates to be determined in the foreign exchange markets. The subsequent volatility of exchange rates was an important impetus for the development of a whole series of so-called derivatives, designed to provide insurance against adverse exchange rate movements. Then, in 1980, as inflation increased in the US, the legal limit on interest rates was abolished – an important pre-condition for the subsequent introduction of sub-prime mortgages, which charged interest rates some five percentage points higher than standard mortgages.

Following the election of President Reagan in 1980, the process of financial liberalisation deepened. A new banking act in 1982 relaxed the regulation of banks, including savings banks, many which promptly plunged into risky, high yield business and, after making widespread losses, eventually required a government bail-out costing some 150 billion dollars at the end of the decade. In 1987, the Reagan government replaced Paul Volcker as head of the Federal Reserve with Alan Greenspan, who was seen as more sympathetic to financial deregulation and,

27. This is mentioned, amongst others, by Dean Baker, *Plunder and Blunder: The Rise and Fall of the Bubble Economy*, Sausalito, 2009.

under Greenspan, rules on interstate banking and the separation of commercial and investment banks began to be interpreted ever more liberally. The final step, taken in 1999 under the Clinton government, was to repeal the 1933 law that enforced the separation of commercial and investment banks, opening the door for the creation of giant financial conglomerates.

Under Greenspan important decisions were also made *not* to introduce tighter regulation in various areas. The Fed allowed banks to set up subsidiaries, usually in the Caribbean, known as ‘structured investment vehicles’ which were used to hold financial investments while avoiding the usual rules on minimum capital holdings (which enables banks to absorb losses without going bankrupt).²⁸ This was where the banks held their investments in the complex mortgage-based securities which, when their value collapsed, set off the crisis. The Fed also decided not to introduce a tighter regulation of financial derivatives, many of which were custom designed (standardisation reduced banks profits) and were sold ‘over the counter’ or outside organised exchanges. Credit default swaps (CDS), a derivative which provides insurance against a bond failing, played an important role in the crisis. Such insurance appeared to make investments in mortgage-backed securities even safer. However, many CDSs were sold by investment banks – in particular the investment banking division of AIG – that did not have the resources to meet their obligations if the bonds should fail. Incredibly, a CDS can be purchased without owning the bond it is insuring, providing the purchaser with a strong interest in the bond failing!

The deregulation of the financial sector, which began in the 1970s, and gained force thanks to the neo-liberal policies of the Reagan and Clinton governments, facilitated the expansion of the financial sector in the US, the development of new, ever more risky financial instruments, and the enormous build up of credit which fuelled the stock market bubble in the 1990s and the housing bubble in the next decade. However, while deregulation was certainly a key pillar of neo-liberal philosophy, the actual process of deregulation was introduced step by step in response to pressure from the financial sector, which had found ways of initiating such changes inside the limits of previous laws.²⁹ The financial sector is still subject to far greater regulation than any other sector of the economy, and the state has attempted to steer the process, most notably by intervening with expansionary policies whenever financial stability appeared to be threatened. It is such intervention to contain crises that has led to the emergence of giant finan-

28. In Europe, banks – including the German *Landesbanken* – opened similar subsidiaries, usually in Dublin, to hold their investments in mortgage-based securities. Spain was alone in not allowing its banks to evade minimum capital requirements in this way.

29. This point is stressed in Leo Panitch and Martin Konings, ‘Myths of Neoliberal Deregulation’, *New Left Review*, no. 57, May-June 2009, pp. 67-83.

cial institutions which are seen as ‘too big to fail’. While the audacity of the big financial institutions’ schemes for generating profits beggars belief, they are the instigators of financial deregulation rather than its result. This implies that calls for financial re-regulation will, on their own, not be sufficient to deal with the forces that gave rise to the crisis.

EXCESS CAPITAL

The fifth and final explanation to be examined here argues that the root cause of the crisis lies in the huge sums of capital which have been accumulated in the US (and Europe). The incessant drive to obtain the highest possible return on this capital has led to stagnant or at best very low increases in income for large sectors of the population, thereby restricting the growth of their purchasing power in the economy.³⁰ As a result, in the US the growth of household consumption and of the economy at large became dependent on many households borrowing more and more, a highly precarious strategy which led to the build up of an untenable mountain of debt securities that at some stage was doomed to collapse.

In the 1950s and 60s, capital was quite closely tied to specific industrial and commercial companies. When profitability declined with the end of the post-war boom in the 1970s, the owners of money capital sought greater mobility for their capital so that they could take advantage of whatever opportunities might offer the highest rates of return. This was reflected in the growth of international flows of financial capital. These were predominantly between the developed capitalist countries but, when opportunities presented themselves, capital also flowed into developing countries. Here, with smaller financial markets, this often led to bubbles in share or land prices, and when these bubbles burst, the capital would rush out, precipitating a major crisis.³¹

From the 1950s to 1970s, the stock of financial wealth in the US grew roughly in line with GDP, but this growth then accelerated rapidly. According to a study by McKinsey Global Institute, it rose from 194 per cent of GDP in 1980 to 442 per cent in 2007.³² This growth could only be sustained so long as the financial assets were able to secure an adequate return. To this end, financial institutions generated a whole range of exotic, complex instruments for which they charged high fees. As already noted, financial investors also pressured non-financial corporations to give priority to generating higher dividends for share holders, a process which required a constant process of rationalisation and cost cutting, and led to the outsourcing

30. For wage developments in the US see Table 3.5, Mishel Lawrence, Jared Bernstein and Heidi Shierholz, *The State of Working America 2008/2009*, Ithica, 2009.

31. The most notable episodes include the crises in Mexico (1994-95), Asia (1997-98) and Russia (1998).

32. McKinsey Global Institute, *Global Financial Markets*, September 2009. The largest increase was in holdings of bonds and shares.

of tasks, including to low-wage countries.³³ At the same time, non-financial corporations began to invest in financial assets, which offered a higher return than they could achieve through productive and commercial projects. Consequently companies tended to invest a smaller proportion of their funds in fixed capital, a development which also had a negative effect on job creation. The overall result was to weaken the growth of employment and to create a sense of insecurity at work – described by mainstream economists as the ‘frightened worker’ effect. At all events, the growth of real wages for both working and middle-class employees was seriously constrained.

The problem is demonstrated by the relation between the growth of labour productivity and the growth of wages. Between 1950 and the mid-1970s, productivity and real wages both increased by around 80 per cent. Between 1980 and 2007, however, while productivity again increased by some 80 per cent, real wages increased by slightly less than 40 per cent.³⁴ In this situation, the number of two-income households increased, and the number of hours worked also increased as workers attempted to compensate for these developments. However, given the increasing gap between the increase in output and the increase in households’ purchasing power, the key factor which sustained the growth of consumption was borrowing.

In the 1990s, middle and upper-middle class households who felt richer as a result of the increased value of shares they owned, either directly or indirectly through investment and pension funds, began to borrow extensively to finance consumption spending. After the share price bubble burst in 2000, rising house prices enabled many households to borrow, either by refinancing their mortgages, or by simply borrowing against the rise in value of their homes (so-called ‘home equity withdrawal’).

Credit-financed spending not only helped to close the demand deficit, it also provided financial capital with a further means of appropriating interest from a significant segment of the population. However, because such borrowing was dependent on asset-price bubbles it could not be sustained. When house prices ceased to rise, the growth of consumption faltered and the US economy entered a recession. When the edifice of dubious financial instruments folded, the financial system almost collapsed and, with credit virtually unavailable, even to the best known companies, the US economy entered a slump. The overblown financial sector could for a time reap spectacular profits and enable the US economy to

33. For estimates of the gains to US corporations from outsourcing to low wage countries, see William Milberg, ‘Shifting Sources and Uses of Profits: Sustaining US Financialisation with Global Value Chains’, Schwartz Centre for Economic Policy Analysis, The New School, Working Paper 2007-9.

34. Based on figures for hourly output, hourly wages and consumer price inflation from US Bureau of Labour Statistics, Series PRS85006092, PRS85006102 and CUSR0000SA0.

constantly push out the boundaries of growth. But the lurch from one bubble to another built up ever more explosive tensions that eventually came home to roost.

CONCLUSION

The model of finance-led capitalism which developed in the US from the 1980s and in continental Europe from the 1990s provided the basis for a pattern of precarious growth that was very dependent on the growth of credit and the emergence of bubbles in asset prices. Central bank intervention made it possible to sustain growth in the US each time it faltered, but at the expense of accumulating ever greater contradictions. As European banks invested in apparently high yielding US securities, they too became entangled in these contradictions. When the crisis broke in 2007-2008, governments appeared to accept a need for widespread financial reform, but once the threat of collapse had receded, they reverted, essentially, to the same policies that had failed so dramatically.

This response reflects, in part, explanations for the crisis which imply that a recurrence of the near collapse can be avoided without the need for fundamental changes. To this end it is argued, variously, that the pattern of perverse incentives must be modified; that over-expansionary monetary policies must be avoided; and that a means of reducing global imbalances must be put in place. But critics of neo-liberalism have questioned this tepid approach and called for a thoroughgoing re-regulation of the financial sector. There is also an even broader critique which argues that the source of the problem does not lie only in the financial sector, but with the huge sums of capital that, since the 1970s, have sought the freedom to roam around the world in search of the highest possible return in finance, industry or commerce. This, it is argued, has led to a sustained – and successful – downward pressure on the incomes of large sectors of the population, both in the US and in Europe, and left economic growth dependent on credit financed consumption or a striving for export surpluses. According to this view the underlying forces which led to the crisis can only be countered by a fundamental change in the distribution of income, wealth and power.

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THE UNITED STATES FOREIGN INVESTMENT POLICY: CONFLICT OF PRINCIPLES IN CFIUS REFORM

Edna Aparecida da Silva*

ABSTRACT

The text deals with the relation between foreign investment and security in the domestic debate in the United States. Arguments based on the notion of “economic security” suggest the adoption of protectionist measures that would represent a rupture in terms of the principles and the liberal bias that distinguish the foreign investment policy in the U.S. since the post-war. These concerns led to the approval of the Foreign Investment and National Security Act (FINSIA) in 2007 that reformed the Committee on Foreign Investment in the United States, responsible for monitoring and investigating mergers and acquisitions of U.S. companies by foreign investors, based on the implications for national security. It is observed the defense of the traditional policy of open doors by the Executive and the Treasury Department, because of the systemic implications and the sensitivity of the U.S. to economic interdependence. However, the debate has generated effects on the behavior of other actors in the international system, such as “investment protectionism” in OECD countries, and as with the relation between trade and investment that guided the United States strategies in the GATT/WTO negotiations, the axis “investment and security” will possibly affect multilateral negotiations. Therefore, this article analyzes the concept of economic security, identifies positions on domestic policy on the reform of CFIUS since its creation in 1970 until the reform of 2007, and discusses their significance from the standpoint of international politics.

RESUMO

O texto trata da relação entre investimento estrangeiro e segurança no debate doméstico nos Estados Unidos. Argumentos fundados na noção de *economic security* sugerem a adoção de medidas de natureza protecionista que representariam uma ruptura em termos de princípios e da concepção liberal que particularizam a política de investimento estrangeiro norte-americana desde o pós-Guerra. Estas preocupações levaram à aprovação do Foreign Investment and National Security Act (FINSIA), em 2007, que reformou o Comitê sobre Investimentos Estrangeiros nos Estados Unidos, responsável pelo monitoramento e investigação de fusões e aquisições de empresas americanas por investidores estrangeiros, com base em suas implicações para a segurança nacional. Observa-se, por parte do Executivo e do Departamento do Tesouro, a defesa da tradicional política de *open doors*, em razão das implicações sistêmicas e da sensibilidade dos Estados Unidos à interdependência econômica. Contudo, o debate tem gerado efeitos na conduta dos demais atores do sistema internacional, como o “protecionismo de investimentos” nos países da Organização para a Cooperação e Desenvolvimento Econômico (OCDE), e, como ocorreu com a relação entre comércio e investimento, que orientou as estratégias dos Estados Unidos nas negociações comerciais do Acordo Geral de Tarifas e Comércio (General Agreement on Tariffs and Trade – GATT)/Organização Mundial do Comércio (OMC), o eixo “investimento e segurança” possivelmente terá impactos nas negociações multilaterais. Nesse sentido, o artigo analisa o conceito de segurança econômica, identifica as posições na política doméstica sobre as reformas do Comitê de Investimento Estrangeiro dos Estados Unidos (Committee on Foreign Investment in the United States – CFIUS), desde sua criação em 1970 até a reforma de 2007, e discute o seu significado do ponto de vista da política internacional.

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1 INTRODUCTION

Until mid-1980s, direct foreign investment was not an issue in the American domestic political debate (GRAHAM, 1991). Recently, mergers and acquisitions of American companies have drawn attention to the regulatory regime of national security analysis, increasing reactions to foreign investments in the United States, especially regarding sovereign funds and State-owned companies' investments in the energy and defense industry sectors (TASSEL and CHUNG, 2007, p. 7; GAO, 2009).¹

According to the liberal conception of international economic order, conceived at the end of World War II, the United States foreign investment policy, is based on principles of national treatment, the right of establishment and non-discrimination. However, the increasing flow of foreign investments and its implications in terms of competitiveness have become central in the debate scenario about the relative decline of the USA economy, especially from the 1980's on; since then, this issue has become the instrument for political and regulatory proposals, challenging the liberal principles of open investment policy. The ongoing status of the political debate and the regulatory changes in the United States, as well as in other countries, outlines a new horizon to the international policy on foreign investment: the adoption of protectionism hue policies, clearly not in agreement with the regulatory-liberal model, established according to legitimate objectives of public policies, protection of national security or requirement of benefits for the domestic economies. The so-called protectionism of investments has been justified by the relationship between investment and national security, in the wake of failures regarding multilateral regulation of investments, therefore, out of reach of the World Trade Organization (WTO) disciplines.

Concerns with the security dimension of foreign investment in the USA emerged in the 1970s as a reaction to Arab investments and to foreign acquisitions in the banking sector, becoming stronger in the 1980s with the direct foreign investment, particularly Japanese investments. Currently, the attention is drawn to sovereign funds and direct investments controlled by or with the participation of governments, whose operations call attention to the public opinion and the Congress, due to its possible implications for American national

1. Even investments below 10%, considered as passive investments that do not establish control or ownership, are target of Congressmen initiatives, since this kind of investment is not within the scope of security investigations (The Wall Street Journal, 2008, p. A12). Under Law 110-49, created by The Foreign Investment and National Security Act (Finsa) in 2007, such investments shall be submitted to security analysis when establishing control.

security.² It is possible to state that the United States revisit the same uneasiness of Latin American countries and Europe during the 1960s regarding American multinational companies: fears about the effects of foreign influences in the national economy and their implications in economic, political and mainly, in the American case, security terms.³

It was in this context that, in 2006, the approval for acquisition of Peninsular and Oriental Steam Navigation Company (P&O), a British enterprise operating port terminals in the US, by Dubai Ports World (DPW) unleashed an intense reaction from the American Congress.⁴ According to the public opinion, the quickness of the approval indicated the need of reforming the analysis processes of acquisitions with national security implications, clearly perceived as inconsistent with the set of security policies adopted by the Government after the September 11 terrorist attacks. This episode proved a potential conflict with the goals presented at President George W. Bush's National Security Strategy: preservation of the national security and maintenance of free capital flows, especially direct foreign investment.⁵

Thus, the obscure Committee on Foreign Investment in the United States – CFIUS and the policy of foreign investment inflows has become focus of the Congress and the Senate's attention. In this discussion, the notions of economic security and national security have appeared as vectors of the proposals for regulatory reform, allowing the concerns about sovereignty, economic independence and security to gain strength in the American political set.

In the course of such discussion, the American Congress approved H.R. 556, The Foreign Investment and National Security Act (FINSa), in February 2007 that, with unanimous approval by the Senate and President George W. Bush's enactment, turned into law in July 26, 2007 (P. L. 110-49). This Act amended section 721 of the 1950 Defense of Production Act (DPA), authorizing the President to analyze mergers, acquisitions and takeovers that might result in

2. Among such transactions, there are the acquisition of IBM computer division by the Chinese Lenovo in 2004 and its non-performed operations, as well as the purpose of Unocal acquisition, an American company of the energy sector, by a branch controlled by the Chinese government, China National Offshore Oil Company (CNOOC) in 2005, and the case of 3Com in 2008, a company of equipment and network solutions acquired by Bain Capital Partners, an investment company in which the Chinese Huawei Technologies (manufacturer of telecommunications products) holds minority stakes. In 1990, the George Bush administration canceled the sale of Mamco Manufacturing of Seattle, an American manufacturer of airplane components for the Chinese government, which was the only case the law that allows the President to block foreign investments, based on national security arguments, was used (Rosenthal, 1990).

3. Besides the tone of debates, many authors observe that the foreign presence in the United States cannot be compared to the presence and influence of American multinational corporations in other countries.

4. The same scenario happened in 2005 when China National Offshore Oil Corporation Ltd., (CNOOC), an State-owned company tried to purchase Unocal, an American oil company also disputed by Chevron. In this case, political pressures led to withdrawal of proposal to acquire CNOOC.

5. Cf. The National Strategy Security of the United States of America, March 2006, pages 26-27. Information available at: <<http://www.whitehouse.gov/nsc/nss/2006/nss2006.pdf>>.

ownership or control by foreigners of American companies and blocking those that present implications for national security. In general, FINSA has encoded CFIUS structure, role, processes and responsibilities and it established the role of the Executive's departments, agencies and investments bureaus.⁶

The reference of the relation between investment and security in the FINSA text emphasized the strictness of analysis processes for mergers and acquisitions proposals and, by establishing new criteria, made the impression that the United States would have modified its open-investment policy. As an expression of the liberal internationalist model of international capital flows regulation which established international standards for dealing with foreign investment and policies recommended by international economic organizations (IKENBERRY, 2004, 1999; JACKSON, 2000), this policy is part of guidelines set by international economic organizations, such as WTO and The Organization for Economic Cooperation and Development (OECD), especially part of the Code of Liberalization of Capital Flows and Current Invisible Operations and the multilateral and regional trade agreements, such as The General Agreement on Tariffs and Trade (GATT) and The North-American Free Trade Agreement (NAFTA). It means that liberal values and principles of the international economic order would be challenged at the scope of the American domestic policy.

Both the political debate and the changes effectively introduced in the American domestic regulation have affected international economic relations, encouraging other countries to adopt similar policies. It is worth recalling that the requirement of reciprocity is one of the components of the US international economic policy and, at the same time, one of the principles of the public international law, expressed in the institute of rebuttal, conferring legitimacy to treatment retribution among players.⁷

According to OECD, over the past five years the analysis of national security regarding foreign investment inflows in national economies has been one of the policy-makers' focus. There is a debate on the possibility of the European Union adopting such mechanisms,⁸ although some countries, like the United Kingdom, France and Germany, already have their reviewing systems for acquisitions in "sensitive sectors". The same situation has occurred in other countries. China approved legislation that will block investments that might affect the

6. In November 2008, after the discussion of several purposes in public hearings, the Department of Treasury, through The Office of Investment Security published the final procedural regulations and guidelines for FINSA compliance (Department of Treasury, 2008).

7. "Rebuttal is the act by which a subject of Public International Law is opposed to other subjects that exercise their rights by harming them. Rebuttal is retaliation to an act that, without being a clear infringement of the International Law, might put a State in a disadvantage situation. Rebuttal, as answer to an act, is inspired in the principle of reciprocity, establishing a relation between the offender's act and the offended person's loss " (Lafer, 1979, p. 38).

8. "Europe needs to screen investment" (Financial Times, August 11, 2009).

“national economic security”. Japan expanded the covered sectors and Russia established sectors of strategic importance for security and defense. In 2009, Canada and Germany introduced security review mechanisms in all sectors, and India is discussing the CFIUS review model. It is possible to note flexibility in the framework of national policies of foreign investment regulation, regarded as less welcoming by some (SAUVANT, 2009a) and as protectionist by others.

This article deals on the debate about reforms of the regulation policy regarding foreign investment inflows in the US, identifying critical aspects of the new regulation established by FINSA, in 2007. It aims at demonstrating that the focus on national security, according to the National Strategy Security, has been functional for maintaining traditional guidelines of the Executive, CFIUS and Department of Treasury regarding the policy of foreign investment attraction, to the detriment of the Congress and Department of Trade claims for the inclusion of the economic security criterion and a more protectionist perspective. The concern about systemic implications of domestic choices that narrow possibilities of changes according to domestic pressure and of effects on structural problems in the American economy, such as public deficit, competitiveness and unemployment is highlighted. However, the new criteria of FINSA have made analysis more complex, not as predictable as the organizations of international investors would desire. It has simultaneously granted to the Congress greater interaction with the CFIUS’s analysis processes, as well as the direct foreign investment policy. By observing the new regulations approved by the Congress, such as 2007 CFIUS and the Defense Production Act Reauthorization of September 2009,⁹ it is possible to verify that foreign investment securitization¹⁰ in the American domestic policy allowed creating consensus on the need of the Executive and federal agencies working in terms of defending strategic sectors, dissonant to liberal conceptions, and of a competitiveness policy that mobilizes elements of industrial policy.

The text is divided into four sections, in addition to this introduction. Section 2 presents the debate on the relation between economy and security, setting the concepts of national security and economic security. Section 3 analyzes the US foreign investment policy. The fourth section covers the history of CFIUS and its reforms,

9. The Defense Production Act Reauthorization, approved in September 2009, allows the President and Federal agencies to foster the American economy in sectors that are critical to the national defense. Among other possibilities, “the guarantee of private loans for supporting the productive capacity, creating, maintaining, expanding, protecting or restoring production and supply, as well as services essential to the national defense; loans to private businesses whose activities reduce the current or forecasted insufficiency of industrial resources, items of critical technology or materials essential do the national defense; and actions to create, maintain, protect, enhance or restore the domestic capacities for national defense” stand out.

10. Securitization is a very common term used by economists: it refers to securities and debenture bonds. In this aspect, it means to convert bonds into purpose loans or securities to be subsequently issued. In this article, securitization refers to a process of incorporation of topics that got a place in the national security agenda (Buzan, 1997).

highlighting the new procedures and criteria for reviews of foreign investments security established from FINSA and, lastly, the meaning of the debate and the regulatory changes according to the international policy view is discussed.

2 ECONOMY AND SECURITY

From the 1970s, issues like economic embargo, raw-materials supply, energy issues and industrial competitiveness gained space in the field of security concerns, especially with the oil crisis and the emergence of economic powers in the world economy, such as Japan and Germany. The problems of the American economy, such as loss of industrial competitiveness, unemployment, commercial deficit, concerns about the balance of payments stability have strengthened the propositions of policies based on the concepts of “national security” and “economic security”, which feed the debate on the development of policies and foreign investment regulation in the United States.

Economic issues gained the status of national security issues, in the course of the discussion about the US position in the international system (MATHEWS, 1989, p. 162). The perception that the country, due to the increase of interdependence in the fields of trade, production, and financial exchanges would be more sensitive to other countries’ economic policies was crucial to the incorporation of economic issues in the domestic political debate.

Fears about the foreign presence and control in basic sectors of the economies have historically raised reactions of economic nationalism and protection demands of commercial nature (MODEL, 1967). Restrictions to foreign investments reflect the country’s insecurity, indicating its intention to protect local industry in relation to foreign competitors, as well as to preserve control over its economy (TOLCHIN and TOLCHIN, 1988, p. 226). This happens because direct foreign investments, beyond the economic contributions to the host country according to the liberal perspective, also involve fear and distrust of national economies being dominated by foreigners, which explains its capability of creating political mobilization – in American case, especially regarding electoral interests.

The perception in the domestic debate is that, due to vulnerability, direct foreign investment is a security issue. In this sense, far from measuring the effectiveness of threats, according to Buzan, Waever and Wilde (1998, p. 24), it is possible to observe that:

Security is thus a self-referential practice, because it is in this practice that the issue becomes a security issue – not necessarily because a real existential threat exists, but because the issue is presented as such a threat.

This perception of threat is linked to the place of economic issues in the security agenda and it may be explained by a set of changes that happened in the 1990s, with the end of Cold War and the restructuring processes of the world economy, especially the financial liberalization and vertical integration of multinational corporations. More specifically, changes in the security agenda of post-Cold War, concerns of the neo-realistic agenda on the implications, in terms of power, of an occasional loss of competitiveness and the increase of capital flows dependency and the debate over the globalization of the American defense industry and high-technology sector (SORENSEN, 1990; MORAN, 1990/1991 and 1993; KAPSTEIN, 1989/1990; FRIEDBERG, 1991).

In the 1990s, with the end of Cold War, the security agenda has expanded its scope, including other issues than external military threats. The literature has discussed the meaning of such changes, as well as the securitization and politicization of topics such as economic, human, food and environmental security, amongst others, highlighting the multidimensional nature of security issues (BALDWIN, 1997, p. 23; VILLA, 1999; BUZAN; WAEVER; WILDE, 1998; MATHEWS, 1989). The securitization refers to the *status* of security that certain issues acquire, whilst not *stricto sensu* related to defense or security.

The focus of the neo-realistic agenda about the security dimension of structural weaknesses in the American economy has played an important role. In this perspective, the relative decline of its economic power could represent a reduction of military capabilities, a core aspect of its power position in the interstate system (MORAN, 1993). The military power, one of the pillars of the American hegemony, stands in the economic resources mobilization that involves industrial capacity, access to energy and technology (POSEN, 2003, p. 10; KIRSHNER, 1998).

Another aspect refers to the globalization of the American defense industry. Kapstein explains that the planning of the military security in The United States has been based on the concept of an economically independent defense industry. However, the increasing dependency of foreign vendors that supply components used in military equipment has affected defense contracts, especially in the case of vendors with competitive advantages in some sectors, due to globalization trends verified in civil sectors, such as automobiles and computers. The dependency of external sources of energy supply and defense equipment reinforced fears about the national security (KAPSTEIN, 1989/1990, p. 85- 90).

Reich (1986) notes that since the 1950s, through government purchases and research consortia financing, the American government has been a booster of the defense industry, as well as the aerospace sector, creating the market and stimulating new sectors, mainly the high-tech ones. In that sense, the defense industry has been a dynamic element of competitiveness for the American industrial base.

To a significant extent this government-created market has been open only to US firms. Although the “Buy American” provisions of the government procurement laws were relaxed somewhat in 1979, government contracts involving national security are still awarded solely to domestic firms (REICH, 1986, p. 865).

Such comments reveal one of the reasons why investors chose direct investment. It means that policies for the control of technology transfer stimulate mergers and acquisitions, whereby foreign investors aim to be granted with access to sectors of technological innovation and “critical infrastructure”, such as information systems, software, energy, amongst others, treated by the American legislation as sensitive sectors and protected by a dense network of agencies.¹¹

The recognition of the extent of economic issues on security and its place in the national security agenda has a long tradition and it does not represent any novelty. The acknowledgment that the productive capacity represents one of the bases for the military power is shared by different schools of thought, liberal or mercantilist ones (KIRSHNER, 1998). Nevertheless, it is necessary to distinguish the dimension of security of the economy from the meaning of the notion of economic security that has been mobilized in the domestic political discussion in the US about investment regulation.

According to literature, the concept of economic security has several meanings and it is regarded as little precise (VILLA, 1999). For Cable, this concept:

1. Refers to aspects of commerce and investment that affect the defense capacity of a country, such as freedom to acquire arms and technology, trust in suppliers of military equipment or threat by opponents that improve their technological capacity;
2. Defines economic security in terms of instruments for economic policy that are used for aggression or defense, such as trade and economic boycotts, restrictions to energy supply;
3. The idea that a relative military capability, or power projection might be weakened by a low economic performance and require a response for economic policy;
4. An extension of the concept encompassing fears of economic, ecological and social instability (CABLE, 1995, p. 306-307).

11. In addition to CFIUS, there is a dense network of laws and regulations on foreign investments, among which are worth highlighting: control programs of the United States foreign trade, such as the regulation of the Trade Department, the Export-Administration Regulation (EAR), that limits the exports of dual-use items, products (software) and military and commercial technologies; the International Traffic in Arms Regulation (ITAR) of the State Department, that controls exports and transfers of defense goods, software of technical information created for military or intelligence purposes; the Office of Foreign Assets Control of the Department of Treasury, responsible for programs of trade sanctions, which also forbids imports and exports operations with countries or entities due to security reasons or American national policies; regulations and security controls of the U.S. Securities and Exchange Commission (SEC) and reviews of the U.S. Federal Trade Commission (FTC) and the Justice Department, that evaluate the effects on competition according to antitrust laws. Besides those, there are sectorial requirements, such as the ones applicable for the telecommunication sector and for financial institutions.

Cable explains that his analysis is focused on the concept of economic security or on a geo-economic perspective, not because it is the most important one, but because in The United States such concept was “moved to the centre of the debate, perhaps crowding out more legitimate issues more directly linked with traditional notions of security” (CABLE, 1995, p. 308). The concept of economic security that informs the political debate and the initiatives of domestic reforms of investments in US is established in the field of the strategic-military perspective, as indicated in Cable’s first and third definitions, pointing out to the need of an “strategy of economic policy”, as observed in the notions of technology and critical infrastructure in CFIUS analysis criteria of security.

This concept, part of the speech of different players, such as academics, policymakers and government agencies, reveals positions favorable to changes in US policies as a reaction to the increment of economic interdependency.

The relation established between “national security” and “economic security” generates conflicting demands regarding foreign investments regulation and the role of government and its agencies. On the one hand, demands for more inflow control and restrictions. On the other hand, concerns about avoiding the adoption of measures that might reduce or hamper capital flows, considered important to financial balance in American economy. In this scenario, the notion of economic security suggests the adoption of protectionist measures, pointing in the direction of rupture in terms of values and a liberal conception of the State’s role.

Despite the intense mobilization of the Congress, the reactions to the September 11 attacks regarding the US safety, summed to multiple pressures for a more restrictive attitude regarding the regulation of the domestic foreign investment policy, the viewpoint of the Executive and the CFIUS perspective of action have kept consistent with the liberal internationalist tradition that particularize the foreign investment policy since the post-war period. Since the establishment of CFIUS, the position of the Executive and the Department of Treasury have been in defense of the open doors policy and the maintenance of the neutrality of the Federal range, in clear opposition to the attempts of the Congress to set monitoring policies and stricter regulation regarding foreign-owned companies.

How the history of CFIUS shows, subject of the next section, even if the United States seek to preserve the open doors policy in the preambles of legislative acts and speeches, the set of criteria approved in the 2007 reform indicates that regulations have incorporated new concepts that express changes in the sense of a protectionism policy. It is possible to observe that

In the US there is a strong disharmony between the prevailing economic speech (that consecrates principles of free trade and non-interference by the government) and the reality of a tradition full of development policies, which by the same reason

has this scarce public visibility. Despite that, it is constantly reproduced in the operation of different branches of the government apparatus, at Federal and state levels, as well as in the framework of relations that they keep with the most diverse of society. This is one side of its strong institutionalized nature that justifies them in pieces of legislation (VELASCO and CRUZ, 2009, p. 50).

The analysis of legislative changes, in the fine print of security regulations approved by the American Congress, identifies a set of provisions that translate elements of a competitiveness policy and of the industrial base, legitimized by its relation with the national security. The securitization of the foreign investment, mobilizing security issues, has made viable the maintenance of some coherence with liberal principles of local and international policies of the American State, and, at the same time, the development of policies in compliance with demands of protectionism hue, covered by the exception nature conferred by security arguments. It is what one sees, as it will be shown in the next section, in the case of CFIUS and in the text of the Defense Production Act Reauthorization approved in September 2009 that authorized Barack Obama's administration to create a fund to stimulate the American defense industry capacity, recognizing its connection with the world competitiveness and the need to protect sensitive sectors.¹²

In the context of reactions to the industrial policy topic, the relation between economy and security has allowed the development of a consensus on the protection of the defense industry and strategic sectors.

Such issues have served as bases for the relation established between investment and national security and nourished the debate on the domestic investment regulation reform, conducting the reforms of CFIUS in 1988, with the Exon-Florio amendment, and with FINSA in 2007.

3 THE UNITED STATES FOREIGN INVESTMENT POLICY

Foreign investment in the USA, since its independence until World War I, has played an important role in development (WILKINS, 2004; CHANG, 2004). Since then, as Chang describes, even if considered as necessary, it has been coping with fears of the American economy domination and its effects.

In order to ensure that the foreign investment would lead to the loss of national control in key-sectors of the economy, a huge amount of federal and state legislation was edited in the US since its independency to mid-1920s, when the country became the World's main economy. Such legislations focus especially on the finance, transportation and natural resources extraction (agriculture, mining, logging) sectors, which were the main recipients of foreign investments during this period (CHANG, 2004, p. 11).

12. S.167: Defense Production Act Reauthorization of 2009. Available at: <<http://www.govtrack.us/congress/billtext.xpd?bill=s111-1677>>.

Since the 19th century, restrictions to foreign investments were justified by concerns of national security as a measure of exception, consistent with liberal traditions. Some sectors, such as nuclear energy and domestic sea transportation were blocked for foreign investment. Others, such as broadcasting, telecommunication and local air transport only had limitations. Some were governed by the principle of reciprocity, such as land leasing for mining and gas pipelines (WILKINS, 2004).

With the end of World War II, when the country emerged in the indisputable condition of economic power, the US adopted its open doors policy for foreign investments. Since then, the country's domestic and international policy is guided by principles of non-discrimination, national treatment and right to access. This policy can be found in declarations, regulations, policies, international treaties and agreements.

For instance, a presidential declaration of 1977 observed that the USA policy regarding international investment was not meant to promote or to discourage flows of investment or activities. A presidential declaration of 1983 noted that the direct investment was welcome in the United States once it would be a response to market forces. Most recently, the former President George W. Bush issued a political declaration of support to open regimes of investment in 2007, stating that the government of the USA unequivocally supports international investments in the country (GAO, 2009, p. 8-9).

The report refers to Jimmy Carter's statements in 1977, acknowledging that market forces allow the best allocation of economic resources and Ronald Reagan's in 1983, restating the neutral position of the Federal government regarding capital flows. The investment policy that has been defended by the American Executive power is summarized in George W. Bush's words:

A free and open international investment regime is vital for a stable and growing economy, both here at home and throughout the world. The threat of global terrorism and other national security challenges have caused the United States and other countries to focus more intently on the national security dimensions of foreign investment. While my Administration will continue to take every necessary step to protect national security, my Administration recognizes that our prosperity and security are founded on our country's openness.

As both the world's largest investor and the world's largest recipient of investment, the United States has a key stake in promoting an open investment regime. The United States unequivocally supports international investment in this country and is equally committed to securing fair, equitable, and nondiscriminatory treatment for US investors abroad. Both inflow and outflow investments benefit our country by stimulating growth, creating jobs, enhancing productivity, and fostering competitiveness that allows our companies and their workers to prosper at home and in international markets (BUSH, 2008).

In this sense, the adoption of security measures for investments would not compromise the design of the American liberal policy of capital flows opening. This second formulation seems to be the most adequate for understanding the interpretation that has been built on the current route of CFIUS changes.

Congress' efforts to regulate foreign property of domestic assets date back to the World War I. In that moment, the German domain over the chemical industry stimulated the Congress to approve the Trading with Enemy Act in 1917, which authorized the President to regulate transactions involving foreign countries' interests. Afterwards it was replaced by the International Emergency Economic Powers Acts, which restricted Presidential authority on foreign assets and a formal declaration of national emergency (WEIMER, 2009).

According to Weimer (2009), between the World War I and the 1980s, the American Congress widened protections against foreign investments through a direct legislation on specific sectors, such as transportation, communication, banking, natural resources, energy and defense. However, it did not ban investment, only established limitations and imposed conditions. According to GAO's report, such legislation covers three categories: those limiting direct foreign investment in certain sectors, others restricting activities of acquired firms or their branches and those that do not clearly limit investments but only requiring transparency regarding ownership.

This reveals a significant trait of CFIUS and its processes of security analysis appear. Through CFIUS, the President is allowed to block an operation or to order its disinvestment.

Over the 1970s and the 1980s, a new scenario was set in the American domestic politics. The growth of foreign investments from developed economies, with growth rates higher than the American ones and with technological competitiveness, as well the oil crisis combined with the regulatory pressure on US based multinationals in host countries questioned the need of a review in the domestic policy.¹³

In the academic field, the 1980s were marked by discussions of theses about the hegemonic decline (discussion of Gilpin and Kennedy's theses) and, in the political level, by mobilization of the Congress and public opinion on the discussion about policies more adequate to the US new economy framework. This period, briefly mentioned herein, marked the emergence of the industrial policy issue in the United States, which in face of a strong opposing mobilization, as explained by Velasco and Cruz (2009), would be extinct by the end of the decade,

13. An example widely mentioned in the US is about the regulatory initiatives in Canada, through the Foreign Investment Review Agency (FIRA), created in 1973 in order to require net benefits to the local economy, emphasizing the security extent of the economy control. Such initiatives would directly affect the United States interests, the greatest investor in the Canadian economy. CFIUS was developed in the context of this discussion.

reappearing in the discussion of the 1990s as “competitiveness policy”.¹⁴ According to Eisinger (1990), in Walter Mondale in 1984 and Dukakis’ campaigns in 1988, the arguments in favor of the industrial policy have become public issues. In 1987, the attempt of acquisition of Fairchild Semiconductor Corporation by the Japanese Fujitsu Ltda. helped the Congress to approve the amendment of the Defense Production Act in 1988, which is called Exon-Florio, formalizing the authority of CFIUS in the processes of the foreign investment analysis with national security implications.

And then the United States international economic policy was changed. The trade policy, through the 1984 Trade and Tariff Act, established requirements of reciprocity and opening of markets in the sectors of services, investments and intellectual property. It was clearly an offensive policy of trade liberalization with the aim to reduce barriers and change countries’ policies in order to conforming them to their goals. In the case of investments, the purpose was to cut barriers, enhance the principle of national treatment and the right of establishment. Such proposals were supported in Chapter 11 of NAFTA and unsuccessfully integrated the text of OECD’s Multilateral Agreement on Investment in 1998 (VELASCO and CRUZ, 2009, p. 50-52).

And then the issue of reforming the regulation policy for direct foreign investment is back.

If the United States performance in the international level was about increasing liberalization and the requirement of reciprocity, a disharmony would be verified regarding the domestic discussion on direct foreign investment regulation. In this sense, Reich states that:

in the issue of foreign direct investment, largely unnoticed, that the US continued to adopt a pattern of behavior consistent, in important aspects, with a definition of a hegemon.... While the US has therefore pursued domestic closure in trade, the same is not true of investment. In that sense, the US ‘underwrites the rules of system’ by sustaining on a unilateral basis and paying any of the costs associated with unreciprocated behavior. US Foreign Direct Investment (FDIUS) policy may therefore be last bastion of behavior consistent with a hegemonic status. (...) More pointedly, the U.S. has sustained a system of largely unimpeded, generally non-discriminatory access for foreign firms to the world’s largest single recipient access for foreign direct investment in the face of consistent ‘free rider’ (protectionist, discriminatory) behavior by the states whose major firms constitute some of its largest investors, whether that behavior is the product of public or private sectors barriers. Many of these costs have been incurred by virtue of the insistence of the United States government that it retain only the most minimal limitations of the free flow of foreign direct investments, both into and out of the United States (REICH, 1996, p. 28-29).

14. In this context, arguments against demands of industrial policies are explored by Eisinger (1990) and Velasco and Cruz (2009).

As seen in Reich's analysis, the United States preserve their direct foreign investment policy, even if their position in the global scenario has changed. In other economic issues, such as the trade policy, there were changes in policies with reciprocity requirement from their partners.

The American economy, in view of the deepening of economic interdependency, faces problems that will not be solved in the medium term, thus generating significant concerns (GRAHAM and KRUGMAN, 1995). Among those, there are deficit in the balance of payments, dependency of foreign investment flows, along with trade deficit and loss of the competitive position, both regarding the local market and exports in sectors that had been previously guided by the USA, such as electronics, industrial tools, automobiles, steel, computers, semiconductor chips, printers, technology and industrial design. The dependence on energy and strategic resources from other regions, such as oil and natural resources, which is a central aspect of discussion, still makes the maintenance of multilateral commitments and the preservation of the international economy opening a focal point of the American international policy.

According to Kang (1994), this topic has gained an electoral meaning and the regulation policy of foreign investment inflow is no longer an obscure issue, becoming subject of debate and propositions linked to concerns about economic policies:

growing conviction among U.S. politicians that economic security is a crucial element of national security and their perception that economic competitiveness is increasingly becoming a relevant electoral issue have driven the U.S. policy toward direct investments inflow from liberal encouragement to discretionary restrictions in some sensitive sectors of the domestic economy (KANG, 1994).

In this scenario, the United States are facing controversial directive policies. Since its establishment in 1975, according to terms used in the literature, the debate and proposals for CFIUS reform reveal a long-term conflict between the perspective of the conservative free traders that oppose the restriction to the American economy access and the nationalistic or interventionist ones, favorable to stricter controls on foreign investment inflows. Both positions, developed over decades of debate, represent deep forces in the US policy and are supported by republicans and democrats.

From the realistic perspective, it would be necessary to protect competencies in high-technology industrial sectors, which are essential to the defense industry and competitiveness. From the "American nationalistic" point of view, in several political scenarios, the direct foreign investment represents a threat not only to property and economy participation standards but also to the national security due to the foreign control of sectors like defense and high-technology industry. In these terms, they propose that the notion of "economic security" should be

added to the set of criteria used in the analysis of security implications, observing its impacts on competitiveness, essential commerce and jobs.¹⁵

From a liberal perspective, only issues of *strictu sensu* national security would justify limitations or blockages to operations, as established by the national legislation. This position, favorable to free capital flow, prevailed in George W. Bush's administration, who opposed to proposals of restrictions to investment flows that would reduce growth and market efficiency.¹⁶ This view emphasizes the benefits of unrestricted access of foreign investments, such as the incentive to competitiveness, in addition to macroeconomic aspects, effects on jobs, saving accounts and balance of payments. According to Souza (1994), this is the position that has been traditionally adopted by the Executive.

The domestic debate on foreign investments in the American economy confronts two interpretations that are different in terms of diagnosis. For liberals of several hues, the foreign investment is beneficial to the economy, although they recognize the need of monitoring operations of enterprises linked to products that are vital to the defense sector. Since taxation and reduction of public spending are not considered as politically viable alternatives and also not accepted by Americans, the choice for maintaining the balance of current accounts with external capital flow is kept (GRAHAM, 1991). Under this comprehension, as explained by Reich, the problem of the United States is not the foreign investment, but, instead, the issues of macroeconomic standards, such as low saving accounts, for which investment flows are a solution. That is, this interpretation removes the discussion focus on national competitiveness in favor of the issue of companies' profitability (REICH, 1996, p. 30-31; GRAHAM, 1991).

Another one is the approach of critics, according to which the industry competitiveness in high technology sectors and those linked to the industrial defense basis should be protected. Among these, there are the realists that underline the relation between investment and exports, the extent of national security and the industry competitiveness. Another essential aspect is the relation between multinationals and the States of origin:

companies are or at least should be related to their national base of origin; they are not interpreted as nationality-regardless, even though they are involuntarily just national agents (e.g., Gilpin 1975; Wellons, 1986). To the critics of American politics, part of the problem is that multinational companies originated from the main economic

15. According to Kang (1997), in the discussion of Exon-Florio amendment clauses of 1988, the White House opposed to the use of the term essential commerce, due to its ambiguity and the fact that it confronted the objective of reducing investment measures regarding commerce, as provided in the Trade Related Investment Measures (TRIMs) established in the Uruguay Round of GATT.

16. According to George W. Bush, "International investment in the United States promotes economic growth, productivity, competitiveness, and job creation. It is the policy of the United States to support unequivocally such investments, consistent with the protection of the national security" (Bush, 2008, p. 101).

trilateral competitors of the United States, widely-known Japan and Germany, seem to be more closely associated to considerations on the economy of their country of origin than to North-American multinational companies, even with results of contrasting ideologies, parameters of different sets of government standards or alternative calculations of self-interest. Regardless the cause, this essential difference seems to have significant implications to the composition of each country's economy and its structure of manufacturing basis. (REICH, 1996, p. 31).

Such interpretations summarize the general lines of divergences and tensions between the Congress and the Executive regarding the balance between the foreign investment attraction and requirements of national security that explicit the conflicts about their institutional role (SOUZA, 1994, p. 171). If, on the one hand, there is criticism to the foreign presence and its impact in terms of competitiveness and security; on the other hand, there are interests from the Executive and the Department of Treasury in terms of the meaning of capital flows for the macroeconomic balance. Not to mention the local pressures on the Congress from groups exposed to greater competition and from the interests of international investors and companies. Indeed, this is one of the critical aspects, since American companies that intend to operate with foreign investors face the transactions costs due to regulatory requirements, whether by Federal agencies and legislation or by the CFIUS analysis process. Therefore, as long as the Congress and the Department of Commerce reverberate pressures of interests groups, macroeconomic management issues prevail in the Executive and in the Department of Treasury's positions.

The United States economic policy has been a result of the relative influence of both positions, more than the adoption of a pragmatic guideline to the solution of the issues at stake, especially regarding the policy of direct foreign investment inflow (GASTER, 1992, p. 92).¹⁷ According to Mastanduno (1998, p. 825-854), by the end of the 1980s, government agencies responsible for economy and security issues were openly conflicting with priorities for the US foreign policy. In the same direction, according to Vernon and Spar (1989, p. 110), the American government did not developed a coherent policy for dealing with problems created by multinational companies' operations, despite the intensity of debates over the past decades.

It is in this scenario that the sense of discussion about the foreign investment policy reform and the creation of CFIUS is defined, which is the subject of next section.

17. What does explain political and legislative results and the little change in regulation, despite such increasing demand? According to Souza (1994), the institutional conflict may enlighten governance problems and bring comprehension to such issue. In the author's point of view, the perspective of institutional cooperation does not capture the political dynamics, suggesting focus on institutional conflicts. The author identifies coherence in the Executive position regarding direct foreign investment, despite political differences and party ideologies.

4 THE COURSE OF CFIUS

Until the 1970s, the concerns about investments outflow and the effects on foreign policy, balance of payments and employment prevailed in the domestic political debate (BLOCK, 1989, p. 226-234). This is so because of incentives offered by the United States government in order to encourage investments of American private capitals abroad, linked with the post-War foreign policy, resulting in the expansion of American multinational corporations. This moment was a breakthrough regarding the change of US position in the international economy, that, besides being the country of origin of multinational companies, it also assumed the host condition.

In the 1960s and 1970s, the international debate on relations among multinational companies and countries of origin and destination would mobilize academics, governments, the legislative power and international organizations. Niehuss (1979) observes that developed countries addressed issues like national security, employment security, collective negotiation, work relations, transfer pricing, allocation of costs and profits, policy of capital movement and balance of payments. In that moment, multinational companies were target of intense efforts for the creation of an international regime due to several regulatory initiatives of States that hosted American multinational companies, both in Europe and in emerging countries. It means that the American domestic policy would react in the same direction of the rest of the States, evaluating implications of the foreign presence and the benefits for host economies.

In 1973, due to Arab, Japanese and Western Europe investments flows, as well as the acceleration of international acquisitions in the banking sector, the Congress demanded an evaluation of the open doors policy (NIEHUSS, 1975). The proposals of congressmen, such as Dent-Gaydos Bill, Roe Bill, Günter Bill and Metzemabaum Bill, would suggest restrictions to inflows, limitation to percentages of participation, monitoring and the creation of a review agency, in a debate clearly influenced by other countries' initiatives, such as Canada and Mexico.

In the Cold War context, Americans were worried about impeding transfers of information and military technology to foreigners. For this purpose, they created networks of regulatory statutes in addition to CFIUS, established in 1975.

As a response to such demands, President Gerald Ford created CFIUS in 1975, through the Executive Order 11858 (BAILEY, HARTE and SUGDEN, 1994, p. 107). The committee was formed aiming to monitor and assess the impacts of foreign investments in the USA, as well as to coordinate the implementation of investment policies. The Department of Treasury and Ford's administration stressed that a possible amendment would cause losses to American interests, defending the preservation of the Federal government's neutrality policy (NIEHUSS, 1975, p. 70).

In this sense, several difficulties for an eventual change in the regulation policy of investment inflow were pointed out. Among these, the United States leadership in the development and support of the liberal international economic regime was highlighted since the World War II. As observed by Krasner (1977, p. 56), the American policy can be summarized in two basic characteristics: “first, is the minimization or elimination of barriers to the movements of goods, services, technologies, and capital across international boundaries. The second is the control of such movements by private, as opposed to state-owned, corporations.” (KRASNER, 1977, p. 56). The other is the existence of international commitments, such as bilateral treaties and the possibility of retaliation of countries hosting American enterprises (BAILEY, HARTE and SUGDEN, 1994, p. 114). Such arguments have strongly reverberated in the discussion about FINSA in 2007, with emphasis upon international effects regarding changes in the domestic regulation policy.

These arguments drew Congressmen’s reactions, leading to the resubmission of other draft laws, now focusing on the protection of American companies. The 1976 Foreign Investment Survey Act determined surveys on direct and portfolio investment inflow and outflow. The 1978 Agricultural Foreign Investment Disclosure Act required the notice of agricultural land purchases in the lumber and forestry sectors.

Despite the involvement of the Department of Commerce regarding direct foreign investment issues, the CFIUS presidency was assigned to the Department of Treasury and the committee was formed by the Secretaries of State, Defense and Commerce, the Presidency’s advisor for economy issues and the executive director of the White House Council of International Economic Policy (CIEP). CFIUS was established as an informal and flexible mechanism, without specific guidelines, whose tasks would be supervision and monitoring of foreign investments and preparing recommendations to the President who would decide if proposals to acquiring American firms would involve implications on national security or not. The Office of Foreign Investment in the United States (OFIUS) would assist CFIUS in the task of monitoring and analyzing investment inflow impacts, which would include studies on concentration and distribution by sector, impact on national security, energy, natural resources, agriculture, environment, real estate investments, employment, balance of payment and trade.

Jimmy Carter and Ronald Reagan’s administrations kept the same conduct regarding CFIUS: defense of neutrality and the non-discriminatory treatment. Some measures, such as the 1981 fiscal reform – which reduces tax on corporations’ profits, providing increase on profit rate of foreign investment in the United States – and participation of foreign institutions as primary dealers of American public debt bonds, unleashed politicization of domestic regulation and pressures on the Congress, which progressed in the 1980s, as shown in many draft laws that were presented (SOUZA, 1994). However, the Executive’s posi-

tion was kept with the support of the Department of Treasury and Department of State that opposed changes in the investment policy.¹⁸

In the Congress perspective, CFIUS was not a sufficient response to its demands due to submission of Executive control, of continued approval of foreign acquisitions in sensitive sectors and by remaining immune to its influence (BAILEY, HARTE and SUGDEN, 1994). Foreign investment flows reached higher levels in the 1980s and, in spite of Japanese investments had been surpassed by the British, and it was the Japanese presence in high technology industries and in international financing that placed Japan in the focus of concerns on economic security. According to Kang (1997), candidates, particularly Democrats, exploited in the election's debate the complaints against Japanese competitive practices.

At that time, the proposal to acquire Fairchild Semiconductor Corporation by Fujitsu, Japanese electronics enterprise, favored the approval of Exon-Florio amendment in 1987. This operation was considered as an exemplary case of concerns under focus because it was an acquisition in the defense industry involving national security and the essential commerce, since one of Fairchild's branch office supplied high speed circuits for the United States defense and intelligence community. In view of the volume of pressure, the Japanese firms gave up on the operation.

Among the several propositions for legislative change in 1987, two were determinant for the debate's course: paragraph 907 of House Bill 3 and section 907 of Senate Bill 1420, which, with special emphases, equally incorporated the notion of economic security. House Bill 3 proposed that authority should be given to the Department of Commerce to supervise mergers, acquisitions, takeovers, joint ventures, and license contracts, and to evaluate the implication for national security, essential commerce, and economic welfare. The notions of "essential commerce" and "economic welfare" required that the impact of foreign control on domestic industries, such as unemployment, reduction in collection, loss of investment or capabilities were considered in the evaluation processes. They also required the provision of detailed information on all operations of the Department of Commerce. This proposal, even if it did not deny foreign investment beneficial effect for the American economy, highlighted their long term effects on the economic and political independence. The Senate version also attributed supervision responsibility to the Department of Commerce, but it excluded license contracts and joint-ventures.

Thus, the Exon-Florio amendment was established as a new section of the Defense Production Act of 1950, defeating those who advocated its inclusion as a section of the Commerce Code, limiting it to the national security context (BYRNE, 2006, p. 858-869).

18. Initiatives by the Congress and the content of draft laws related to CFIUS are described in details by Bailey, Harte and Sugden (1994, p. 106-148).

These proposals generated negative reactions in public hearings. The Executive declared opposition to incorporating economic security concept as review criteria, advocating maintenance of the opening policy toward direct foreign investment, and warning about the fact that “the Exon-Florio economic security element would not only harm the USA economy, discouraging direct foreign investment in the country, but could lead other countries to close their doors to the United States direct foreign investment (DFI)” (BYRNE, 2006, p. 860). Representation entities of industrial interests, such as Business Roundtable and the Chamber of Commerce, reiterated the same concerns of the Executive. Other members of the Congress argued that the amendment should refer strictly to national security issues. One of the White House objections was related to using the term *essential commerce*, which would compromise its objective of negotiating an agreement to reduce investment measures related to trade (Agreement on Trade Related Investment Measures – TRIMs) then under discussion in the GATT Uruguay Round. The option would be the sentence “harm to national security” in the text proposal and its application would be evaluated on a case by case basis.

In spite of pressure, the approval of Exon-Florio amendment to the Omnibus Trade and Competitiveness Act of 1988 resulted from an agreement between the House of Representatives and the Senate with the Executive, just as declared in a Conference report in 1988. Thus, it was defined that the amendment did not created barriers to foreign investment, its action was restricted to operations involving national security and it would not authorize investigation on investment that did not involve foreign control. Concerning the national security concept, it would be interpreted in a broad sense, without determining specific sectors (DAVIDOW and STEVES, 1990, p. 50). This lack of a definition for the notion of security was kept in FINSA, in spite of the requirement of greater accuracy that marked the context of its designing.

The amendment authorized the President to investigate the effects of foreign acquisitions on national security and, based on evidences, to uphold or prohibit those acquisitions. Exon-Florio provisions regarded mergers, acquisitions and takeovers by or with foreign persons, people or corporations, resulting in control.¹⁹ The Congress, in 1992, added a statute requiring CFIUS to undertake mandatory investigations when an operation were under control or involved a foreign government. Thus, the procedures for CFIUS review process were set, as well as its composition that were on force until the approval of the Foreign Investment and National Security Act (FINSA) in 2007.

CFIUS continued to be chaired by the Department of Treasury, comprising 12 members, the Secretaries of State, Treasury, Home Security, and Commerce, the United States Trade Representative (USTR), the chairman of the Council of

19. Control means power of decision on assets disposal, of contract performance, of operations and location of facilities. At last, defining the organization's objective.

Economic Advisers, the Attorney General, the directors of the Office of Management and Budget and the Office of Science and Technology Policy, Presidency advisors for national security and economic policy.

Committee's investigation process initiates through a voluntary notification from the parties involved in transaction or by a member agency's recommendation. In practice, CFIUS does not open investigations; it only stimulates those involved in sensitive transactions to present voluntary notifications. The committee, in view of a notification, defines in 30 days if the operation will be subject of investigation; if positive, it should comply with the deadline of 45 days to present its recommendation to the President, who, in his turn, issues his decision within 15 days. Operations submitted to this procedure are exempt of later review or legal appeal.

A major aspect of CFIUS procedures are the risk mitigation agreements.

Each member agency negotiates the inclusion of changes or adjustment in proposals individually with the parties, through agreements, such as the performance requirements, in order to make transaction undertaking feasible. If there are difficulties in remodeling the transaction, the investor can withdraw the proposal at any time and resubmit it later.²⁰

Georgiev (2008) calls attention to CFIUS activity, which received 1.500 notifications between 1988 and 2005, opened investigations on 25, of which 13 were withdrawn by firms, and 12 were sent to the White House that blocked only one. Investigations encompass less than 2% of the notifications. These data are indicative of CFIUS's functionality in consultation processes and institutional work prior to submissions. Inclusively, they show the committee's nature that seems to work as modeling instrument of operations for compliance of regulatory requirements more than a restricting mechanism.

The continuity of investments and CFIUS were under Congress surveillance throughout the 1990s. Many acquisition proposals were object of political pressures and public opinion mobilization, in some cases openly stimulated by the domestic competitors of the foreign investors, which led to withdrawal of proposals in order to prevent a negative recommendation from CFIUS.²¹

20. This mechanism is one of the factors that explain the low rate of reviews that are target of investigation by the CFIUS. Proposals are modeled in a complex consultation and restructuring process that allowed increased volume of operations without conflict with security provision or antitrust laws. It is an indication of the relationship between the American State and international businesses' interests.

21. One example was the case of the UV Corporation acquisition proposal, an American steel corporation working in the aerospace sector, by Thomson-CF, a French state owned corporation, in partnership with the Carlyle Group, competing with Martin Marietta, an American aerospace corporation. In spite of its voluntary notification to CFIUS, it did not reach a risks mitigation agreement with the Department of Defense related to missiles division. Its competitor argued that Thomson had sold weapons to Iraq and, thus, America's enemies could have access to technology. Another case was the China National Offshore Petroleum Company's attempt to acquire Unocal, an American oil enterprise that had reserves in other regions, competing with American Chevron. Members of the Congress put pressure over the Department of Treasury, and the debate in public hearings touched the problem of foreign oil dependence and geopolitical concerns related to China. This context of pressures to block the operation by CFIUS let the Chinese government to withdraw its proposal (Petrusic, 2006, p. 1373-1393; Georgiev, 2008, p.125-134; Byrne, 2006, p. 870-879).

In 2006, with the Dubai Ports World's case, demands for CFIUS reform were renewed. This acquisition would have granted control over 11 terminals in six US ports and, according to agencies, committee's approval resulted from mitigation agreements' success. President George W. Bush and the administration argued that the Arab Emirates were allies and cooperate in the war against terrorism, and one of the first to adhere to the Container Security Initiative.²² However, the House of Representatives and the Senate denounced the operation. The House's Appropriations Committee voted, by 62 to 2, the blocking of transaction, pressing for the transfer of part of ports to American buyers, and it proposed changes in Exon-Florio amendment to Congress in order to strengthen CFIUS review processes.

Although the operation had been cancelled due pressures, the Congress restarted hearings to discuss national security issues and the need of reforming procedures that, according to some analyses, would represent a strategy of the Executive to respond to pressures without changing its rejection stand on imposing restriction on foreign investments inflows. The committee's work, for others, allows balancing national security requirements and the open doors, preventing protectionist outbursts that could affect foreign investment inflows in the United States.

In summary, the basic points that emerged in the debate about CFIUS reform in 2006 were: a proposal to change committee's chairing from the Department of Treasury to the Department of Commerce, Defense or Home Security, and criticisms on the definition and narrow interpretation of national security concept and on the lack of transparency in reviewing processes.

A conflicting issue that goes back to its establishment is its chairing by the Department of Treasury. This happens because, for critics, its analysis would be led by economic concerns in detriment of national security issues. Proposals attempting to change CFIUS chairing to the Department of Commerce, relating "national security" to "economic security" had the opposition from the Department of Treasury.²³ In addition to criticism related to Exon-Florio implementation by the Department of Treasury, this was one of the outstanding points in the Government Accountability Office report of 2005.

As its advocates point out, maintenance of CFIUS chaired by the Treasury would represent a signal of the United States intention in keeping its traditional opening policy, while the transfer to the Department of Commerce could be

22. By means of such agreement, countries allow inspection in embarked cargo with destination to the United States at these country's ports.

23. According to Bailey, the bill proposed by Mel Levine (D – California) and Frank Would (R – Virginia) proposed: expand the definition of 'national security' to include wider economic issues. New factors are required – such as the concentration of foreign direct investment in the industry in question, the effect on 'critical' technologies, and whether the target-firm had received US government funds – to be considered by the administration before approving acquisitions. They also sought to transfer control of CFIUS to the Commerce Department, arguing the Treasury had a conflict of interests in its dual functions of encouraging foreign acquisitions of Treasury bills and screening acquisitions that might affect national security (Financial Times, May 14, 1991 and May 31, 1991, apud Bailey, Harte and Sugden, 1994).

interpreted as a flexion in the sense of protectionist nature guidance. The notion of “national security”, although broadly defined, would have been solely interpreted in its relation with defense issues. In spite of proposals to create exhaustive risk factors lists, the definition of what would be a menace to national security consisted of remains in the realm of Executive’s competence. Byrne (2006) explains that the relative “vagueness” in the notion of national security is a major point for flexibility of regulation, as it allows negotiating mitigation agreements and maintenance of balance between risks contention and preservation of open investment policy. System stability, for the author, limits politicization of topics and more effective treatment of actual security risks implicated in operations.

Another criticism made by the Congress pointed the lack of transparency of procedures and criteria for review. Based on confidentiality clauses of the Exon-Florio, the information submitted by the parties to CFIUS as proprietary information and testimonies are exempt from submission to the Freedom of Information Act.²⁴ As the review process accesses corporate information, these data are confidential and only recommendations and results are publicised or disclosed to Congress.

From a political point of view this debate is polarized, as it occurs since 1970s. On the one hand, arguments favorable to a more restrictive approach, based on concerns about national sovereignty and industrial competitiveness, that advocate a more restrictive Federal regulation, supervision and control transparency over mergers and acquisition transactions carried out by foreign capital in the American economy, greater institutionalization of these mechanisms and a more active role of the Congress. This is the position of the public opinion and of domestic interest groups who, concerned with increasing competitiveness firebrand and the loss of sovereignty over American assets, provided electoral relevance to the topic. Concerns for the business sectors are on capital goods price increase and domestic competition. In this sense, authors such as Tolchin (1996) advocate the need to redefine the role of public administration to deal with issues affecting the United States international competitiveness.

On the other hand, there is the position according to which most of foreign investment would not involve security issues, except the defense industry or some segments of sensitive technologies sectors, such as information. This reading confers much emphasis to the role of foreign investment in the United States economy, both from the point of view of macroeconomic balance and employment (GRAHAM, 1991). According to Byrne (2006), for whom the CFIUS mechanism already allows a proper balance between national security and openness to foreign investment, adoption of the “economic security” concept as a criterion for

24. The Freedom of Information Act (FOIA) ensures the right of access of any citizen to Federal agencies information and records.

CFIUS review would remove the focus from national security and would set it on economic protectionism. This would be a sign that the traditional policy of openness was changing, without increase in queries related to national security issues, which, from his point of view, would be sufficiently addressed in the review process carried out by the Committee.

Despite the pressures and the mobilization of members of the Congress, between 2006 and 2007, the Congress and the Senate approved and President George W. Bush enacted, in July 2007, the Foreign Investment and National Security Act, FINSA, which became the Law 110-49. This approval resulted from the compromise between the House and the Senate, to the extent that included some Congressional demands without changing the liberal regulatory perspective. FINSA defines the procedures of the analysis processes of foreign investments operations and its targets, clearly set out in its preamble, the reconciliation of national security demands with the promotion of foreign investment in view of their importance for job creation. That is, it becomes clear the perspective of mitigating concerns that were placed in the discussion of national security requirements required limitations on foreign investment inflow in American economy.

Even though the FINSA and regulations by the Treasury, published in December 2008, in their general lines, have preserved the traditional regulatory perspective, they have ambiguous elements that preserve the conflicting institutional dynamics that gave rise to them. The incentive to voluntary notifications and pre-filing consultations is noticed in the procedural perspective. These provisions enable companies to submit their proposals to previous evaluation, so operations are modeled to suit all regulatory requirements, minimizing objections or polemics. From the substantive point of view, the concept of covered, control, critical infrastructure, critical technologies transactions and those controlled by Governments was defined.

Among the established changes three aspects stand out.

Firstly, a greater communication of CFIUS with Congress is set out. The Committee shall submit substantive reports with information on findings of 30 days reviews that have resulted in 45 days investigations, and all 45 days investigations that did not present recommendations to the President, in addition to the description of transactions and identifying the factors that guided the decisions. Still, it shall produce annual reports or notes about a particular transaction, when requested by the Congress. However, the Congress will not have control or interference in the investigation processes remaining under the Executive's command.²⁵

25. Since then, CFIUS produced two reports for the Congress; the first in December 2008 related to 2006-2008 period, and another in November 2009. Available at: <<http://www.treas.gov/offices/international-affairs/cfius/docs/CFIUS-Annual-Rpt-2008.pdf>>.

Secondly, the expansion of the guiding criteria of the investigation process. New criteria were incorporated, such as the assessment of potential effects on critical infrastructure like energy assets, sales of goods or military technologies to countries that pose military threat; on potential effects of critical technologies for national defense (without considering domestic or foreign condition), among others, such as the dispersion of military technologies or long-term projections of U.S. energy requirements. However, the types of transactions that may have security objections were not objectively defined. Following the legal text, critical infrastructure refers to “systems and assets, physical or virtual, which are vital for the United States, so that destruction or weakening of such systems and assets may have a debilitating impact on national security” (GEORGIEV, 2008, p. 133), while critical technologies relate to “technologies, critical components or critical technological items essential to national defense”.

Thirdly, a change in the regulatory framework that defined a role for intelligence agencies is set out. The Director of National Intelligence will have the responsibility to draw up an analysis of threats involved in foreign investments.²⁶

This reform, publicly welcomed by organizations representing international investors, such as Business Roundtable, Financial Services Forum, Organization for International Investment and by the United States Chamber of Commerce, clearly indicates the perception of sensitivity to imperatives of economic interdependence and the limits to its ability to establish dissonant regulatory guidelines. Businesses groups mobilized in defense of FINSA, considering that those changes would safeguard national security without restricting or discouraging investments. A common ground in those manifestations consisted in highlighting foreign investments contribution to the United States economy, such as their potential for jobs generation and preservation of foreign investment opportunities for American investors. From this point of view, a more restrictive policy would have consequences in investment ambience related to American international investors in host countries.

Criticisms that fostered the 2007 reform date back to 1990 when the Exon-Florio was approved and due to CFIUS performance. The Dubai Ports World case, the security policy and George W. Bush administration after the September 11 and the strong appeal of the topic with the public opinion seem to have favored Congressional demands for reform and expansion of its role in safety investigations. However, while the relation between “investment and trade” approaches the Congress and the Department of Commerce in formulating foreign investment policy, the relation “investment and security” has justified its conservation under the Executive’s authority and limited movements toward a regulation with more restrictive profile. This enables continuity of a stand historically taken by the

26. Those points are dealt by Georgiev (op. cit. p. 132-133).

Executive, of maintaining a liberal regulation for capital flows, especially for direct foreign investments, and as alternative to deal with structural problems of the American economy, such as financing current accounts deficits without resorting to other options, less palatable to American taste, such as reduction of Federal expenditures, tax increase or policies affecting international investors' interests.

It is observed that changes in foreign investment regulation resulting from the relationship between security and investment gained density in political discussions and were approved by the Congress in the wake of security concerns after the terrorist attacks of September 11, 2001. What is intended to demonstrate is that this context favored the approval by the Congress of a regulation that incorporated positions which until then had been object of intense resistance – such as the notions of “critical infrastructure” and “sensitive technologies”, which in FINSA define priority sectors of the American economy for which protection mechanisms should be established – as well as a policy of competitiveness under the national security arguments. These proposals aiming at a proactive role of the Federal Government and its agencies related to defending American nation's industrial competitiveness have been generated in the context of 1980 and 1990 discussions about the relative decline of the American economy.

5 CFIUS BETWEEN DOMESTIC AND INTERNATIONAL POLICY

The expansion of the definition scope of national security with the adoption of criteria derived from the notion of economic security in the CFIUS review procedures indicates a rupture with the principles that traditionally guided foreign investment inflow policy. This is what, in some measure, occurs already in the case of the defense industry, whose mitigation agreements established between investors and members of the CFIUS agencies include performance requirements, as a condition to minimize security impacts and to allow the approval of operations, even if those requirements are clearly banned by the WTO agreements. As it was the case with Sematech, a research consortium in the semiconductor sector, which did not allow the participation of foreign investors, harming the principle of non-discrimination.²⁷

When the debate on domestic policy and the reform of the CFIUS is analyzed, in addition to identifying effective changes, the intention is to highlight their political meaning and the systemic effects of domestic policy. The emergence of “investment protectionism” would represent a policy of restriction of the international flow of capital and the adoption of domestic policies driven by an autonomist, protectionist, or neo-mercantilist perspective, which would have impacts for multilateral negotiations, since they directly touch on the fundamental principles of international economic organizations.

27. “In principle, Sematech's membership structure represents a choice in the part of the member firms rather than a federal policy of exclusion. In practice, however, the exclusion has surely also reflected the preferences of the US Department of Defense, which funds the consortium” (Graham and Krugman, 1995, p. 125).

In order to contain these effects, the OECD has launched, in 2006, the initiative Freedom of Investment, National Security and Strategic Industries (FOI), an intergovernmental dialogue on the need to maintain the commitments of the member countries to a liberal international investment policy based on the principles of transparency, liberalization and non-discrimination. Reacting to what it called “investment protectionism”, OECD recommends that national security regulations, while legitimate, should be used by member States only as exception measures.²⁸ In the same sense, the Santiago Principles are quoted, set out in October 2008 by the International Monetary Fund (IMF) with the purpose to preserve the open policies for international investment, avoiding the adoption of restrictive regulations for sovereign wealth funds, and creating guidelines for funds’ performance.

The “investment protectionism”, which is identified on policies adopted by the central countries, reacts to investment flows from emerging economies such as China, Russia, India and Brazil, mainly in oil, energy, software and telecommunications sectors, called “critical infrastructure”.²⁹ The rhetoric of resource protectionism and the reactions to globalization in central countries, anchored in national security arguments, can be understood in part by reactions to threats from global terrorism after September 11, 2001 and, to some extent, by the growth in acquisitions by private and State companies from emerging economies, which were stressed as a result of commodity and energy prices hike, a trend which should deepen due to the financial crisis unleashed from 2008 (UNCTAD, 2005; MALAWER, 2006, p. 34-35). In this same regard, Sauvants analyses that:

for some countries, like the United States, this reevaluation is based in national security concerns (largely undefined) that arose in the aftermath of the terrorist attacks of September 11, 2001. But there also seems to be a reaction to the “new kids on the block”, namely multinational enterprises from emerging markets, especially when these are state-owned and seek to enter the US market through mergers and acquisitions. Thus, strengthening the active screening mechanism of the Committee on Foreign Investment in U.S. (SAUVANT, 2009b).³⁰

28. Since then, the OECD has analysed and recommended policies to maintain a favorable regulatory environment and non-discriminatory access to foreign investors. These recommendations are indicated in the Guidelines for Recipient Country Investment Policies relating to National Security published in July 23, 2009. Available at: <<http://www.oecd.org/dataoecd/11/35/43384486.pdf>>.

29. Several proposals for acquisition were withdrawn due to the politicization of foreign investments for security reasons. China Mobile Communications Corp., the wireless carrier, was forced to give up the acquisition of European based company Milcom International Cellular in 2006. Russian Gazprom’s attempt to take control of Centrica in the United Kingdom and invest in gas pipelines in Europe concerned the British and Europeans, particularly after conflicts with Ukraine because of gas cuts. In 2007, the Indian Tata Steel undertook the takeover of Anglo-Dutch Group Corus, formerly British Steel, after dispute with the Companhia Siderurgica Nacional. In 2006, Gazprom, controlled by the Russian State, took control of 50% plus one of the shares of the private energy project Sakhalin II, whose initial partners were Anglo-Dutch Shell and Japan’s Mitsui and Mitsubishi corporations; in the same year Gazprom decided to control 100% of the shares of the energy project that will explore the Stokhamn gas deposit in the Barents Sea, excluding Chevron/Texaco, Conoco Phillips (USA), Hydro (Norway), Statoil (Norway) and Total (France).

30. “For some countries, like the United States, this re-evaluation is grounded in national security concerns (largely undefined) that arose in the aftermath of the terrorist attacks of September 11, 2001. But there also seems to be a bit of a reaction against the “new kids on the block”, namely multinational enterprises from emerging markets, especially when these are state-owned and seek to enter the US market through mergers and acquisitions. Hence the strengthening of the active screening mechanism of the Committee on Foreign Investment in U.S.”

It is observed that the coherence between domestic and international positions of the United States foreign investment policy has been worn out. Since 1970, foreign investment gained wider exposure in the domestic political debate because of concerns with competitiveness, employment and balance of payments, trade deficit issues, putting at risk the positions traditionally held by the Americans in international economic negotiations and multilateral economic institutions.

Here it is worth remembering Ikenberry's arguments (1999; 2004) about the rules and institutions that underpin the American hegemony. For the author, one of the pillars of this hegemony is the rules and liberal institutions such as economic openness, reciprocity and multilateralism, rooted in Western Nations' domestic policies. The United States domestic and international economic policy adopted the same values and principles, which consolidated the balance and stability of hegemonic order (IKENBERRY, 1999; 2004). In fact, this guidance was followed by Americans in international economic organizations, especially in OECD initiatives related to liberalization of capital flows. This position is present in the guidelines and policies of the World Bank and the IMF, in defense of international capital flows liberalization.

Anyway, the United States domestic policy options defined the normative standard of international regulation of foreign investment and, at the same time, it is observed that it was this country's hegemony in the international system that defined the model of domestic policy of foreign investment. In the condition of capital exporter, they advocated the right of establishment and national treatment, principles of neutrality policy in relation to foreign investment inflow, and an active policy of encouraging the outflow, with an emphasis on protection. In this sense, the Federal Government programmed a policy to stimulate American investment abroad and acted to minimize private investors concerns with security. The normative model of regulation of international investment, both in outflow and in inflow policy, had assumed the United States supremacy in military and economic terms.

The defense of national treatment and the creation of mechanisms for the protection of investments carried out by Overseas Private Investments (OPIC), ensured the participation of private capital in the post-war arrangements. Through this mechanism, the Federal Government guided private American investment abroad, particularly in Europe, participating in the economic and political restructuring of the world order designed by United States. This relationship between the expansion of capital and the priorities of American foreign policy was one of the central points of criticism and fears of host countries, both in Europe and in Latin America, regarding multinational corporations, which were perceived, with property, as instrument of American foreign policy.

After the World War II, the United States was the country of origin of international investments and, hence, the neutrality policy of the Federal Government in relation to foreign investment inflow did not have sensitive implications in the American economy. They pressed other countries, the companies' hosts, to adopt policies consonant with the principles of non-discrimination and national treatment, in accordance with their domestic policy.

The context of the domestic political debate and regulatory changes in the United States will surely have significant effects for the treatment of foreign investment in the multilateral context, as in the WTO negotiations (SILVA, 2006). And it makes a question to emerge: in which extent the controversial demands between the governance of the world economy, based on liberal principles and emerging policy of economic competitiveness, could create difficulties for the exercise of American hegemony regarding the foreign investment issue, both in domestic and international economic policies?

The insights identified in the American debate, make it clear that the actors have the exact size of these regulatory and political limits to their domestic policy options. An important fact is that the United States is the country of origin and destination of direct international investment flows. The actors, the Executive and its agencies, are aware that this move would affect other countries' regulatory policy, leading them into adopting the same policies, affecting American State interests and of groups benefited by those policies, such as the transnational corporations. As several authors note, this has been one of the main reasons why the Executive prevents the adoption of a more vigilant or restrictive approach for the domestic regulation of foreign investment and seeks to balance the needs of national security with maintaining open investment policy.

The effects of domestic American debate are visible already. The adoption of similar measures by other countries, despite the Executive and Treasury's initiatives and strategies to avoid restrictive measures, begins to emerge on the international scene. Other developed countries such as Canada, France and Germany, expanded national security issues to economic considerations and the protection of national champions and have established monitoring mechanisms, which should be followed by other countries, such as China and Russia (SAUVANT, 2009b). As Larson and Marchick warn (2006, p. 8, p. 18), Russia observes CFIUS reforms carefully, while India and China are proposing similar measures based on security restrictions to be implemented along the same CFIUS lines, coating with legitimacy that they follow the same course of the United States policies.³¹

31. It is essential to note that Japan is moving in the opposite direction, as evidenced by the reform proposals made by Cabinet Office to the Minister of Economy, Hiroko Ota, seeking to expand foreign investment in Japanese economy, through the revision of the rules that restrict foreign investment based on national security arguments (Nakamoto, 2008, p. 10).

In reaction to FINSA, China adopted an antitrust law, and in 2006 transactions regulation and monitoring were approved, based on national security arguments, the Provision on the Acquisition of Domestic Enterprises by Foreign Investors.³²

The keynote of the ongoing debate between the Executive and the Congress and the position of agencies, committees and public opinion expose a relative fragility and allows observing the United States' perception of their ability to establish the normative parameters of foreign investment in the domestic economy. It should be noted that the assessment of the systemic meaning of domestic regulatory alternatives is a concern of the relevant actors in the debate on the domestic regulatory regime in the United States.

In the political environment of the debate on foreign investment regulation and the apparent restrictions for domestic alternatives indicate two perspectives of future scenarios. In one of them, concerns about economic independence, sovereignty and national security, which they consider expansion of Federal controls on direct foreign investment as necessary gain strength, what would represent a very significant regulatory change in terms of international economic policy and would indicate a more autonomous action capacity of the United States in relation to systemic pressures. On the other hand, protection of liberal norms and reaffirmation of commitment to the maintenance of the free trade and openness to investment policy will remain as it has been the United States international position, which means a lower possibility for change and it would be a clear indication of the weight of the systemic and regulatory factors on its capacity of action in domestic policy.

The emergence of investment protectionism follows parallel to the maintenance of an open policy. This is because the investment is not under WTO disciplines, although aspects of international investment have been regulated in investment agreements related to trade (TRIMs), trade and services (GATS) and intellectual property (Agreement on Trade-Related Aspects of Intellectual Property Rights – TRIPs), and because restrictive regulations are based on national security arguments. This means that they are established in the realm of States' legitimate security and national interest.

The question that feeds the debate is about the possibilities and implications of a change in domestic policy regulations, along with international governance based on liberal principles. In this sense, it is important to think about the United States' capacity of action in international economic policy and on the impacts of their domestic choices in the international system.

32. It is worth noting that in the case of China, transaction approvals considered as affecting national security are carried out by the Ministry of Commerce.

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CHINA'S NEW CONCEPT OF SECURITY AND THE STRATEGIC MULTILATERAL RELATIONS WITH SOUTHEAST ASIA

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ABSTRACT

Since 1978 Chinese foreign policy has gone through many changes. We understand that the change that affected its behavior the most was the turn to pragmatism that took shape in Mao's final years and developed in the post-Mao era. This new orientation combined with the changes introduced into the international system some years later, with the end of the Cold War, encouraged Beijing to approach regional multilateral initiatives. In this article we aim to analyze, from a realist perspective, China's foreign policy to Southeast Asia in the multilateral strategic sphere. We will examine two cases: the Spratly dispute and the Chinese participation in the ASEAN Regional Forum (ARF).

RESUMO

A política exterior chinesa desde 1978 até a atualidade sofreu numerosas modificações. Considera-se que a mudança que em grande medida afetou o seu comportamento externo foi a virada para o pragmatismo que começou a ser concebida nos últimos anos da era maoísta e passou a ser implementada nos anos posteriores. Esta nova orientação, combinada com as mudanças produzidas anos depois no sistema internacional com o fim da Guerra Fria, favoreceu a aproximação da República Popular da China (RPC) com iniciativas multilaterais da região. Neste artigo tenta-se abordar o realismo das relações internacionais na política exterior chinesa com o Sudeste da Ásia no plano estratégico multilateral. Para isso, vai concentrar-se em dois casos, o conflito pelas Ilhas Spratly e a participação no Fórum Regional da Associação de Nações do Sudeste Asiático – Asean (ARF).

1 INTRODUCTION

Since 1978, the Chinese foreign policy has gone through many changes. We take into consideration that the change which affected its exterior behavior in larger scale is the pragmatism, which took shape in the last years of Mao's era, and started to develop in the years that succeeded it. By definition, pragmatism is a behavior that is neither guided by a set of values nor by established principles. The pragmatic behavior is simply oriented towards achieving goals, and it is guided by national interests (Suicheng, 200:44)

This turn in the foreign policy was developed in a way corresponding to the process of economic development initiated by Deng Xiaoping, known as the Four

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Modernizations¹. It became the main goal of the Chinese leaders, who, through a pragmatic vision, estimated that in order to achieve it, the maintenance of a stable regional environment would be needed in order to allow them to concentrate in the development of better commercial relations with the system's great powers, as well as with China's closest neighbors.

Both conditions – pragmatism and the priority given to regional stability – echoed in the relations between the People's Republic of China (PRC) and South-east Asia. In its turn, the national significance given to modernization contributed to improve China's image overseas (Cheng, 1999: 176). The SEA states, which saw the country as a constant threat and as a revolution exporter, embraced the economic model. These countries realized, in this process, Beijing's intention to distance itself from a communist featured production and political design model towards one which would integrate the elements of political openness and capitalist economic development.

The end of the Cold War marked a new turning point in China's foreign policy towards the SEA. For the Asean, the Soviet withdrawal, which followed the end of the dispute, was seen as a loss of counterweight in Chinese power, and raised the need for a redefinition of security strategies in the region by focusing its attention on the emergence of China as a major actor in the regional area. For Beijing, the end of the dispute and the resulting Soviet withdrawal from the region favored the creation of an empty space of power the United States would not be willing to take over, which would allow it to have its regional image adjusted. China began to deepen the bilateral bonds it had with the Southeast Asian countries, and to restore its broken diplomatic relations. In August 1990, it regularized its relations with Indonesia, and in November 1991, just over a year later, it did the same with Vietnam. As far as Singapore was concerned, a country with which it had not yet maintained formal diplomatic ties, relationships were built in October 1990.

Since then, the combined efforts of the SEA countries – through the Association of Southeast Asia Nations (ASEAN) – which were trying to involve China in the region's security, and Beijing's interest in dissipating the feeling of threat it used to inspire in its neighbors, taking into account the priority given to regional stability, favored the country approaching the integration of multilateral initiatives. At the same time, a new definition of the concept of security started to be developed within the Chinese political elite. Formulated to guide relations in Asia, and in the Pacific, this concept has trust, mutual benefits, equality and coordination as its main components. Here we can notice not only Beijing's set priority to regional stability and peace, but also its greater predisposition to adopt multilateral ways of interacting with the region.

1. A process of economic modernization focused in the areas of agriculture, industry, science and technology and defense.

This gradual behavioral change in terms of Beijing's foreign policy directed towards the Asean, especially at the multilateral level, is the demonstration of an overall attitude of the Asian giant towards multilateral initiatives. Some examples of this include its participation in the block and the Asia-Pacific Economic Cooperation (APEC) since 1991, its admission in the World Trade Organization (WTO) in 2001 and its commitment in the so-called *six party talks* to solve the problem in North Korea. The multilateral strategies are part of a wide range of policies that fit their peaceful rise; however, Beijing's practice in this type of initiative is recent and scarce. Hence China, despite having gained comfort in the use of multilateral mechanisms – mainly in the economic field – still prefers bilateralism as a form of relationship with other countries, and their use of multilateralism is selective and subject to the type of problem addressed depending on how much it may affect the interests of the country.

Since tension between bilateralism and multilateralism affects, and will continue to affect, the maneuverability of the Chinese authorities in the foreign policy, we consider it relevant to analyze the country's performance at the region's multilateral level, and which interests its gradual behavioral change has answered. (Wu, 2004: 64-65).

In this article, we intend to approach the reality of international relations in the Chinese foreign policy directed towards Southeast Asia in the multilateral strategic plan. Besides considering the state as a unitary actor (Sodupe, 2003, p. 81) – premise taken to analyze both the PRC and the Southeast Asian countries – it is assumed that the State's interests are defined *a priori*, that is, previously to the relationship (apud WELDES HOUGHTON, 2007, p. 37). Despite the interest being taken as given, we consider that the behavior can be influenced by the relationship with other actors. This allows us to see how, through interaction, one can produce changes in China's behavior in the region, although its interests remain stable.

In order to conduct such analysis, this study will be focused on two cases, the Spratly Islands dispute and the participation in the Asean Regional Forum (ARF). In the first case, we can see how the behavior of the PRC evolved, in regard to the territorial dispute. We emphasize the way the Asean managed to engage its neighbor in multilateral dialogue, and in how it limited the use of force. In the second, we analyze how the calculation based on cost-benefit led China not only to approach the forum in 1997, but to gradually increase their involvement through the years.

We take these two processes as case studies because they constitute the two main areas of strategic cooperation that have gradually involved China in multilateral negotiations with Southeast Asia. In the Spratly Islands dispute, one can see with greater clarity China's and the Asean's joint efforts to advance the resolution

of the dispute renouncing the use of force and using mechanisms of cooperation, and in this problem is more clearly manifest the extent to which the PRC is willing to submit the treatment and resolution of regional conflicts to multilateral frameworks. In turn, the ARF is the first attempt to award a regional institutional character to multilateral dialogue on security issues in the region, representing a milestone in the strategic multilateralism in Eastern Asia.

2 FIRST APPROACH TO MULTILATERALISM: CHINA'S PARTICIPATION IN THE ASEAN REGIONAL FORUM

China's post-Cold war foreign policy emphasizes a "new concept of [regional] security"² through what Beijing describes what it considers to be the most appropriate means to organize the current security relations. According to Capie and Evans (2002: 175-177), this concept reflects the Asia-Pacific countries' efforts to maintain peace and stability in the region. In this conception, we have the need to guide the mutual relations by the five principles of peaceful coexistence, dialogue and the building of trust.

Along with this definition, but gradually, China began to show a bigger interest for multilateral dialogue and cooperation organizations since the 1990s. Its entry into ARF, since 1994, matched this change of perception.

The Asean Regional Forum is a multilateral strategic dialogue structure, which began in July 1993, in Singapore, during the annual meeting of the Asean countries' ministers of foreign relations (Leifer, 1995:51). The process of configuration of this space started in Singapore with Asean's Declaration of the Fourth Summit of Heads of State, in 1992, whose third article states that:

Asean could use established forums to promote external dialogues on enhancing security in the region as well as intra-Asean dialogues on Asean security cooperation (...) taking full cognizance of the Declaration of Asean Concord. To enhance this effort, Asean should intensify its external dialogues in political and security matters by using the Asean Post Ministerial Conferences (PMC).³

Thus, dialogues with extra-regional States were established on strategic issues through the PMC. China was not among the original⁴ partners. However, in May 1993, during the meeting of Asean's high officials and its extra-regional partners, it was agreed to invite the PRC along with Russia, Vietnam, Laos and Papua New Guinea to the Asean Regional Forum.⁵ The first meeting of the ARF

2. In 1996, the country's leaders began to refer to a "new security concept" as a regional initiative, with an emphasis on strengthening trust through dialogue, and promoting security through cooperation. This concept was enshrined in the People's Republic of China (2002).

3. See: Asean (1992b).

4. United States, Japan, South Korea, Australia, New Zealand, Canada and the European Union.

5. See: Asean (1993).

happened in July 1994, in Bangkok, aiming at promoting agreements to build trust (Leifer, 1995, p. 52).

Currently the Forum includes the ten Asean countries and 17 partners.⁶ The body has many features of the Asean, and its structure and functioning differentiated it from security alliances. Its main mechanisms of decision-making respect the "Asean style": they are based on the consensus, on reaching a solution acceptable to all parties, they favor the building of trust through knowledge sharing and transparency, and they facilitate cooperation through successive negotiations which, in turn, feed the learning. The advisory nature of the ARF and its relevance in building spaces for cooperation are reflected in their goals. In them, it is established that the forum will foster dialogue and consultation on political and security issues common to the members, and work on building trust and on preventive diplomacy in the Asia-Pacific region (ARF, 1995a).

Besides accepting ARF's invitation to participate in the ARF, and to attend the 1994 inaugural meeting, the Chinese involvement in the institution was passive and apprehensive. According to Susan Shirk (1994: 7), the country sent representatives to most regional discussions on cooperation in security issues; although it acted as an observer. This was partially due to the lack of a concrete policy on the part of the party and of the government on cooperation concerning security.

In turn, China had serious reservations with regard to the ARF, which were mainly due to the concern that the United States – a member of the ARF – would use it to intervene in the country's internal affairs. Secondly, China feared that the Asean would try to internationalize the Spratly Islands conflict through the forum and take a single stance against the PRC (Kuik, 2005). Accordingly, at the inaugural meeting of the ARF in 1994, the country announced it would not allow the issue of the Spratly Islands territorial dispute to be discussed at the forum. China not only kept the issue off the agenda of the organ, but also received support from Malaysia and the Philippines to thwart Indonesia's proposal of granting a more active role for governments in informal workshops to discuss the conflict. This attitude, which largely explains Beijing's preference for bilateralism, can be seen as a sort of widespread reluctance from China to engage more concretely and substantially in multilateral discussions, due to its fear that its neighbors would use the body against the country (SHIRK, 1994, p. 11th).

A third reservation was due to the fear of placing the Taiwan issue on the agenda of the ARF. Finally, Beijing was worried about the problem of military transparency (KUIK, 2005). The forum encourages its members to introduce levels of transparency concerning their national defense capabilities, in terms of

6. Australia, Bangladesh, Canada, China, United States, India, Japan, Mongolia, New Zealand, Pakistan, Papua New Guinea, North Korea, South Korea, Russia, Sri Lanka, Timor-Leste and the European Union.

weaponry and technology. Initially, the Chinese government, particularly its defense officials, was reluctant to reveal any information concerning this area. This was mainly related to the conception that the ambiguity and the respect towards the military capabilities of the country, gave it a greater deterrent power. So if others had known about the scarcity and low-technology of its weaponry, the country would be in a position of greater vulnerability (SHIRK, 1994, p. 11).

Despite these fears, Beijing decided to participate in the ARF, which implied an innovation in its strategic foreign policy for the region. This participation was stimulated by two main reasons. On the one hand, more by the need to prevent initiatives that could threaten its national interest (KUIK, 2005) than by a belief in multilateralism. On the other, by the perception that it would be an effective tool to reduce the fears that its fast-growing aroused in neighboring countries (SHIRK, 1994, p. 8).

The perception of threat that China raised among its neighbors was attributed to the emptiness of power left after the withdrawal of Soviet troops and to the reduced North-American presence in the region following the end of the Cold War. To the eyes of the Southeast Asian countries, the resulting emptiness of power could be filled in, initially, by Japan. However, given the steady growth of the Chinese economy, suspicions that the latter could move in Southeast Asia as a regional power arose.

Both RPC's leaders and diplomats tried to disrupt this perception by stating that the Chinese economy and military capability are at low levels of development. Participation in a regional cooperation body on security issues, which concentrates not only the countries of the area, but extra-regional partners, was seen by the leadership as a way to help to build trust in leaders from Southeast Asia about the Chinese intentions.

Thus, the incentives that lead China to implement multilateral strategies were due, mainly, to rational calculations. The Chinese leaders estimated that the trend towards multilateralism in regional security was a process that could not be stopped and that China could not ignore. Not participating in the ARF would imply China's isolation from the area and could give rise to suspicions in Asean countries at a time when the country was trying to get closer to their neighbors. Therefore, the PRC chose to participate in the body, so as to avoid isolation in order to shape, since its conception, the incipient process of cooperation, so that it would not threaten their interests or national security (KUIK, 2005).

The first positive guidance from Beijing toward strategic multilateralism in the region began to emerge in 1992 with the declaration of the deputy foreign minister, Liu Huaqiu in favor of the progressive establishment of mechanisms for dialogue on security in the bilateral, sub-regional and regional levels. Gradually,

during the first half of the 1990s, the Chinese leadership was developing a more favorable position with regard to multilateral dialogue on strategic issues in the region (SHIRK, 1994, p. 7). This was partially due to the change of view regarding the ARF, a result of China's participation in the process. The institutional characteristics of ARF, on the one hand, and the intention of the members of Asean – the main drivers of agency – to maintain equitable relations with the powers on the other, contributed to change China's perception about the organization (KUIK, 2005).

The main institutional resource that, according to Foot (1998), allowed a raise in China's comfort level regarding their participation in the forum is the consensus as a decision-making mechanism. This mechanism, says the author, releases Beijing from the obligation to form coalitions or to invest resources in getting allies for voting (FOOT, 1998, p. 428). A second resource that favored this approach is the ARF's commitment of only advancing at a pace that is acceptable to all members. As stated in section 21 of the ARF's *concept paper*:

The ARF should also progress at a pace comfortable to all participants. The ARF should not move "too fast for those who want to go slow and not too slow for those who want to go fast" (ARF, 1995a).

This assures the Chinese leadership that decisions will be made gradually, thus respecting the country's preference for gradualism – a preference shared with Southeast Asian countries (SHIRK, 1994, p. 10). In this sense, both parties reject the European model of regional institutionalization of strategic cooperation. Beijing argues that a formal characteristics institution like the Commission on Security and Cooperation in Europe (CSCE) would not be an appropriate model for Asia, given the countries' diverse political, economic, social and cultural development.

Instead, Beijing argues the mechanism of incremental progress, using dialogue through different channels, and also informally. That is, China – along with the Southeast Asian countries – opposes the structuring of dialogues for permanent working groups (FOOT, 1998, p. 432). However, in the second ministerial meeting of the Forum held in Brunei in 1995, its members agreed to establish inter-governmental meetings and inter-sessional groups, whose maintenance would be discussed in the next meeting.⁷ These discussion forums were not established as formal, structured bodies within the ARF, and currently they are also composed of academics and members of research institutions in the region. These characteristics relate to the nature of the ARF and reduce the Chinese concern of becoming involved in a formal body to limit its sovereignty in the future.

One last feature of the ARF, and also a fundamental condition for the participation of China, is that the adopted agreements are voluntary and non-binding,

7. See: ARF (1995b).

and that the mechanisms of cooperation have emphasis on the building of trust and dialogue as a method of creating such trust. Beijing's initial concerns may be attributed to the fear that the organization was not sensitive to Chinese interests. This perception began to change as the country began to familiarize itself with the organizational style of the ARF (FOOT, 1998, p. 432), and led to a change in its way of participating in the organ (KUIK, 2005) and in the consideration the leadership had about the whole process of regional multilateralization.

These changes start to become evident in 1997, with the more active role that China adopted within the ARF. In March 1997, the country co-organized the meeting of the Inter-Sessional Support Group on Confidence Building Measures in Beijing. In the words of the then foreign minister, Qian Qichen, this was the first time China had hosted an official multilateral conference on security issues (FOOT, 1998, p. 426). On the third ministerial meeting, the PRC presented proposals for confidence building measures on issues of defense and security. In that same year, the Spratly problem began to be discussed for the first time within the ARF, despite China's initial reticence (EVANS, 2003, p. 750).

The previous developments were complemented in 2002 and 2004 with the publication and presentation to the ARF of the white papers on defense. In obvious resonance with the traditional stance of the country about the dangers implicit in the introduction of transparency in military affairs of State, Beijing publishes in these documents both the goals of its military policy and its expenditure on weapons (EVANS, 2003, p. 756). Also, regarding sovereignty, the White Paper of 2004 highlights that one of the main goals of the country's defense policy is "To stop separation and promote reunification, guard against and resist aggression, and defend national sovereignty, territorial integrity (...)." (INFORMATION OFFICE OF THE STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA, 2004). In this section, reference is made to the issue of Taiwan and the islands of the South China Sea, making it clear that Beijing is not willing to discuss and resolve, multilaterally, conflicts that may become a threat to its territorial sovereignty or integrity.

In summary, it is clear from the analysis of China's participation in the ARF that the rules of political realism continue to dominate the decision-making of the Chinese leadership regarding foreign policy and security.⁸ Pragmatism rather than a belief in multilateralism as a mechanism, has guided China's approach toward the body. This can be noticed on the initial incentives that led Beijing to take part in the forum, and then to more actively participate in it. Nevertheless, it is considered that the role of the Asean in this sense was, and still is, important to foster the integration of China into the body, adapting to the Beijing's demands

8. See: Foot (1998).

regarding gradualism and informality, and accepting the conditions that China imposes for its participation.

3 THE SPRATLY ISLANDS AND THE COMMITMENT TO REGIONAL DIALOGUE

Located in the South China Sea, the Spratly Islands are an archipelago consisting of approximately 400 islands, reefs and shoals. This territory had been under French colonial rule, and soon some islets were used by Japan as military bases during the Pacific War (LEIFER, 1995, p. 222). Despite these occupations, the islands have never been within the exclusive jurisdiction of any of the surrounding States (LEIFER, 1995, p. 221).

The conflict for sovereignty over the Spratly Islands began just after the Second World War, since the 1951 San Francisco Peace Agreement did not clearly define who would respond for the archipelago. This omission set the bases for the development of successive confrontations for the possession of the islands as well as the neighboring maritime space (ODGAARD, 2001, p.2). Actually, there are six countries involved in this dispute: China, The Philippines, Malaysia, Vietnam, Brunei and Taiwan. Out of these six countries, only China, Vietnam and Taiwan claim the whole archipelago (ACHARYA, 2001, p. 158).⁹

China bases its claims on the islands on historical grounds, including the Spratly Islands expeditions undertaken by the Han Dynasty in 110 AD and the Ming dynasty between 1403 and 1433. At the same time, Chinese traders and fishermen have worked on the area for a long time; moreover, China uses archaeological evidence to reassert their claims (GLOBAL SECURITY, 2009). The axis around which revolves the conflict is precisely that, in its resolution, the United Nations Convention on the Law of the Sea ignores what China sees as its historical rights on the South China Sea, giving control of the resources to coastal states (BUSZYNSKI & SAZLAN, 2007, p. 144). The legal and political vacuum resulting from the San Francisco Conference allowed coastal states to submit justified claims of sovereignty.

The PRC protested against external intrusions on the islands and against the French taking possession of them in 1933, and Japan in 1939, giving legal support to their claims. In 1947, the Nationalist China had occupied some of the Spratly Islands after the Japanese left them vacant, but withdrew when the conflict with the Communist Party for control of the mainland began. The presence of the United States, and then of the Soviet Union, in Southeast Asia prevented the PRC from effectively occupying the Spratly (BUSZYNSKI & SAZLAN, 2007, p. 145). The government appealed to maps to make its complaint public, but the dimensions

9. The main opinions used to support the arguments in this work were taken from professor Amitav Acharya.

and exact coordinates have never been defined. According to Buszynki & Sazlan (2007, p. 146), the inability to back up their historically based claims through occupation explains China's frustration regarding the subject, and its determination to regain the territories.

We understand that it is relevant to distinguish how China, until the early 1990s, addressed the problem of the Spratly Islands. Since the mid 1970s, complaints about the exploitation of the islands were accompanied by the political will to use force, to propel their counterparts to recognize the rights of the Chinese territory (GALLAGHER, 1994, p. 170). In 1974 came the first Chinese clash with the Republic of Vietnam (South Vietnam). In this first opportunity the Chinese forces moved South Vietnamese vessels that were located in the Paracel Islands (LEIFER, 1995, p. 181). The second confrontation took place in March 1988. This time around, the PRC faced the Democratic Republic of Vietnam, whose ruling elite, after the unification, decided to claim their rights over the archipelago. The origin of the conflict dates back to January that same year, when China began to occupy part of the Spratlys. The country's intention of extending its area of control led it to face Vietnam. The victory over the latter allowed Beijing to occupy six more islands and to continue its expansionist project in the archipelago. This confrontation of small magnitude was revealing as an indicator of China's willingness to support its territorial claims on the islands at the expense of neighboring states, even through the use of force (ODGAARD, 2001, p. 3).

Some alternative ways to extend its presence in the disputed area involved the sending of fishing fleets, oceanographic vessels with civilian and military personnel of high rank, and the construction of aerial and military infrastructure in the Paracel and Spratly Islands. The Mischief Reef episode is the most important in this sense. The reef, composed mainly of coral, is located within 200 nautical miles of the coast of the Philippines, and the country has been claiming it since 1962 (ZHA and VALENCIA, 2001, p. 86).

In 1995, China occupied the reef and began to build the infrastructure. This advance was seen by Asean states with growing concern, since it appeared to be a reflection of the Chinese intention to exercise its sovereignty over the islands by force and imposition. This episode happened after the declaration of February 25, 1992, by which the Congress established that the South China Sea was part of Chinese territorial waters (and BUSZYNSKI SAZLAN, 2007, p. 150). Thus, the Mischief Reef incident shows the Asean the Asian giant's predisposition of reasserting its claim over the entire territory of the Spratlys by any means necessary, even if it means disrespecting the principle of non-aggression and peaceful resolution of disputes, which are two of the pillars of the regional organization.

A tendency to resort to unilateral measures – whether violent or nonviolent – can be seen in the Chinese foreign policy over the islands as a way of extending

its sovereignty over them at the beginning of the 1990s. At the same time, the Southeast Asian countries sustaining claims over the area also resorted to mechanisms that, far from establishing bases for resolving the conflict, exacerbated the problems, mainly around complaints by the exploitation of natural resources. Currently, Vietnam occupies 21 islands, Malaysia has control over three, and the country has even built a hotel in one of them, and the Philippines occupies eight islands, arguing that they do not form part of the Spratlys and were unclaimed (GLOBAL SECURITY, 2009).

Despite the unilateral measures the PRC and the involved Southeast Asian countries took over the years, efforts aimed at the cooperation around the conflict have been implemented since 1991. The kickoff to the negotiations between the parties – which consolidated the foundations for further cooperation in the region – was the Declaration on the South China Sea that Asean issued in 1992. In it, the need to settle the sovereignty issues over the islands without resorting to force is emphasized, and the Declaration also decides to study the possibilities of cooperation in the region with regard to navigation, communications, environmental protection, the fight against piracy and theft, and cooperation in the campaign against the traffic of illegal drugs (ASEAN, 1992a).

Some years later, a second document to deal with the dispute begins to be prepared: the Declaration on the Conduct of Parties in the South China Sea. The original proposal was held at the East Asia Summit in Manila in 1999, where the ASEAN countries agreed upon a draft document, which was not accepted by China. The establishment of a binding regional code of conduct was being proposed. After three years of negotiations, and after numerous objections from the PRC government, the result was a nonbinding statement signed in Cambodia in 2002. It makes no explicit reference to any particular archipelago. This was mainly due to Beijing's insistence of excluding any mention of the Paracel Islands – claimed by Vietnam, but currently occupied by China (ACHARYA, 2003). Moreover, the document refers to the South China Sea leaving enough conceptual scope for the provisions to apply to all the islands contained therein. The statement also urges the parties to:

exercise self-restraint in the conduct of activities that would complicate or escalate disputes and affect peace and stability including, among others, refraining from action of inhabiting on the presently uninhabited islands, reefs, shoals, cays, and other features and to handle their differences in a constructive manner.¹⁰

Emmers (2002) states that this section lacks the capacity to end the fighting in the area, because the PRC government has opposed to include a commitment to stop the building of infrastructure in the islands.

10. See: Asean, 2002.

We agree with the authors who emphasize the limited willingness of China to make concessions on the total claim of sovereignty over the Spratly Islands and to be subject to conditions limiting its action in the area. Nevertheless, despite having no binding force, and despite respecting the objections raised by the Beijing government – something the ASEAN countries allowed, to finally reach an agreement that would create the bases for preventing armed conflicts in the area – the declaration represents an important step in the dialogue of the parties to resolve the conflict.

Firstly, we can observe an important change of policy in the PRC because the statement, in its first article, states that “the Parties reaffirm their commitment to the purposes and principles of the Charter of the United Nations, the 1982 UN Convention on the Law of the Sea” (ASEAN, 2002), implying that Beijing would be truly recognizing the principle of occupation – that this convention provides – as the basis of support of claims of sovereignty. This allows the convention to be framed in a convention of the United Nations, and to take the dispute to an international level, a noticeable change on the previous foreign policy of the PRC (ACHARYA, 2001, p. 135).

Secondly, the 2002 statement makes clear to the eyes of the country’s leadership that the Asean states adhere to the recognition of the People’s Republic of China as the only legitimate Chinese government, since Taiwan was the only plaintiff that did not sign the document, nor participated in its making.

Parallel to the talks and multilateral negotiations that preceded this document, the PRC continued to strengthen its bilateral ties with the countries that took part in the dispute. Within the Asean, countries keep different postures and perceptions toward China,¹¹ and these differences allow Beijing to approach parties individually and cause divisions within the organization about the stance against the conflict. The existing differences among the members – such as the overlapping of the territory each party claims and their opinions about the military role of the United States in the region – combined with the offers China presents to some of the states on a bilateral basis – mainly to Vietnam and Malaysia – have contributed to consolidate the rifts within the Asean and to hinder the achievement of a common stance regarding China (ACHARYA, 2001, p. 137; Emmers, 2002). Two clear cases in which one can notice China’s bilateral approaches with some Southeast Asian countries are the signing of bilateral codes of conduct with Vietnam and the Philippines, and Beijing’s progress towards obtaining the support of Malaysia to solve disputes in bilateral terms.

11. Malaysia, Singapore, and especially the Philippines fear that China will develop an expansionist approach in its security policy. But while Malaysia and Indonesia used to see China as a long-term threat to regional security during the Cold War – unlike Singapore and Thailand, for whom the main threat was Vietnam – now Malaysia and Thailand appear to have a more benevolent opinion of China than the Philippines, which considers itself as the main “front” against the advance of China in Southeast Asia (ACHARYA, 2003, p. 2).

In 1993, Vietnam and China signed a Code of Conduct by which they pledged to not use force and to refrain from any action that could worsen their relations (ACHARYA, 2001, p. 135). The signing of the Agreement on Delimitation of the Territorial Sea, of the Exclusive Economic Zone and of the Continental Shelf in the Gulf of Tonkin was the first bilateral territorial instrument signed by China and Vietnam, undoubtedly a transcendental breakthrough in solving the problems in the border zone. It came into force in both countries on 30 June 2004.¹²

China also signed a code of conduct with the Philippines in August 1995, after the Mischief Reef incidents, with the intention of avoiding future incidents in the South China Sea and increasing maritime cooperation. During the two rounds of bilateral negotiations that preceded the signing, the parties reached an agreement on confidence-building measures that contributed to improved relations (STOREY, 1999, p. 95). Although it allowed the establishment of the *status quo* on the Kalayaan Islands¹³ – the main objective of the Philippines – this agreement failed to constrain China's behavior, and the country continued to build on Mischief Reef in 1996 and in subsequent years (STOREY, 1999, p. 95).

It was with Malaysia that China achieved its greatest advances in terms of bilateral cooperation and negotiation. According to Acharya (2001, p. 136), Malaysia was approaching the Chinese stance regarding the search for solutions to the bilateral dispute. This is attributed mainly to the attitude adopted by Malaysia in the ARF ministerial meeting in 1999. Before this meeting, Malaysia completed the construction of infrastructure on Investigator Shoal, a sandbank claimed by the Philippines, China, Taiwan and Vietnam. This unilateral action had serious implications for ASEAN. Firstly, marked a break in the common posture of members about China. Secondly, violated the Declaration on the South China Sea. Finally, it opened the possibility for the emergence of a new wave of occupations by other parties in the dispute. Later, Malaysia, anticipating the reaction of the other members of Asean, refused to address the issue at its ministerial meeting and joined the Chinese posture, ensuring that the problems of the South China Sea should not be included in the agenda of the ARF. Malaysia also opposed the draft code of conduct by arguing that it was very similar to a treaty – by its binding character – and that each article should be carefully evaluated (VALENCIA, 2001).

Hitherto, we discussed the official negotiations of the issue concerning the territorial dispute for the islands – both multilaterally and bilaterally. Besides these official negotiations, unofficial dialogue initiatives between the parties were held. In this sense, and with support from the Canadian government, informal workshops

12. For more information, see Vietnam (2004).

13. The name 'Kalayaan Islands' comprehends the archipelago located about 230 nautical miles west of the Palawan Island. This is the name Filipinos use to refer to these islands, which are claimed by the country and are part of the Spratly Islands group (Storey, 1999, p. 95).

were set up in 1990 between academics and government officials about the management of potential conflicts in the South China Sea (ODGAARD, 2002, p. 125).

The main success of this forum has been the working on a common knowledge base, allowing the proposals for cooperation in areas of marine scientific research, navigation safety, transport, and communication to be put on the table. The networks that emerged between the scientific communities of the States through dialogue have established the preconditions for cooperation on common problems. These workshops have attempted to define which areas are open for cooperation and which are not. In the first two meetings in which China participated in 1991 and 1992, the potential for cooperation was identified. In the following rounds, between 1993 and 1996, the areas of possible cooperation have been specified, including the expansion of technical and scientific initiatives (Odgaard, 2001).

One of the main obstacles to achieving concrete goals within the workshops is the preference for autonomy manifested by China. It implies a determination to maintain freedom of action and avoid subjecting the country to obligations it can't be released from in the future. In the context of the conflict through the islands, this posture of Beijing's assumes reservations about the format of the negotiations on the common problems of the South China Sea – demanding informality, the exclusion of sovereignty issues off the agenda, and only allowing international agencies to participate as advisers. Rather, the practice of consultation in the Asean was developed to maintain a constant dialogue that allows the accommodation of divergent interests in foreign policy in the presence of serious threats against the security of the member States. Instead of prioritizing practical cooperation, it has focused on promoting solidarity within the Asean through the process of dialogue. This created confidence that the member States would not pursue their national interests at the expense of stability and peace in the region (Odgaard, 2001).

The proceedings of the workshops represent the Asean attempt to approach the positions between China's practice of autonomy, and the consultation that has developed between the members of the organization. One of the main problems of those meetings was that many issues that could not be solved by dialogue remained pending, and as a consequence the results were not immediate. At the same time, the constraints imposed by China – mainly informality, and especially avoiding dealing with issues of sovereignty – have exempted the States from taking binding commitments (Odgaard, 2001). Added to these conditions is Beijing's refusal of executing any negotiations involving Taiwan (ACHARYA, 2001, p. 135).

The process Asean has been facing to commit China to multilateral dialogue on strategic issues – especially concerning the Spratly Islands conflict – is gradual, and sometimes unsuccessful. However, it is considered that, in the light of what has been analyzed, it can be said that in some respects Beijing has been more inclined to participation and dialogue in multilateral frameworks.

It should be taken into account that the problem of the Spratly brings into play the territorial sovereignty and the access to natural resources that China considers essential to its development – just like the other countries in the conflict. These conditions contribute to the fact that, unlike what happened in the ARF, Beijing is not presenting initiatives to advance the multilateral dialogue and is showing a preference for bilateralism. As a result, one can see that – on the contrary of what happens in the economic area – in the areas Beijing finds most sensitive, multilateralism is not often used as a complement to bilateral strategies.

4 FINAL REFLECTIONS

Beijing's conduct in the regional strategic plan clearly falls in the pragmatic logic mentioned at the beginning of the article. Multilateralism is, as this author understands it, a strategy that started to complement bilateralism because in a more and more interdependent world, and with an overwhelming amount of multilateral processes, the state has the ability to interact at both levels.

Nevertheless, one should differentiate the thematic areas to which this strategy can be applied. From a realistic point of view, it is observed that in matters of high politics – such as territorial integrity and safety – the bilateral strategies tend to be more used. This is clear when we look at the Chinese foreign policy, which began to diversify its strategies toward multilateralism in recent years. Whereas in the economic realm one can observe Beijing's active participation, and even initiative, in the Asean Plus Three and in the conformation to the Asean-China Free Trade Area; in the strategic realm one can see more reservations. One example is the refusal to make reference to the sovereignty over the Spratlys within the multilateral dialogues framework of the ARF, discussing the development in parts of the archipelago over which it exercises ownership (Evans, 2003, p. 758) and giving it a formal treatment for the resolution of the dispute.

The approach of the PRC to multilateral agencies in the region is the product of a combination of factors: on the one hand the commitment of the Asean countries to involve the Asian giant in the regional security and stability; on the other hand, the Chinese leaders' evaluation of the need to integrate their country in the regional processes so as not to be excluded from a region where it competes against other powers. Thus one can see a growing excitement on Beijing's part toward multilateral processes – especially in the economic area – although its leaders still feel more comfortable with bilateral strategies (WU, 2004, p. 65).

The gradual approach of the PRC toward the ARF and the commitment to the non-use of force in the conflict over the Spratlys can be considered a small step in a broader calculation, in which the internal economic development remains the main priority. As long as it remains the goal, it is considered that China's conduct

won't deviate from a pacific standard, keeping a responsible leader policy in the region, and a non-aggressive attitude towards extraregional powers – especially the United States – within a security concept based on multipolarity and on the peaceful settlement of disputes.

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THE MULTISYSTEM OF GLOBAL TRADE REGULATION: PROPOSAL FOR A NEW THEORETICAL REFERENCE AND A NEW ANALYSIS METHODOLOGY*

Vera Thorstensen**

ABSTRACT

Due to the current complexity of international trade regulatory framework, our aim is to propose a new theoretical approach that allows the analysis of the different systems of rules that intervene in commercial activities. Such approach is necessary in face of the new challenges in formulating Brazil's International Trade Policy.

RESUMO

Diante da atual complexidade do quadro regulatório sobre o comércio internacional, o objetivo deste artigo é propor uma nova abordagem teórica que permita o exame dos diferentes sistemas de regras que intervêm nas atividades comerciais. Tal abordagem se faz cada vez mais necessária em face dos novos desafios enfrentados na formulação da política de comércio internacional do Brasil.

1 A NEW APPROACH TO INTERNATIONAL TRADE REGULATION

Activities related to international trade represent an increasingly significant part of the development process of Brazil. In the global scenario, the country stands out among the twenty biggest importers and exporters of goods. Domestically, the activities related to trade have been growing and, nowadays, they represent about 25% of the GDP. The presence of Brazil in the services area still has little significance, but its participation has been increasing.

Brazil's role as an actor in the international trade scenario has been growing due to a framework of accelerated development and expansion of the internal market. The Country has turned into a great exporter of value-added agricultural products, so as of a wide range of industrial products. At the same time, due to its economical and political stability, it acquired a presence of increasingly importance in several international economic forums.

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The major question being asked is how to define international trade and which elements must be included in the policy agenda for foreign trade. Nowadays, the activities related to trade aren't comprised only of exports and imports of agricultural and industrial goods, but also of a wide range of services, that include the most diverse sectors, such as financial, telecommunications, transportation, distribution, construction, tourism, as well as professional services. It is increasingly harder to separate the economical activities connected to the production of goods to the ones related to the performance of services. Even more, the expansion of economical activities depends not only on the interaction between different international actors, but it is also subject to several policies that reflect determinants of economical nature. Determinants that are broader than the ones related to pure trade, but essential to its execution, such as international and national regulations for investments, competition, intellectual property rights, concerns about the environment and climate change, labor and human rights. It is also important to highlight the role of the regulation of transnational firms' trade and its impact in global value chains. This is the global view of the governance of international trade, which has been redefined as global trade.

In today's world, political and economical conflicts are solved by a wide range of rules and regulations that are negotiated between the main international actors and, more recently, involving a large number of countries. With arduously agreed rules, the supervision mechanisms for the execution of these regulations and political-legal systems (diplomatic-legal) for dispute settlement, the stability and the predictability of the international system regulations have been allowing longer economical growth periods.

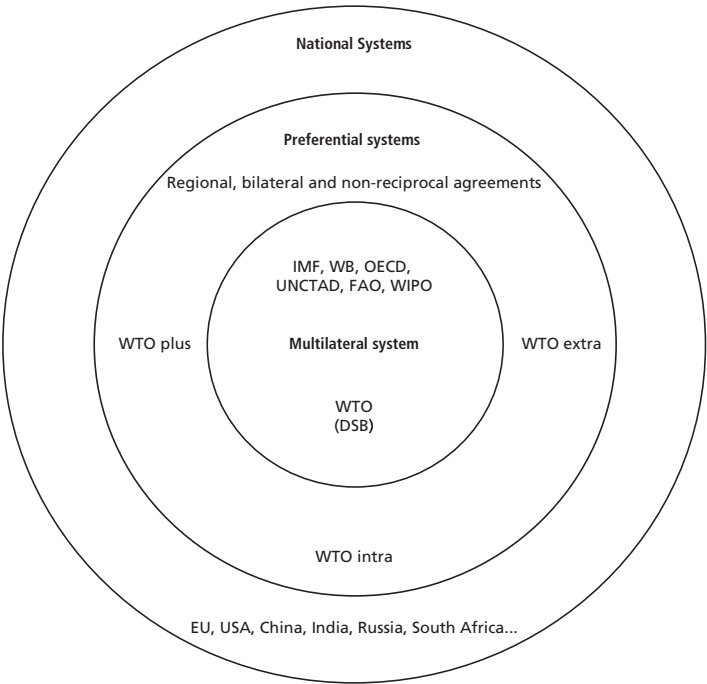
Since the 1950's and throughout the last few years, the negotiations of different regulatory frameworks for global trade have been taking place in different forums. The most comprehensive milestone, in terms of the number of parties involved and of its evolution, is the multilateral trade system, initiated with the General Agreement on Tariffs and Trade – GATT, and that now has the World Trade Organization (WTO) as reference. At the same time, over the years, there has been an increase on the expressive number of regional, bilateral and non-reciprocal regulatory frameworks, through preferential agreements, that includes countries from several regions or distant partners, but with more intense commercial interests. Ultimately, great international partners also define regulatory frameworks for trade by establishing their own policies, following and expanding the multilateral and preferential frameworks, under pressure of the main political and economical agents.

These three great regulatory systems comprehend the most diverse operating areas of global governance, related to trade or, even if they're not directly linked to trade, that end up affecting it. All these elements have direct impact in the formulation of different countries' foreign trade policy, as well in the strategic decisions of economical agents. Under this point of view, both government and sector producers begun to follow more closely the evolution of regulatory frameworks defined in the multilateral scope, so as the regulations negotiated in the preferential scopes (regional, bilateral, non-reciprocal) and certain national policies that might impact on the definition of each country's foreign trade policy and of the competitiveness in productive sectors. The analysis of the issues linked to international trade and to investments, therefore, demands a broader view, that is, a multisystem view of global trade.

To summarize it, the most relevant issues on global trade and investment field now demand not only a more comprehensive theoretical reference, but also a more integrated methodological analysis that takes into consideration the several sources of international trade regulations. Thus, the aim of this paper is to propose a new conceptual approach for the study of trade regulations – through the multisystem of global trade regulation – and a new analysis methodology for specific products or sectors – the crosssectional analysis of the global trade regulations.

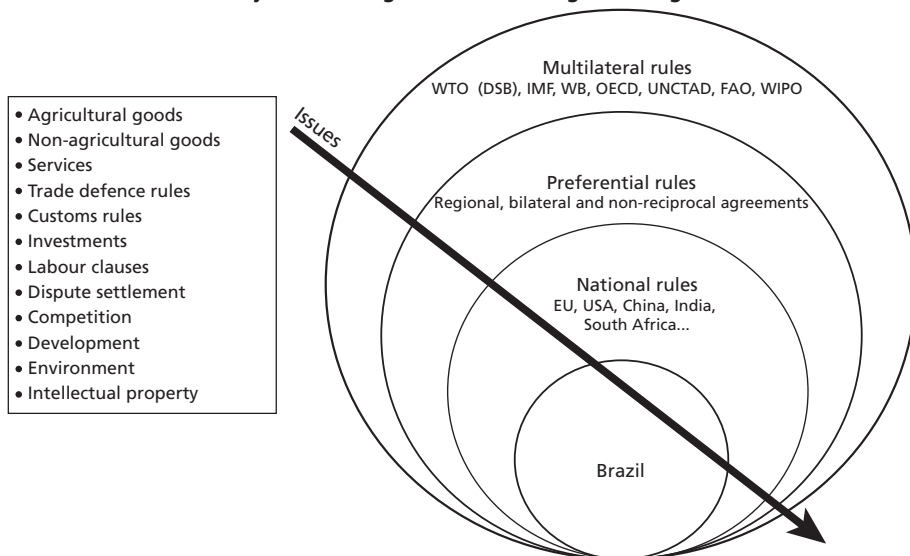
In other words, the new theoretical reference, the multisystem of global trade, must comprehend the rules of the multilateral system, including: *i)* the World Trade Organization (WTO) and other organizations and international conventions directly or indirectly related to trading, such as the International Monetary Fund (IMF), the World Bank (WB), the Organization for Economic Cooperation and Development (OECD), the United Nations (UN) and its affiliates – the United Nations Conference on Trade and Development (UNCTAD); the World Intellectual Property Organization (WIPO); the International Labour Organization (ILO); United Nations Framework Convention on Climate Change (UNFCCC) etc; *ii)* the preferential systems (regional, bilateral, non-reciprocal) centered in the most important economic poles; and *iii)* the national systems, including the trade policies, the decisive structures and the instruments of the main international trade partners instruments (picture 1).

PICTURE 1
Multisystem of the global trade regulation



The crossectional sectorial analysis, in turn, must highlight the details of the regulatory framework for each one of the main issue of international trade – agricultural, non-agricultural and services – and the specificities of the rules for each sector, such as customs rules, trade defense rules and rules against technical barriers to trade (picture 2).

PICTURE 2

Crossectional analysis of the regulation for the big issue of global trade

Only after this comprehensive analysis, countries, including Brazil, will be prepared to formulate their own trading policies, to define their trading structure and instruments and to assess the impacts of those regulations on their interests.

Given this situation, there is an increasingly necessity to create a new generation of specialists in the international trade and investment areas, integrating economics, law, administration and international relations students, as well as reformulating the post-graduation courses in the area. It would also be necessary to create new forums for discussion between the government, entrepreneurs and academics about the most pressing matters on global governance that affect international trade.

2 THE MULTISYSTEM OF GLOBAL TRADE REGULATION

An integrated view on the regulation of global trade, under this point of view, now includes not only the subsequent analysis of the different regulation systems that define international trade – including issues directly linked to trade, issues related to trade and issues that affect trade – but also, and above all, a greater understanding of the crossed effects between the several systems: *i)* the multilateral-plurilateral system, created through international negotiations between members of international organizations and/or international treaties negotiated by a significant number of countries; *ii)* the preferential systems (regional, bilateral, non-reciprocal), negotiated by the parties of trading agreements in different levels of economic integration; and

iii) all national foreign trade systems, negotiated internally by the main international partners, and defined by its foreign trade policies.

Each defining rules system comprises its own negotiation, decision making, theme comprehensiveness, supervision of implementation and conflict resolution structure.

The complexity of this regulatory framework lies on the fact that each system was created in a different period of time, reflecting different levels of influence and economic power of the several international actors, besides the interaction between the economies of each country.

2.1 THE SYSTEMS OF GLOBAL TRADE REGULATION

To give a more detailed idea of the different systems, here it follows an examination of each one of the three main regulatory structures of global trade, so that we can assess how the systems cross each other in the definition of rules that have an impact on the main issues of global trade.

The most challenging part of the global trade multisystem analysis might be the issue of the conflict of rules, since the agreements were made in different periods, involving several parties and comprehending a wide range of issues.

The expansion and proliferation of preferential agreements – accompanying the growth of importance of the issues related to trade and to non-tariff barriers present in the preferential and national scopes – intensified the possibility of conflicts between the rules present on the three levels of the multisystem of global trade. Only a deep analysis of the rules of each system will be able to provide real information on the existence and the impact of the conflicts, so as to offer solutions.

2.1.1 Multilateral and plurilateral trading system

The structure and regulations of the multilateral system represent the most comprehensive level of participation on the trade regulation. It is comprised by treaties and international conventions negotiated by a significant number of countries, that create organizations or bodies for the implementation and supervision of the negotiated rules, and determine the forum for future negotiations. Many times, they achieve an agreement with a smaller number of parties through agreements said plurilateral, that also deserve close analysis, once its implications are relevant for the parties not involved.

The most relevant organization as a source of multilateral trade regulation is the WTO, which has evolved from the GATT. Other relevant organizations, established at the same period that the GATT, were the IMF and the WB-Bretton Woods' institutions, created after World War II as the basis for a multilateral

economic system. Other relevant organizations and bodies, since its decisions impact directly on trade rules, are: WCO; WIPO and FAO, besides the organizations or bodies with different interests from developed and developing countries like OECD and UNCTAD. Among the specific bodies, we must include: ISO and Codex Alimentarius. Other treaties and conventions, because they include rules that have an impact on trading, must also be analyzed, such as: ILO; MEAs, the multilateral environmental agreements, which include trade rules; and the UNFCCC, on climate changes.

Three organizations, listed below, should be highlighted.

- WTO – The World Trade Organization: It is the main source of rules for international trade. It comprehends the GATT rules since its foundation, in 1947, until the rules of agreements approved in the Uruguay Round (1986-1994), the Marrakesh Agreement. The current negotiation round is the Doha Round, initiated in 2001 and not yet concluded, that contains important reforms to the trading system and, even though it's still not completed, it is an important indication of the content of the rules to be agreed.

The WTO's main goal is to promote the economic development through the liberalization of international trade. Its main role is to negotiate rules for international trade, assuring its fulfillment through an efficient mechanism for dispute settlement. During the GATT years, the main form of liberalization was achieved in negotiation rounds aiming tariff reductions or the elimination of tariff barriers on products. Along the years, the liberalization of trade came to involve more and more instruments that included rules on trading practices, trade barriers and trade defence. With the creation of the WTO in 1995, trade regulation comprehended a wider range of economic activities: *i*) goods (agricultural and non-agricultural), *ii*) services, through the General Agreement on Trade in Services – GATS; *iii*) intellectual property, with the Agreement on Trade-Related Aspects of Intellectual Property Rights – TRIPs); and *iv*) investments, through the Agreement on Trade-Related Investment Measures –TRIMs), the GATS and the Agreement on Subsidies and Countervailing Measures.

Still under the scope of WTO, due to its direct implications on international trade, we need to highlight the decisions of the panels and the Appellate Body (AB) of the Dispute Settlement Body (DSB). This body is a unique mechanism in the international system, since measures considered inconsistent with the rules of the multilateral trading system should be modified, otherwise they may become subject to trade retali-

ation by the winning party. This possibility gives the WTO significant power and separates it from the other international organizations that do not have such sanction power. The DSB is considered a *sui generis* system, since it applies together principles and practices from both the Civil Law and the Common Law. Thus, in spite of the decisions of panels and appeals only being applicable in case in dispute, they are transformed into jurisprudence of the system and, from then on, can guide future decision of the Dispute Settlement Body. As a result, the regulation of international trade, nowadays, is based not only in the reading of existing agreements, but also in the interpretation of the DSB decisions. The knowledge and analysis of such jurisprudence become, therefore, essential to the understanding of the multilateral regulation.

- IMF – The International Monetary Fund: one of the institutions created in 1944, after the II World War, which goals are to strengthen the international monetary cooperation and the stability of the exchange rates; to assure the financial stability through resources for the balance of the payments; to make international trade easier, to promote employment and sustainable growth; and to reduce poverty. Today it has 187 members. The IMF offers guidance and funding for members in economic trouble and for developing countries to achieve macroeconomic stability. One of its main roles is to follow-up the international monetary system, in order to assure the stability of exchange rates and to encourage the members to eliminate the exchange restrictions that affect trade. At first the system was based in the gold standard, but since the crisis in the 1970's, countries adopted different exchange policies, which make the task of supervising much more complex.

IMF stood out once again in the international scenario after the 2008 crisis, when its main members agreed not only to reinforce the resources to the fund, but also to reform its decision system, conferring more weight to developing countries.

In order to perform the follow up performed by the IMF, each member agrees to submit its economic and financial policies to the examination of the international community; commits to the adoption of policies that lead to ordered economical growth and to the price stability; avoids exchange rate manipulations that aim at obtaining unfair competition advantages; and provides economic data. The monitoring of the fund seeks to identify the problems that might cause financial and economic instability. According to what is provided in

Article IV of IMF's Articles of Agreement, the researches in the scope on the Article include the analysis, by the technical body of the fund, of the economic situation of each country, which is then discussed in the Executive Committee, for later presentation to all members. With the recent discussion about the effects of exchange rate undervaluation of important international partners like China and the US, the issue of currency wars and its impacts of "subsidization" of trade came to be examined not only by the IMF, but also by the WTO.

- WB – The World Bank: created together with the IMF, back then as the International Bank for Reconstruction and Development (IBRD), today is an institution dedicated to development and an important source of funding and technical assistance to developing countries. Its mission is to fight poverty by providing resources, knowledge, technical capacitation and incentives to partnerships between the public and private sectors. The WB Group is comprised of 187 members and, besides the bank, it also includes the International Development Association (IDA), dedicated to less developed countries; the International Finance Corporation (IFC); the Multilateral Investment Guarantee Agency (MIGA); and the International Centre for Settlement of Investment Dispute.

These five institutions provide loans for developing countries at reduced interest rates, credit without interest and donations for investments in education, health, public administration, infrastructure, financial development, agriculture, administration and natural resources.

The World Bank Group supports international trade as a platform for sustainable growth and for development through funding programs and technical assistance that aim to improve the global competitiveness of countries. These programs aim at the promotion of a global trading system that supports development, includes competitiveness in countries' strategies and that encourages reforms in trade policies and trade facilitation, in the scope of the "aid for trade".

2.1.2 Preferential trading systems (Regional, bilateral and non-reciprocal)

Together with the multilateral regulation derived from WTO, the preferential regulation created by preferential trade agreements is becoming more important. It includes regional, bilateral and non-reciprocal agreements, especially the ones centered on important trading actors, like the European Union (EU) and the US, and agreements negotiated by emerging countries like China, India, South Africa and Brazil, and also Russia, that has recently acceded to the WTO.

The knowledge of such regulation is important not only because it presents rules that go beyond the ones established by the WTO in several areas like services, intellectual property and trade-related investment measures, but also because it includes rules for areas that are still not integrated to the WTO, such as investment, competition, environment, and labor standards.

It is also important to carefully analyze the typology of the preferential agreements negotiated by relevant partners, since the expansion of the number of countries with agreements centered on a hub country end up determining regulation standards that later will be taken to multilateral instances. Moreover, when a significant number of countries follow a certain agreement model, in later negotiations the level of freedom for countries interested in integrating the group decreases.

Thus, the regulation system for preferential trade agreements includes an extensive network of regional, bilateral and non-reciprocal agreements, with an estimate by the WTO of about 400 signed agreements that, like the WTO, have the objective of promoting economic development, whether through trade liberalization, or through economic integration. Historically, the first generation of preferential agreements aimed mainly the elimination or reduction of tariffs; the second and the third (current) generations of preferential agreements, in turn, contain a wide range of rules on several aspects of international trade, having the WTO as basis, but also including areas in which the OMC still has not agreed on trade rules.

Like the generations of preferential trade agreements, the literature also evolved and multiplied. The first generation of studies, following Viner's line of thought, focused on the impacts of preferential trade agreements on the trade creation and trade diversion and their impacts on the multilateral system. The second generation developed several economic theories to identify if the preferential trade agreements were building blocs or stumbling blocs of the multilateral trade liberalization. The current generation of studies starts with these approaches, but it focuses on the real world: it analyses each one of the existing preferential trade agreements, examining its features and identifying the rules derived from the WTO and the rules that go beyond its scope, so that they can perform a compatibility analysis of them with the principles of the WTO and analyze how these new rules could be multilateral.

Among the main studies that follow this third approach, the pioneer work, developed by the IDB and the WTO Office, is called *Regional Rules in the Global Trading System*, edited by Estevadeordal, Suominen e Teh (2009). This study developed an analytical mapping of the regional and bilateral regulations in six trade topics: market access, trade defence, technical barriers, services, invest-

ments and competition. It aims at providing a wider basis for discussion and for the elaboration of policies related to the preferential trade agreements. The conclusions the study presents are important lessons: *i*) preferential trade agreements are multiplying and consolidating; *ii*) regionalism and the multilateralism are being constructed together; and *iii*) preferential trade agreements cannot be ignored by the multilateral system. More significantly, the study highlights that the preferential trade agreements can be used as a political objective, but also as an instrument for increasing multilateral liberalization.

Another relevant study is *Multilateralizing Regionalism: Challenges for the Global Trading System*, by Baldwin and Low (2009). This study caught the attention to the fact that the proliferation of preferential trade agreements is causing incoherence, costs, instability and unpredictability in the international trade relations. The basic idea of the study is that the entanglement of overlapping trade agreements will end up creating an increasing interest for the multilateralization of such agreements, which will gather to create bigger entities, getting closer to a multilateral system.

A third relevant study addresses families of agreements, especially the models of the EU and the EC. In *Beyond the WTO? An Anatomy of EU and US Preferential Trade Agreements*, by Horn, Mavroidis and Sapir (2009) identified the existing rules for these agreements, rating them as WTO plus rules (that deepen multilateral rules) and WTO extra (that are beyond multilateral rules). Afterwards, they also assessed if such rules were legally binding. The authors concluded that: *i*) the preferential trade agreements of the EU and the US chose different strategies to include rules that go beyond the WTO agreements. A fourth study is *The Rise of Bilateralism: Comparing American, European and Asian Approaches to Preferential Trade Agreements*, by Heydon and Woolcock (2009). This study questions if bilateral agreements are based in generally accepted principles – which could mean compatibility with multilateral efforts – or if such agreements establish distinct standards that would make future multilateralization harder.

This and other works consider the multiplication of the current preferential trade agreements as a clear sign that the members of the WTO are bypassing the multilateral rules, but accepting bilateral, regional or non-reciprocal rules. The problem is that these rules are including and disseminating different kinds of discipline for trade. In these agreement, there are rules already included in the WTO (WTO intra), others that are deeper than the WTO rules (WTO plus) and some out of the WTO scope (WTO extra). Considering the political impasse to complete the Doha Round, in this moment, two scenarios can be foreseen for the next future: preferential trade agreements being negotiated to reinforce rules of the WTO and to allow a general multilateralization or the opposite, to weaken

the whole multilateral regulation system, transforming the WTO into a discussion group about international trade.

The multiplication of preferential trade agreements throughout the years and the variety of regulations they include demonstrate that analyzing systematically the main existing preferential trade agreements would be interesting for the formulators of the foreign trade policy in Brazil, the main agents of foreign trade, the productive sector, and even the academics interested in the area.

2.1.3 National trading systems

Subsequently, the analysis of the regulation of global trade must examine the wide system of rules derived from the national regulatory frameworks of the main international actors, like the European Union, the United States, China, India, South Africa, Russia and other countries of interest.

This analysis should identify how the national rules internalized the multilateral and preferential rules, and also how the other policies defined by these partners can affect international trade for third parties. These rules can interfere on trade by creating obstacles to exports, as well as affecting internal production, through imports. As examples of that, we have the rules for Registration, Evaluation, Authorisation and Restriction of Chemical Substances – REACH from the EU for chemicals, the potential rules of the US and the rules already defined by the EU for trade and climate changes, or even rules in negotiation of the Anti-Counterfeiting Trade Agreement – ACTA on the protection to intellectual property.

The analysis of the national systems must include some important aspects:

- The main characteristics of the formulation of the foreign trade policy of each partner; which government bodies participate in its definition, how the private sectors articulates, how the national interests are defined;
- The main foreign trade policy instruments: tariff levels, trade defence measures, non-tariff barriers;
- Relevant elements of other policies related to trade (investment, intellectual property, and competition).
- Relevant elements of other policies related to trade (environment, labor standards, and human rights).

This analysis will allow the identification of the national regulatory framework of the most significant partners and will make it possible to examine how these countries articulate to bring the rules they consider relevant to

defend their interests to the preferential systems and the multilateral system. Moreover, this examination should proceed with the analysis of compatibility of each rule with the WTO principles and agreements and, if necessary, raise the matter in the Dispute Settlement Body of the WTO.

3 CROSSECTIONAL ANALYSIS OF THE REGULATION OF THE MAIN ISSUES OF GLOBAL TRADE

Once defined the three main systems of global trade, the next step is the cross-sectional analysis of these systems for each one of the international trade issues. That is justified because the three systems form a global trade regulatory framework that surrounds and constrains all trade activities, and it should be analyzed universally, comprehending all pertinent regulation.

The cross-sectional analysis must include not only the general principles and rules of the GATT and the WTO, such as the most favored nation clause, national treatment, transparency, but also the jurisprudence created in cases taken to the Appellate Body, since each issue or sector of global trade will have a specific application of each principle. Those issues should include the ones listed below.

Issue 1 – Agricultural goods and rules for trade in agricultural goods

Brazil has become, in the last few years, one of the most important exporters of agricultural goods of higher value-added in the world. This position allowed it to participate decisively in international forums concerning the sector, like in the WTO, in the scope of negotiations on agriculture, in FAO, for discussions on hunger, and the UNFCCC, on discussions on climate change. As a great producer of alternative energy sources, Brazil has an increasing interest in being heard in the discussions on sustainable development.

As a big exporter, Brazil is interested in following in details the negotiations and the elaboration of rules related to market access, to the quality of products and on sanitary and phytosanitary measures, which are becoming protectionist barriers in the most relevant countries to Brazilian exports.

Examples of how Brazil can successfully use the WTO dispute settlement mechanism as a supplementary form of international negotiations are the main cases of trade disputes related to agriculture, as well as the cases about sugar and cotton, that established important understandings on rules related to the agricultural sector.

Therefore, the understanding and the use of the international regulatory framework for agriculture became a priority task for the sector.

The first phase of the analysis must include the examination of the multilateral regulatory framework, beginning with the GATT rules, followed by the Agreement on Agriculture and including the main advances in negotiation of the Doha Round, as signalization of future rules. The examination should include the paradigmatic cases on agriculture taken to the Dispute Settlement Body of the WTO and the decision of the panels and the Appellate Body that have been complementing the interpretation of these agreements. The second phase should include the rules that are being negotiated by the main international actors in their regional and bilateral trade agreements, especially the ones centered on the EU, USA, China and India. The third phase must include the analysis of the regulatory framework of the main global trade actors, such as the EU, USA, China, India and South Africa. The fourth phase of the analysis, the final one, must include the impact of the national and international regulatory frameworks on Brazil and on the competitiveness of the Brazilian companies regarding the agricultural sector.

In detail, the crosssectional analysis of agricultural goods trade regulation must include:

- Multilateral rules for agricultural trade established in the main articles of the GATT – Article 1 (most favored nation), Article 2 (schedule of commitments), Article 3 (national treatment) and Articles 11 and 13 (quantitative restrictions);
- The Agreement on Agriculture of the WTO and rules on the access to markets, internal support and subsidies to exports;
- Doha Round negotiation texts that allow a good glance at the new rules to be agreed in the agricultural area;
- The main panels and decision of the Appellate Body on the subject, including the cases of cotton, sugar and chicken, brought by Brazil and considered of systemic interest;
- The Agreement on Sanitary and Phytosanitary Measures and an examination of the new trade barriers that are being created in the markets that interest Brazil, such as the US, the EU, China, India and South Africa, through technical regulations and standards for agricultural products;
- Agreements on Technical Barriers to Trade, Pre-Shipping Inspection, Rules of Origin, Imports Licensing and Government Procurement and examination of the new trade barriers that are being created in markets that interest Brazil;

- Agreements negotiated in the scope of *Codex Alimentarius* and its impact on trade;
- Regulation established by the US, the EU, China, India, South Africa and Mercosur in their main preferential agreements (regional, bilateral, non-reciprocal), with emphasis on the preferential rules of origin;
- Regulatory framework of the main actors of global trade, such as the EU, the US, China, India and South Africa; and
- An analysis of the impact of international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies of the agricultural sector.

Issue 2 – Non-agricultural goods (industrial, mineral and fishing)

Brazil is also a producer and exporter of goods with different value-added levels, such as minerals, chemicals, textile, cars and aircrafts. Differently from what takes place in the agricultural sector, in which imports are reduced, the industrial area faces strong competition from external producers, especially Chinese. So it is interesting for Brazil to know and use international rules to open markets and to defend itself from imports considered unfair.

The examination of the regulatory framework of international trade must include the GATT articles, the articles related to market access, the many agreements related to the regulation of customs activities (customs valuation, imports licensing and non-preferential rules of origin), besides rules on technical barriers, an issue that is attracting increasingly attention in the international scenario. In the following step, the analysis must focus on the preferential framework of the regional, bilateral and non-reciprocal agreements and, afterwards, on the national regulatory frameworks of the main international partners. Finally, it should include the impacts of the international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies concerning the non-agricultural sector.

The WTO rules have undergone through a significant interpretation process by the panels and Appellate Body of the Dispute Settlement Mechanism. So it is relevant to choose sensibly and to analyze cases considered to have systemic implications.

The cross-sectional analysis of the regulation of non-agricultural goods must include:

- The main articles of the GATT relevant to the industrial, mineral and fishing areas – Article 1 (most favored nation), Article 2 (schedule of commitments), Article 3 (national treatment), Article 5 (freedom of

transit), Article 7 (customs valuation), Articles 11 and 13 (quantitative restrictions);

- Texts in negotiation at the Doha Round related to market access;
- The main panels and decision of the Appellate Body of the area;
- Agreements on Technical Barriers to Trade, Pre Shipping Inspection, Rules of Origin, Imports Licensing, Government Procurement and examination of the new trade barriers that are being created in the markets that interest Brazil;
- Agreements negotiated in the scope of the International Organization for Standardization – ISO on international regulations and standards;
- Regulation established by the US, the EU, China, India, South Africa and Mercosul in their main preferential agreements, with emphasis on rules of origin;
- National regulatory frameworks of the main actors of global trade, such as the EU, the US, China, India, South Africa and Mercosul; and
- The analysis of the impact of international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies: industrial sector, mineral extraction sector and the fishing sector.

Issue 3 – Rules for trade defence: antidumping, countervailing measures and safeguards

With the growth of international trade, the interest of international partners on trade defence measures such as antidumping, countervailing duties and safeguards also increases. The detailed knowledge of those rules is becoming more and more relevant, not only as a defense instrument in case of damage to the national industry, but also in cases in which they are used against Brazilian exports.

Trade defence issues are getting special attention from panels and the WTO Appellate Body. A significant number of cases decided at the DSB refer to the trade defence area. Thus it is relevant to choose sensibly the most relevant cases, as well as to promote a deep analysis. Among them, special attention should be conferred to the cases referring to the method of zeroing used in the definition of dumping, in which the AB has been deciding against several practices by US.

A special examination must be done on the issue of subsidies and its different modalities, such as forbidden subsidies or subsidies subject to countervailing measures. The examination of the decisions of panels and of the Appellate Body of WTO will allow more detailed understanding of the practices of other international

partners that were considered incompatible with the WTO rules, and that needed to be discontinued, or that may be subject to countervailing rights. That knowledge can be interesting for the formulation of several international trade, industrial and development policies, as well as trade defence. Special attention should be given to cases about aircrafts (large and medium-sized).

With the international crisis of 2008, several countries started to subsidize their industrial activity, which certainly will affect the export activities. The examination of international rules on subsidies will allow Brazil to be prepared to sue those countries if these subsidies start to affect exports for markets in which it has interest.

The crosssectional analysis of the regulation of trade defence rules must include:

- The main articles of GATT that are relevant to the commercial defense area: Article 6 (antidumping and countervailing measures), Article 16 (subsidies) and Article 19 (safeguards);
- Agreements on Antidumping, Subsidies and Countervailing Measures, and Safeguards from the WTO;
- Texts in negotiation at the Doha Round about antidumping and subsidies agreements;
- The main panels and decision of the Appellate Body of the area, including the case of aircrafts between Brazil and Canada, and between the US and the EU, considered cases with systemic implications;
- The regulation established by the US and the EU in their main preferential agreements (inclusion by the US of a clause on zeroing in anti-dumping);
- National regulatory frameworks of the main actors of global trade, such as the EU, the US, China, India and South Africa; and
- An analysis of the impact of international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies.

Issue 4 – Services

The activities related to the international trade of services has grown faster than the trade in goods and has represented an increasing share of the trade balance of the major international partners. The international regulatory framework of the area is more recent than the goods' one and was only included in the multilateral system with the Uruguay Round. However, the liberalization of the sector has accelerated autonomously, by pressure of the domestic demand of technological advances.

Sectors such as financial, telecommunications, tourism, transportation, civil construction, professional services, quick delivery, among others, have been occupying, with their activities, an increasingly share of international trade, which creates a special need for knowledge of the international regulation on that area.

The following modes of provision of services are relevant to the analysis: *i)* crossborder supply; *ii)* consumption abroad; *iii)* commercial presence; and *iv)* presence of natural person. For each form, countries have negotiated segments in different manners, specifying conditions for its liberalization. Since the service movement is not controlled in the borders, but through domestic regulations, the examination of the service trade becomes much more complex than the goods trade examination.

The decisions of panels and the Appellate Body of the area is less dense but important cases were still taken to the DSB in the telecommunication and internet games areas.

The liberalization of many service segments is being done quickly, outside the context of the WTO, in the scope of the preferential agreements (regional, bilateral and non-reciprocal) centered mainly in the EU and the US. So it is relevant to make a detailed analysis of the agreements of these two blocs, but also on countries that interest Brazil, like China, India, Indonesia and South Africa, besides the Protocol on Services of Mercosul.

The crosssectional analysis of the service regulation must include:

- The agreement on services (GATS) from the WTO;
- Texts in negotiation on the new liberalization concessions offered at the Doha Round;
- The main panels and decisions of the Appellate Body of the area, including the telecommunication case between Mexico and the US and the case on gambling between Barbuda and the US;
- The regulation established by the US, the EU, China, India and South Africa on their main preferential agreements and examination of the liberalization proposals offered in these agreements;
- National regulatory frameworks of the main actors of global trading, such as the EU, the US, China, India and South Africa;
- An analysis of the impact of international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies in the services area.

Issue 5 – Issue related to trade: intellectual property

The intellectual property area has been playing an important role in international trade, both for the trade of the product of the knowledge itself, under the exploration of patents, and the protection of knowledge (brands, patents, author rights, design, etc) through international trade. At the WTO, the area is regulated through the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs).

A sensitive segment is the one referring the commercialization of drugs and the traffic of such inputs, that were treated specially on the Ministerial Decisions of the WTO on Public Health and TRIPs (2001). Recent cases brought to the Dispute Settlement Body allowed panels and the Appellate Body to decide important matters related to the TRIPs.

Like in the services area, the great international partners have been trying to establish a more dense regulation than the one determined by the TRIPs through preferential trade agreements. Thus, it is relevant to make a more detailed examination of the main partners of Brazil.

The crosssectional analysis of the intellectual property regulation must include:

- The main agreements on the regulatory framework of intellectual property: author's rights, brands, patents, design, confidential information, among others;
- Agreement on the Trade-Related Aspects of Intellectual Property Rights of the WTO;
- Texts in negotiation on the register of alcoholic beverages, traditional knowledge, geographic indication and biodiversity on the Doha Round;
- The main panels and decisions of the Appellate Body of the area, including the case on intellectual property between the US and China;
- The regulation established by the US and the EU in their main preferential agreement, which already include extensive regulation on intellectual property, besides the WTO framework.
- An examination of the preferential agreements of other partners, such as, China, India, South Africa and Mercosul partners;
- National regulatory frameworks of the main global trade actors, such as the EU, the US, China India and South Africa; and
- The analysis of the impact of international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies.

Issue 6 – Trade-related issues: investments

The international regulatory framework of the investment area is complex and scattered, because the many attempts to create a multilateral regulation for the area failed, such as it was the case of the negotiations on the scope of the OECD (Multilateral Agreement on Investment – MAI) and the WTO (Multilateral Framework on Investment – MFI). With the increasing internationalization of companies in Brazil, detailed knowledge of the international regulation on the area is increasingly urgent.

The international partners have been producing a significant typology for the agreements on investment, including a wide range of rules on: non-discrimination; national treatment; transparency; investment protection; and solution of investor conflicts against the State. That variety can be noticed in over 2,500 agreements that were put into inventory by the UNCTAD.

The regulations on investment related to trade are another relevant issue, since they determine the prohibition of incentives based in the performance of exports and in the use of local content. Those rules were negotiated at the WTO, in the Agreement on Trade-Related Investment Measures (TRIMs). However, many international partners have been expanding the prohibition list, when negotiating their preferential agreement, to include the prohibition of demands on the transfer of technology, the formation of joint-ventures or national capital shares, or limits on the number of foreign labor. It is relevant to make a more detailed examination of the agreements centered on the EU and the US, as well as partners that interest Brazil, like India, China and South Africa, and also the Mercosul partners.

The crosssectional analysis of the regulation on investment must include:

- Agreements of the WTO related to investment, such as the Agreement on Trade-Related Investment Measures (TRIMs), the General Agreement on Trade in Services (GATS – Mode 3) and the Agreement on Subsidies (Parts 1 to 4);
- Texts in negotiation on the Agreement of Subsidies of the Doha Round;
- The main panels and decisions of the Appellate Body on the subject;
- Text for negotiation (MAI) in the scope of the OECD;
- Text for negotiation in the scope of the Doha Round of the WTO, that was lately removed from the round;
- Bilateral investment agreements of the main international partners;
- Analysis of the regulation established by the US and the EU in their

main preferential agreements (inclusion by the US of clauses on investment beyond the TRIMs framework of the WTO);

- Investment agreements of the main partners of Brazil;
- National regulatory frameworks of the main actors of global trade, such as the EU, the US, China, India, South Africa and the Mercosul; and
- An analysis of the impact of international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies.

Issue 7 – Trade-related issues: competition

The regulatory framework on the area of competition is also complex and is scattered through different international agreements. Despite already being part of the national regulations of most countries, the attempts to create a multilateral framework ended up failing. The OECD has a committee on the issue and, besides doing researches, it aims at the discussion of national practices and to propose cooperation measures.

Also in the scope of the WTO, the issue was included in the Doha mandate. The negotiations progressed, but ended up being excluded from the negotiator mandate. The most interested countries created their own analysis mechanisms of national and cooperation between parties' practices, through review mechanisms, such as the International Competition Network.

The issues that have been object of discussion are related to clauses of non-discrimination, national treatment, transparency, prohibition of harmful cartels and settlement of conflicts.

However, with the expansion of the transnational activities of companies, the development of a national regulation on competition by several countries created conflicting rules, once the criteria of operation of those rules are distinct (case of fusions and purchases that are accepted in the US, but not in the EU, and vice-versa).

It is also relevant to do an examination of the clauses negotiated by the main international partners in the scope of their regional agreements.

With the greater presence of Brazilian companies abroad, the detailed knowledge of the regulation on the area of competition also deserves special attention.

The crosssectional analysis of competition must include:

- Understanding of the OECD in the area of competition defense;
- Negotiation texts on the issues of competition related to trade in the scope of the Doha Round;

- The main panels and decision of the Appellate Body of the area;
- The implications of the commercial defense measures for the area of competition defense;
- The regulation established by the US and the EU, as well as by the main partners of Brazil in their main preferential agreements;
- National regulatory frameworks of the main actors of global trade, such as, the EU, the US, China, India and South Africa; and
- The analysis of the impact of international and national regulatory framework on Brazil and on the competitiveness of Brazilian companies.

Issue 8 – Areas that affect international trade: environment and climate change

The regulatory framework on the area of environment and on climate change is also significantly fragmented. There are over 200 agreements on the environment, and about 20 of them have specific clauses on trade, covering diverse issues, such as the protection of endangered species, the prohibition of the use of substances that affect the ozone layer, even the trade of nuclear waste. With global warming, the US and the EU are creating rules on carbon emission that affect not only internal trade, but also imports, impacting international trade.

However, since neither the environment nor the climate are parts of the trade regulatory framework, the issue became subject to the dispute settlement mechanism of the WTO. The matter is being considered on the DSB, and a series of rules has been established, based on the Article 20 of GATT, that addresses general exceptions and allows restrictions to imports in cases of threat to the health and life of people, animals and plants, or to the preservation of exhaustible natural resources (air, water or endangered species). With the attention of customers, that are increasingly more sensitive to those issues, it is important to follow the development of the rules referring to these areas.

Another aspect of the matter is the one related to the multiplication of national and regional standards, public or private, that intend to inform customers about specific aspects of the product or its production, about the use of green stamps, carbon emission stamps and stamps with the origin of each ingredient. If, on the one hand, those stamps make it easier to sell certain assets, on the other hand, the uncontrolled proliferation of those stamps can turn into an important trade barrier.

The cross-sectional analysis of the regulation of environment and climate change must include:

- The main articles of the GATT that are relevant to the environment and climate change area; Article 1 (non-discrimination of nations); Article 2 (schedules of commitment), Article 3 (national treatment), Article 20 (general exceptions);
- The agreement on sanitary and phytosanitary measures of the WTO and examination of the precaution principle;
- The agreement on technical barriers to trade of the WTO and examination of the matter of labeling and the product processing method (PPM);
- Agreements about the environment with trade clauses;
- Agreements about climate change and its implications on trade (UN-FCCC, Kyoto Protocol, Copenhagen Protocol, Cancun Agreement);
- The main panels and decisions of the Appellate Body of the area, including the cases of tuna fish, shrimps and retreated tyres;
- The regulation established by the US, the EU and partners that interest Brazil in their main regional agreements (inclusion of specific clauses about environment and climate);
- National regulatory frameworks of the main global trade actors , such as the EU, the US, China, India and South Africa; and
- The analysis of the impact of international and national regulatory frameworks on Brazil and on the competitiveness of Brazilian companies.

Issue 9 – Areas that affect international trade: labor standards, human rights and cultural diversity

The expansion and the deepening of the labor rights and human rights area in the international scenario bring to the conclusion that these factors will soon end up affecting international trade. In the context of labor, the international regulation is determined by the International Labor Organization (ILO), that has been approving several conventions referring to the discrimination of gender, freedom to organize unions and the right to strike, prohibition of children labour, equal pay for equal work, among other. The US and the EU have been including those conventions in their preferential agreements, especially the ones with developing countries.

Brazil, that until recently had no interest in negotiating rules in this area, currently is more open, due to the advance of imports of countries that do not respect labour rights.

On the WTO, Article 20 of the GATT already determines that nothing can be built to stop the adoption of measures related to the imports of goods produced with the work of prisoners. Now it is only a matter of knowing how the clause could be interpreted and used in the context of international trade. The possibility of using the concept of public order or Article 20 to stop imports of products that have violated, in its production, labour or human rights standards can also be raised.

More recently, with the consolidation of the Human Rights Board in the scope of UN and the recognized efficiency of trade to make rules on the environment operational, it is only a matter of time before a country evokes a clause on labor or human rights to justify restriction measures to imports from another country.

In the cultural area, Unesco approved, in 2005, the Convention on the Protection and the Promotion of the Diversity of Cultural Expressions. This Convention affects international trade directly by establishing rules on the trade of goods, services and people linked to cultural production. Besides craftwork goods, these rules affect directly the production of movies, CDs and DVDs, and the live musical production (special visas are provided for musicians and producers). Those areas must also receive attention, since Brazil is becoming a producer and an exporter in this segment.

The crosssectional analysis of the regulation of labor standards, human rights and cultural diversity must include:

- Conventions of the ILO that have commercial implications;
- Conventions on human rights that have commercial implications;
- The main articles of GATT that are relevant to the labor rights defense area;
- The main panels and decision of the Appellate Body that can show possible routes of action for the inclusion of those areas in the WTO;
- Regulation established by the US and the EU in their main regional agreements (inclusion of a clause on labor rights and cultural diversity);
- National regulatory frameworks of the main actors of global trade, such as the EU, the US, China, India and South Africa; and
- An analysis of the impact of international and national regulatory frameworks on Brazil and the competitiveness of Brazilian companies.

4 CONCLUSION

The theoretical reference of the multisystem of global trade and the methodology of the crosssectional analysis of global trade, proposed here for studying the regulation of international trade, can be summarized in some items, presented below.

1. The object of analysis should not focus only in the concept of foreign trade or international trade. More than direct exporting and importing activities, trading activities are related to broader issues, such as intellectual property, investment and competition. Moreover, trade is affected by regulations created for different issues, such as labor standards, human rights, cultural diversity, environment and climate change. The issue of floating exchange rate, that had until now been “forbidden” in the trading area, in the crisis of 2008, started having a definite space in the discussion about trade policies. With today’s reality, the concept of international trade must be expanded to comprise a broader concept – global trade.

2. The study of the regulation of global trade, to unravel all its implications, cannot be a privileged domain of only one area of knowledge, whether it is economy or administration, law or international relations. The real understanding of its details demands a new approach, a multidisciplinary approach, in which economists and administrators do not get lost in the hermetic language of the laws, but understand the legal logics and the rules for interpreting treaties; and, in turn, lawyers, attorney and internationalists will not feel frightened when facing a mathematical equation, but will understand the meaning of the cross elasticity and the results of simulations of general and partial equilibrium models. Not only the legal implications of regulations should be examined, but also their economical impact and the effect on the competitiveness of the production sectors.

3. The apprehension of the complexity of the issue demands a new theoretical, multisystemic reference, in which each one of the different regulation levels is explained and analyzed in detail, since it reveals different intensity of rules. Each regulation system reflects particular interests of each one of the actors that negotiated it. The actual complexity of the different regulatory frameworks is revealed when the analyst understands, step by step and incrementally, the interaction of rules in its different systems. This is the theoretical basis of the methodology proposed here. The regulation of global trade is actually a regulation multisystem that comprehends the multilateral, preferential and national levels.

4. The analysis of the global trade regulation also demands a step beyond, whatever it is, to leave what is general to enter the specific; start from the agreement rules and apply them to real sectors. In other words, leave the agreements on agriculture and reach the implication of the rules for the meat, soy, orange and

ethanol sectors. Leave the agreements for textiles and reach the rules of origin for towels and T-shirts, from the dumping agreements to the trade defence of footwear, from the agreements on subsidies to automobiles and aircrafts. But in these cases, the analysis of each sector demands a crosssectional approach, leaving the multilateral and embracing the preferential, and from that to national, sector by sector or product by product.

Summarizing, the analysis of the regulation of global trade presents a great challenge in order to be done. It demands the construction of an extensive database for the regulations of different systems, as well as the different sectors which are interesting. Moreover, it demands the creating of a complete base and data of the international trading flows, country by country and its main products, which would allow the economic analysis of the implications of the rules negotiated. Only with the examination of rules and numbers an analyst can be prepared to assess its actual implications for the foreign trade policies of a country and its effects on the competitiveness of the production sectors.

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LESSONS IN MACROECONOMIC POLICY FOR DEVELOPMENT, IN LIGHT OF EXPERIENCES OVER THE LAST DECADE*

Roberto Frenkel**

ABSTRACT

During the 2000s, economic policies proved to be important lessons for developing countries. Its role was crucial to promote growth, financial stability and strong performance in face of external, real and financial shocks. This importance was confirmed by developing countries in the 2000s, which have adapted to innovations in macroeconomic policies, leading to acceleration of its growth and changed its international situation. These countries have been less hit by the effects of financial crises and enjoyed greater degree of freedom to have acyclic policies, however countries that retained their prevailing policies of the 1990s in Latin America, have suffered severe consequences of crises, from which did not recover.

RESUMO

Durante os anos 2000 as políticas econômicas se mostraram lições importantes para os países em desenvolvimento. Seu papel crucial foi o de impulsionar o crescimento, a estabilidade financeira e um desempenho vigoroso frente aos choques externos, internos e financeiros. Essa importância foi confirmada pelos países em desenvolvimento que nos anos 2000 se adaptaram às inovações nas políticas macroeconômicas, levando à aceleração de seu crescimento e modificou a sua situação internacional. Estes países foram menos golpeados pelos efeitos financeiros das crises e desfrutaram de maior grau de liberdade para dispor de políticas acíclicas, em contrapartida os países que mantiveram suas políticas predominantes dos anos 1990 na América Latina, sofreram graves consequências das crises, das quais não se recuperaram.

1 INTRODUCTION

One can get important lessons on economic policy contrasting the experience of developing countries during the years 2000, including their performance during the recent financial crisis, with the three previous decades of financial globalization.

The most important lesson that can be derived from this contrast is the crucial role of the macroeconomic policies for stimulating growth, financial stability, and a robust performance against real and financial external shocks. Furthermore, the contrast can be distilled into a set of orientations of macroeconomic policy that contribute to reach the simultaneous fulfillment of the three aforementioned objectives.

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This work is dedicated to the development of this lesson and the identifying of the mentioned policy orientations. In the second part we synthetically expose the said orientations and discuss some aspects of their instrumentation, particularly of the monetary and exchange rate policies.

A synthesis of the first part says that a significant number of the developing countries adopted innovative macroeconomic policies in the years 2000. This induced an acceleration of their growth and modified their international situation. These changes not only favored the economies that adopted the new policies but also all the developing countries, through two channels. On the real side, through the drag effect that the acceleration of the economies which adopted the new policies on the rest of the developing countries, including in this channel the improvement in the terms of trade experienced by many of these economies. On the financial side, through the beneficial effect that the changes in the policies and their results had on the relations between the international financial system and the group of developing countries.

The beneficial global effects on the set of developing economies operated in the years 2000 on the period previous to the financial crisis, and also during its first phase, between mid-2007 and the collapse that followed the collapse of the Lehman Brothers.

In the following phase, when the crisis struck full on the developing economies, the effects were mixed. Those economies that had adopted the new macroeconomic configurations were less hit by the financial effects and enjoyed greater degrees of freedom to implement anticyclical policies. On the other hand, the developing economies that had maintained their international financial insertion marked by macroeconomic policies similar to those that predominated in Latin America during the 1990s (for example, the economies in center and eastern Europe) suffered the worst consequences of the crisis, of which they have not yet recovered.

The first part of the work is presented in two sections. In section 1 we expose three notable favorable changes in the behavior of the developing economies in the 2000 decade, in comparison with the behavior shown during the three previous decades. The first change is that after 2001 no external and financial crises occurred, while these had been growingly frequent and intense in the previous period. The second change that we point out is the dissipation of the segmentation in which the emerging market economies were found in the international financial system built by globalization. The third change refers to the acceleration of growth in the years 2000 with respect to the three previous decades and the greater resilience shown by the developing economies against the external shocks originated by the recent crisis.

In section 2 we sought a joint explanation of the aforementioned changes. We indicate that these are associated with the adoption of novel macroeconomic policies by a significant number of developing economies: the adoption of floating exchange rate regimes and the practice of exchange rate policies tending to preserve competitive real exchange rates or to avoid great appreciations; the accumulation of voluminous international reserves and the change in sign of the results of current accounts of an important set of these economies, that passed from deficit to surplus, whose aggregated effect is the inversion of the direction of the flows of capital that had ruled in the three previous decades.

The second part of the work is presented in section 3. Heading this section is a synthetic exposition of the new orientations of macroeconomic policy and forthwith we discuss some aspects of the implementation of the exchange rate, monetary and fiscal policies.

Closing the work, section 4 brings the final considerations.

2 THE FAVORABLE CHANGES IN THE 2000 DECADE

2.1 Crisis in the developing countries¹

In the first thirty years of the financial globalization period, since the early seventies until the beginning of the XXI century, the financial and exchange rate crises in the emerging market economies became more frequent and intense. In contrast, after 2001 there were no new crises in the emerging market economies despite occurring in the period several episodes of economic turbulence with contagion effects. Strikingly, the crisis in the United States did not spark a financial crisis in any emerging market economy. In this section, we will characterize the crises of the emerging market economies in the first three decades of financial globalization.

Since the outbreak of the subprime mortgages crisis in the United States, there have been some reactions criticizing the dominant paradigm and a budding revalorization of the contributions of those scholars that address the issue of financial crisis as a general subject. The contribution of Minsky seems to have caught special attention.

The fact that analysts and observers of the financial markets have rescued Minsky's ideas from the intellectual exile that they were condemned is not surprising. The conditions that provoked and contributed to the development of the current

1. This point is based on Frenkel and Rapetti (2009).

financial crisis clearly reproduced Minsky's model for economic crises.² In it the crises are always preceded by a period of economic and financial boom. During the boom phase, the optimistic expectations about the future are generalized, trust is incremented, and the perception of risk is diminished. In this context, the agents assume risk positions and the system becomes increasingly fragile. Reaching a certain point, some event draws the attention of the agents to the high degree of risk exposure existent in the system. Thus, a period of difficulty starts. In response to the perception of a higher risk, most of agents modify their portfolios in favor of safer and more liquid assets. The excess of demand for liquidity and low risk assets end up popping the bubble, which results in a massive loss of wealth. In this recessive phase, pessimistic expectations prevail. As in the previous phase, where the effects of positive feedback predominated, in this stage the negative effects stand out. The deflationary developments in the financial markets make most of the agents notice that their liquidity being restricted or their assets being directly located in a state of insolvency; in either of these cases, their relative decisions to spend are adversely affected. Private consumption decreases and investments collapse. What started as a contraction of the financial sector reaches the whole economy. In short, the financial crisis leads to a systemic crisis.

The factors that triggered the cycle in the recent financial crisis of the USA (and other developed countries) are essentially endogenous. This is a key point in the theory of the financial systems of Minsky: the bubbles and the innovations that develop in the boom stages are a natural and spontaneous consequence of the evolution of the financial system.

The real estate bubble and the financial innovations that originated with the securitization of mortgages (and other debts) constituted in the basic ingredients of the boom phase of the Minskyan cycle in the recent crisis. Both the bubble in real estate prices and the financial innovations are processes that developed in the housing and financial markets, and were feeding off each other during a long period. There is no doubt that there were also external elements that influenced both processes: there are discussions, which probably will last for a long time, on the role of financial deregulation, the lax monetary policy and foreign capital inflow to the US, as factors that stimulated these processes. However, although some of these factors may have been relevant, the comparison with the crises in the emerging market economies reveals a crucial difference between the endogenous dynamics of the cycle in the United States and the exogenous character of

2. Minsky's works on the financial crises and their relation with macroeconomics are numerous. Minsky (1975) presents a critical analysis on the neoclassic assimilation of Keynes' contribution and the relevance of the finances by Keynes' standards. A synthesis of his model for financial crises is found in Minsky (1977). The most brilliant and mature exposition of his thoughts is found in Minsky (1986). Kindleberger (1977) offers an extensive historic panorama of the crises analyzed by Minsky's standards.

the elements that sparked the boom phase of the crises in the emerging countries, as will be discussed shortly.

Most of the crises in the emerging countries took place in Latin America. In effect, since the beginning of the 1970s the region started to participate in the financial globalization wave and, since then, suffered numerous crises. Other developing countries were later incorporated into the financial globalization process, during the first years of the 1990 decade and, together with Latin-American countries, became known as “emerging market economies”. The crises in some of these economies, as those of the five counties in Eastern Asia, Russia, and Turkey, are added to the long list of crises in developing countries.

Minsky’s model has inspired numerous studies on the financial crises of the developing countries³. In the second half of the 1970s, Argentina and Chile were immersed in the Minskyan boom and recession cycles that generated systemic financial crises that erupted close to one year before their respective balance of payments and exchange rate crises (1980 in Argentina and 1981 in Chile). Similar Minskyan cycles were also observed in the Mexico and Argentina crisis of 1995, Eastern Asia in 1997-1998, Russia in 1998, Brazil in 1999, and Argentina and Turkey in 2001. In all of these episodes, the crises were preceded by long boom periods which created price bubbles in asset prices and financial intermediation in a context of increasingly risky behavior. The analysis of all the episodes shows that the crises were not a result of unsustainable financial policies, external shocks, or behaviors that involved high moral hazard due to implicit or explicit government guarantees. On the contrary, they were result of a growing financial fragility, due to the confluence of a greater appetite for risk by the private sector and a lax regulation of the financial market during the boom phase (Taylor, 1998).

The financial crisis of the US and the ones that hit the emerging economies are similar in their dynamics of Minskyan characteristics. There is, however, a crucial difference that lies in the factors that initiated the boom phase of the Minskyan cycle. In the case of the emerging market economies, the financial innovations and the bubbles that developed in the boom phase are consequence of the implementation of new rules of macroeconomic policy, including the opening of the capital account, which generate a profitable environment for the financial arbitrage between foreign and local assets.

This conclusion emerges from the comparative analysis of the crises in the emerging economies (Frenkel, 2003). The analysis, in effect, shows a series of common characteristics. In first place, the conditions that sparked the boom phase are originated by relatively drastic changes in the macroeconomic policies. In

3. A seminal model of financial crises in developing countries, as a Minskyan legacy, is found in Frenkel (1983).

general, the liberalization of the local financial market and the capital account are combined with some rule for the predetermination of the nominal exchange rate (as the fixed parities or the exchange rate “tablitas”). The implementation of new macroeconomic rules may be seen as an exogenous shock on the financial system, which generates incentives for the arbitration between external and domestic assets and induces inflows of capital that triggers the booms. In second place, in all the cases, the international capital movements played a fundamental role both in the boom and in the recession. Lastly, the laxness of the local financial market regulations is observed. This can occur due to the recent liberalization or to a too great expansion of the financial activity during the boom phase, which exceeds the existing regulatory capacity. In synthesis, the onset of the Minskyan cycle in the economies of the developing countries has an important exogenous component. The capital inflows and outflows play a significant role in multiplying the financial forces that push the cycle. The conditions that gave place to the crisis in the emerging market economies in the first decades of financial globalization changed in the 2000s, as will be explained in section 2.

2.2 Financial traps and segmented international financial integration

The emerging market countries were integrated into the international financial system in a segmented manner and several of them tended to fall into financial traps (Frenkel, 2008a). The international contagion and the herd behavior of investors are characteristic aspects of this segmentation. The segmentation tended to fade in the years 2000.

In the first three decades of the financial globalization of the emerging market countries that followed paths leading to the accumulation of large foreign debts tended to fall into financial traps that result in crisis in almost all cases. Argentina during the period of 1998-2001 is a clear example of this situation. But a country that falls into a financial trap of high debt and high risk premium can find itself stuck in this situation even if it has already experienced and overcome an external and exchange rate crisis. Brazil, for example, after suffering an external and exchange rate crisis in 1998, corrected the main characteristics of its previous macroeconomic policy. But these changes did not alter the financial heritage from its previous trajectory, in a way that the Brazilian economy remained caught in a financial trap until the beginning of the 2000s. Later, Brazil found a noncritical way out of this situation mainly through the generation of surpluses in its current account, as mentioned in section 2.

The financial traps are the result of two main connections between the economy and the international financial market. The first is determined by the great volume of financing needs. The refinancing of debt maturities and the financing of high structural deficit in the current account constitute in the main link in the relation

between the country and the international financial market. This situation is highly vulnerable to contagion effects or any other source of volatility. It is also more prone to self-fulfilling prophecies. The market evaluates this situation imposing high risk premiums and the country loses a large degree of its economic policy freedom, because of the urgency imposed by the need for international financing to issue favorable signs to the eyes of the market.

The second connection results from the effect on the interest rates. A high country risk premium makes foreign financing more costly, contributing to worsen the foreign debt ratios. On the other hand, the sum of the international rate plus the country risk premium determines the floor of the local real interest rate. The integration of the emerging market with the international financial market results in a segmented integration, in which the international interest rate that the country is facing and the local interest rate are significantly higher than the rates in the developed countries. The high interest rates have negative effects on growth and on the internal and external financial fragility.

In the late-nineties, the phenomenon of segmented integration was evident for the highly indebted countries, like Argentina and Brazil. However, other developing countries, whose policies managed to avoid accumulating high foreign debts, also experienced a segmented integration. After having participated in the process of financial globalization during a long period (almost three decades in the case of Latin America), the financial assets of these economies constituted in a "class" whose returns included a considerable country risk premium. These risk premiums had reached their minimum in 1997, just before the Thai devaluation. But after the Asian and Russian crises, the risk premiums rose and remained elevated until the beginning of the years 2000s.

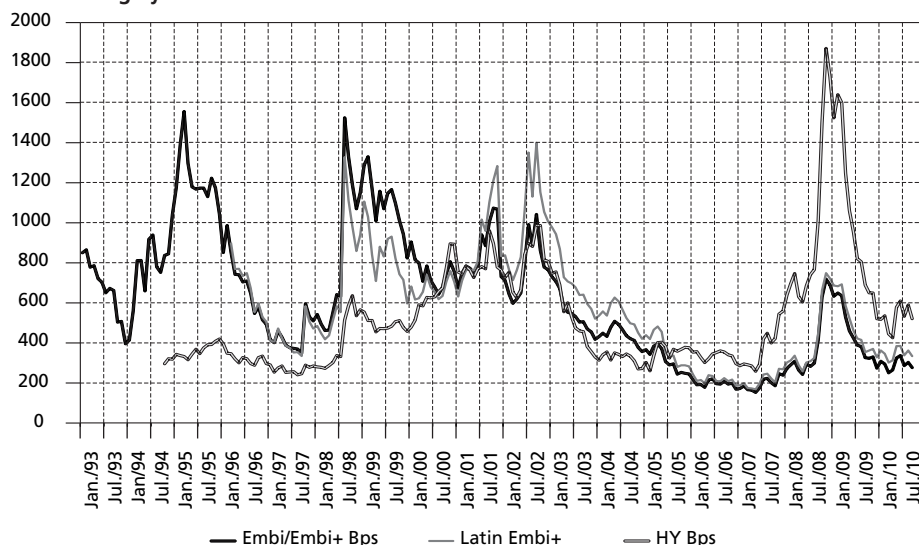
Persistently high country risk premiums were an unexpected result of financial globalization. Since its first steps, the advocates of financial globalization presented complete integration of the local financial system and the international system as the ideal state to which the process would converge. The complete integration implies in a global intermediation system in which the return of the savers' assets, on the one hand, and the capital cost for the debtors, on the other, become the same for the economically equivalent transactions, independent from the geographical location of savers and investors. The convergence of the globalization process towards complete integration would have meant in the persistent reduction of the country risk premiums. It did not happen like this until the early 2000s.

In the beginning of the XXI century it seemed difficult to find exits for the countries that found themselves in financial traps or, more generally, established an international context capable of avoiding the segmentation of developing economies, without an important effort of international cooperation. However,

the segmentation of the emerging market economies tended to fade later in the years 2000s, but this did not originate in an (nonexistent) improvement in international cooperation, but in the changes in policies and balance of payment results of a significant number of emerging market economies, as argued in section 2.

GRAPH 1

Risk premium of emerging market economies, of the emergent of Latin America and of high yield bonds of the United States



Source: US high yield bonds, data from the Merrill Lynch US High-Yield Master II (H0A0) index; sovereign bonds of emerging market economies and the emergent of Latin America, EMBI+ index of JP Morgan (EMBI until November 1997 and EMBI+ since December 1997).

Effectively, the country risk premiums of the developing economies followed a downward trajectory since early 2003 and by mid-2005 they fell under the registered minimum during the period previous to the Asian crisis. In early 2007, the average risk premium reached its historic low in a level that was significantly inferior to the one observed before the Asian crisis and also significantly inferior to the spread of the high yield bonds of the United States. The country risk premiums tended to elevate since mid-2007, but still, before the collapse of Lehman Brothers, the risk premium of the emerging market economies were similar to the levels that predominated during the best moments of the period previous to the Asian crisis. On the other hand, the financial contagion of the collapse that followed the bankruptcy of Lehman Brothers was brief and in 2009 many of the developing countries recovered their access to international credit at relatively low interest rates.

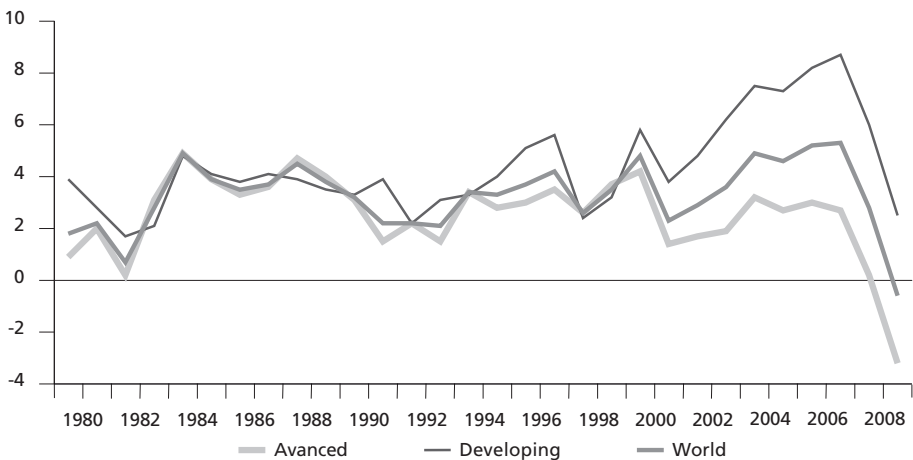
2.3 Acceleration of growth and resistance against external shocks in the 2000s

In the years 2000s took place a notable acceleration of the growth of developing countries. Furthermore, these countries showed a new resilience to real and financial external shocks caused by the recent global crisis.

In the eighties and in the nineties the cycles of the advanced countries and those of the developing countries were highly correlated and the average rates of growth of both groups were roughly speaking similar. For example, during the period of 1992-2001, the advanced countries grew at an annual rate of 2.8% while the developing countries grew at an average annual rate of 3.8%. As it may be noticed in the following graph, the difference in favor of the average growth rate of the developing countries during this period is explained by a relatively faster growth of these economies between the Mexican crisis and the Asian and Russian crises, but the crises of 1997-98 had a relatively greater contractive effect on the developing economies, so that the rates of both groups of countries tended to balance out again in the late 1990s.

GRAPH 2

Annual growth rates of the world, the developing economies and the advanced economies



Source: elaborated with data from the IMF World Economic Outlook, October 2010.

During the years 2000s the cyclical correlation between the two groups of countries persists, but during this period, for the first time since the beginning of the financial globalization, the developing countries (and also the subset of the economies of Latin America) grew at systematically more elevated rates than the advanced economies. Between 2002 and 2008 the average annual growth rate of the developing countries was 6.7%, while the advanced economies grew an average

of 2.1% per year. During the period there was a substantial acceleration of the growth of the developing economies in comparison to the previous decades, and also a significant departure of their rates in relation to the rhythm of growth of the advanced economies.

On the other hand, it is also notable the novel resistance shown by the developing economies in facing the impacts of the global crisis. This was synthetically illustrated observing the behaviors of the levels of activity in 2009, the calendar year in which the recessive effects of the crisis were concentrated. During this year the advanced countries fell 3.2% while the developing countries grew an average of 2.5%.

Nevertheless, the performance of the developing economies in 2009 by regions shows great heterogeneity. On the one hand we find the catastrophic behavior of the economies of center and eastern Europe, where almost all of the countries suffered recessions and an average contraction of 3.6%. On the opposite side, solely a small number of developing Asian economies experienced recessions and the region grew an average of 6.9%. In Africa and Latin America and in the Caribbean the national performance were more heterogeneous.

No country was free of the external recessive impacts of the contraction in international trade (Griffith Jones and Ocampo, 2009). Effectively, no country can isolate itself from the recessive effects of the contraction of its exports. These effects are specific to each country and depend on their particular commercial insertion. The decline of international trade was the main mechanism of transmission of the recessive effects to developing countries. An important channel for some countries was the drop in remittances of workers that emigrated to developed countries, notably in Central America and Mexico, for example. These effects also are specific to each country and independent of their national policies.

Another channel for transmission of the recessive effects is the financial. This played a role of secondary importance in many developing economies. Beyond the relatively brief impact of the collapse that followed the bankruptcy of Lehman Brothers, in an important number of countries there has been a decoupling of the financial contagion effects of the recent crisis. The phenomenon contrasts vividly with the important effects that had the financial contagion of the Asian and Russian crises on the emerging market economies.

Our hypothesis is that, besides the specific recessive impacts through the real transmission channels in each developing economy, the resistance to the crisis is directly linked to the macroeconomic policies applied in the previous years and their reflections in the greater or lesser fragility to face external shocks.

These policies and results were, on the one hand, the determinant factor for the decoupling of financial contagion and also, on the other hand, of the possibilities of implementing anticyclical policies.

To test this hypothesis we carried out a econometric study with a sample composed of 48 developing countries⁴ and 30 advanced countries, focusing on the performance of the GDP in 2009. The regression shown below is one of the results of this study. It is a regression on the sample of 48 developing economies whose dependent variable is the growth rate of the GDP in 2009 (REALGDP2009).

The independent variables are the rate of growth exports in 2009, (CAIDA-EXPO09), the short term external debt/output ratio at the end of 2007 (DEUD-ACORTOGDP2007), the average of the ratio current account/output in the 2005-2007 period (CTACTE20052007), the international reserves/output ratio at the end of 2007 (RESERVASGDP2007), and the average growth rate in the period previous to the crisis 2005-2007 (REALGDP20052007).

In the sample of developing countries (48 countries) the GDP in 2009 contracted an average of 1.9% and the decline in exports was of 21.3%. The sample includes 12 countries⁵ that had Stand-by agreements with the IMF between July 2008 and November 2009. In this group, the average contraction of GDP in 2009 was of 5.6% while the exports contracted an average of 24.1%. In the remaining group of 36 countries that did not have an agreement with the IMF, the GDP had an average contraction of 0.7% and the exports contracted an average of 20.4%. In the estimation that is shown as follows, the reserves/output ratio is equalized to zero in the case of the 12 countries with agreement with the IMF.

The following table shows the results. In the estimation, the variation of the GDP in 2009 as well as the independent variables are expressed in percentages, so that the regression coefficients have a direct interpretation.

4. The countries included are: Argentina, Armenia, Azerbaijan, Bangladesh, Belarus, Brazil, Bulgaria, Chile, China, Colombia, Costa Rica, Croatia, Cyprus, Dominican Republic, Ecuador, Egypt, El Salvador, Estonia, Georgia, Guatemala, Honduras, Hungary, Indonesia, Jordan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Malaysia, Malta, Mexico, Moldova, Mongolia, Morocco, Nicaragua, Panama, Paraguay, Peru, Romania, Russia, South Africa, Tanzania, Thailand, Tunisia, Turkey, Ukraine, Uruguay, Vietnam.

5. The countries of the sample with a Stand-by agreement are: Armenia, Belarus, Costa Rica, Dominican Republic, El Salvador, Georgia, Guatemala, Hungary, Latvia, Mongolia, Romania, Ukraine.

TABLE 1
Dependent variable: REALGDP2009
Method: M.C.O.

Variable	Coef.	Standard error	t-Statistic	Prob.
CAIDAEXPOS09	0.230666	0.070028	3.293899	0.0020
DEUDACORTOGDP2007	-0.180065	0.075302	-2.391245	0.0213
CTACTE20052007	0.227194	0.104493	2.174249	0.0354
RESERVASGDP2007*(1-DUMIMF)	0.101975	0.045814	2.225826	0.0314
REALGDP20052007	0.527259	0.211063	2.498112	0.0165
C	-0.276486	1.997482	-0.138417	0.8906
R-squared	0.479726	Average Dependen. var.		-1.910417
R-squared adjusted	0.417788	E. S. dependen. var.		6.159519
E. S. of regression	4.699886	F-statistic		7.745329
Resid. sum squared	927.7349	Prob (F-statistic)		0.000031

Obs.: number of observations: 48.

As may be seen, all of the coefficients are highly significant (under 4%) and the constant is undistinguishable from zero. The independent variables explain 48% of the variation of the GDP rates in 2009.

As was expected, the coefficient of the export rates in 2009 is positive. The coefficient indicates a contractive effect of 0.23% for each percentage point of decline in exports. With an average contraction of 21.3% in the sample, the fall in exports implies an average decline of 4.9% of the product.

The coefficient of the external short term debt/output ratio is negative (- 0.18) and of an important magnitude. The coefficient of the average r of the current account/output ratio in the 2005-2007 trienium is positive (0.23) and its magnitude is similar to the coefficient that measures the impact of the decline in exports in 2009. We will discuss such results further on.

The coefficient for the growth trend in the period previous to the beginning of the crisis (0.53) is positive and of an important magnitude.

Lastly, the coefficient of the international reserves/output ratio at the end of 2007 ratio is positive (0.10). As indicated before, in the estimation presented we equalize to zero the ratio of the international reserves/output ratio of the countries that signed Stand-by agreements with the IMF, under the hypothesis that they should have requested these programs for insufficiency of international liquidity. We have already mentioned that all the countries that signed Stand-by agreements experienced in 2009 an average contraction of the GDP greater than the rest of the countries in the sample. Thus, the significance of the coefficient of the reserves ratio in the shown estimation may be a result of a greater contraction of the GDP, caused by factors diverse to the availability of reserves, of the economies that

signed agreements with the IMF. Effectively, the coefficient of the reserves ratio loses significance if the IMF agreements are not taken into account and neither is significant if the estimation is made on the subsample of countries that did not sign these agreements. On the other hand, if we exclude the reserves variable and include a dummy variable for the countries that signed agreements with the IMF in the estimation of the equation, the coefficient of the dummy has significant results at 8%, and a value of -3 . That is, controlling for the rest of the variables, excluded the reserves, the countries with IMF agreements contracted an average of three percentage points more than the rest of the sample. We will comment this point further on.

When we run the regression on the set of advanced and developing countries in the study, the decline in exports in 2009 is the only variable with a significant coefficient. In contrast, in the sample of developing economies, all the variables included in the regression show significant influence, together with the decline in exports, on the differential impact of the external shock on the level of activity in 2009. The results of the regression indicate that, controlling for the respective declines in exports, in 2009 the countries that grew the most (or that decreased less) were those developing countries that were experiencing greater growth rates before the crisis, the ones that had smaller short term debts before the crisis, the ones that showed greater results of current account in the period previous to the crisis, and those that had greater availability of reserves (or that did not have to require IMF support).

At first it is presumable that the differential effect of the external financial shocks generated by the crisis⁶ are correlated with the degree of dependence of the previous performance of the economy to the capital inflows. Aggregate indicators of this dependency are the situation of the current account, the magnitude of the financing needs of the public and private sectors, the proportion of foreign capital in the financing of the banks, firms and government, and the magnitude of available international reserves. But these data not only indicate the sensibility of the workings of the economy to a sudden stop, but also the degrees of freedom of the economic policies to pursue compensatory actions.⁷

In light of the criterion of dependency from the capital inflows, the coefficient of the short term external debt /output ratio has a direct interpretation. A smaller short term external debt implies a smaller capacity of the sudden stop of generating illiquidity situations with recessive impacts. It is worth mentioning

6. The magnitude of the external finance shock on the developing economies, measured through various indicators, was similar to the shock caused by the Asian crises. But its duration was briefer in this opportunity.

7. For example, this criterion separates well the Asian and the Latin American emerging market economies, on the one hand, the central and Eastern Europe economies, plus Turkey and others of recent international financial insertion, whose dependency on capital income is similar to what Latin America had in the nineties (Ocampo, 2009).

that the total external debt/output ratio has less significant results than that of the short term debt.

Beyond the neat greater recession of the countries that signed agreements with the IMF, it is worth saying that are not well identified the differential effects of a greater or lesser availability of reserves on the level of activity, in the presence of other independent variables. A possible cause is that many of the countries in the sample have voluminous reserves, so that their different magnitudes have not differentially affected the levels of activity through the various functions served by the availability of reserves. Indeed, the role of the reserves in facing a sudden stop is to avoid default, which has not occurred in any of the cases (it can be conjectured that there would have been default events in some of the economies that signed agreements with the IMF if they had not received this support). The availability of reserves allows to provide liquidity in international currency to private or public debtors that find themselves forced to cancel their international debts in a sudden stop, but does not avoid the recessive effects of these cancellations if these foreign debts are not totally refinanced in local currency by the local finance system or by the government. This explains the significance of the coefficient of external short term debt, despite the existence of abundant external reserves. On the other hand, part of the countries in the sample have floating exchange rate regimes and gave way to the devaluation of their currencies when facing the external shock. A function of the reserves in these cases is to allow official intervention in the exchange rate market to control the magnitude of the devaluation. Neither does this function depend on the differential magnitude of available reserves, when exist in general sufficient reserves to intervene.

To interpret the coefficient of the average of the current account/output ratio during the period of 2005-2007 it is useful to express the result of the current account with the following identity:

$$(SP - IP) + (SG - IG) = CC$$

Where SP and IP indicate private savings and investments and SG and IG indicate government savings and investment. The first two terms of the first part of the identity are, respectively, the financial surplus of the private sector and the financial surplus of the government. A positive result of the current account means that the aggregate economy is increasing its stock of net foreign assets (or reducing its net foreign debt) and consequently indicates a relatively smaller dependency on external financing to provide the resources in international currency needed for the normal movement of the economy. On the other hand, expressed as shown above, a positive current account result is an indirect indicator of surplus situations of the private sector, of the government, or of both sectors, and consequently, as indicator of a smaller chance of a sudden stop to induce illiquidity situations

with recessive effects. Therefore, the result of the current account of the balance of payment is also an indirect indicator for the local financial ability to financing expansive policies in face of negative external shocks.

The role played by the current account results for the period of 2005-2007 in the resistance facing the impacts of the recent crisis is consistent with various studies, with data from previous periods, on the relation between the results of current account and growth, as indicated in section 3.

3 THE NEW MACROECONOMIC POLICIES AND THEIR RESULTS

3.1 Factors of the not occurrence of crisis in developing economies and of the fading of the financial segmentation

After the Asian crises two important innovations were registered in a great number of developing economies. The first innovation was the change of the exchange rate regimes⁸. In the new context, the flexibility is the characteristic shared by the exchange rate regimes of most of these economies.

Traditionally it is understood by flexibility that the exchange rate is determined by the international currency market without intervention from the monetary authority. But in the present context of the developing countries, flexibility also denotes that the monetary authority retains the right to intervene in this market. It is generally understood that in a pure floating exchange rate regime the monetary authority has a commitment with regard the determination of exchange rate. But the pure floating regime is not the one of minimum commitment, since in it the authority assumes the commitment of non-intervention. In contrast, in the current system of many developing countries there is no commitment of non-intervention and the monetary authority intervenes at its discretion.

An advantage of this regime is its preventive role, since it cannot be victim of speculative attacks. The regime combines the advantages of the floating exchange rate regime with the degree of liberty of the monetary authority to react before the changes in the local and international contexts, and adjust the behavior of the exchange rate and the monetary policy to the necessities of the economic policy. In practice, if not *de jure*, in the recent experience of most of the emerging market economies it is found this type of exchange rate regime, that is generally denominated as “managed float” (Williamson, 2000 y Bofinger and Wollmerhäuser, 2003).

Along with the movement of the exchange rate regimes towards a greater flexibility, another innovation of great importance in the financial globalization

8. In Frenkel and Rapetti (2010b) present an analysis on the evolution of Exchange rate regimes in Latin America.

process has been the reversion of the direction of net capital flows, which started to move from the developing countries to the advanced economies.⁹

Many of the emerging market economies that had been integrated into the international system as receivers of capital inflows to finance deficits in current accounts, started in the beginning of the years 2000 to generate surplus in current accounts – or to reduce significantly their previous deficits – and to persistently accumulate international reserves.

Effectively, in a set of 29 emerging market economies¹⁰ only four had surpluses in current accounts in 1997. In the same set, the number of countries with surplus in current accounts was 14 in 2001, 18 in 2004, and 14 in 2006. In this set of countries, the ratio between the aggregated amount of the surpluses and the absolute value of the aggregated amount of the deficits was 0.35 in 1997; 1.40 in 2001; 3.93 in 2004 and 4.64 in 2006. Excluding China, the aforementioned ratio was 0.04 in 1997; 1.13 in 2001; 2.73 in 2004 and 2.15 in 2006.

There was a complete turnaround of the conditions in which these countries integrated the international financial system. From receptors of foreign savings they became exporters of savings and intermediaries of international capital flows. This modified their position in the international finance system.

Surpluses in current accounts and the availability of voluminous international reserves are indicators of external strength, since they indicate a low probability that the country will find difficulties in honoring its foreign commitments. Furthermore, as indicated above, the surpluses in current accounts are also indicators of financial strength of the domestic agents. These indicators are used by the international investors in their portfolio decisions. On the other hand, empirical research also shows that they are good forecasters of the probability of the balance of payments crises (for example, Kaminsky, Lizondo and Reinhart, 1998). Consequently, it is not hard to explain why the perceived risk and the country risk premiums declined in the national cases with current accounts surpluses.

But the emergence of a significant number of surplus countries had benefic effects on the countries where the current account deficits persisted and on the relation between the set of developing countries and the international financial

9. In the eighties there was also a period in which the capital net movements were from the low risk countries to the high risk ones. But this was a transitory consequence of the external adjustment of the Latin American countries after the debt crisis. In the course of the renegotiations of the default debt, which extended from 1982 and 1990, there was practically no external voluntary private financing and many of the countries generated surplus in current accounts to serve some proportion of the interests.

10. The set includes 24 of the 25 countries included in the Emerging Markets index developed by MSCI Barra (Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Thailand and Turkey), to which were added Bulgaria, Ecuador, Panama, Ukraine and Venezuela.

system. A lesser number of countries with deficits, in a context where many of the emerging market economies show surpluses, reduced the work of contagion and herd behavior and, consequently, reduced also the perceived risk of the countries with deficits. The “class” of emerging market assets is more heterogeneous and many of these assets correspond to robust economies. This configuration benefited the perception of risk of the countries with deficits and that of all the class of emerging market assets.

To finish this topic, a brief discussion of the national Latin-American cases can illustrate different manners in which the aforementioned changes in the international conditions contributed to find solutions to the harsh restrictions in place in the early 2000s. At this time, as mentioned in section 1, Argentina and Brazil were caught in financial high debt and high country risk premiums traps

In the case of Brazil, the strong improvement in the current account was the key factor that enabled the country to leave the financial trap in which it was stuck in since the last third of the 1990s. The improvement reduced the external financial fragility and contributed to the reduction of the country risk premium, operating in conjunction with the reduction of the average premium of the emerging market countries that was happening simultaneously. The following decline of the international interest rates faced by the country allowed the deceleration of the growth of foreign and public debts and the improvement of their sustainability prospects. In short, the transition from deficits in current account to surplus lead the financial behavior of the economy to a virtuous cycle replacing the vicious cycle set by the financial trap.

The restructuring of the Argentinian debt represents the case of a country that benefited from the appearance of a set of emerging market economies with surplus in current accounts. The default of the foreign debt took place in December 2001, before the changes in the conditions of the international financial market. At the start of 2003 the government launched an initiative of a debt swap that implies the haircut of 75% on the nominal value of the original debt. The swap was completed in 2005 with an adhesion of 76%. The success of the restructuring was surprising, considering the volume of the debt in default and the magnitude of the haircut; they were the historic maximum in both cases. It is clear that the new financial conditions contributed to the end result. The swap took place when the risk premiums of the emerging market countries were falling, making the financial offer attractive, whereas a few months earlier, with the risk premiums higher for the emerging market countries, it would have been considered unacceptable.

3.2 The acceleration of growth

Until now we discussed that the innovations in the exchange rate regimes, the emergence of surplus in current accounts (or the reduction of previous deficits), and the accumulation of reserves positively affected the behavior of the developing economies, generating a context where new crises did not emerge and the perceived risks and the risk premiums of the countries were reduced. In what follows the focus of the argument is on the acceleration of growth experienced in the 2000s.

The role played by the positive results in current accounts and the accumulation of reserves is not limited to the financial level. A series of comparative international studies suggests that these variables are key factors in the explanation for the accelerated growth in the developing economies. These empirical works show that current accounts and international reserves are positively correlated with growth. For example, the influential work by Prasad, Rajan and Subramanian (2007) has demonstrated the positive correlation between the results of current accounts and growth in the non-industrialized countries during the period of 1970-2004. Similar results were obtained by Bosworth and Collins (1999) and UNCTAD (2008). On the other hand, the positive correlation between accumulated reserves and growth was documented by Polterovich and Popov (2002) and Levi Yeyati and Sturzenegger (2007), among others.

Even when the positive correlation between these variables seems a well-documented empirical fact, the mechanism through which the surpluses in current accounts and the accumulation of reserves favor growth is not obvious. A possible mechanism is related to the financial channels discussed in the previous point and is explained below. The international financing of the developing economies was volatile and subject to sudden stops. These features tend to negatively affect the growth in at least two ways. The massive exits of capital can generate an external crisis with persistent effects on the economic structure and consequently reduce the long term growth rate (Stiglitz, 2000). On the other hand, even if crises are avoided, the volatility of capital flow can negatively affect investment decisions and growth. Consequently, the surpluses of current accounts (or smaller deficits) and the accumulation of reserves may have contributed to growth by reducing the volatility and the probability for crisis. These are plausible arguments. In fact, the aforementioned work by Prasad, Rajan and Subramanian (2007) demonstrates that one of the reasons for which the countries who grew more were the countries who used less external savings resides is the fact that they did not experience a crisis. However, this study also indicates that the association between current accounts and growth does not derive exclusively from the inexistence of a crisis in surplus economies, because the correlation is also verified on the sub-periods of the past in which there was no crisis in any developing economy. This last result suggests that the current account and the accumulation of reserves effects on growth did

not operate exclusively through the reduction of volatility and the probability of crisis. A hypothesis that has gained a growing number of followers in recent times is that the surplus of current accounts and the accumulation of reserves influence growth because they are associated with competitive real exchange rates (RER). We discuss this question further on, but previously we can extract a conclusion of what was already exposed.

In light of the aforementioned empirical evidence, the period between 2002-2008 – with numerous developing countries exhibiting current account surpluses, financial strength and accelerated growth – can be seen as the amplification of a historic pattern. In the years 2000, a greater number of countries than in the past have followed trajectories with surplus current accounts and higher growth rates. In some cases, these results were induced by policies explicitly oriented to stimulate growth through the preservation of competitive RER, which generated at the same time higher growth rates, surplus in current accounts and accumulation of reserves. In other cases the results were mainly consequence of international factors that were exogenous to the economic policies of these countries (for example, the drag through trade of the other developing economies with accelerated growth, low international interest rates, quick expansion of the United States, high prices of the commodities). However, even in the cases in which the results cannot be attributed mainly to national policies, the authorities aimed to enhance external strength and moderate the appreciations of the currency through the accumulation of reserves. In consequence, the trajectories followed by numerous developing countries in the years 2000 can be seen as a confirmation *a posteriori* of the policy lessons implied in the aforementioned empirical studies.

We turn our attention now to the role of the competitive RER. There exists an ample consensus on that the primary motivation of the surpluses in current accounts and the accumulation of reserves is the willingness of the countries to maintain competitive RER, or at least, to avoid appreciations. Results of the aforementioned empirical studies corroborate that the surplus in current accounts and the accumulation of reserves are highly correlated with competitive RER (depreciated) (see, for example Prasad, Rajan and Subramanian, 2007). Is also a consensus on the hypothesis that the surpluses in current accounts and the accumulation of reserves affect growth because they are associated with competitive RERs. Several empiric studies provide substantial support to this hypothesis.

Razin and Collins (1999) earlier showed that competitive RER (depreciated) was associated with higher growth rates with a sample of 93 countries during the period of 1975-1992. The work of Aguirre and Calderon (2005) finds that moderately depreciated RER positively affect growth. A recent work by Rodrik (2008) uses data panel for 184 countries during the period of 1950-2004 and also

finds that the two variables are positively correlated. Rodrik also finds that the competitive RER is associated with the growth of industrial activity, and that the expansion of this sector is significantly correlated with aggregated economic activity. This result suggests that the effects of the RER operate (at least partially) through the expansion of the industrial activities. The result is also important because it is free from the inverse causation problem, because at the level of the firm, the RER can be considered exogenous, which cannot be assumed in the aggregated cross-sectional studies. With a similar objective, a study by Eichengreen (2007) with a sample of 28 industries, in 40 emerging market economies, during the period of 1985-2003, finds that depreciated RER are positively correlated with the growth of industrial employment. Other empirical studies which obtained similar results on the relation between competitive RER (depreciated) and growth are Bhalla (2008), Gala (2007), Hausman, Pritchett and Rodrik (2005), and Prasad, Rajan and Subramanian (2007).

The works mentioned up to this point suggest that the new international insertion of numerous developing economies, with surplus in current accounts and accumulation of reserves, accelerates growth not only by reducing volatility and the risk of crisis, but mainly because of how it affects the real exchange rate. This seems to be a widely shared idea. On the other hand, the channels through which the RER affects growth is the reason for greater dispute. On a macroeconomic level, the academic debate is articulated around two visions: the one which conceives that the restrictions to growth are found in the supply and the other that places the restrictions on the demand.¹¹

Those who conceive that the growth of developing economies is mainly restricted by demand are inspired by a Keynesian point of view. Under such perspective, the effective demand is the main motor behind growth in the economies with unemployed or sub-employed workers. With this perspective, a stylized explanation of the operation channels of the RER-growth relation is the following.

In an open economy, a competitive RER induces the rise in demand and the production of exports and substitutes for imports. The resulting increase in production generates an additional increase in demand, output, employment, and income. Higher levels of output, through the accelerator, induces higher investments and growth. Additionally, the acceleration of growth in the aggregated demand and output has a positive feedback effect on the growth of labor productivity (denominated on occasion as the “Kaldor-Verdoorn Law”) (Frenkel and Taylor, 2007). Lastly, in a Keynesian framework it is not difficult to demonstrate that a

11. We have no space here for a more detailed presentation of this debate. A revision of the debate on the transmission channels of the RER to growth is found in Frenkel and Rapetti (2010a).

more depreciated RER leads to higher investment and savings rates, along with an improvement of the current account.¹²

The Keynesian interpretation of the RER-growth relation can be completed with an element of the structuralist view. In a closed economy the source for the increase in aggregated demand is not as important as in an open economy. The distinction is well known in the developing economies, where growth has been repeatedly restricted by the insufficient offer of foreign resources. This is a crucial aspect of the competitive RER policy: the increase in aggregated demand is obtained simultaneously with the relaxation of external restrictions. The promoters of export-led growth, with John Williamson (Williamson 2003 and 2008) as a notable example, have pointed out for some time the importance of a competitive RER as a crucial ingredient of a development strategy that seeks to avoid external restrictions (as used to be called) on growth.

The Keynesian-structuralist framework provides an explanation that fits well with the stylized facts showed by the economies that practice competitive RER policies, but among those who recognize the positive association between RER and growth there are different views, so that the debate on the transmission channels is open.

We conclude by pointing that there is robust evidence that suggests that the preservation of a competitive RER is the key mechanism through which surplus in current accounts and the accumulation of reserves push growth. But the operation channels of the RER-growth relation are not clearly identified and it is probable that they vary in different countries. This question demands more research, and so does the implementation of competitive RER policies, as will be discussed in section 3.

4 THE NEW DIRECTIONS OF MACROECONOMIC POLICY AND ITS IMPLEMENTATION

As an introduction to this section, we present a list of the components of the new macroeconomic configurations.¹³ We define them by observing the implementation of the new policies in a number of important developing economies. They are stylized formulations that intent to collect the best practices (in our opinion) of each one of the exposed orientations. In the set of countries where the new configurations are found there is much diversity, not only because there are differences in practices, but also because the developing economies are heterogeneous in multiple dimensions. The orientations are the following ones:

12. In a neoclassical framework, surplus of current accounts is a consequence of the savings rate which overlaps the investment rate. In a Keynesian framework, a competitive RER that influences in greater investment by the mentioned mechanisms causes an increase of the savings rate that finances investment and the surplus in current accounts.

13. Amar Bhattacharya suggested denominating this set of orientations as "the new fundamentals for macroeconomic policy in developing countries".

- 1) A managed floating exchange rate regime that combines the flexibility of the nominal exchange rate with discretionary interventions of the monetary authority in the international currency market.
- 2) The preservation of a competitive trend in the real exchange rate level and to avoid strong appreciations in the short run.
- 3) Surplus as a tendency and transitory moderate deficits in the current account of the balance of payments.
- 4) Accumulation of considerable international reserves.
- 5) An active monetary policy facilitated by the sterilization of the official interventions in the exchange market and the inexistence of fiscal dominance and exercised in coordination with fiscal policy. Eventually, the implementation of capital controls is necessary to simultaneously achieve i) and v).
- 6) Balanced tendency in the fiscal accounts results and moderate fiscal deficits.

The subset of orientations *i)* through *iv)* focuses on promoting growth and employment, the strength of external accounts, and the prevention in the facing of real and financial external shocks. The two following orientations are more traditional, although there are new aspects in formulating the monetary and fiscal policies. The focus of the component *v)* is the control of aggregated demand and inflation and, as indicated, the monetary policy should be coordinated with the short term fiscal policies. The component *vi)* is the long term orientation of fiscal policy. This orientation focusses on facilitating in the short term anti-cyclical fiscal policies (the control of aggregated demand and inflation in the boom phases and the fiscal stimuli in the contraction phases) and preventing the accumulation of important public debts.

In the following we discuss different aspects and problems of the implementation of the policy orientations listed above.

4.1 Exercising exchange rate policy

In a context of a free exchange rate market, the Central Bank (CB) intervenes with discretion with the purpose of preserving a competitive and stable trend of the RER. The attribute of the goal's stability does not refer to the short term, but aims at longer terms. Its objective is to influence private expectations of stability of the competitive RER and reduce uncertainty in the periods relevant to the employment decisions and investment in existing or new tradable activities. In particular, persistent tendencies in the exchange market inducing appreciation expectations in the long term should be avoided. This is important for two rea-

sons. Firstly, to avoid that self-confirmed bubbles make more costly – in terms of monetary expansion – the buying interventions of the CB. Secondly, because the effects of the appreciation and depreciation of the RER are not symmetrical. Investment in tradable activities is largely irreversible, in such a way that in this sector there are motivations to bestow a great weight to the appreciation risk. For this reason, beyond the signals provided by the interventions in the market, the CB and the government should endeavor, without compromising quantitative goals or rules, in signaling the stability of the tendency of RER as a strategic objective of economic policy.

On the other hand, the nominal exchange rate should float in the short term. The uncertainty of the future nominal exchange rate discourages the speculative capital movements. This is one of the advantages of floating, together with protecting reserves from a speculative attack.

In consequence, the CB interventions are marked by the aforementioned conflictive demands. The monetary authority should avoid that positive or negative tendencies expectations are formed in the RER and, on the other hand, the exchange rate should float. The fluctuation range should be sufficiently wide to discourage short term capital movements and straight enough to induce stability expectations of the real RER.

The exchange rate market is an asset market. The buying and selling decisions are largely determined by expectations of future prices. If BC interventions and signals stabilize these expectations around the RER policy goal – given fiscal and monetary policies consistent with stability – the very market forces tend to stabilize the price trajectory, fewer interventions are required and they are less costly. For this reason, the CB interventions should be strong, in the sense of providing a clear sign of the monetary authority's will.

4.2 The coordination of the macroeconomic policies

The adoption of a RER goal should be part of a wider scheme that includes the fiscal and monetary policies consistent with this guideline. The monetary, fiscal and exchange rate policies are interconnected and should be coherently designed and implemented. For this reason, the adoption of the exchange rate objective should be conceived as a component of the regime for macroeconomic policy, capacitated to pursue multiple and conflictive objectives in a coherent way. This regimen simultaneously pursues objectives of growth, employment, activity level and inflation. The competitive and stable RER is an intermediate target of the regime, as can a certain interest rate be for monetary policy or a determined result for fiscal policy.

The aforementioned regime characteristics make essential to coordinate macroeconomic policies in a governmental instance with high power of analysis and

decision. It could be sustained that the coordination in conducting the policies would be advantageous under any regime¹⁴. But in this regime, coordination is imperative, because the three macroeconomic policies – exchange rate, monetary and fiscal – are active and complementarily concur in achieving the objectives. Since there is conflict among the objectives, the complementarity of the policies should be guaranteed by the established coordination of a single driving source.

4.3 Competitive RER and the inflationary pressure

A unique feature of a stable and competitive RER macroeconomic regime maintains lit a powerful motor for expanding aggregated demand and employment. It is precisely through these effects on the demand for tradable goods from local production, on the demand for investment and on the demand for employment that the regime induces the growth stimuli for production and employment. For the same reason, this establishes a permanent element of inflationary pressure that does not exists in other policy regimes.

The expansionary impulse on aggregated demand established by a competitive exchange rate is difficult to specify and to quantify. As indicated in section 2, the transmission channels are not clearly identified and may differ between countries. Furthermore, the effects of a competitive RER in the same country can change through time as per its cyclical situation. Consequently, the competitive RER is relatively rustic instrument, not apt to being managed with fine-tuning. Furthermore, signaling stability of the RER trend is a crucial objective of exchange rate policy, in such a way that even though the necessary knowledge for using the RER as an instrument for control of aggregated demand would be available, the variability of the RER would conflict with the main objective of the policy.

The regime of a competitive and stable RER differs from other policy context in this crucial aspect: in this regime the RER establishes a permanent expansionary impulse on demand. This unique characteristic of the regime imposes also particular features on the policies that accompany the exchange rate policy: the presence of a permanent expansive impulse emphasizes the brake role that monetary and fiscal policies should play in specific moments. In general, the fiscal and monetary macroeconomic policies focus on the control of aggregated demand and can play expansionary or contractive roles. The same is true in a competitive RER context. But in this regime the RER permanently pressures on the throttle of the vehicle. Since there is a permanent pressure on the accelerator, the anti-inflationary pressure rests exclusively on the braking role of the fiscal and monetary policies.

14. Although there are those who argue that it is best to segment the objectives and attribute exclusive responsibility for one of them for a specific institution. For example, an independent Central Bank that is exclusively responsible for inflation. Obviously, we do not agree with this idea.

These considerations lead macroeconomist to an unexplored territory. Certainly there is little discussion and experience with respect to the role of fiscal policy as a breaking mechanism for the expansion of aggregated demand. The regime of competitive RER is relatively new and macroeconomic policy found itself obligated to make its path on the way. Its instrumentation requires creativity and constant monitoring of data of the economy and of the consistency of exchange rate, monetary and fiscal policies.

4.4 Exercising an active monetary policy

At this point, we will analyze the question of monetary autonomy, that is, we ask ourselves if in a competitive RER regime (or more broadly, in a context where the CB aims to avoid appreciation and for this makes buying interventions in the exchange rate market) the economy counts with sufficient autonomy to exercise monetary policy. Our conclusion is that the sterilization generally allows sufficient monetary autonomy for exercising an active monetary policy.

The main theoretic objection that has been made to the policy of intervening in the exchange market supports that this leads to the loss of monetary autonomy. The criticism is based on the widespread trilemma of an economy open to the capital movements. The trilemma postulates that the CB cannot control simultaneously the exchange rate and the interest rates in a context of free mobility. The trilemma is false in specific circumstances and consequently is false as a general characterization of open economies.

The condition that allows for the control of the exchange rate and the simultaneous preservations of the monetary autonomy is the existence of excess supply of international currency at the exchange rate targeted by the CB. In this context, the monetary authority can determine the exchange rate by buying the excess of supply in the exchange market, and can control the interest rate by sterilizing the monetary effect of this intervention by issuing Treasury bills or CB bill in the monetary market. The CB has two available instruments to achieve its two objectives: the intervention in the exchange rate market to fixate the exchange rate and the intervention in the monetary market to determine the interest rate.

A simple explanation of the exposed is the following. The excess supply of foreign currency, at the exchange rate by the CB and the prevailing interest rate, implies an excess demand for domestic assets. The completely sterilized intervention can be imagined as a policy implemented in two steps. In the first step, the CB's intervention in the exchange market generates an expansion of the monetary base. The resulting situation would show a greater stock of monetary base, an unaltered stock of domestic assets, and a smaller interest rate than the initial. In the second step, the complete sterilization would totally compensate the change in the private

portfolio that took place in the first step. The CB absorbs the increment in the monetary base and issues an amount of domestic assets equivalent to the initial excess demand for domestic assets (the excess of foreign currency supply) returning the domestic interest rate to its previous level (Bofinger and Wollmerhäuser, 2003).

We underline that the condition that invalidates the trilemma and enables the CB to determine simultaneously the exchange rate and interest rate is a situation of excess supply of foreign currency when the exchange rate is in the level targeted by the CB. We believe that this idea is not very disseminated because the literature that discusses the monetary autonomy and the exchange rate regimes and policies rarely treat conditions of excess supply and in vast majority is focused on situations of balance of payments deficit. But the maintenance of a competitive RER (depreciated), for its effects on the current and capital accounts generally tends to produce the conditions that invalidate the trilemma and enable a certain degree of monetary autonomy.

In explaining the sterilization operation exposed above, we suppose a simplified financial structure. The portfolio of the agents includes only monetary base, domestic assets and foreign assets. There are only two interest rates: the local rate and the international rate. The explanation above presented has the following reasoning behind it. Given certain configurations of the portfolios and certain interest rates structure, there is an increase of the preference for domestic assets for any reason (for example, a reduction of the international interest rate or a decline of the local perceived risk by investors). This change in preferences, with the current interest rates, determines an excess demand for domestic assets and the corresponding excess supply of external assets. Since the CB emits the same local asset that is on demand (the only domestic financial asset of the model), a monetary policy of maintenance of the local interest rate implies the complete sterilization of the base emission resulting from the buying intervention in the exchange market. With this simplified model, the preservation of the interest rate is equivalent to the complete sterilization, which is the same as keeping the monetary base stock unaltered.

How does the existence of a broader menu of domestic assets affect the analysis? To explore this question we will discuss as follows a more complex model, with two local financial assets. Let us suppose then that the local assets menu is composed of the monetary base and two assets that yield interest, short term assets, and long term assets (bonds, for example). Let us also suppose that the CB operates solely in the short term assets market. Let us imagine now that the excess demand for domestic assets resulting from the change in preferences of the preceding reasoning and is distributed in some way among the local short and long term assets. The first step of the CB operations – buying excess foreign currency to maintain the

exchange rate – would result in short and long term local interest rates both lower than the initial ones. In this case, if the CB completely sterilized the emission of the base by putting out short term assets, the resulting short term interest rate will be greater than the initial. This is so because the long term interest rate would be smaller than the initial and, if the elasticity of substitution between the monetary base and the long term asset base is significant, the demand for base money would be greater than the initial. To keep the base stock equal to the initial one, it would be necessary that short term interest rate was higher than the initial, to compensate the effect of a lower long term interest rate.

The increase of short term interest rate of the previous exercise has this result because the CB, that operates exclusively in short term assets, performs a complete sterilization of its intervention in the exchange market to keep the base stock unaltered. Whereas if the CB pursues the maintaining of the short term interest rate at its initial level (for example, because this is its monetary policy instrument), it can do this and for this it should not perform a complete sterilization but a partial one, allowing the supply of monetary base to be accommodated to a greater demand due to the influence of a long term interest rate inferior to the initial one.

The example with three local assets illustrates the more general case in which there is a great quantity of local assets, including land and real estate, that are demanded as counterparts of the exceeding supply of foreign assets. It is clear that the CB cannot control the whole structure of the interest rates, neither in an open economy nor in a closed one. The monetary autonomy exercised through the sterilization policy should be understood as the capacity of the monetary authority to control the interest rate instrumental to its monetary policy. The goal of the sterilization policy should be the interest rate of the assets with which the CB operates and not a quantitative base goal (or any other monetary variable).

In practice, and it is frequently mentioned, it has occurred that the sterilization policies induce the increase of domestic interest rates. The preceding discussion suggests a possible explanation of these cases and comments. If the CB pursues quantitative monetary targets (base or other monetary variables) and to preserve them carries out a complete sterilization of its purchasing interventions in the exchange market, it is probable that the interest rate of the class of assets with which the CB operates becomes elevated. But in this case the problem is not the sterilization policy, but the goal that it pursues.

4.5 Sustainability of the sterilization policy

In the previous point it is concluded that in conditions of excess supply of foreign currency in the exchange market, the sterilized purchasing intervention, is

possible at any time. In this point we will focus on the sustainability of this policy: is it possible to keep doing it indefinitely? The answer is: no, not at any circumstance.

The sustainability of this sterilization policy depends on the interest rate earned by the international reserves and the local interest rate, on the trajectory of the exchange rate, and on the evolution of the variables that determines the demand and the supply for monetary base. The conclusion which one arrives at (Frenkel, 2007 and 2008) is that there is a maximum local interest rate that is allowed by the sustainability of the sterilization policy. The CB has freedom for fixating a local interest rate that is equal or lower than this maximum interest rate. More formally:

In each moment of time the unit cost of sterilization is:

$$s = i - r - e$$

where s is the cost of sterilization, i is the local interest rate, r is the international interest rate, $e = dE/E$ is the rate of increase in the price of the international currency ($E = \$ / \text{US\$}$, is the exchange rate).

The cost of sterilization s is null if $i = r + e$, that is, if the local interest rate is equal to the sum of the international interest rate plus the rate of increase of the exchange rate. Or, which is the same, if the uncovered interest parity condition (UIP) is strictly verified.

The sterilization policy is obviously sustainable if the cost of sterilization is null or negative. If it were the sustainability condition, the sterilization policy would only be sustainable if $i \leq r + e$. This is, $r + e$ would be the maximum value of the interest rate that would make the sterilization sustainable. Greater rates than this would make the policy unsustainable.

In Frenkel (2007) we demonstrate that the mentioned condition is not necessary for sustainability. We demonstrate that the policy can be sustainable with local interest rates that are greater than $r + e$ and we calculate the maximum rate allowed by sustainable sterilization. The conclusion result simply from taking into account the seigniorage received by the CB.

In the cited work we define the degree of monetary autonomy as the difference between the maximum local interest rate that allows the sustainability of the sterilization and $r + e$.

$$g = i_{\max} - (r + e)$$

where i_{\max} is the aforementioned maximum rate and g is the degree of monetary autonomy.

Given the international interest rate and the rate of increase (tendency) of the nominal exchange rate, the degree of autonomy is greater the higher the

local interest rate that can be determined without making the sterilization policy unsustainable.

The sustainability criterion that we use is that the CB's total liabilities – interest-bearing liabilities plus the monetary base – is not incremented more than the international reserves valued in domestic currency, in such a way that as time goes by, the relation between the total liabilities of the CB and its reserve assets remains constant or is reduced.

From this criterion is derived a simple condition on the maximum interest rate that can yield the sterilization bills of the CB. The sterilization policy is sustainable for interest rates that are equal to or inferior to this rate. Such maximum sustainable rate results from the quotient between two variables. The numerator is the sum of the interest rate perceived by the international reserves plus the rate of increase of the exchange rate. The denominator is the ratio between the amount of interest-bearing liabilities and the value of the international reserves in domestic currency. The intuition of the expression is clear. The numerator is the total return of the reserves in domestic currency (the international rate plus the rate of increase of the exchange rate). The denominator is a number lower than one, so that the maximum sustainable rate is greater than the numerator. The smaller the denominator, that is, the smaller the proportion between the stock of interest-bearing liabilities of the CB and value of the reserves in domestic currency, smaller the proportions of liabilities for which the CB pays interests and greater is then the maximum sustainable interest rate. More formally:

We define the sustainability condition of the sterilization policy as:

$$dP \leq d(RE)$$

where P is the liability of the CB. The condition means that the sterilization policy is sustainable if the relation between total liabilities of the CB and the value in local currency of the international reserves $P/(RE)$ is not increased. In Frenkel (2007) it is shown that the condition for sustainability results in:

$$i \leq (e + r) / l_R$$

where $l_R = L/RE$ is the coefficient between the interest-bearing liability stock of the CB and the value in domestic currency of the international reserves.

If $l_R < 1$ the domestic interest rates that sustain the sterilization policy can be greater than $e + r$ and higher the lower is the ratio l_R . As was explained above, the CB operations determinate each moment the domestic interest rate and the exchange rate. The sustainability of these operations depends on the domestic and foreign interest rates, of the temporal trajectory of the exchange rate, and also of l_R .

The maximum domestic interest rate that maintains the sustainability of the sterilization policy is:

$$i_{max} = (r + e) / l_R$$

Consequently, the degree of monetary autonomy is:

$$g = i_{max} - (r + e) = (r + e) (1 - l_R) / l_R$$

The degree of monetary autonomy, that is, the difference between the maximum sustainable domestic rate and $r + e$, is greater the smaller l_R is.

It is clear that the relation l_R varies through time, modifying the range of sustainable interest rates and the degree of monetary autonomy. If l_R increases with the passage of time, the degree of autonomy tends to reduce, and vice-versa. This consideration suggests analyzing the tendency of the condition for sustainability for establishing if the maximum interest rate that allows for the sustainability of the sterilization policy tends to increase or to reduce with the passage of time. Or, which is actually the same, if the evolution of the monetary variables and the exchange market determine that the degree of monetary autonomy tends to increase or to decrease.

The condition for permanency is obvious: that there is no increase in the relation between the interest-bearing liabilities of the CB and its reserves valued in domestic currency. That is, that the stock of interest-bearing liabilities of the CB grows at a rhythm that is equal to or less than the value of reserves in domestic currency. More formally: the condition for permanency of the degree of autonomy is defined as

$$d(L/R E) = dl_R \leq 0$$

If the monetary variables and the exchange market satisfy this condition, this implies that the maximum sustainable interest rate and the degree of autonomy tend to remain stable or to increase. If the condition is not verified, the degree of autonomy tends to reduce, although this does not mean that a sterilization policy that is sustainable in a moment becomes rapidly unsustainable. It means that the maximum sustainable interest rates tend to be reduced with the passage of time and that, if the situation is maintained, the possibility of exercising an active monetary policy will be lost.

It is demonstrated that the permanent condition of the degree of autonomy can be expressed as another restriction on the local interest rate:

$$i \leq (e + r) + (B/L) \beta (p + y) - (C/R)(1 - l_R) / l_R$$

where B is the stock of monetary base; β the elasticity of demand of the nominal monetary base; p is the inflation rate; y is the output growth rate; and C is the flow of purchases of the CB in the exchange market.

Local rates that are equal or less than the second part of the expression preserve the permanence of the degree of autonomy. Higher rates, although sustainable, imply that the degree of autonomy tends to be reduced, because the relation between the stock of interest-bearing liabilities of the CB and the reserves tends to increase. The restriction depends on the ratio between the monetary base and the stock of interest-bearing liabilities of the CB (B/L) and the growth rate of the demand for base β ($p + y$). Also, as can be seen in the last part of the equation, the restriction depends negatively of the ratio between the flow of purchases of the CB in the exchange market and the stock reserves (C/R) (equivalent to the growth rate of the international reserves net of the interests that these earn). The intuition is clear: the greater the purchases of the CB in the exchange rate market, the greater is the growth of the stock of sterilization liabilities and their cost and the quicker tend to be reduced the maximum sustainable interest rates.

The preceding analysis supposes a freedom of capital movements. However, beyond the purpose of showing the conditions that give place to the sustainability of sterilization in this context, it is opportune to be served by the last part of the presented inequality to highlight the roles that can play the control of capital inflows and the purchases of foreign currency by the government.

Effectively, the inequality indicates that the regulation of capital inflows, that moderate the magnitude of the CB purchases (reducing C/R), contributes to preserve the permanency of the degree of autonomy enjoyed by the economy at a determined moment. For the same reason, the fiscal policy can also contribute to the preservation of the degree of autonomy. In conditions of fiscal surplus the government can invest in part of this flow in foreign assets, reducing in this manner the purchases of the CB necessary to sustain the targeted exchange rate.

In Frenkel (2007), there are presented various numeric exercises, in different inflation and growth scenarios and with plausible data and parameters, which suggest that the sterilization policies become sustainable and that there are considerable degrees of permanent monetary autonomy in settings that are ordinary in many developing economies. It can be concluded that the exchange rate policy of a competitive RER regime does not generally inhibit the exercise of monetary policy. The orthodox criticism in this respect is not valid. Even with free mobility of capital (with the obvious hypothesis that the domestic and foreign assets are not perfect substitutes) the regime is not incompatible with a considerable degree of monetary autonomy that can be exploited to exercise an active monetary policy.

The conclusion does not imply, however, that in a competitive RER regime, or more generally, in a context of avoiding appreciation, the control of the aggregated demand dynamics and the inflationary pressure can be exclusively trusted

to the monetary policy. If the highest limit of the interest rate that allows the sustainability of the sterilization policy is conjugated with a low elasticity of aggregate demand to the interest rate, these circumstances can significantly inhibit the regulatory capacity of the monetary policy. The interest rates that are necessary to sensibly affect the aggregate demand could be higher than the sterilization sustainability limit (Frenkel, 2008). A low elasticity of the aggregate demand to the interest rate is observed even in developing economies with a relatively high degree of financial intermediation. It can be presumed that this characteristic is found in a great number of these economies.

Our conclusion to this respect is that in a competitive RER regime active monetary policy can and should be exercised, because it is imperative to use all the available instruments to control the aggregate demand dynamics and the inflationary pressures. But the responsibility for this control cannot be trusted exclusively or mainly to monetary policy. This conclusion highlights the crucial role that the fiscal policy should play as a regulatory instrument on aggregate demand and inflationary pressure.

5 FINAL THOUGHTS

It is striking that the evidence presented in this work has scarce recognition on the part of the multilateral financial institutions. Although without recognizing the role that the new macroeconomic configurations played in the acceleration of growth of the developing economies, the effects that have had the changes in the relationship between these countries and the international financial market can hardly be ignored. It should be accepted, at least, that the new context alleviated in great measures the negative traces that financial globalization showed until the beginning of the years 2000. But the official doctrine of the international financial institutions does not register it.

The IMF, for example, continues to officially promote macroeconomic policies based on pure floating and inflation targeting monetary policy. Among other negative traces (for example, the volatility of the exchange rate), the pure floating can lead to a great appreciation of the exchange rate, particularly in the current international financial conditions, and to consequently debilitate the robust foreign balances and growth.¹⁵

15. However, inside the IMF there have been discrepancies after the crisis. For example Olivier Blanchard and collaborators (Blanchard et al, 2010) published a Staff Position Paper that reflects the intention of reorienting the recommended macroeconomic policies. In the C section of the work, entitled "Inflation Targeting and Foreign Exchange Intervention", which focuses on the developing countries policies, the authors recommended interventions in the exchange rate markets to avoid strong appreciations, accumulation of reserves and sterilization policies. In another Staff Position Paper, published shortly after the one mentioned, Jonathan D. Ostry and collaborators (Ostry et al, 2010) accepted the control implementations on the entry of capital incomes in certain circumstances. The policies suggested in both documents collide with the official IMF orientation.

On the other hand, since the G-20 decided to triplicate the loan capacity of the IMF, in April 2009, the institution promoted the idea that it can replace the role played by the international reserves accumulated individually by the developing countries. The initiative overlapped with critical opinions about the preservation of high reserves, originated from the very IMF and also from scholarly sources (for example, Rodrik, 2006). If the lender of last resort role of the IMF is strengthened, it is good for the international financial system, but the initiative clearly points to central banks not intervening in the exchange market and leaving free the market forces in the determination of the exchange rate. It is clear, however, that after the experience in the recent decade, particularly the one in the global crisis, it seems difficult to convince the central banks of the developing countries that accumulating reserves is inefficient.

In principle, it is doubtful the effectiveness that the aforementioned initiative could play a similar role to that played by the availability of voluminous reserves. The eventual assistance of the IMF to cover deficiencies of international liquidity of the countries would be subject to a conditionality (even if it were an ex-ante conditionality).¹⁶ Accordingly, the effective availability of this liquidity would be uncertain and consequently a default risk would survive for this reason. This consideration shows that international reserves and the supranational lender of last resort are not equivalent.

Regarding this issue, the treatment by the European Union (EU) and the IMF of the problems faced by the refinancing the European public debts in the first semester of the current year adds new elements for judging.

In the first place, the recent European experience provides evidence that allows conjecturing of the probable effects of the aforementioned initiative. Although the lender of last resort function of the IMF will be translated into a new financing line, with the minimal imaginable restrictions for its access by the developing countries, it seems difficult that its effects on the risk premiums of these countries result greater than the effects that, in the case of the Eurozone, showed the recent EU-IMF bailout added to the potential assistance of the Central European Bank. And these effects are evidently inferior to the ones provided by the availability of reserves in the case of the emerging countries. In other words, it seems improbable that an international agreement within the IMF, which constituted the institution as a lender of last resort for the developing economies, offer to investors better guarantees than the ones recently established in the Eurozone for the countries that integrate it, and that at their turn, result

16. In fact, two lines created by the IMF with this purpose in the past (the Contingent Credit Line, in the second half of the nineties, and the Short Term Liquidity Facility, in October of 2008) were not requested by any country and had to be deactivated. The recently created Flexible Credit Line was requested by three countries, but has not been used.

clearly inferior to the guarantees provided by the availability of reserves in the emerging market countries.

In second place, the recent European experience serves to illustrate the enormous difficulties of coordination that would face the initiative to establish an international lender of last resort. The EU is doubtless the most suitable area imaginable for an international agreement that dispels the sovereign default risks of the countries that integrate it. If an agreement is so difficult in this area, what would be the real possibilities of a global agreement? The difficulties would surely be greater than in the case of the EU.

A frequent objection to the competitive RER policies, surplus in current accounts and accumulation of reserves, is that they imply in a fallacy of composition. Certainly, not all the countries of the world can simultaneously implement these policies. However, in principle it is not inconsistent to recommend these orientations to the set of developing economies. Of course that the generalization of these policies in the set of developing economies implies necessarily in that the aggregate of current accounts of the advanced countries should be in deficit. As such, the debate on the new macroeconomic configurations of the developing countries overlaps with the debate on the “problem” of global imbalances.

It is a fact that developing countries have failed to implement policies that tend to generate current account surpluses simultaneously and it does not seem to happen in the near future, so that the above policy recommendations for each of the developing countries may not be accused of global inconsistency, even if the global imbalances are perceived as a problem. On the other hand, a small country in international terms has no reason to worry about the international repercussions of its policies. However, if the international debate and the possibilities of improvement of the international institutions to make them more favorable to development are valuable, the issue of global consistency of the development policies must be addressed.

The debate on global imbalances essentially involves the judgment about the sustainability of deficits in the United States and other advanced economies current accounts. Obviously, we have no place in this work to discuss the subject, but there is an aspect of the debate that must be underlined: the role attributed to the global imbalances in the recent crisis.

In the midst of the first decade of the 2000s, some analysts predicted that the global imbalances would be abruptly adjusted, causing an international crisis. Those who imagined a crisis originating in the current account deficit of the United States reasoned by analogy with the crises originated in the current account deficits in emerging market economies. Faced with the growing deficit trend in the current account they predicted a sudden confidence reduction in North-American assets,

which would involve the public debt papers, and the consequent rapid liquidation of dollars and dollar-denominated assets. This would cause an abrupt depreciation of the dollar, whose inflationary effects would induce the Federal Reserve to significantly elevating interest rates, which would push the United States and the rest of the world into a recession.

Effectively, a crisis did occur, but it was not the one expected by those who focused on global imbalances. In fact, the opposite of what was expected occurred: the crisis generated a “flight to quality” that produced for some time the appreciation of the dollar and of the Treasury bonds of the United States.

Anyhow, among those calling for urgent solutions for the “problem” there are many that support that the global imbalances played a central role in the gestation of the current crisis. Without detailing these arguments, we can say that they are not very convincing in the scholarly level. The consensus at this level locates as the main factor of the crisis the great financial fragility reached by the globalized system centered in the United States, facilitated by the weak regulation exercised by the government in the developed countries, together with the bursting of the real estate bubble in 2006. In fact, the financial crisis affected more the developed countries with high surpluses but greatly exposed to assets in the United States, like Germany, than other developed countries with deficits in current accounts, with a smaller exposure to North-American risk. With respect to the relation between the crisis and the global imbalances, the scholarly consensus recognizes that both can have a common root in the extremely low savings rate of the North-American economy before the crisis, but discards the high deficits in current accounts as the main cause.

Beyond the debate on the sustainability of global imbalances, there has recently been intensified the pressure of the advanced countries on the developing economies, especially China, for them to appreciate their exchange rates and debilitate their current accounts. The intensification of the pressure does not appear now primarily motivated by the tendencies of foreign balances, but as an urgency in increasing foreign sales. Effectively, the recuperation of domestic demand is poor in the United States and in other developed economies and the effects of the monetary policies are weak. The increase in net exports seems as the only viable way to stimulate the reactivation. On this path, the United States and other developed countries have placed the exchange rates and trade balances as priority subjects at the IMF and the G-20. Besides the international pressure, several of the developed countries have adopted measures for devaluating their currencies; including Japan, whose position in the global imbalances should guide its exchange rate policy in the opposite direction. An “exchange rate war” is being waged, as Brazil’s Finance Minister has denominated, in which all are prone to lose, both the developing countries as the advanced ones.

The developing countries should participate in this debate taking the discussion beyond the short term and putting the development question at the forefront. With this perspective they should propose a profound reform of the international monetary system, which among the objectives it should include the consolidations of the best traces of the international configuration of the years 2000. For example, they should promote an international agreement on exchange rate regimes and real exchange rates that would allow for the developing economies to follow high growth-cum-exports rate trajectories.¹⁷

For the circumstances that prevail in the advanced countries, the conditions for the success of this kind of proposal seem at these times the worst. But some aspects of the situation are advantageous for, at least, starting this discussion. For example, the situation has the virtue of clearly showing the role of the exchange rate regimes and the real exchange rates, without the paraphernalia with which these subjects are surrounded in neoclassical economy. In second place, the subject has been placed at the forefront of international attention by the developed countries and is open to negotiation possibilities.

To gain support for the suggested reform would require reviving the Bretton Woods spirit in a context of great poverty of initiatives of international coordination.

It is difficult but not impossible. Two conditions seem necessary to advance on this path. The first is the widespread recognition of the lessons provided by the history of financial globalization. The second is to recognize the benefic effects that an international agreement on exchange rate regimes and policies would have both on the developing and advanced countries. The exchange rate war is not good for anyone.

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GLOBAL IMBALANCES AND INSERTION OF THE DEVELOPING COUNTRIES (1990-2010)*

Giuliano Contento de Oliveira**

ABSTRACT

The discussion about the global imbalances began to gain more space in academic debate since the mid-1990s. In the 2000s this discussion was intensified because of the worsening U.S. current account deficit. The counterpart of the United States as a net debtor nation was the excessive current account surplus in some economies such as Germany, Japan and especially China. Nevertheless, in many developing economies the increase of the international reserves resulted principally of capital inflows. That is, many peripheral economies constituted vulnerable reserves. In this sense, the paper has the purpose of discuss the peripheral economies' insertion in the global imbalances environment. I argue that this insertion is differentiated and that the peripheral countries should use the favorable international environment to constitute international reserves by current account surplus.

RESUMO

A discussão a respeito dos desajustes globais passou a ganhar espaço no debate acadêmico a partir de meados da década de 1990, acentuando-se a partir dos anos 2000, ante o agravamento do déficit em transações correntes americano. A contrapartida do aumento da posição devedora líquida dos Estados Unidos foi a geração de excepcionais superávits em transações correntes em algumas economias, como Alemanha, Japão e, sobretudo, China. Não obstante, em muitas economias periféricas, o aumento das reservas internacionais decorreu preponderantemente do ingresso de fluxos de capitais estrangeiros. Ou seja, muitas delas constituíram reservas vulneráveis. Neste sentido, este artigo tem o propósito de discutir a inserção das economias da periferia no ambiente de crescentes desajustes globais. Argumenta-se que esta inserção é diferenciada e que os países da periferia deveriam aproveitar os contextos favoráveis no ambiente internacional para constituir reservas internacionais a partir da geração de superávits em conta-corrente.

1 INTRODUCTION

The condition “global imbalance” consists of the prevalence of significant and lasting current account surpluses in the balance of payments in some and deficits in other economies.

The discussion about these global imbalances became to gain ground in academic debate in the 1990s, and even more so in the years 2000, upon the

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escalation of the US current account deficits. Despite the series of US balance of payments current account deficits registered during the 1980s, more exactly from 1982 on, this discussion took center stage among academics and analysts as soon as the deficits began a steady upward trend in the middle of the late 1990s. It was in the years 2000, however, that the current account deficit of the balance of payments in the US economy was a source of great concern for many observers and researchers in the field, and in 2006 was USD 803 billion, or 6% of the Gross Domestic Product (GDP).

The counterpart of the accumulation of such high deficits in the US economy was the exceptional surpluses in balance of payments current accounts in economies such as Germany, Japan and, particularly, China, in addition to oil-exporting countries and some other developing economies in Asia and the periphery of the system. Therefore, an increase in the credit position of other economies or, at least, a reduction or shift in the net debt position corresponded to the rise in the US net debt position.

During the years of international bonanza between 2002 and 2007, both in trade and finance, many peripheral economies accumulated vast international reserves. However, not all succeeded in forming an “external shield” – in other words, to achieve a high level of international reserves based on considerable continuous positive balances, and which could improve foreign debt indicators and allow a wider range for maneuvering the economic policy, especially in times of crisis.

The purpose of this paper is therefore to discuss the differentiated insertion of developing economies in the sphere of increasing global imbalances, partially offset at the time immediately after the recent global crisis. It is argued that such insertion is differentiated, and that the developing countries should take advantage of the favorable international contexts in order to form international reserves by generating current account surpluses instead of increasing such reserves through positive balances in the capital and financial accounts of the balance of payments. Therefore, the increase in international reserves from net private capital inflows, namely those intended for procuring financial assets, is called a “vulnerable external shield”.

This paper is divided into two sections in addition to this introduction and the conclusion. The first section includes a brief review of the literature about the global imbalances, highlighting their main conditioning factors and systemic effects. Critical analyses also addressing the Bretton Woods II, published by Dooley, Folkers-Landau and Garber (2003), and the Bretton Woods III, by Bibow (2010a; 2010b) are also critically analyzed. This is followed by a discussion on the process of inserting peripheral economies in the system within this process, calling attention to the way in which many economies have increased their international reserves.

2 GLOBAL IMBALANCES

The thorough discussion on “global imbalances” must not ignore the status of the USA as a hegemonic country and, subsequently, the dollar’s position as international currency, with US dollar-denominated contracts in global transactions, or China’s position in the new international economic order. Foreign accounts of economies that can issue world currency cannot be addressed in the same way as foreign accounts of economies that have inconvertible currencies or lower degrees of convertibility. The capacity to issue currency for foreign currency-denominated contracts in the global context places the USA in a privileged position in the hierarchy of the international financial and monetary system, including, it should be said, the high indebtedness capacity. Albeit obvious, unfortunately this weighting has not often been considered in discussions on “global imbalances”.

The power to issue international currency gives the USA a wide range of privileges, such as assuming significant deficits in balance of payments current transactions. Under the flexible-dollar standard, the USA can afford to settle its net debt position in its own currency, to be issued by the Federal Reserve (Fed). The US interest rate represents the price by the abstinence of global liquidity, that is, represents the benchmark rate of the entire capitalist system, acting as a kind of regulatory instrument of international liquidity. Moreover, US dollar-denominated contracts give asset holders access to the world’s most liquid and deepest capital market. Consequently, the fact that the net-debt position in the international context is assumed by the USA, in other words, by the hegemonic country in the global capitalist system, under the aforementioned standard, should not be understood as an anomaly but as a privilege resulting from a monetary and financial international system highly asymmetric, organized and based on the US dollar. This is why Metri says:

The current financial power of the USA is absolutely original. It is expressed through its enormous indebtedness capacity, that is, its vast capacity to absorb the global financial wealth, and yet with no counterpart of any kind to its economic policy. The USA may, therefore, put in place and follow through its imperial projects, since the world funds them, and its framework policies towards its main rivals in the capitalist system, since its economic imbalances are absorbed by them (METRI, 2004, p.18).

Assuming expressive deficits in the balance of payments current accounts does not put at risk the convertibility of the system’s key-currency, because the dollar standard is no longer based on the convertibility prerogative. The US dollar is accepted as global currency because it allows access to the world’s deepest and most liquid markets thanks to its financial currency status (currency-denominated contracts), backed by the US financial system and public debt (METRI, 2004).

This, however, does not mean disregarding the considerable and continuous negative results in the US current account balance, especially since the years 2000.

This status indicates, in fact, a dynamic imbalance between the US economy's consumer and saving levels, resulting in exceptionally high levels of private indebtedness.

Indeed, there are no limits to the US foreign account, as Metri (2004) maintains, while the conditions supporting the flexible-dollar standard stay in place. In fact, the theories that advocate the collapse of the dollar as international currency should base their argument on the weakening of the US financial system, and on domestic counterparts of the global imbalances, instead of the US balance of payments current account imbalances *per se*. Even in this case, however, several questions can be raised about the hypothesis of the dollar's collapse in the short run, considering the exceptional ability shown by the US financial system throughout its history to reinvent and refresh itself. It is worth mentioning that the actual position of the US dollar as global contract denominator implies an induced system of international cooperation in order to keep the US currency as international money, since its sudden devaluation would cause unbelievable devaluation of the global financial wealth¹.

Returning to the specific discussion on global imbalances, Macedo e Silva (2006) remember that the implosion of the "*dot-com*" bubble in 2000-2001 gave way to a possible outbreak of a systemic crisis, considering the substantial devaluation of the prices of stocks related to "new economy" businesses and the subsequent reduction in family and corporate equity – a decrease that, in turn, triggered events leading to the restitution of savings by the economic players directly and indirectly involved in the stock market. After jumping from 500 to 1000 points between early 1991 and mid-1995, the National Association of Securities Dealers Automated Quotations (Nasdaq) index soared to 5,132 points in March 2000. By October 2002, however, this index was fluctuating around 1000 points.

In order to prevent the outbreak of a systemic crisis, Fed substantially reduced the short-term interest rate – the federal funds rate – in a short space of time from 6% to 1% a year between January 2001 and June 2003. The interest rate dropped from 2.5% to 0.89% p.a. in this aforementioned period. Only in June 2004 did the Federal Reserve again increase the basic interest rate.

But if, on one hand, the US flexible monetary policy prevented the "new economy" crisis from becoming a systemic crisis, it did, on the other, help increase family and corporate indebtedness. By increasing private sector indebtedness and boosting consumption the US current account deficit increased even more, generating the dynamic imbalance between the internal levels of consumption and savings. In addition to the soaring internal and external private deficits, the US

1. According to Belluzzo (2005, p. 230): "(...) the mercantilist strategies of Asian countries – conceived for the generation of commercial surpluses and accumulation of reserves – necessarily imply the demand for dollar-denominated assets".

flexible monetary policy implied a sharp rise in global liquidity and laid the foundations for the formation of the real estate bubble (MACEDO e SILVA, 2006). By mid-2004, the ratio between family debt (mortgages plus credit to the consumer) and available personal income exceeded 100%, compared to slightly over 80% in 2000. Between 2000 and 2005, the balance of payments current account deficit leaped from USD 416 billion to USD 748 billion, from 4.2% to 5.9% of the GDP.

The amassing of great financial wealth has substantially altered the spending decisions of the economic players, given the increasingly strong influence of asset price fluctuations. The growing importance of financial assets in the composition of private wealth, according to Coutinho and Belluzzo (1998), Braga (1998) and Aglietta (2004), implied an increasing “financialization” of the economies. Under the aegis of finance-led capitalism, the monetary policy now had to deal with new conditions and new constraints, operating on the edge, in view of the impositions arising from the conduct of those players who dictate the pace of globalized markets, as well as the paradoxical effects from handling the different instruments of monetary policy (CINTRA, 2000; BELLUZZO, 1997).

In this finance-controlled system, the lassitude of the monetary policy required to prevent the outbreak of systemic crises leads to the recovery of asset prices, but at the same time lays the foundations for the formation of new bubbles. The recovery of the US economy after 1993 was headed by the sharp rise in financial asset prices, particularly by actions associated with the “new economy”, a movement that helped raise the federal funds rate by the Fed and later the implosion of the “*dot.com*” bubble. To handle this, the US Federal Reserve was forced to substantially reduce the short-term interest rate. Once again, the economic recovery was headed by the appreciation of real estate and securities asset prices, plus the gradual rise in family and corporate indebtedness. Thus, the same monetary policy that is used to prevent the implosion of the assets bubble becomes a systemic crisis – and also to facilitate the recovery – lays the foundation for further assets bubbles later.

The US economy made a quick recovery from the adverse effects when the “new economy” bubble burst by adopting anti-cyclical fiscal and monetary policies². Moreover, such measures raised the level of family and corporate indebtedness – a result of both the “cheap cash” and optimistic expectations that became prevalent. Ultimately, the US economy was free of the crisis. But, throughout the 2000 decade, the now “triplet deficits” were prevalent: public, private (families and businesses) and external (current account balance). The last deficit, it should be mentioned, resulted from the policies focusing on economic recovery and consequently from

2. Besides proceeding to the indicated reduction of the short-term interest rate between 2000 and 2001, the US economy went from a surplus of 1.1% of the GDP to a deficit of 4.5%. As a result of these initiatives, the economic recession was short and moderate.

the rise in levels of the private sector's indebtedness, and closer economic relations between the USA and China. The public deficit and, first and foremost, the private deficit, competed to boost the deficit in the US current account balance as a result of the dynamic imbalance between internal supply and demand.

Furthermore, the consolidation of China as a dual center of global economy³ and the expressive trans-nationalization movement of US companies to that country also contribute to the significant increase in the current account deficit in the USA, mainly between 2003 to 2008, ascribing to it a not insignificant structural component. The US foreign accounts imbalance, therefore, makes it necessary to consider the overflow process of US production worldwide by forming global production chains and subsequently redefining the international division of labor. In other words, the increase in the US current account deficit is also a result of the international inter and intra-company trade flows, and of the importance of the growing international exchanges of semi-manufactured goods and the autonomous private capital flows and their subsequent impacts on the service remuneration of factors.

Within the contemporary global imbalances, therefore, there is a structural dimension, since such imbalances also result from a globally integrated production system, considering the growing segmentation of production of multinational corporations, delegating to the peripheral countries the stages that especially require intensive labor and natural resources (KREGEL, 2008; TAVARES, 1997).

2.1 Bretton Woods I, II, III, IV...

As discussed, the intensification of the US external deficit and the subsequent growing accumulation of reserves by the peripheral economies, particularly in Asia – and China in particular – raised major discussion on the nature and sustainability of global imbalances. One hypothesis with widespread repercussion in the academic field was that developed by Dooley, Folkers-Landau and Garber (2003; 2004). According to the authors, the structure of the contemporary international financial system has strong similarities to the Bretton Woods structure, only considering new players. In the words of Dooley, Folkers-Landau and Garber (2003, p. 2): “the global system that has evolved and grown since the advent of Bretton Woods has maintained a single dynamic structure.”

In this approach, the current international financial system involves a re-invigorated relationship between the center and the peripheral economies. The system's center issues the international reserve currency and does not impose controls over the goods, services and capital markets, contrary to the countries on the

3. In other words, as a net exporter of goods requiring intensive labor and net importer of machinery and equipment, technology and raw material – with highly dynamic regional impacts (Medeiros, 2006).

periphery. In the Bretton Woods context, the center was represented by the USA and the periphery by Europe and Japan; today, the periphery is represented by Asia, with the USA remaining as center of the global capitalist system (DOOLEY, FOLKERS-LANDAU & GARBER, 2003).

According to the aforementioned authors, while the periphery still finances the US current account deficits and accumulates financial assets in dollars, global imbalances will be a solution rather than a problem, since the US external deficit encourages global demand and therefore contributes to creating jobs and income in the rest of the world. That is, while the USA is able to generate a net balance in its capital and financial account of the balance of payments equal to or higher than the current account deficit, no problem of any kind should be expected with regard to the continuity of this center-periphery relationship.

The peripheral and particularly the trade-account economies adopt depreciated exchange rate policies in order to expand their exports and thereby grow faster, besides accepting the dollar as international currency. Such countries accumulate international reserves with a preponderant share in US currency, investing such resources in assets denominated in the system's global currency. Therefore the periphery in ascension guarantees the financing of the current account deficit of the central economy that issues the key currency. As a result, there is a growth strategy on the periphery based on its increase in exports, while the center is seen to have a growth strategy based on indebtedness.

The central country in this system plays the role of a global commercial bank, providing long-term loans and collecting in the short term. Dooley, Folkers-Landau and Garber (2003; 2004) maintain that, as a result of the re-emergence of the Bretton Woods system and incorporation of the current Asian periphery, there are currently three main economic and monetary zones, as follows: a trade-account region, Asia; a central country, the USA; and a capital-account region, represented by Canada, Europe and Latin America. For the trade-account region, the growth strategy consists of exporting goods and services to the USA. The current account surpluses are invested in US Treasury bonds to help maintain the exchange rate – against the central currency – at a depreciated level. The capital-account region, on the other hand, lets its currencies fluctuate against the dollar, with governments preferring not to interfere in defining the exchange rate. The central country, therefore, acts as an issuer of international currency and intermediary of the system based on its financial system. When allocating accumulated international reserves to the central country, the trade-account countries on the periphery guarantee the continuity of the desired exchange parity and contribute to maintaining the center's low interest rate. The center, as a result, is able to facilitate a growth strategy based on indebtedness at a very low cost (DOOLEY, FOLKERS-LANDAU & GARBER, 2003; OLIVEIRA, MAIA & MARIANO, 2008).

The papers by Dooley, Folkers-Landau and Garber (2003; 2004) caused widespread criticism and academic discussions. The Bretton Woods II theory, as mentioned, consists of the idea of a core in the system with exorbitant privilege and an export-led growth periphery based on an undervalued exchange rate. According to Eichengreen (2004), this view suggests that: *i*) the international monetary standard can be maintained indefinitely. *ii*) there is no reason for the collapse of the dollar as the system's main currency, because there is no need to adjust the US foreign accounts; *iii*) the same incentive systems prevailing in the Bretton Woods context – and for maintaining the system – would be currently in place; and *iv*) the countries on the periphery form a cohesive bloc of economies ready and willing to act in benefit of the collective interest.

Thus, Eichengreen (2004) understands that the Bretton Woods II theory is based on highly questionable assumptions, among them: *i*) it presumes that Asia subordinates its individual interests to the collective; *ii*) it disregards changes in the global economy since 1960; *iii*) it works on the hypothesis that there is a cohesive bloc of countries acting in benefit of keeping this arrangement; ⁴ and *iv*) suggests, as mentioned, that the current monetary standard can be maintained *ad eternum*.

According to Eichengreen (2004), however, peripheral countries are more numerous and heterogeneous today in comparison to the period when the Bretton Woods system was in force. Unlike Europe in the 1960s⁴, Asia's political priorities are less homogeneous, hindering the subordination of its individual interest to the collective. In addition, in Asia regional cooperation is currently less strongly institutionalized compared to the arrangement prevailing in Europe in that period. But there are other differences. The author believes that there is an alternative currency to the dollar today, unlike the Bretton Woods period when the pound sterling was hardly an attractive alternative to the US currency. The US external deficits, moreover, result from the low savings rate, unlike the Bretton Woods context, when a high savings rate prevailed, which tended to make the financing of deficits more favorable. He says that in the current arrangement it is harder to maintain the status quo due to the freer environment of capital flows after removing controls. He also states that, after liberalization of domestic financial markets, even the prevalence of an undervalued exchange rate and high internal savings does not guarantee generation of additional investments in the tradable goods sector due to the favorable credit conditions for the non-tradable sectors. This means that the current growth strategy of the Asian countries may change sooner than expected, which would create a problem for financing US deficits.

4. Like the gold pool, instituted by the end of 1961 by Great Britain, Switzerland and members of the European Economic Community, designed to protect the convertibility of the dollar in gold at a then fixed price – that is, to defend the prevailing dollar-gold standard (Eichengreen, 2000).

Thus Eichengreen (2004) believes that nothing can guarantee the perpetuation of the export-led growth strategy by Asian countries, because it involves not only benefits but also costs. The author (2004, p. 27) believes that governments from peripheral countries are alert to the need to constitute diversified economies capable of growing not only through exports but also upon internal demand. China itself, he says, corresponds to one case in which consumption, instead of exports, has constituted the most dynamic component of the aggregate demand. For these reasons, Eichengreen was adamant when he stated right in the introduction of his paper, that:

The final point is that Asian policy makers are not ignorant of this history. They understand that the world has changed in ways that diminish the attractions of systematic undervaluation designed to promote export led growth. This makes it less likely that they will blindly repeat the policies of the past. (EICHENGREEN, 2004, p. 6).

On this matter particularly, attention should be called to the opinion of Feldstein (2011). According to the author, China will soon end the period of collecting expressive current account surpluses provided by the huge trade surpluses, and by vast income from its foreign assets. Feldstein (2011) comments that the new five-year plan set up by the Chinese government foresees the drop in the country's high domestic savings index, currently around 45% of the GDP to improve its population's quality of life.⁵ The plan provides higher real wages, increased profits distributed by state-owned companies and rising public expenses in different services, with special attention to medical care, education and housing. Based on the accounting identity that the current-account balance corresponds to the difference between domestic savings and the internal investment in factories, housing and stocks, Feldstein (2011) maintains that a drop in the Chinese internal savings to 39% of the GDP will transform the current account surplus – currently around 6% of the GDP – in deficit. In this case, China would no longer be a net buyer of bonds from the US and other developed countries, thereby pushing up the interest rates in these countries. No less important, the drop in Chinese internal savings tends to pressure the government to allow greater appreciation of the exchange rate in order to prevent inflationary pressures from increasing domestic consumption, besides refocusing production on the domestic market. In view of this new growth strategy, Feldstein sustains that:

Americans are eager for China to reduce its surplus and allow its currency to appreciate more rapidly. But they should be careful what they wish for, because a lower surplus and a stronger renminbi imply a day when China is no longer a net

5. Medeiros (2010, p. 9-10), however, based on Lai's paper (2008), emphasizes that China's investment has been overestimated due to the substantial rise in real estate and land prices in that country. It is estimated that together the investments in infrastructure and real estate are 25% of the Chinese GDP.

buyer of US government bonds. The US should start planning for that day now (FELDSTEIN, 2011).

Following this line of thought, Fan Gang, professor at Beijing University and the Chinese Academy of Social Sciences, states that criticism by the US Congress against the Chinese government for manipulating the exchange rate and, consequently, against the “global imbalance” is unfounded. Although there has been no significant appreciation of the Chinese currency in recent years, according to the author, the Chinese current account surplus has decreased from 11.3% in 2007 to 4.6% of the GDP in 2010. This reduction has resulted basically from the rise in internal demand.

According to Gang (2011), the adoption of the new five-year plan (2011-2015) by the Chinese government tends to imply an even greater reduction in the Chinese trade balance in the next few years, after the 30% drop between 2007 and 2008 and the 6.4% drop between 2009 and 2010. In fact, the drop in Chinese national savings, resulting from the intended universalization of the social protection system, increasing investments in health and education, extending public services to rural migrants in recently industrialized regions, expenditure in infrastructure, etc., tend to balance China’s relationship with the rest of the world. The author also defends that resolving the “global imbalance” requires adjusting not only the Chinese but also the US economy, especially in terms of increasing domestic savings.

Nevertheless, as advised, under the flexible-dollar standard, the USA can equalize its foreign accounts autonomously, regardless of Chinese financing. Pressures from a high interest rate resulting from a possible decrease in Chinese demand for US bonds tend to displace part of the global liquidity to the USA, because the short-term interest rate of the hegemonic center, as mentioned, is the instrument par excellence for regulating global liquidity. The downside of this and subsequent increase in the federal funds rate, however, would not apply to financing restrictions to the US economy, but to the potentially negative impact on the domestic demand in the USA and the rest of the world. However, the rise in the Chinese domestic consumption level and a possible valuation of the Yuan would tend to reduce the deficit in the US current account, but not eliminate it, due to its structural component. It is worth mentioning, once again, that the center’s indebtedness means, instead of weakness, the objectification of its power and strength in global monetary and financial contexts. Hence, the USA should because it can. And the rest of the world finances it because it is convenient.

So the discussion on global imbalances involves a complex and peculiarly interrelated set of phenomena. It is not only about a consequence of the low level of US savings or the high level of investment in Asian countries, especially China. Nor does it result solely from intensification and proliferation of an increasingly

fragmented global production system, after instituting global production chains. Nor is it about the exchange rate undervaluation policies and accumulation of foreign currency practiced namely by the Asian countries, particularly China, or the global dollar surplus resulting from the prevalence of low interest rates in the developed countries, namely the USA – consequence mostly of its own defense strategy and/or growth based on the constitution of high levels of international reserves by some countries on the periphery and also by some developed countries. This is in fact an outcome of all these interrelated factors, whose effects are self-cumulative.

Iley and Lewis (2007, p. 4,) say that “because observers disagree on what factors have produced the deficit, there is little agreement on what actions are needed to bring about an adjustment and when they will occur”. Some suggest an adjustment of the public and private savings in the USA. Others, the increase in US foreign sales, and the need to pressure the other countries to adopt a growth strategy based on internal demand. There are also some who suggest the need to facilitate a coordinated international arrangement, such as a new Plaza agreement. Lastly, others, like the former Fed president Alan Greenspan, understand that the adjustment tends to happen through the market (ILEY & LEWIS, 2007).

According to the thinkers behind the Bretton Woods II hypothesis, the dollar crisis can be prevented while other countries are still willing to finance deficits in US current transactions. As mentioned, Dooley, Folkers-Landau and Garber (2003; 2004) believe that the external US deficits are positive, since they contribute to the periphery’s faster growth. Within this hypothesis, of course, is the idea that the almost permanent US current account deficits can be sustainable over time, in disagreement with the catastrophic theories that appeared in the wake of the intensification of negative external deficits recorded by the US economy, especially after the “dot-com” crisis, which predicted the end of the dollar as the system’s central currency and the USA as the global economic center.

In addition to Eichengreen’s (2004) reservations regarding the hypothesis in question, other structural issues must be considered, as Cunha, Prates and Biancareli (2007) and Oliveira, Maia and Mariano (2008) recall. A first aspect already mentioned deals with the fiduciary nature of the current international currency, unlike the gold-dollar standard of the Bretton Woods system. This condition aggravates the asymmetries resulting from a hierarchical international financial and monetary system, where refusing to accept the currency issued by the system’s center means the loss of the deepest and most dynamic capital market in the world. The replacement of the Bretton Woods II system by an international laissez-faire system, therefore, increased the asymmetry and the international monetary system’s hierarchy, establishing a wealth systemic standard subjugated to the

financial realm. Besides, since a large part of the US current account deficit results from exporting US company subsidiaries, how is it possible to sustain, in today's set-up, non-acceptance of the dollar? The contemporary monetary standard itself also imposes an induced system of international cooperation, as mentioned. From this viewpoint, even if admitting the hypothesis of flight against the US currency influenced by US external deficits, this strategy would imply losses for the other economies, either in terms of competitiveness – in view of exchange valuation – or in equity terms, due to the devaluation of wealth induced by the dollar's fall.

For advocates of the Bretton Woods II hypothesis, however, the transition from the dollar-gold standard to the flexible-dollar standard did not involve any drastic change in the Bretton Woods operating mechanism. Also, all changes in the global economy since the end of the Bretton Woods system are not considered. As Cunha, Prates and Biancareli (2007) state, under the deregulated and liberalized finances, the central banks' capacity to influence the exchange rate becomes very limited in contexts of deep-rooted uncertainty. They also maintain that the trade-account and capital account typology cannot be applied to all peripheral countries, even when considering only Asian countries. Lastly, they say that, despite the significant simplification, the hypothesis in question admits that the periphery functionality to operate the system has required application of restrictions on the international free capital flow.

The Bretton Woods II hypothesis can accommodate some of the main possible consequences of a critical understanding of today's international economy; an understanding that considers at least the prevalence of a dollar-centric financial and monetary order. Yet within the Bretton Woods II analytical structure, the dollar continues as the system's central currency, even given the existence of obdurate US current account deficits, because of the existence of a functional periphery, as mentioned earlier, instead of the privileges that the ability to issue international currency grants to the hegemonic country. This is why it can be claimed that the Bretton Woods II hypothesis is unable to dynamically grasp contemporary international relations, because it is an analytical structure that ignores the widespread and deep changes in the global economy since the 1960s. Thus, it is not enough to systemically understand the nature and dynamics of an international monetary system organized from a dollar-centric fiduciary and increasingly deregulated currency (OLIVEIRA, MAIA & MARIANO, 2008, p. 217).

More recently, within the context of the global crisis, Bibow (2010a; 2010b) now supported the hypothesis of a Bretton Woods III system. According to the author (2010a; 2010b), instead of a Bretton Woods II system, sustainable despite the persisting deficits of the US current account balance, as described by Dooley, Folkers-Landau and Garber (2003), the emergence of a Bretton Woods III is

necessary, in which the US fiscal policy and public debt would take the lead in the growth of the US and world economy. Public rather than private indebtedness would provide a more sustainable growth of the global economy. He believed that the Bretton Woods II hypothesis, based on the sustainability of US current account deficits from a relationship of mutual interest between the surplus and deficit countries, ignores that the counterpart of the US external deficit was not conditioned by the generation of a safe debt but by high risk assets (toxic debts).

Bibow (2010a, p.5) however does not break entirely with the Bretton Woods II hypothesis and even understanding an international financial and monetary order centered on the dollar, agrees with the general points of the Bretton Woods II perspective. His major point of disagreement with the Bretton Woods II hypothesis concerns the fact that it ignores that the counterpart of the US current account deficit was not based on public debt (good quality debt) but above all on toxic debts (BIBOW, 2010a, p.6). Therefore, continuity of the US and global economy growth requires an increase in US public spending bearing in mind that the private sector is unable to continue in debt.

Bibow (2010a) then adapted the Bretton Woods II hypothesis to the new international conjuncture and reconsidered the need for an active fiscal policy in the USA to help the global economy to recover, and to call attention to a matter almost ignored in the discussions on global imbalances, namely the internal imbalances resulting from global imbalances. Although, in a subsequent article he was more critical towards the Bretton Woods II hypothesis, stating that it disregarded the changes to the international monetary system since the 1970s, Bibow (2010a; 2010b) could have come to the same conclusions, rejecting the static and restrictive premises incorporated explicitly and implicitly in the Bretton Woods II hypothesis.

His criticism regarding the Bretton Woods II hypothesis, therefore, is restricted essentially to the omission of the counterpart of the US external deficit, that is, public debt instead of private debt. When ignoring the internal counterparts of global imbalances, this hypothesis wrongly presumes that the imbalances in the US balance of payments current transactions could be sustainable over time. The global crisis revealed how impossible it was to maintain this trend (of current account imbalances) and buried the Bretton Woods II hypothesis (Bibow, 2010b). The increase in public spending, in this sense, is conceived not only as a means to help recover the US economy's internal demand, but also to reinstate a global architecture along the lines of Bretton Woods II, now under the public spending counterpart.

Nevertheless, in the analytical structure of Bretton Woods III, as in that of Bretton Woods II, for the dollar to continue as the central currency, in a context of US current account deficits, there must be a functional periphery of the export-led growth type in order to facilitate US financing. It would not be necessary to mention

the “staging” concept of the development process implicit in this analytical framework, incompatible with the understanding of underdevelopment as a special kind of capitalist development.

It is also worth mentioning that Bibow (2010a; 2010b) also addressed the Bretton Woods IV hypothesis, which could also be called, according to him, Bretton Woods 0, since it refers to the system originally proposed by Keynes in the early 1940s to reorganize the international monetary system after World War II. Bibow (2010a) believes that Bretton Woods III can provide a more stable and sustainable system where it is possible to transit to the desired Bretton Woods 0 system.

3 INSERTION OF THE PERIPHERY

In the 1990s, given the deepening of this international monetary arrangement based on the logic of free international capital flows, the global adjustments were processed by sudden shifts of capital flows and financial crises, considering the growing inability of the International Monetary Fund (IMF) to lead the adjustment process between the surplus and deficit countries. This imposed on the periphery countries the need to constitute high levels of international reserves by forming considerable surpluses in a balance of payments current account, a protection mechanism against shifts in the international capital flows and therefore the financial crises. This strategy, however, competed to intensify the global imbalances (KREGEL, 2008).

A logic shift was indeed observed in the conventional handbooks of international economics since the “developing countries” became net capital exporters.

The rise of Asia as a dynamic international pole, whose increasing demand is substantially driven by exports, has threatened the correlation of forces involved in the adjustment process of global imbalances. In the most recent period, the “developing countries”, especially the Asian economies – particularly China –, have taken the lead in the financing circuit of such adjustments: the high current account surpluses are used to finance part of the demand of the world’s largest economies. Receipt of interest by the new international net creditors, in turn, contributes to the consolidation of the balance of payments current account.

In the case of Asian economies, particularly the Asian Tigers⁶ and the Association of Southeast Asian Nations (Asean-4)⁷ more China, this strategy has helped form an external shield, which protects them from sudden reversals in global capital flows and widens the capacity for adopting independent economic and social policies. And it is worth mentioning, at a negligible fiscal cost, due to

6. Group formed by Hong Kong, South Korea, Singapore and Taiwan.

7. Group formed by Indonesia, Malaysia, the Philippines, and Thailand.

the low differential between domestic interest rates (that apply to the *quasi fiscal* deficit resulting from the monetary sterilization policies) and foreign interest rates (that pay the international reserves invested in bonds of developed countries) (CINTRA, 2005, p. 19).

In Latin America the increase in international reserves in many of these economies is a distinctive factor in relation to the earlier periods of international bonanza. But the current conditions do not mean that there is a new standard for inserting these economies in the globalization process. While, in the case of the Asian economies, the international reserves increased under the predominant influence of current account surpluses, the Latin American countries experienced a much higher increase in international reserves than in the current account surpluses, a sign of the relevance of private capital flows for constituting an “external shield”. In Central and Eastern Europe, the increase in reserves was the result of incoming net flows of private capital, which more than compensated by recurring and expressive deficits in current account balance. In other words, despite the recent increase in international reserves in all groups of emerging and developing economies, the Asian standard of insertion in the global economy is still essentially restricted.

This distinction of the conditioning factors for the increase in international reserves found in the emerging and developing economies in the upward trend of international liquidity between 2002 and 2007, and the subsequent and differentiated reactions of these economies to the recent global crisis, was the result, in fact, of quite different strategies in these countries for insertion in the globalization process, involving exchange arrangements, degrees of financial openness and the institution building of the domestic financial systems and differentiated foreign trade structures (PRATES, BICHARA & CUNHA, 2009).

During the period of international bonanza in the aforementioned interregnum, foreign sales in some of the peripheral regions strongly benefitted from the increase in volume and, especially, from the prices of goods with relevant weight in exports. In Latin America, in this sense, the commodities price was a crucial factor, even in the economies that experienced greater exchange rate appreciation. In contrast, the sharp rise of the commodities prices caused successive deficits in current account balance in Central and Eastern Europe, net importers of commodities. Such deficits, it should be mentioned, were completely financed by the input of private capital flows, in a context of growing financial openness and a considerable difference between internal and foreign interest rates. In Asia, the strong demand caused an increase in the sales volume of manufactured goods, which contributed significantly to the generation of substantial surpluses in current account balance, as Prates, Bichara and Cunha (2009) explained.

The insertion of developing economies in the environment of global imbalances continued therefore to be unequal despite the prevalence of some

similar outcomes, largely due to a highly favorable international environment between 2002 and 2007, some of which are: i) an increase in international reserves; ii) control of domestic inflation; and iii) faster economic growth. As demonstrated, once again, at times of crisis the difference mentioned here is felt strongly in terms of minimizing the adverse impacts arising from sudden shifts in the general status of expectations by the conductors of the orchestra of financialized global capitalism, namely: institutional investors, big banks and treasuries of large corporations.

In the case of economies in which an increase in international reserves basically originated from the net inflows of private capital, such as the Central and Eastern Europe economies, the sudden shift in global financial market expectations and consequent reversal of capital flows were very damaging, much more so than those found in the other economies, particularly in Asia. In fact, such economies formed a “vulnerable external shield” during the period when the bonanza of global market prevailed. They were then exposed to the mood changes of volatile globalized financial markets.

Between 2008 and 2009, for example, while the GDP of the Eastern and Central Europe economies plummeted from 3% to -3%, the GDP of the Asian developing economies dropped from 7.7% to 6.9%. In the case of the Latin American group of economies, the GDP shrank from 4.3% to -1.7%. It should be mentioned that in this period the investment/ GDP ratio dropped from 24.8% to 18.8% in the first group; rose from 38.2% to 40.8% in the second; and fell from 23.6% to 19.8% in the third.

When discussing the contagious effect of the crisis on emerging currencies, Prates, Bichara and Cunha (2009) show that, although the exchange depreciation occurring in almost every developing and emerging economy following the crisis (last four months of 2008) did not follow only its current account results in the countries where the scale of the current account deficit and subsequent need for external financing were greatest, the exchange devaluations were more pronounced compared to this region's economies in which their foreign accounts were less vulnerable. With regard to the impacts of the global crisis on emerging and developing economies in different regions, particularly concerning the effects on economic growth, the authors state that: “In the sphere of Central and Eastern Europe countries, the economies with more external vulnerability (high current account deficits and debts in foreign currency) were those with the worst performance” (PRATES, BICHARA & CUNHA, 2009).

Although the “external shield”, as defined in this paper's introduction, cannot prevent the “contagion effect” since it does not attack the root cause of the stubborn instability of international private capital flows, of a structural

nature and intrinsic to today's financial and monetary international system, it is a very important tool for the peripheral economies to react actively against the negative impacts of the sudden shift in these flows, and to put in place national development strategies. Thus, an insertion minimally sovereign in the globalization, considering the current hierarchical and unequal international financial and monetary arrangement, requires economic policies designed to strengthen foreign accounts and diminish dependence, which involves capital controls, of the international risk capital flows.

Nevertheless, the international reserves accumulation strategy by peripheral countries tends to perpetuate the global imbalances prevailing in contemporary capitalism. This then raises the question of how to make this strategy compatible with a situation of substantially reduced global imbalances. This question, together with the lessons that can be learned from the different historical experiences of late capitalist development, brings up the recommendation that the countries on the periphery should seize the few opportunities they have when the center, either intentionally or otherwise, adopts a growth strategy that encourages, even if non-sustainably, the condition of buyer and debtor of last resort. Under the protection of liberalized and deregulated markets, the global imbalances have helped some economies that can put in place a development strategy, one of its main characteristics being an "external shield".

Although during the time of widespread international liquidity between 2002 and 2007, some approximation was seen between the "Latin-American standard" and "Asian standard" (Asian Tigers, Asean-4 and China) with regard both to the accumulation of international reserves and to the composition of net capital flows— with a larger share of direct foreign investments –, the most recent evidence indicates that this approximation was merely circumstantial, particularly with regard to the results of the balance of payments current account.⁸

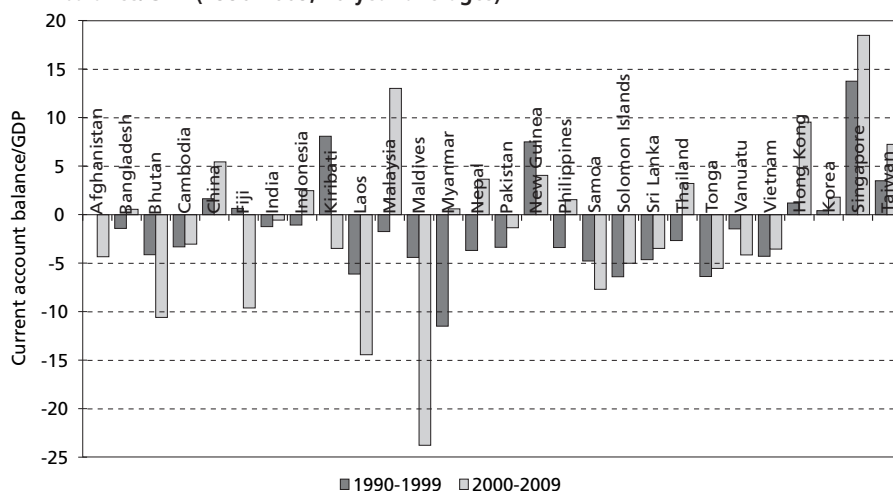
Considering the Latin America and Caribbean group, according to IMF data in the World Economic Outlook Database, only Argentina, Bolivia, Chile, Peru, Trinidad & Tobago, Uruguay and Venezuela presented current account surplus in 2009. Just for the sake of comparison, in the case of the Asian Tigers – economies considered developed by the IMF –, significant current account surpluses were found in percentage of the GDP in 2009. In Hong Kong, this ratio was 8.7%; South Korea 5.1%; Singapore 17.8%; and Taiwan 11.3%. In the case of Asean-4 member-States and China, the indicator was 2% in Indonesia, 16.5% in Malaysia, 5.3% in the Philippines; 7.7% in Thailand, and 6% in China.

8. Regarding the background to the differentiated insertion of Asia and Latin America in the globalization process, see Medeiros (1997).

The “Asian standard” of insertion, specifically in relation to the persisting current account surpluses, refers basically to the Asian Tigers, Asean-4 and China. Ignoring the sub-group formed by Asean-4 and China, few Asian economies considered as “developing countries” had significant persistent current account surpluses. Graph 1 below shows the average current account balance in a percentage of the GDP between 1990-1999 and 2000-2009, for the developing economies in Asia – excluding East Timor and Brunei – and the Asian Tigers, ratifying this statement.

GRAPH 1

Asian developing economies and newly industrialized countries (NICs): current account balance/GDP (1990-2009, 10-year averages)



Source: IMF (2010).

Prepared by the author.

Concerning the Asean-4 economies, including the case of Indonesia, Malaysia and Thailand, they first obtained substantial and persistent current account surpluses after the Asian crisis since 1998. In the case of the Philippines, after the 2.3% current account surplus in 1998, current account deficits were verified between 1999 and 2002, with surpluses again only from 2003 onward.

From graph 2 showing this indicator for the Latin-American and Caribbean economies, contrary to the Asian Tigers and China in the 1990s and 2000s, and the Asean-4 member countries in the decade 2000, practically every country recorded current account deficits in the period 1990- 2000, considering their arithmetic averages.

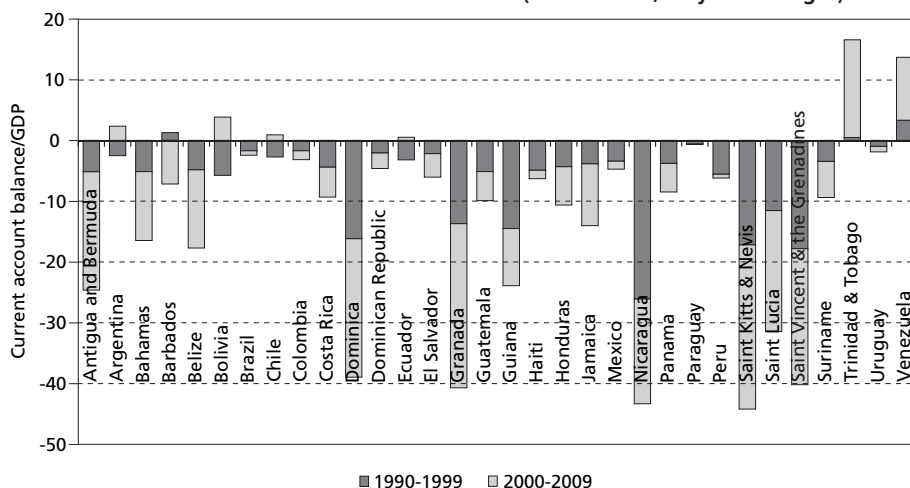
Graphs 3 and 4 show that, while for the group of Asian developing economies – including China and the Asean-4 – the current account result has a significant

share in the variation of international reserves, an increase in reserves was found in the Central and Eastern European group, despite successive balance of payments current account deficits, especially in recent years.

In relation to the group of Latin-American economies, between 2003 and 2006, although the variation in reserves was in step with the current account surpluses since 2007, a progressive divergence began between the result of foreign accounts (current account) and the increase in international reserves. The situation was similar to the group of economies in Sub-Saharan Africa, while the group of economies in the Commonwealth of Independent States (CIS) and the Middle East plus North Africa, also had a high ratio between the international reserves and the current account balance, albeit at different levels, during the expansion of international liquidity in the years 2000.

GRAPH 2

Latin America: current account balance /GDP (1990 – 2009, 10-year averages)

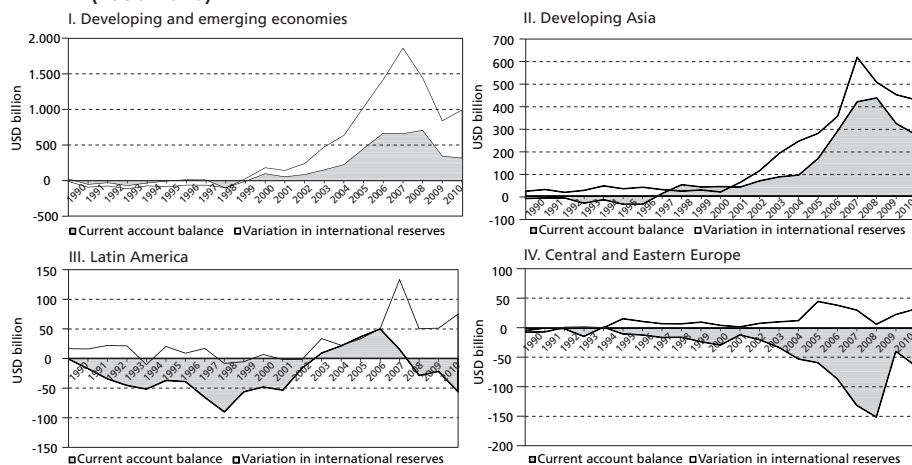


Source: IMF (2010).

Prepared by the author.

GRAPH 3

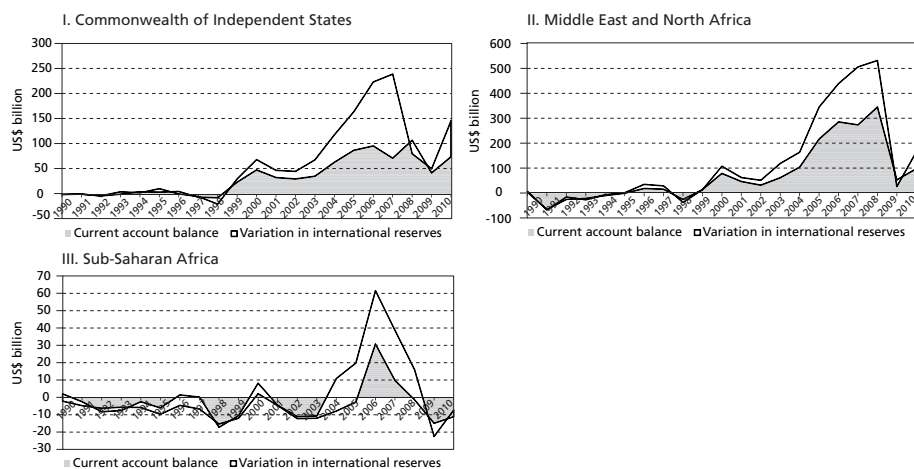
Current account balance and change in international reserves: selected groups – part 1 (1990-2010)



Source: IMF (2010).
Prepared by the author.

GRAPH 4

Current account balance and change in international reserves: selected groups – part 2 (1990-2010)



Source: IMF (2010).
Prepared by the author.

Of course, the analysis of the aggregate group of regional economies, although it allows some similarities and differences between different regions of the world, implies ignoring not insignificant intraregional characteristics. Accordingly, tables 1 and 2 show the accumulated current account balance between 2000 and 2009 for the Asian developing economies and the newly industrialized countries (NICs) and for Latin American economies, respectively, as well as the variation in international reserves in each country selected for this period – obtained by subtraction between the position of reserves in 2009 and 2000. The tables also show the ratio between the accumulated current account balance between 2000 and 2009 and the variation in international reserves – in absolute terms – in the these economies.

In the Asian case, considering the largest economies in the region, only India recorded a deficit in the accumulated current account balance for this period while at the same time had significant expansion of international reserves of USD 227.8 billion. In China, in contrast, the reserves increased USD 2.3 trillion between 2000 and 2009, against an accumulated current account surplus of USD 1.7 trillion. In Indonesia, Malaysia, the Philippines and Thailand, the generation of current account surpluses plays a leading role, albeit at different levels, for increasing reserves. This dynamics was not necessarily found in several smaller economies in the region, as can be seen in table 1. In the case of the Asian Tigers, in South Korea the accumulated current account balance was the predominant share of the increase in reserves, while in the other economies the balance in question exceeded in different degrees the expansion of the reserves in the period 2000-2009.

With regard to Latin America and the Caribbean, in only six of the 30 economies considered in Table 2, the increase of international reserves between 2000 and 2009 was accompanied by the generation of a positive accumulated current account balance, to a greater or lesser degree than the increase in reserves. This was the case of Argentina, Bolivia, Chile, Ecuador, Trinidad & Tobago and Venezuela. In the other economies, the international reserves increased without obtaining a positive result in the current account balance accumulated between 2000 and 2009. In Brazil, international reserves grew USD 205 billion in the period in question against a negative accumulated current account balance of USD 62.5 billion. In Mexico and Peru, reserves rose USD 64 billion and USD 23.6 billion, respectively, considering the accumulated current account deficit of USD 101.5 billion and USD 3.7 billion.

TABLE 1

Accumulated current account balance and change in international reserves in the Asian developing economies and NICs (2000-2009)
(In USD billion)

Country	Accumulated current account balance – USD Bi (A)	Change in reserves – USD Bi (B)	(A)/(B)
Afghanistan	-1.98	8.73	-0.23
Bhutan	0.58	0.45	1.29
Brunei	46.18	0.95	48.66
Cambodia	-2.30	2.35	-0.98
China	1,707.01	2,264.08	0.75
Fiji	-2.88	0.15	-18.59
India	-75.39	227.74	-0.33
Indonesia	64.73	35.05	1.85
Laos	-4.77	0.56	-8.45
Malaysia	199.06	67.11	2.97
Maldives	-2.37	0.14	-17.18
Myanmar ²	1.41	1.01	1.39
Nepal ³	1.72	0.55	3.11
Pakistan	-27.72	9.82	-2.82
Papua New Guinea	1.92	2.27	0.84
Philippines	24.30	25.64	0.95
Samoa	-0.31	0.10	-3.04
Solomon Islands	-0.32	0.11	-2.79
Sri Lanka	-9.81	3.60	-2.73
Thailand	58.96	103.51	0.57
East Timor	5.29	0.21	25.63
Tonga	-0.16	0.07	-2.31
Vanuatu	-0.19	0.11	-1.72
Hong Kong	177.61	148.23	1.20
Korea	128.94	173.81	0.74
Singapore	251.44	107.63	2.34
Taiwan	253.88	241.59	1.05

Source: IMF (2010; [sd]).

Prepared by the author.

Notes:¹ Bhutan: variation in reserves between 2000 and 2008

² Myanmar: variation in reserves between 2000 and 2005.

³ Nepal: variation in reserves between 2000 and 2005.

Comment: The value of international reserves was converted from special drawing rights (SDRs) to dollars based on the end-of-period exchange rate.

Accordingly, while the Asian Tigers, China and, after the Asian crisis, the Asean-4 economies financed the other countries' deficits, principally of the USA, mostly from the reserves obtained from a surplus in the balance of payments current account, other economies, such as those in Central and Eastern Europe and many in Latin America, acted simply as a financial depository for global capital, whose function was subjugated to the valuation of volatile and fictitious share equity: such economies obtain borrowed resources by paying high interest rates in order to finance, at low interest rates, the US deficits, playing a passive role in

the dynamics of global imbalances and benefitting only circumstantially from the bonanza of the international financial markets. They cannot, therefore, constitute a stock in international reserves from the substantial ongoing current account surpluses, less sensitive to the sudden mood changes of the speculating global financial markets, result of the international reserves accumulation strategy based on private capital inflows.

TABLE 2

Accumulated current account balance and change in international reserves in the Latin American and Caribbean economies (2000-2009)

(In USD billion)

Country	Balance accumulated in current account – USD Bi (A)	Change in reserves – USD Bi (B)	(A)/(B)
Antigua and Barbuda	-1.92	0.06	-29.87
Argentina	35.22	21.04	1.67
Bahamas	-7.57	0.66	-11.47
Barbados	-2.37	0.40	-5.95
Belize	-1.31	0.09	-14.46
Bolivia	5.71	6.66	0.86
Brazil	-62.54	204.89	-0.31
Chile	16.48	10.25	1.61
Colombia	-26.44	15.83	-1.67
Costa Rica	-10.79	2.75	-3.92
Dominican Republic	-11.09	2.26	-4.91
Ecuador	2.71	1.93	1.40
El Salvador	-6.97	1.09	-6.40
Guatemala	-12.25	3.22	-3.80
Guyana	-1.39	0.33	-4.26
Haiti	-0.72	0.61	-1.19
Honduras ¹	-6.56	1.16	-5.65
Jamaica	-11.67	1.02	-11.42
Mexico	-101.48	64.08	-1.58
Nicaragua	-8.42	1.08	-7.77
Panama	-8.02	2.31	-3.48
Paraguay	-0.26	3.08	-0.08
Peru	-3.75	23.65	-0.16
St Kitts and Nevis	-1.17	0.09	-12.79
St Lucia	-1.74	0.10	-18.12
St Vincent and the Grenadines	-1.09	0.03	-33.49
Suriname	-0.55	0.59	-0.94
Trinidad & Tobago	30.20	7.79	3.88
Uruguay	-2.61	5.50	-0.47
Venezuela	167.41	8.78	19.06

Source: IMF ((2010; [sd])).

Prepared by the author.

Notes:¹ Honduras: reserves variation between 2000 and 2008.

Comment: The value of international reserves was converted from SDR to dollars based on the end-of-period exchange rate.

In many economies on the periphery, especially those with wider financial openness, the net capital inflow implied major valuations of the exchange rate in the period prior to the global crisis and pronounced devaluations during the international crisis, in the wake of the contagious effect. More recently, with the ultra-expansionist monetary policy adopted by the Fed (quantitative easing) to overcome the crisis and subsequent expansion of the dollar's liquidity in the world, many emerging economies have again undergone strong appreciation pressures on their exchange rates. In order to resolve the exchange over-appreciation, many governments have adopted highly active conversion policies.

In the case of economies with current account deficits and high interest rates, the recurring major interventions in the exchange market by central banks have implied an increase in international reserves and internal public debt in view of the subsequent monetary sterilization policy. For those countries exporters of commodities, like Brazil, the exchange intervention prevents an even greater exchange appreciation. But in contrast, this initiative operates to prevent the foreign exchange effect (appreciation) resulting from the input of external resources – either through a capital and financial account or current account – counterweighs the inflationary effects from the rise in commodity prices and/or the internal monetary expansion.

In the countries that accumulate reserves from current account surpluses and strive to keep the exchange rate at a competitive level, the exchange interventions also evidently result in undesirable effects. In China, as Brender and Pisani (2010, p. 73-75) demonstrate, the Central Bank adopts a series of initiatives to hold back the inflationary impacts from the massive purchase of foreign currency, such as the imposition of direct and indirect restrictions on bank loans, issuance of securities for monetary sterilization and the adjustments in the bank's mandatory collection fee, as well as the short-term interest rate (inter-bank). But in the Asian economies, not only is the differential between the internal and external interest rates lower, the increase in reserves by obtaining current account surpluses allows the formation of a more solid "external shield", since it is not directly and extremely dependent on the sudden fluctuations in expectations of the international financial markets.

The increasing international reserves in the context of persisting and substantial current account deficits, in this sense, causes potential relevant internal constraints on economic policy (increased public debt, internal monetary expansion, asset inflation, and so on) and, at the same time, only a circumstantial when not fictitious "external shield". Contrary to the generation of foreign currency from the export of goods and services, which is more autonomously managed by the central bank, the international reserves obtained from the incoming foreign capital, namely allocated to the purchase of stock and securities, can soon become

extinct, considering the frequent changes in expectations common to the context of free financial markets – even though incoming foreign capital by this means is able to also circumstantially boost the domestic capital markets and give more breathing space to the foreign accounts.

4 IN CONCLUSION

Under the impacts of the great recession, the US current account deficit shrank from 6% of the GDP in 2006 to less than 3% in 2009. According to the IMF projections (2010) in the World Economic Outlook Database, for the period 2011-2015 the US economy should have an average current account deficit of less than 3% of the GDP. Is this only a temporary situation or does the recovery of the US economy, spurred on by significant fiscal and monetary stimuli, tend to put external deficits back at higher levels in a near future?

Bibow (2010, p. 10) believes that the external adjustment of the USA would only be possible if the country adopted an export-led growth strategy, on one hand, and the large surplus economies, on the other, were to adopt a growth strategy based on internal demand. Yet despite the tax incentives adopted by the surplus countries immediately after the global crisis, Bibow states that there is little evidence of such economies being willing to abandon the export-led growth strategy. In the latter case, US and global economy growth depends on the continuity of the expansionist fiscal policy in the USA. This is why, under the desired system that the author calls Bretton Woods III, “*fiscal policy is back!*” (BIBOW, 2010b, p.10).

Even in this case, however, recent evidence shows the huge difficulties undergone by several countries, including the USA, in order to move on with their expansionist fiscal policies. Many European countries and even the USA have felt strong pressure to reduce public spending. Under the “watchful eye” of globalized financial markets, a number of countries have been forced to more “wisely” calibrate their fiscal policy in order to guarantee good risk ratings granted by the rating agencies that had turned a blind eye to toxic assets. The US Congress, in turn, has repeatedly shown signs of discontent toward the significant tax packages often requested by President Barack Obama. It is worth mentioning that this so happens even with the prevalence of an exceptionally low real interest rate in the USA, which sharply reduces the charges on the public debt.

The adoption of a new five-year plan for 2011-2015 in China, however, may actually alter the dynamics of a key conditioning factor of the contemporary global imbalances, since it tends to increase the level of domestic consumption and reduce the Chinese trade surplus. But only the near future could show whether the new plan will represent a change in the foreign accounts of the world’s sec-

ond largest economy or whether it will be just one more long-term signal by the Chinese economy.

After the theoretical discussion on global imbalances, this paper has shown that this context opened to the possibility of accumulating international reserves for the peripheral economies, namely in Asia, by generating surpluses in the balance of payment current account. Nevertheless, in several “emerging and developing” economies, based on the IMF rating, the increase in reserves was accompanied by successive significant current account deficits, having resulted, basically or predominantly, from the private capital net inflows. It follows, therefore, that the insertion of the periphery in the global economy continued to be highly differentiated, so that it would not be possible to sustain the idea of a “new insertion standard” for the group of peripheral economies in the globalization process, bearing in mind the important qualitative differences related to the increase in their international reserves.

Consequently, would the vulnerably shielded economies on the periphery be bound to decrease the rate of economic growth in order to increase the internal savings level and, thus, help obtain balance of payment current account surpluses? It may be said that part of the current account deficit for many of these economies began from the high level of goods and services consumption that may be considered conspicuous. However, the external procurement of capital goods, technology and highly skilled specialized services may contribute to the economic and social development in the mid and long terms. No less important is the existence of internal channels of dynamic and effective financing, which may also contribute to improvement; of the current account balance by helping boost its productive capacity at a faster rate, without implying the need to substantially complement imports on the bundled offer, nor inflationary tensions. This represents only one of a number of issues gravitating around the subject discussed by this paper, and encouraging further studies on the topic.

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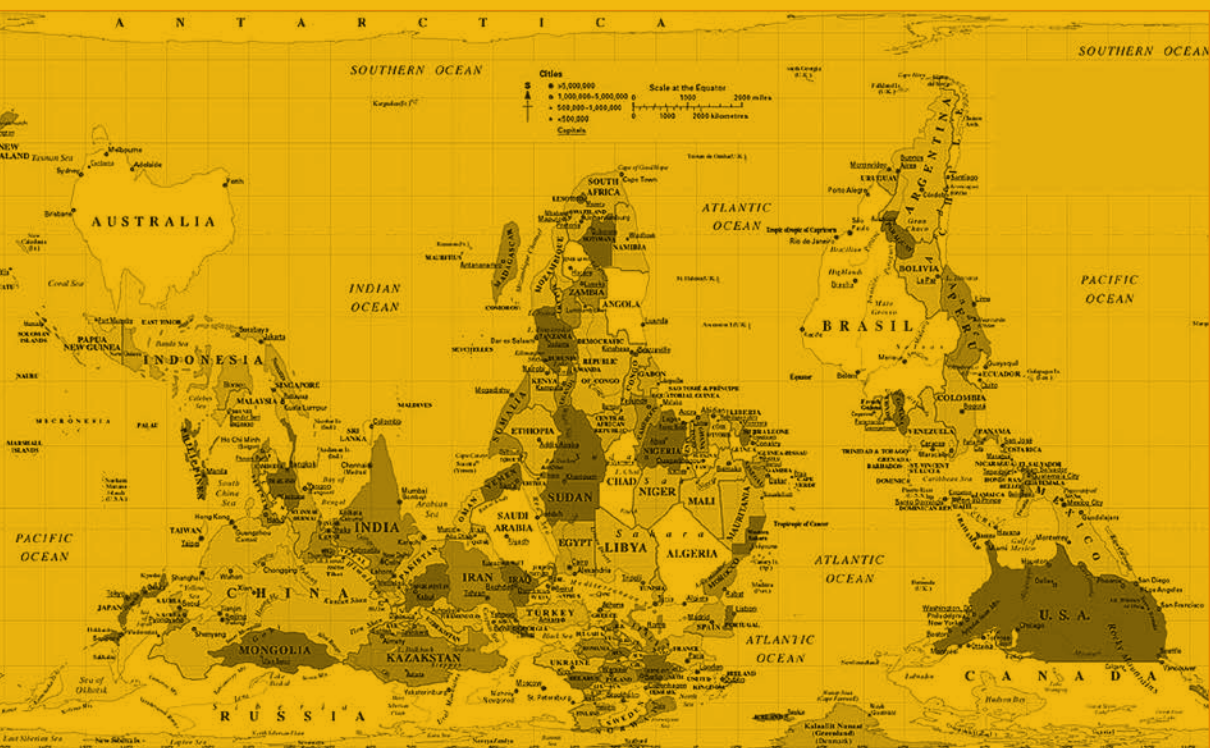
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