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„Post-Bretton-Woods Monetary Policymaking in Emerging Markets – Learning and Diffusion in Brazil

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On my honour as a student of the Diplomatic Academy of Vienna, I submit this work in good faith and pledge that I have neither given nor received unauthorized assistance on it.

Sebastian Egger, 17. 7. 2020

Abstract

The collapse of the Bretton Woods system of monetary management in 1973 has ushered in a new era of international capital mobility. While this holds certain benefits for global markets such as a more efficient allocation of capital, emerging market economies in particular have since faced a new kind of financial volatility. This thesis thus looks at financial and monetary policymaking regarding capital account liberalisation, specifically at the case of Brazil from 1973 to 2018. In doing so, it aims to shed light on what inspired policy change in Brazil in the given period. The methodology applied in this research features the conceptual tools of policy learning and policy diffusion, which help to differentiate between policies that were inspired endogenously, and ones that were inspired exogenously. The thesis finds that while path-dependent processes of policy learning have featured prominently in Brazil's recent history of monetary policy, there has been a period of policy diffusion as the predominant influence on Brazil's monetary policymaking from the mid-1990s to the 2008 global financial crisis.

Das Ende des Bretton-Woods-Systems 1973 führte zu einer neuen wirtschaftlichen Periode internationaler Kapitalmobilität. Wenngleich dies bestimmte Vorteile für die Weltwirtschaft mit sich brachte, wie etwa eine effizientere Allokation von Kapital, bedeutete diese Entwicklung vor allem für aufstrebende Märkte eine neue Form der monetären Volatilität. Die folgende Arbeit untersucht daher die Entscheidungsfindung für Geldpolitik in aufstrebenden Märkten, im Speziellen anhand der relevanten Geschichte Brasiliens von 1973 bis 2018. Dabei steht im Fokus, wie Entscheidungsträger zu ihrer jeweiligen Politik inspiriert wurden, was mithilfe der methodologischen Konzepte der *Policy Diffusion* und des *Policy Learning* analysiert wird. Die Arbeit kommt zu dem Schluss, dass obwohl endogenes *Policy Learning* in Brasilien lange vorherrschend war und weiterhin ist, es von Mitte der 1990er bis zur weltweiten Finanzkrise 2008 eine Phase gab, in der vorwiegend *Policy Diffusion* stattfand.

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§1 – Economic and Methodological Theories

The popular economics textbook by Krugman, Obstfeld and Melitz introduces the reader to its chapter on financial globalisation with the following passage: "If a financier (…) had gone to sleep in the 1960s and awakened after 55 years, he would have been shocked by changes in both the nature and the scale of international financial activity. In the early 1960s, for example, most banking business was purely domestic, involving the currency and customers of the bank's home country. Five decades later, many banks were deriving a large share of their profits from international activities".[1] They go on to explain that today's degree of international financial liberalisation, while having positive effects for an economy's efficiency similar to the effects provided by trade in goods and services, as well as "greater diversification of foreign risk", is suspected by "many observers" to cause "financial fragility".[2] They link this to the "free-wheeling nature" of international banking, assessing that in fact, the financial crisis of 2007-2009 would empirically support such a belief.[3]

The following thesis has no intention to comment on or contribute to the ever-evolving literature on financial globalisation and its effects. Instead, it looks at financial globalisation from the point of view of policymaking in developing economies. Specifically, it qualitatively reviews the monetary history of Brazil in the period of 1973 to 2018, i.e. from the collapse of the Bretton-Woods system to the election of current president Jair Bolsonaro. The main underlying question to this research will be how Brazil's monetary policy was shaped by internal and external influences since the collapse of the Bretton Woods system, specifically from 1973 to 2018. This question entails a comparative element, as it aims to contrast policy-decisions that were inspired endogenously to ones that were inspired exogenously. In this context I explore two related questions, namely firstly *how* the Brazilian policymaking in the relevant policy area actually looked like and secondly how *successful* the chosen policies were in practice. These two sub-questions arise from the necessity to analyse quality and origin of

[1] Krugman, Obstfeld, Melitz, p. 642
[2] Krugman, Obstfeld, Melitz, p. 644-650
[3] Krugman, Obstfeld, Melitz, p. 669, 650

policies in order to appropriately draw conclusions towards policymakers' reasons for adopting them.

The methodological framework of my answer to the above questions uses the concepts of policy learning and policy diffusion. While policy learning as a theory originated in the discipline of political sciences, policy diffusion originated from communication sciences and the study of international business management and has only more recently found its way to the studies of developing economics and political economy. The reason why I have chosen to work with these concepts is two-fold. First, they provide an ideal framework to capture my underlying interests of reason and quality of enacted monetary policies. Second, it is possible to "tease out and compare" the two and their various subcategorisations in the course of historical analysis, in essence qualitatively "trying on" different interpretations for the origin of policy change.[4] Finally, my analysis is inspired by the research of Sarah M. Brooks and Marcus J. Kurtz, who in their paper on statist legacies in Latin America are arguing against the current academic trend ascribing financial policy change in Latin America solely to the international diffusion of policies.[5] Instead, they stress the path dependence of financial policy in the region.[6] These two diverging views can be well analysed and empirically described by looking at the case of Brazil with the analytical "lenses" of policy learning and policy diffusion.

This attempt is divided into three broad parts and structured as follows: In the first part, I lay out the theoretical background of the topic of financial globalisation as well as further specify my methodological framework. I initiate this in §1.1 by defining the scope and implications of financial globalisation in a worldwide setting. After outlining the history of financial globalisation and establishing that it indeed created a changed situation that policymakers had to react to, I further specify the situation it created for developing countries in particular in §1.2. Then, in §1.3 I discuss the chosen methodological concepts introduced above and give a brief literature review on them.

My second part, constituting the empirical part of my thesis, consists of an analytical history of Brazil in the given timeframe. For the sake of best possible context, in §2.1 it gives an

[4] Trein p. 8
[5] Brooks & Kurtz p. 95
[6] Brooks & Kurtz p. 123

overview of the political and institutional history of Brazil, and in §2.2 reviews Brazil's economic history as its economy's development in the past century. Finally, §2.3 reviews and analyses Brazil's monetary and financial policies in the period of 1973 to 2018. The reason I chose Brazil for this case study is that Latin America has long been associated with financial and monetary crises, and within Latin America, Brazil has interestingly had a very mixed rate of success in the past half century when it comes to its monetary policy and its cross-border finance management.[7]

After this extensive historical review, I ultimately proceed to present my analytical findings in §3. These include attempts at a periodisation of Brazil's monetary policy according to the particular influencing mechanisms at play. I find that while Brooks and Kurtz correctly stress the importance of considering path-dependence in Latin American financial policy change, there has been an arguably clear period of policy diffusion from the mid-1990s to the global financial crisis of 2008. Furthermore, I find the policy reaction to the 2008 global financial crisis and the 2013 Taper Tantrum to qualify as endogenous policy learning, as it was inspired by Brazil's experience of financial crises in the 1990s.

I believe my research is significant as it provides an empirical case study for the theoretical explanations of policy change in developing countries. Furthermore, due to the qualitative research design applied, it will be able to shed light on the causal processes at work during the different mechanisms of policy diffusion and policy learning. Last but not least, as it embraces the individual level of analysis, it puts the policymakers specifically in the centre of attention, showing financial policy in developing countries from an even more particularised angle.

[7] Krugman p. 30

§1.1 – Financial Globalisation – A Changed Situation

My first chapter outlines the extent and the history of financial globalisation as well as the different perceptions of economists of it. Furthermore, it establishes that financial globalisation indeed created a new situation that policymakers were largely unfamiliar with and had to "learn" how to react to.

First and foremost, in order to quantify financial globalisation, it is important to define its meaning. I will use as definition the extent of private global financial flows, excluding internationally interwoven public debt as this has been described in the literature as constituting a connected yet separate process.[8] Taking this definition, the extent of financial globalisation is best measured as an economy's gross foreign liabilities and assets in terms of their percentage of the country's GDP.[9]

Looking at the data of this measurement for the industrialised world, it becomes clear that there has been an incredible increase in international financial integration. As can be seen in table 1, Germany's and France's sums of external assets and liabilities have increased from 69 to 326 and from 91 to 418 percent of GDP respectively in the period of 1983 to 2004. Similar developments can be observed for Italy, the UK and the United states, although the process has been even more pronounced in the UK, arguably because of the country's significance in international finance.[10] So while the net assets in terms of GDP of the selected countries have remained modest due to a balanced increase in both assets and liabilities, the sum of financial flows coming in and going out has multiplied in these notable industrialised economies.[11] At the same time, looking at developing countries' external assets and liabilities, we see that on the one hand the movements of financial flows seems to have been more erratic, and on the other hand there is a tendency of developing economies to have significantly higher liabilities as compared to their assets. Also, Brazil shows up with very high foreign liabilities in 1983, which can be explained by its high accumulation of debt in the

[8] Krugman, Obstfeld, Melitz, p. 646, Reinhart, Reinhart, Rogoff, (public debt overhangs) p. 84
[9] Krugman, Obstfeld, Melitz, p. 668
[10] Worldwide Centres of Commerce Index 2008
[11] Lane & Ferretti 2007, p. 235

1980s, a fact that is covered in more detail in §2.2. Anyway, overall there is an observable increase of financial interconnectedness in both industrialised and developing countries.

		1983	1993	2004
France				
	Foreign Assets	44	79	212
	Foreign Liabilities	47	91	206
	Sum	91	170	418
Germany				
	Foreign Assets	38	64	167
	Foreign Liabilities	31	54	159
	Sum	69	118	326
Italy				
	Foreign Assets	23	45	105
	Foreign Liabilities	27	55	124
	Sum	50	100	229
United Kingdom				
	Foreign Assets	152	207	357
	Foreign Liabilities	136	203	371
	Sum	288	410	728
United States				
	Foreign Assets	29	45	84
	Foreign Liabilities	25	48	106
	Sum	54	93	190
Brazil				
	Foreign Assets	15	20	28
	Foreign Liabilities	77	43	78
	Sum	92	63	106
South Africa				
	Foreign Assets	14	21	65
	Foreign Liabilities	48	33	70
	Sum	62	54	135
Mexico				
	Foreign Assets	13	16	20
	Foreign Liabilities	65	55	63
	Sum	78	71	83
China				
	Foreign Assets	10	15	56
	Foreign Liabilities	4	26	47
	Sum	14	41	103

Table 1 - Foreign Assets and Liabilities of selected Economies as percent of GDP. Source: Own based on Philip Lane's data set for "The External Wealth of Nations", accessed on https://www.imf.org/en/Publications/WP/Issues/2016/12/31/The-External-Wealth-of-Nations-Mark-II-Revised-and-Extended-Estimates-of-Foreign-Assets-and-18942

This trend is clearly a global phenomenon, as demonstrated by 2007 figures comparing the volume of foreign currency transactions to the volume of trade, with the former outnumbering the latter with latter with $3.2 trillion to $38 billion per day.[12] As Dani Rodrik puts it, by the early 2000s finance "had swamped the real economy".[13]

[12] Estimate by the Bank of International Settlements, http://www.forex-brokerage-firms.com/news/currency-markets-rises.htm

[13] Rodrik p. 107

In order to put these developments into context, it is important to lay out a quick history of financial globalisation and its underlying factors. Such a history would necessarily have to start with the Bretton Woods system, a set of rules for the financial relations between industrialised countries in effect between 1944 and 1973. This system consisted of fixed but adjustable exchange rates of signatory countries' currencies to the US dollar and the unvarying dollar price of 35$ for an ounce of gold, as well as a limitation on the international movement of capital.[14]

John Maynard Keynes played an important role in the design of Bretton Woods, believing that unfettered capital flows would undermine financial stability and the macroeconomic equilibrium.[15] According to the so-called monetary trilemma, countries can choose a maximum of two of the following three options; discretionary monetary policy, stable exchange rates and free movement of capital.[16] The Bretton Woods system's "delicate compromise", as economist John Ruggie termed it, consisted of allowing "enough international discipline and progress toward trade liberalization to ensure vibrant world commerce", but giving "plenty of space for governments to respond to social and economic needs at home".[17] This essentially meant that in order to counter isolationist arguments regarding trade, fixed exchange rates and independent monetary policy were preferred over free movement of capital in the aforementioned trilemma.[18]

Thus, for three decades after the end of World War Two there was a consensus that the negligible option among the monetary trilemma's choices was free movement of capital, bringing the world economy's financial integration to an historic low. However, there was one figurative "Achilles' heel" in the design of the Bretton Woods system.[19] In order to sustain a global economy, it was important to have a global medium of exchange, some sort of "international money".[20] While in earlier attempts at coordinating countries' monetary systems it was gold that played this role, under the Bretton Woods system, the U.S. dollar effectively became this international currency.[21] The aforementioned peg of the dollar to gold

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[14] Krugman, Obstfeld, Melitz p. 598
[15] Rodrik p. 96
[16] Krugman p. 106
[17] Rodrik p. 69
[18] Ruggie p. 590
[19] Rodrik p. 99
[20] Ibid
[21] Skidelsky p. 53

underpinned confidence in this solution, in effect making the system rely on the United States never devaluing its currency in terms of gold.[22] However, when the U.S. began running a deficit during the Vietnam War in the 1960s, and Europe and East Asia rapidly grew after their recovery from World War Two, economic policymakers started to doubt the United States' willingness and ability to maintain the peg.[23] And when President Nixon was confronted with growing demands from overseas to exchange dollars into gold in 1971, he and his Treasury secretary chose to suspend the fixed convertibility of dollars to gold.[24]

However, it was not just the United States' need to devalue its currency that brought down Bretton Woods. While the 1950s and 1960s were the heyday of Keynesianism, the combination of inflation and unemployment in the 1970s ushered in a new paradigm of economic management. Mainstream economists started to view discretionary monetary policies – as advocated by Keynes – as a source of instability rather than stability.[25] In addition, the strong growth of trade made it more difficult to administer the capital controls put in place by Bretton Woods, as capital flows could be disguised by manipulating trade flows.[26] As Paul Krugman puts it, since the Bretton Woods era the world "has relearned the virtues of free markets", causing freely floating exchange rates to be regarded "as the lesser of three evils" by most economists since the 1990s.[27]

Shortly summarised by the comprehensive illustration seen in Figure 1, taken from an essay on global capital markets by Maurice Obstfeld and Alan Taylor, capital is now more global than ever.[28] While in the twentieth century global capital was tamed first by two World Wars and then by the Bretton Woods system, it has since increased to the impressive figures cited above. Were we to extend Obstfeld and Taylor's graph to the present day, one would see another slight bump during and shortly after the financial crisis of 2007-2009, which I will return to towards the end of this chapter.

[22] Rodrik p. 99
[23] Rodrik p. 100
[24] Frieden p. 340-346
[25] Rodrik p. 101
[26] Rodrik p. 102
[27] Krugman p. 108
[28] Obstfeld, Taylor, p. 127

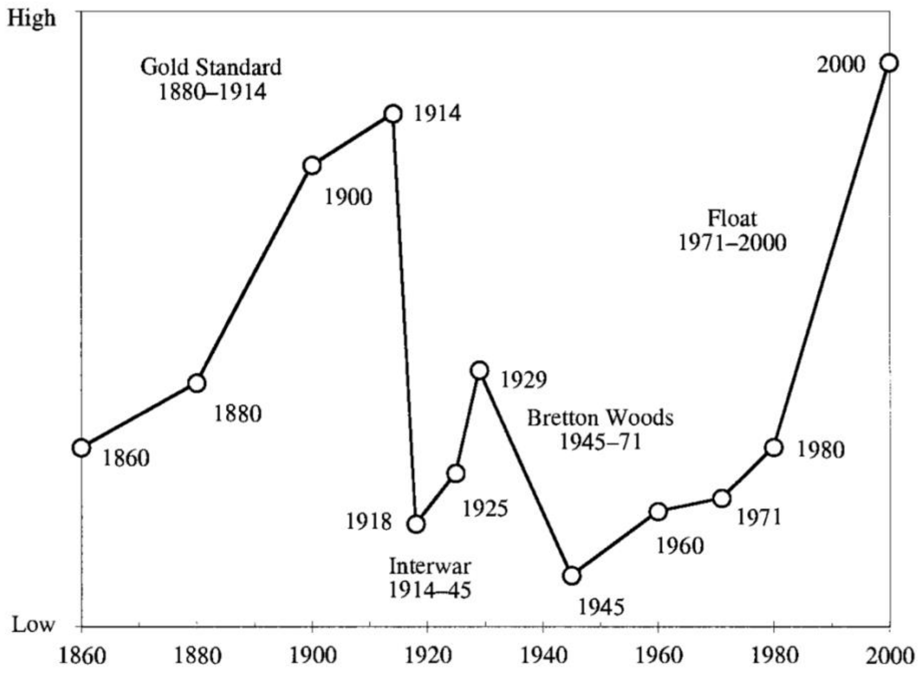

Figure 1 - "A stylised view of capital mobility in modern history". Source: Maurice Obstfeld and Alan M. Taylor's "Globalization and Capital Markets" in "Globalization in Historical Perspective" edited by Bordo, Taylor & Williamson (2005)

As mentioned already, the theoretical case for free capital movement is in some of its aspects similar to the case for free trade. Drawing on the "efficient market hypothesis" (EMH) developed by Eugene Fama in the 1970s, Maxwell Fry argues that policies of "financial repression" distort the efficient functioning of financial markets.[29] According to the EMH, this then results in the "misalignment of financial prices such as interest and foreign exchange rates" and "the underdevelopment of domestic financial markets".[30] Instead, free capital movement would enable the efficient allocation of international savings across the global economy. Seeking the highest returns, savings would go to whichever countries can use them the most productively, thus maximising economic and social welfare.[31]

Another argument for free capital movement is that global financial integration would enforce a "healthy discipline" on states, as the threat of exit of capital would ensure that they "implement sound and transparent policies".[32] This is what Kenneth Rogoff has termed "collateral benefits" of free capital movement, claiming the benefits of financial globalisation

[29] Fry p. 732
[30] Alami, p. 21
[31] Singh, p. 192
[32] Alami, p. 22

"are likely to be catalytic rather than direct".[33] According to this view, by punishing "bad" policies and rewarding "good" ones, "global capital markets would enhance long-term growth and reduce the likelihood of crises".[34] In addition to this, there is empirical evidence that prohibitions further the scope for bribery and cronyism.[35] This naturally applies to capital controls as the measures to restrict free movement of capital.

There is also a theoretical argument that by furthering the diversification possibilities of investors' savings around the globe, financial globalisation points to a more stable international economy.[36] However, as Krugman, Obstfeld and Melitz point out, this cannot be confirmed by empirics, as global financial flows can also constitute risky investment and "there is no foolproof measure of the socially optimal extent of foreign investment".[37]

In fact, with regards to proneness to crisis, empirics seem to be pointing in the opposite direction. As a study by Luc Laeven and Fabian Valencia shows, the frequency of systemic banking crises has vastly increased since the deregulation of finance in the 1970s.[38] While I will return to said study in more detail in the subsequent chapter on developing economies, I would like to briefly touch upon three of such crises to show that financial globalisation has indeed changed the setting for today's economic policymaking.

The first is the so-called Lost Decade, a period of long economic stagnation following the collapse of the Japanese asset price bubble. Said asset price bubble essentially developed because there was a massive increase of capital (and credit) in Japan in the 1980s, due to foreign investor's euphoria about the country's strong economic performance.[39] This led to the absurd situation in 1990 that Japan's market capitalisation, i.e. the total value of Japanese companies' stocks, was larger than that of the United States. This was despite the latter having double the population of Japan and more than double its GDP.[40] When the bubble finally burst, Japan was facing a crisis that made it spend most of the 1990s in a slump, "alternating brief and inadequate periods of economic growth with ever-deeper recessions".[41]

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[33] Kose, Prasad, Rogoff, Wei, p. 10
[34] Alami, p. 22
[35] Krugman p. 108
[36] Krugman, Obstfeld, Melitz, p. 669
[37] Krugman, Obstfeld, Melitz, p. 670
[38] Krugman, Obstfeld, Melitz, p. 654
[39] Okina, Shirakawa, Shiratsuka, p. 396
[40] Krugman p. 61
[41] Krugman p. 57

The problem of price bubbles is not a new one, as historic examples such as the South Sea and Mississippi bubbles famously illustrate.[42] However, financial globalisation greatly increases the threat of such bubbles, since as the famous 20th century economic historian Charles Kindleberger put it, investors moving capital around the globe freely are prone to producing "manias, panics and crashes".[43]

The next crisis I want to look at, the Asian financial crash of 1997, started with a similar story. When the Thai economy experienced intense financial euphoria in the 1990s, policymakers chose not to let the national currency, the baht, appreciate in order to keep its export industry competitive.[44] However, when the tide turned, and speculative attacks on the currency finally forced them to devalue after months of financial mismanagement, the withdrawal of foreign credit hit the Thai economy hard.[45] Yet it was not only the Thai economy that experienced an economic meltdown in 1997, but the entire region of south east Asia.[46] The reason for this contagion was not even direct financial linkage. Instead, it was due to the fact that foreign investment going to Korea, Malaysia, Indonesia and Thailand were often channelled through the same funds that "lumped all the countries together".[47] The effects of this contagion hit the Asian economies hard, with Malaysia and Indonesia being particularly badly affected. According to Paul Krugman, Indonesia was experiencing "one of the worst economic slumps in world history".[48]

Yet again, the contagion of crises is not entirely new. Economists have long been polemicising that "when the United States sneezes, Canada catches a cold".[49] However, deeper financial integration of the world economy both intensifies and heightens the risk for contagion of financial crises. As Dani Rodrik sums it up, financial globalisation creates "much stronger contagion across national borders, as financial difficulties in one country would now quickly contaminate the balance sheets of banks in others".[50]

Perhaps the best example of financial deregulation producing an international crisis is the 2007 financial crash. Citing again from the textbook by Krugman, Obstfeld and Melitz, "the

[42] Ferguson p. 154
[43] Kindleberger p. 44
[44] Krugman p. 81
[45] Krugman p. 87
[46] Krugman p. 88
[47] Krugman p. 93
[48] Krugman p. 92
[49] Krugman p. 93
[50] Rodrik p. 128

global financial and economic meltdown of 2007-2009 was the worst since the Great Depression. Banks throughout the world failed or required extensive government support to survive; the global financial system froze; and the entire world economy was thrown into recession. Unlike some recessions, this one originated in a shock to financial markets, and the shock was transmitted from country to country by financial markets, at lightning speed".[51] While the last sentence of this summary feeds well into my previous paragraph of crisis contagion through the financial sector, it is also important to stress the fact that this crisis *originated* in the global financial markets. For sake of brevity, I will not discuss the technicalities of the 2007 financial crash. Instead, I will continue to follow the account of the crisis that the abovementioned textbook gives. In essence, so-called "subprime" mortgage loans, i.e. mortgage loans given to "borrowers with shaky credits", were bundled with other assets and then bought up by banks throughout the world, "especially in the United States and Europe".[52] When those borrowers were increasingly missing their payments during 2007 due to a slightly increased interest rate and a fall in housing prices, lenders started to become aware of the risks of those loans and pulled back from the markets. Panic ensued after BNP Paribas, a major French bank, announced that three of its investment funds were in trouble as a result of such subprime-related investments. Finally, credit markets "went into panic, with interbank interest rates rising above central bank target rates around the world".[53]

What is interesting about these dynamics is not only the contagious aspect of the crisis, but also how well the details of how it developed correspond to what economist Joseph Stiglitz described – several years prior to the 2007 crash – as "asymmetric information".[54] According to this argument, "financial flows controlled by uninformed investors" increase the likelihood of a severe financial shock. While foreign investors are often more uninformed due to lacking geographical and cultural proximity, additionally "these investors' flight response then magnifies any shock's severity".[55]

Finally, technological advancements and monetary innovations have greatly facilitated the transfer of so-called "hot money", i.e. very short-term investments quickly moving between

[51] Krugman, Obstfeld, Melitz, p. 660
[52] Krugman, Obstfeld, Melitz, p. 661
[53] Krugman, Obstfeld, Melitz, p. 662
[54] Stiglitz p. 55-58
[55] Dymski p. 440

economies in order to maximise interest rates or other rapid capital gains.[56] While the OECD had already dropped previous distinctions between hot money and long-term investment in the 1980s, said technological advancements really enable the movement of capital almost at a mouse click.[57]

Although the dynamics of these crises do not fail to inflict a certain degree of scepticism towards financial globalisation, it is important to keep in mind that the story of capital account liberalisation is more complex than that. Going back to Krugman, our world has "relearned the virtues of free markets", even if these virtues come with certain problems.[58] However, as all of the different views introduced above would agree, financial liberalisation and globalisation need to be met with an adequate set of economic policies.[59] Having established that, I will in the next chapter proceed to discuss the effects of financial globalisation for developing countries specifically.

[56] Rodrik & Velasco p. 3
[57] Rodrik p. 103-104
[58] Krugman p. 108
[59] Prasad, Rogoff, Wei, Kose, p. 201; Krugman p. 184; Obstfeld & Taylor p. 186; Rodrik p. 225

§1.2 – Financial Globalisation in Developing Countries

In the previous chapter I have established that financial globalisation represents a challenge for policymakers around the world by giving an overview of the recent history of global financial markets and major international crises. The next chapter now proceeds to specify this challenge for developing and emerging market economies. Once again, my first aim is to lay out a definition for developing and emerging economies.

For the sake of simplicity, this thesis accepts as definition of developing countries those countries defined as low or medium human development countries by the Human Development Report.[60] This report uses the well-known Human Development Index, which is created by combining the factors of income, life expectancy and education in a country.[61] While I am aware that the literature on developing countries provides both critique of and alternatives to this definition, for the purposes of my study, this official measurement will suffice.[62]

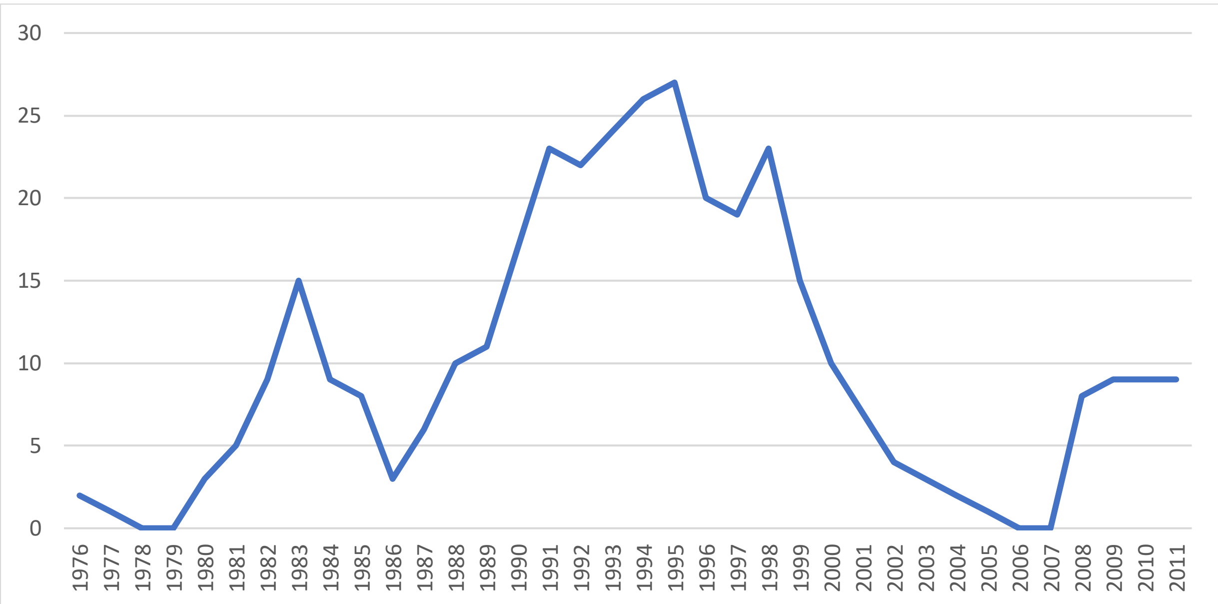

Figure 2 - Number of ongoing banking crises in developing countries per year. Source: Own based on Luc Laeven and Fabian Valencia's systemic banking crises database

[60] Stanton p. 15
[61] Nielsen p. 8
[62] Stanton p. 16-17

The global financial crisis of 2007, as discussed in the previous chapter, is significant as it hit industrialised countries to such a broad and high extent. However, when looking at the numbers of financial crises in developing countries, it becomes clear that they were very much an issue in the decades preceding the 2007 shock.[63] Figure 2, which I created from the database for a study by Luc Laeven and Fabian Valencia, shows that in fact, in the developing world financial turmoil was most prevalent from the late 1980s to the early 2000s.[64] However, there were also periods of financial instability in the early 80s, and after the financial crisis of 2007. Were we to draw the same graph for industrialised countries, we would see the line at around 1 to a maximum of 3 countries throughout the 1970s, 80s and 90s, to then shoot up suddenly in 2007, as can be seen in figure 3.[65] Interestingly, the financial crash of 2007 did not affect developing countries initially, but rather with some delay, which is described in more detail in §2.3.

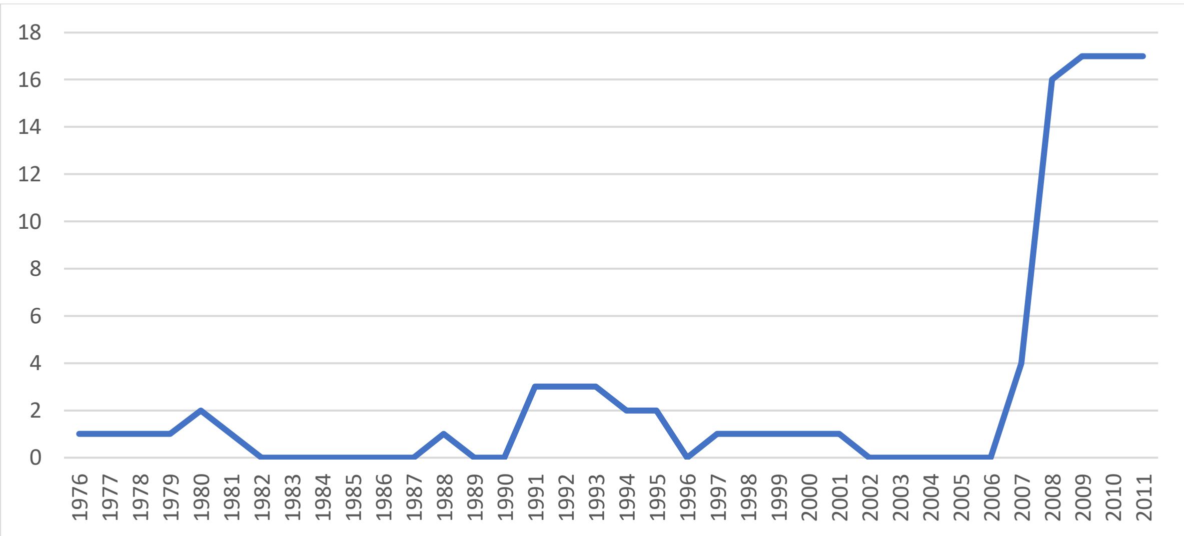

Figure 3 - Number of ongoing banking crises in industrialised countries per year. Source: Own based on Luc Laeven and Fabian Valencia's systemic banking crises database

These vast increases of financial crises in developing countries crucially coincided with the International Monetary Fund's "push to free up global capital".[66] When the IMF started to advocate the liberalisation of capital flows to its emerging market members in the 1980s,

[63] Krugman, Obstfeld, Melitz, p. 655
[64] Laeven & Valencia p. 32-55
[65] Ibid
[66] Barolini & Drazen p. 140

many of those members started dismantling the capital controls they had maintained, just as the industrialised countries had done after the dissolution of Bretton Woods.[67] As Bordo, Eichengreen, Klingebiel and Martinez-Peria have found in an econometric study in 2001, there is a positive significant relationship between these crises and dismantling capital controls.[68] At any rate, this confidence of the IMF towards liberalising the capital account clearly influenced policy makers of developing countries, perhaps producing an overhasty process of financial integration, which is a recipe for problems even in the eyes of proponents of the free movement of capital.[69]

Apart from general monetary fundamentals having to be met by an economy prior to financial integration, there are several reasons why developing countries are more vulnerable to monetary and financial crises. First of all, investors are much more prone to panic when it comes to developing countries. As Paul Krugman explains by reference to the Mexican Tequila Crisis, the financial mistakes of a government can all too easily create a "self-justifying panic" among investors.[70] As we have seen with the East Asian crash of the late 90s, developing economies are often grouped together by institutions channelling foreign capital. However, they are also grouped together in the minds of investors.[71] When comparing the currency crises of Indonesia, Malaysia and Thailand to the similar problems faced by Australia at the same time, this bias becomes revealingly clear. Australia also experienced early stages of a currency crisis in 1998 due to its exports mainly going to East Asia. Yet after its currency depreciated by almost 25 percent, investors saw their chance to cheaply buy into the Australian market and capital returned to the country, causing the "Australian miracle" in the midst of the Asian crisis.[72] This was because investors, despite the economic problems faced by Australia, continued to consider it a "solid economy".[73] This contrast between Australia's experience and the experience shared by Thailand, Indonesia and Malaysia perfectly illustrate the head-start industrialised countries have when it comes to investor confidence.

[67] Joyce p. 875-877
[68] Bordo et.al. 78 (2001)
[69] It is agreed upon by a vast majority of proponents of capital liberalisation that a country undergoing financial integration must have sound monetary fundamentals first, see Prasad, Rogoff, Wei, Kose p. 203
[70] Krugman 54
[71] Krugman 93-94
[72] Krugman 108-109
[73] Krugman 109

Another reason why developing economies have it more difficult are their less developed institutions. Economists have long stressed the role institutions play in the development process, and this holds true for monetary institutions.[74] Following Douglass North, when talking of monetary institutions, one should not only think of central banks, but also of “other organizations such as title insurance and credit rating bureaus”, as these determine the success of managing the capital market just as well.[75] Financial institutions become especially important when it comes to so-called “bank runs”, in which an unhealthy amount of lenders demands their assets back all at the same time.[76] In international finance, such bank runs can reach tremendous proportions, completely eliminating a country’s liquidity and further undermining already doubted institutions.[77] While industrialised countries’ monetary institutions were after some initial struggle able to maintain confidence in the system after the 2007 financial crisis, central banks in developing countries often lack the public trust necessary for such crisis-management.

Last but not least, the sheer amount of capital being moved around in an integrated global capital market can be overwhelming for developing economies. In 2013, the five hundred biggest international asset management companies had more than 70 trillion dollars in their portfolios. As experts at the IMF have pointed out, this means that a reallocation of 1 percent constitutes an in- or outflow of 700 billion dollars.[78] This can be very dangerous for developing economies, whose GDP is usually just a fracture of the sums of hot money being shuffled around the globe. As point of reference, the entire continent of South America currently has a nominal GDP of under 4 trillion dollars.[79] While this should theoretically not create a problem when markets behave rationally, aforementioned euphorias and panics as well as in- and outflows of hot money can be a great source of instability for developing economies due to the large sums as compared to their GDP.

So far, I have described the dangers financial globalisation poses to developing economies in terms of increased vulnerability to immediate crises. However, there is another issue that

[74] North p. 8
[75] North p. 66
[76] Rodrik p. 93
[77] Rodrik p. 94
[78] Tooze p. 474
[79] International Monetary Fund, World Economic Outlook

developing countries can experience when liberalising their capital account, which is less immediate, but can also be problematic, namely the phenomenon of capital flight. This is especially relevant in the case of Brazil, therefore I naturally consider it important to include it in this chapter.

According to the textbook model, capital flight is when a central bank's reserves are running out due to inconsistent monetary policies of a country.[80] "Residents flee the domestic currency by selling it to the central bank for foreign exchange; they then invest the foreign currency abroad. At the same time, foreigners convert holdings of home assets into their own currencies and repatriate the proceeds".[81]

While this sums up the process of capital flight superficially, the literature provides further clarifications that distinguish capital flight from "normal" capital outflows and explain why it occurs.[82] According to Edsel Beja, economists have employed three broad criteria to define capital flight, namely volume, direction and motive.[83] Crucially, one of the motives for capital flight is to "evade taxes or circumvent government regulations".[84] Though capital controls do not necessarily stop such attempts, without them it becomes difficult to "uncover the motive" of a transfer of capital, since "in an open economy, residents can engage in international transactions" freely.[85] Regarding the direction of capital flight, scholars emphasise the higher empirical significance such processes have for developing countries as opposed to developed countries.[86]

Another categorisation of capital flight even includes the concept of hot money covered in the previous chapter. John Cuddington considers capital flight to include short-term speculative capital outflows that respond in a rash manner to "political and financial crises, heavier taxes, (…) tightening of capital controls, or major devaluation".[87] Although it is important to notice the multi-faceted nature of capital flight in the literature, for the sake of clarity I differentiate in this thesis between hot money outflows and capital flight as two interconnected yet different processes.

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[80] Krugman, Obstfeld, Melitz p. 548
[81] Krugman, Obstfeld, Melitz p. 550
[82] Deppler & Williamson p. 40-52
[83] Epstein p. 59
[84] Epstein p. 61
[85] Ibid
[86] Epstein p. 63-64
[87] Cuddington p. 2

Finally, there is the so-called "residual definition" of capital flight. This view simply defines capital flight as the net unrecorded outflow of capital.[88] While this definition is arguably omissive, it is the easiest and most reliable definition in terms of measurement.[89] It simply takes capital flows that cannot be accounted for in the records of foreign exchange transactions and ascribes them to capital flight.[90]

Last but not least, although not quite a reason but rather an illustration of how financial globalisation affects developing countries differently, I want to briefly touch on the so-called Lucas Paradox. The Lucas Paradox is based on the fundamental principle of diminishing returns on investment, which states that the rate of return on investment declines as it is accumulated.[91] Following this principle, in 1990 Robert Lucas derived that "the marginal product of capital is higher in the less productive (i.e., in the poorer) economy. If so, then if trade in capital good is free and competitive, new investment will occur only in the poorer economy, and this will continue to be true until capital-labor ratios, and hence wages and capital returns, are equalized".[92]
However, this is not the case, and surprisingly little capital flows from rich to poor countries.[93] Lucas proceeded to give possible explanations for this phenomenon, namely differences in human capital, differences in the external benefits of human capital, and capital market imperfections.[94] 18 years after Lucas' initial paper, Alfaro, Kalemli-Ozcan and Volosovych published econometric research pointing towards institutional quality as a leading explanation.[95] In any case, according to Céline Azémar and Rodolphe Desbordes, the Lucas Paradox "is strongly related to the failure of financial globalisation to achieve its promised benefits".[96]

To sum up, financial globalisation can be even more complicated to handle by developing countries than it is by rich, industrialised countries. They are more prone to banking crises

[88] Epstein p. 64
[89] Epstein p. 65
[90] Epstein p. 66
[91] Knight p. 26
[92] Lucas p. 92
[93] Lucas p. 94
[94] Lucas p. 95-99
[95] Azemar et.al. p. 184
[96] Azemar et.al. p. 183

and capital flight, and the massive size of modern capital flows is in no proportion to the GDP of most developing countries, making their financial markets much more vulnerable to international investors' euphorias and panics. All these aspects not only create a disadvantage in dealing with these new international conditions, but also imply that it is difficult to compare the processes of financial integration of industrialised and developing economies.

This has clear implications on policymaking in developing countries, in that there is no blueprint to financial integration, and policymakers can not necessarily just replicate the process of industrialised countries. After having discussed both the scope and meaning of financial globalisation in general, as well as the more specific implications it has for developing economies, I now proceed to discuss the methodological framework which helps me analyse the policymaking of Brazil with regards to financial integration.

§1.3 – Methodological Concepts and Categories

In the following chapter I lay out an historiographical discussion of the methodological concepts and categories that form the analytical framework of my research. These encompass the broader concepts of policy learning and policy diffusion as well as their subcategorisations. It is important to note that both of these are in different contexts also used as a subcategorisation of the respective other in the literature. Therefore it is crucial to disentangle the two and lay out the different variations used in existing studies. After having done that, I also define policy learning and diffusion in the context of Latin American economic and monetary policy. I have already summarised the most important mechanisms for my research question in Figure 4, and intend to refer back to this visualisation in the course of this chapter when required.

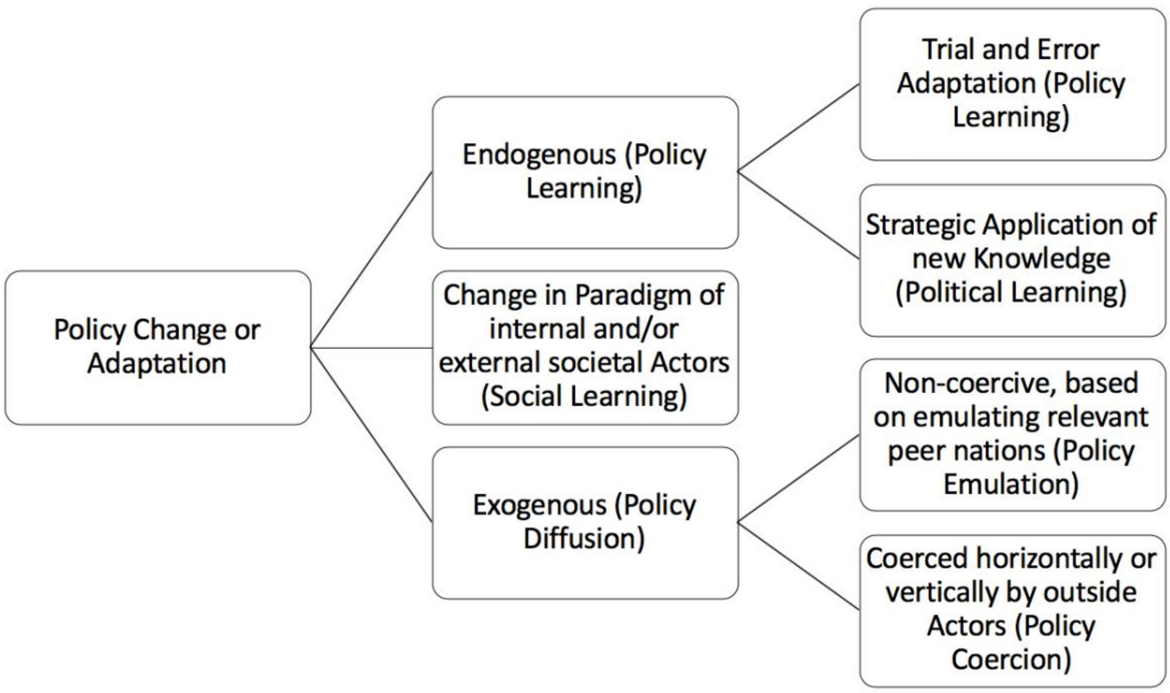

Figure 4 – Policy Diffusion and Policy Learning mechanisms that are relevant for my research. Source: Own based on my literature review on policy learning and policy diffusion

Policy learning as a concept originated in the discipline of political science. In essence, it focuses on the way policymakers adapt policies "based on learning processes or experiences".[97] It goes back to economist and political scientist Herbert Simon, who in 1947 described it in his book on "administrative behaviour".[98] Other early contributions include Karl Deutsch, Charles Lindblom and Hugh Heclo.[99]

More recent ground-breaking work came from Peter Hall, who framed the conceptualisation of what he called social learning.[100] While Hugh Heclo asserted that the crucial aspect of policy learning are the interconnections between policymakers and political elites, Hall's findings differ from this assumption.[101] Instead, he finds that policymakers' learning process depends on what he calls policy paradigms, which are ideational constructs that facilitate differing degrees of policy change potential.[102] He finds that these degrees depend on *social learning*, which entails the process of policymakers changing their ideas and interpretation of a problem.[103] Contrary to Heclo, Hall describes learning as a rather pluralist process, taking into consideration various economic and societal factors, including scientific findings that build on past experiences.[104] He also specifies that there are three degrees of policy change. First order changes, which describe of the adaptation of existing policy instruments, second order changes, which describe the adaptation of new instruments, and third order changes, which entail a change "in the hierarchy of policy instruments".[105] Such changes in the hierarchy of instruments lead him back to his idea of the policy paradigm, the "basic framework of ideas and standards", according to which "a problem is interpreted and the policy made".[106] Summing up, Hall's ideas of social learning focus on the *paradigmatic and ideational part of policy learning*.

Paul A. Sabatier on the other hand agrees with Heclo's earlier emphasis on political elites and the strategic interaction of policymakers competing for power in the learning process.[107]

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[97] Trein p. 2
[98] Simon p. 1-19
[99] Trein p. 2
[100] Trein p. 3
[101] Heclo p. 319
[102] Hall p. 278
[103] Hall p. 279
[104] Hall p. 278
[105] Trein p. 4
[106] Ibid
[107] Sabatier p. 130

However, he further expands this emphasis to analyse "the manner in which elites from different advocacy coalitions gradually alter their belief systems over time".[108] Apart from shifting the focus to those "advocacy coalitions", he "paved the way for an understanding of policy learning as evaluation of policy instruments" in the public policy literature.[109] This differed from Peter Hall's focus on broader policy paradigms, as it provides a framework for looking at specific policy instruments and the ongoing changes in their design based on learning.[110]

Another subcategorisation of policy learning that focuses on abovementioned strategic interaction of actors is provided by Peter May.[111] What he terms *political learning* describes policymakers' learning process concerning both drawing attention to policy problems and advocating their policy ideas. Crucially, the focus of this concept is the judgment about the "political feasibility of policy proposals".[112] A basic premise of this is that a political organisation is interested in maximising its legitimacy. Drawing on both the political feasibility and the ascribed legitimacy of policies, political organisations and actors then "learn new strategies to attain their political goals".[113] An important contribution to the literature of political learning comes from Aaron Wildavsky, who introduced the analytical concept of "strategic retreats", describing a situation in which policymakers back off from a certain policy goal as it is politically too costly to achieve.[114] Finally, as Christina Boswell points out in a 2009 book on the political uses of expert knowledge, when analysing the implementation of policies, one can differentiate between "action organizations and political organizations".[115] While action organisations, which need to legitimise their existence with the impact of their interventions, use their knowledge to best improve policy outputs, political organisations use knowledge "to show their own legitimacy and therefore in a more strategic way".[116] This crucially differs from the idea of policy learning as causing change of policies as a consequence of new scientific ideas.[117]

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[108] Ibid
[109] Trein p. 6
[110] May p. 336
[111] Trein p. 12
[112] May p. 339
[113] Bennett & Howlett p. 289
[114] Trein p. 13
[115] Boswell p. 4
[116] Trein p. 14
[117] Boswell p. 6

The final aspect of policy learning that I want to touch on is the spatial dimension to learning, "focusing on learning and transfer from other countries or regions".[118] This "spatial aspect" to learning is essentially nothing other than what most authors understand as *policy diffusion*.[119]

The study of diffusion goes back in its modern academic usage to communication theorist Everett M. Rogers' 1962 book "diffusion of innovations". In it, Rogers defines diffusion very generally as "the process by which an innovation is communicated through certain channels over time among the members of a social system".[120] The most-cited definition of the diffusion of policies however is laid out by Dolowitz and Marsh, who assess diffusion to be "a process by which knowledge about how policies, administrative arrangements, institutions and ideas in one political setting (past or present) is used in the development of policies, administrative arrangements, institutions and ideas in another political setting".[121] As the two authors point out, there are six main categories of actors who are involved with policy diffusion, namely "elected officials; political parties; bureaucrats/civil servants; pressure groups; policy entrepreneurs/experts; and supranational institutions".[122] Furthermore, these processes can cover "voluntary" and "coercive" transfers of policies.[123] As Diana Stone points out, the coercive element to policy diffusion is quite relevant to the study of developing countries' economic policies, as "the structural adjustment policies of the World Bank and International Monetary Fund (IMF) have long been criticised as coercive form of economic reform measures".[124] Particularly Latin America was affected by this, as the "neo-liberal values of the post Washington consensus" were not only eminent in the World Bank and the IMF, but also in the Inter-American Development Bank.[125]

Policy diffusion is further split up by Brooks and Kurtz into four principal diffusion mechanisms, namely emulation, learning, competition and coercion.[126] Thus in the literature

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118 Trein p. 3
119 Haggard & Maxfield p. 212-214
120 Rogers p. 5
121 Marsh & Sharman p. 270
122 Dolowitz & Marsh p. 345
123 Dolowitz & Marsh p. 344
124 Stone p. 491
125 Stone p. 492
126 Braun & Gilardi p. 298-322

on policy learning, diffusion features as an aspect, and in the literature on policy diffusion, policy learning features as an aspect, which yet again goes to show the interconnectedness of these two concepts. However, I have identified that for my purposes, it is not helpful to distinguish between the learning used as a subcategory by the diffusion literature and the concept of social learning discussed above within the concept of policy learning. As can be seen in figure 4, I have therefore combined them into one mechanism that stands separately from the overarching concepts of policy learning and policy diffusion, as it is usually a combination of exogenous and endogenous elements.

Of the classic subcategories of policy diffusion, emulation concerns the "social construction of appropriate behaviour on the basis of relevant *peer* nations", including following prominent states within those peer nations.[127] This is especially relevant for Latin America, as states in the region share extensive economic and cultural links, and thus more likely qualify as "peer nations".[128] On the other hand, "learning" as part of the diffusion process entails the gathering and using of information about decisions made in other nations and their level of success. Contrary to the emulation based on certain ties to another country, the information gathered in this process can be positive or negative, thus policymakers will respond to specific and distinguishable successes or failures.[129]

Competition and coercion are also very relevant to my research due to its clear connection to the topic of financial globalisation. Competition matters because countries in Latin America often have a similar sovereign risk status and are therefore competing to attract international capital, dynamics that clearly have a potential impact on policymakers.[130] Coercion on the other hand becomes interesting in the context of financial globalisation when looking at the role of international monetary institutions described in the previous chapter. Thereby it is important to distinguish between horizontal policy diffusion, in which one country influences another, and vertical policy diffusion, in which an international actor (like the IMF) is influencing several countries.[131] However, while coercion as a mechanism for policy decisions in Brazil features quite prominently among my findings, competition does not, which is why for the sake of simplicity I have omitted it from figure 4.

[127] Brooks & Kurtz p. 99
[128] Ibid
[129] Braun & Gilardi p. 310
[130] Brooks & Kurtz p. 100
[131] Ibid

What makes these methodological concepts especially interesting for research within the specific topic of capital account liberalisation in Latin America is their relationship to each other. In other words, they can be applied as rival explanation for the implementation of policies. As Sarah Brooks and Marcus Kurtz point out in their study on financial policy diffusion, the dominant strands of literature in the study of capital account liberalisation have "demonstrated an important role for interdependence, or the diffusion of a policy innovation from one country to another".[132] In a quantitative study linking Latin American monetary policymakers' decisions to the rate of success of the prior policies of Import Substitution Industrialisation (ISI), they on the other hand highlight the "path dependence" of Latin American monetary policy.[133] Thereby they are dissenting from the view that policy diffusion is the main source of monetary policy change in Latin America, stressing the "structural legacy" of such policies.[134]

While much of the research on policy learning and policy diffusion is quantitative, the concepts are perfectly employable in a qualitative setting as well, as their definitions allow for qualitative application.[135] As Peter Starke points out in a methodological review in Policy Studies Journal, "qualitative research is methodologically well equipped" to study policy change.[136] He specifically stresses the relevance of cross-case analyses and process tracing, the latter of which I focus on in this study.[137] Process tracing is defined in the literature on qualitative methodology as an attempt to "identify the intervening causal process – the causal chain and causal mechanism – between an independent variable (or variables) and the outcome of the dependent variable".[138] This method aligns perfectly with my underlying research question of how internal and external influences shaped Brazil's monetary policy since the collapse of the Bretton Woods system.

[132] Brooks & Kurtz p. 95
[133] Brooks & Kurtz p. 122
[134] Brooks & Kurtz p. 123
[135] Recent quantitative studies include Covadonga Meseguer's 2009 book "Learning, Policy Making, and Market Reforms" or Sarah Brooks' and Marcus Kurtz' abovementioned paper on statist legacies in Latin America
[136] Starke p. 561
[137] Starke p. 577
[138] George & Bennett p. 206)

In the second part of my thesis, I thus historically and qualitatively analyse the monetary policies of Brazil from 1973 to 2018. In the past three chapters I have identified the underlying process of financial globalisation and its potential dangers to developing countries, as well as discussed the methodological approaches usually applied for the study of monetary policies. Going forward, I proceed to my case study of Brazilian policymakers’ reaction to financial globalisation.

§2 – Historical Empirics – The Case of Brazil

In the spirit of the prominent 20th century French historian Fernand Braudel, this thesis understands the study of history as transcending what Braudel called the "surface disturbances" of "*l'histoire événementielle*".[139] This means that it does not consider it sufficient to simply describe individual events, but instead will aim to integrate those events into as much historical context as possible within the given scope of research. Therefore, the following historical part of my thesis will not only discuss specifically the monetary policies of Brazil in the given period, but will rather base these on a broader account of the country's history.

However, for the sake of relevancy, these efforts omit most of Brazil's cultural and social history and focus on politics and economics. To that effect, I shall proceed followingly: First, §2.1 gives an overview over the political and institutional history of Brazil. In doing so, it establishes that there is a significant bureaucratic continuity in the country's history. By referring to what has been described in Brazil's academia as "bureaucratic rings", it then leads to my first argument that the policymaking regarding the independence of Brazil's central bank has been influenced mainly by the influencing mechanism of political learning.[140]

After this, §2.2 goes on to review Brazil's economic history and development since WW2. What is of particular interest to me in this chapter is how economic policy has influenced the movements of capital, in particular the unregistered movements of capital, i.e. the phenomenon of capital flight. The chapter concludes that in the domain of capital flight, policymaking has also been influenced by political learning.

Finally, §2.3 directly looks at the financial and monetary policy of Brazil in the period 1973 to 2018. While here a broad variety of the influencing mechanisms introduced in §1.3 come into play, what I consider to be the most important finding is that there was a period of policy diffusion, in particular policy coercion, in the period from the mid-1990s to the eve of the global financial crisis 2008.

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[139] Braudel p. 21

[140] Montero in Kesselman et.al. p. 384

§2.1 – Brazil's political and institutional History – Central bank independence and bureaucratism

The following chapter outlines the political and institutional history of Brazil, aiming to contextualise Brazil's monetary policymaking between 1973 and 2018. For the sake of appropriate context, it revisits Brazilian politics from the first Vargas government 1930-1945 to the election of Jair Bolsonaro in October 2018. As the chapter analytically describes the institutional ruptures and continuities in the country, it finally leads into my first argument that central bank independence from the federal government, while in other countries characterised by ruptures and a process of policy diffusion, in Brazil stems from a long history of bureaucratic autonomy.

A political history of Brazil that properly explains the country's underlying economic and monetary processes necessarily has to start with Getúlio Dornelles Vargas, who led Brazil from 1930 to 1945 and again from 1950 to 1952. The "Old Republic", Brazil's first republican government had ended in the 1930 revolution, which brought Vargas to power as the head of a new "revolutionary government". This government "swiftly crushed middle-class and popular dissent" by building a new coalition within the previously divided political elites.[141] A stark contrast to the previous Old Republic was the high degree of centralisation of Vargas' government. He controlled regional governments by suspending almost all state governors with "interventores", handpicked allies of his who would loyally follow his orders.[142] Over time, Vargas reached a position of essentially uncontested power, and increasingly redesigned Brazil's state and society towards a more authoritarian, corporatist political order. This was reflected in the branding of his government and policies as "Estado Nóvo", or "New State".[143]

However, when the ever-growing mobilisation of middle and working classes combined with post-WW2 US-American diplomatic pressure, Vargas saw himself forced to call for democratic elections in 1945. Due to the heated political climate and the bitter campaigning of both the

[141] Montero p. 362
[142] Ibid
[143] Montero p. 363

pro-Vargas and oppositional forces, two months before the elections the military forced Getúlio Vargas to resign. Although in the subsequent two decades there were periodic general elections, with Vargas even serving another term as democratically elected president between 1950 and 1952, institutionally there was no clear break with the corporatist past. As Alfred Montero puts it in the Kesselman, Krieger and Joseph textbook on Comparative Politics, the new constitutional system "guaranteed periodic elections, but the most important economic and social policies were still decided by the state bureaucracy, not by the national legislature".[144] One notable president of this period was Juscelino Kubitschek, under whom Brazil saw significant economic improvements and the establishment of the current capital of Brasília, a planned city in the newly formed Federal District in central Brazil. But even Kubitschek failed to induce enduring economic policy reform, and his successors were even less successful in implementing change, which led to a precarious social situation, characterised by street violence between politically left-wing and right-wing groups. Finally, the military staged a coup d'état, ending an almost two-decades-long phase of democratic elections in 1964.[145]

Aforementioned bureaucratic policymaking capacities peaked in the subsequent period of military rule, which lasted from 1964 to 1985 and was termed "bureaucratic authoritarianism" by political scientist Guillermo O'Donnell.[146] This regime is described as being led by the military and "key civilian allies, most notably by professional economists, engineers, and administrators".[147] The military leadership promoted such a strong bureaucratic state also corresponding to the state-led economic development of "Import Substitution Industrialisation", which is described in more details in the next chapter.[148]

In the later years of this period, the opposition obtained a series of concessions from the military leadership, the most important being political amnesty for dissidents and the establishment of direct elections for governors in 1982. After the opposition parties won a landslide at these gubernational elections, the "Diretas Já" movement, advocating direct elections of the president, gained prominence and size. Although this aim initially failed to be achieved, in 1984 Brazil got its first civilian president in two decades. Five years and a soaring

[144] Montero in Kesselman et.al. p. 363
[145] Ibid
[146] O'Donnell p. 19
[147] Montero p. 364
[148] Skidmore p. 49

inflation later, in 1989, the first free presidential elections were held, bringing to power Fernando Collor de Mello. Collor de Mello won against the popular labour leader Lula da Silva of the social democratic Partido dos Trabalhadores (PT). However, Collor's presidency was certainly not a clean break with Brazil's bureaucratic authoritarian past, as he was eventually removed from office through impeachment in 1992 as a result of his involvement in influence peddling and bribery.[149]

Thus came the presicency of Itamar Franco and his prominent finance minister Fernando Henrique Cardoso. Cardoso famously implemented the "Plano Real" which introduced the Brazilian Real as the country's new currency and finally brought inflation to a halt. The success of that programme brought Cardoso the presidency in the 1994 and 1998 elections, which he once again won against PT leader Lula da Silva. Under the Cardoso presidency, there were two acute monetary dangers that were both averted by the government and the central bank. First, after the 1994/1995 Mexican peso crisis, also known as the tequila crisis, just like other South American economies Brazil experienced contagious symptoms of crisis. However, although the new currency was still in its infancy, the Real remained strong, which additionally increased the popular support for then president-elect Cardoso. Second, after the financial crises in Russia and Asia in the late 1990s, the Real peg to the dollar finally collapsed in January 1999. The currency recovered again, avoiding hyperinflation. In 2000, Cardoso passed the Law of Fiscal Responsibility, addressing the negative effects of municipal and state governments' runaway spending. So although for a long time Cardoso was arguably popular – he was the first Brazilian president to be democratically elected two times in a row – in 2002 a rather significant shift in power occurred.[150]

Alfred Montero argues that this change in popular preference was inspired mainly by the domain of foreign affairs. He assumes that it was on the one hand the ongoing Argentine economic crisis at the time and on the other hand the United States' increased focus on security rather than welfare in the aftermath of the terrorist attacks of September 11, 2001. Specifically, he writes that the "election of Lula da Silva as president in October 2002 stemmed from a popular desire to put the social agenda ahead of the American focus on security".[151] Yet, when after three unsuccessful attempts Lula was finally elected president in 2002,

[149] Montero p. 365-366
[150] Montero p. 366
[151] Ibid

something interesting happened. Once an ardent socialist, after his election Lula embraced the neoliberal reform agenda initiated by Cardoso in the 1990s. Although he enacted certain important social security reforms, and his election was positively seen as a sign of Brazil's democratic maturation, many of his policies got stalled and his pre-election monetary policy plans were not initiated to begin with.[152] I am stressing this fact as it feeds into the argument of a period of coercive diffusion I am making in §2.3, but it is also crucial for understanding the institutional developments in Brazil when the social democratic PT took over the country. Anyway, Lula was re-elected in 2006 and continued to score high approval ratings, paving the way for his successor, Dilma Rousseff. Rousseff, Lula's former chief of staff, was not only Brazil's first woman to become president, but also the first former resistance fighter against the authoritarian regime of the 1960s and 70s. She had been jailed and tortured in the early 1970s, later reorienting her political career as a civil servant in the New Republic in the late 1980s. An economist by profession, she had no prior experience in actual political leadership until her eventual election in 2010. During her government public spending was significantly expanded, including over 127 billion USD new investments of Petrobas, the public oil company, attempting to exploit offshore reserves.[153] Finally, public protests during the 2014 World Cup and 2016 Summer Olympic Games hosted by Brazil decisively increased pressure on the government, and were eventually joined by an impeachment process of Rousseff. She was already in her second elected term, when she got charged with criminal administrative misconduct as well as disregard for the federal budget. She was formally impeached in April 2016. Her unelected successor, vice president Michel Temer suffered from low approval ratings and a general lack of popularity and legitimacy, which was also aggravated by further charges of corruption.[154]

Ultimately, Temer did not even stand for re-election in 2018, and the leftist candidate Fernando Haddad lost to Jair Bolsonaro, bringing to an end the 16 years of PT rule. Two years into Bolsonaro's rule, it is clear that his political style and agenda continue to deeply divide Brazil. While he is usually described as an ultranationalist and socially conservative,

[152] Montero p. 366
[153] Montero p. 367
[154] The New York Times: "President Michel Temer of Brazil Is Charged With Corruption", by Dom Phillips, June 26, 2017

economically he follows a classical liberal and pro-market agenda and advocates closer ties to the US.[155]

Reviewing Brazil's history of politics and political institutions not only helps to understand Brazilian monetary policymaking and its influences discussed in the subsequent chapters of this thesis, but also relates directly to one crucial aspect of monetary policy; central bank independence. According to Helge Berger, Jakob de Haan and Sylvester Eijffinger, there is broad consensus nowadays among economists that central bank independence helps reducing inflation to economically healthy rates.[156] This assumption is supported by "extensive empirical evidence" and is based on the time inconsistency model by Kydland and Prescott.[157] Said model establishes that a central bank's efforts to fight inflation need to be credible in order for their Macroeconomic policies to work. However, as partisan governments are assumed to have an inflationary bias, whenever governments are in direct control of monetary policy, the result is a suboptimal rate of inflation.[158] Rogoff thus advocated in 1985 for independent central banks to make their fight against inflation more credible by detaching their decision-making from party politics.[159] Ever since then, independence has been granted to many central banks around the globe.[160]
In Brazil, the central bank was officially given full authority over monetary policy in 1988, one year before the first free elections in decades.[161] This happened in the context of a comprehensive package of monetary policy reforms and at the end of a very tough economic decade for the whole region.[162] Yet political influence on central bank policy has been possible through more complex corruption networks, often referred to within Brazilian academia as "bureaucratic rings".[163] The concept of such bureaucratic rings refers to the "highly permeable and fragmented structure of the state bureaucracy that allows private interests to make alliances with midlevel bureaucratic officers".[164]

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[155] BBC: "Brazil's President Bolsonaro launches new political party", November 21, 2019
[156] Berger et.al. p. 2
[157] Berger et.al. p. 3
[158] Ibid
[159] Rogoff (1985) p. 1170-1179
[160] Berger et.al. p. 31
[161] Alami p. 98
[162] Alami p. 99
[163] Montero p. 384
[164] Ibid

As we have seen time and again in this chapter, the bureaucracy takes on a very special role in the political economy of Brazil. This not only holds a considerable potential for corruption, but also serves as an element of grand continuity throughout not only changes in leaders, but also throughout changes in entire political systems. It is rather telling that Brazilian scholars have so many conceptual categories to describe their country's political history that are prominently featuring the bureaucracy. Based on the abovementioned facts, I argue that it is not a coincidence that the central bank's monetary authority was formally established on the eve of "bureaucratic authoritarianism", but that it stems from a long tradition of important state institutions being represented by nonelected institutional actors. In fact, this institutional path-dependency leads me to believe that using the conceptual tools introduced in §1.3, central bank evolution in Brazil can best be described by Peter May's concept of political learning.

Before I go into this specific choice of the several inward-influenced categories within policy learning, I first want to list the indicators that central bank independence was not prevailed on Brazil through a process of policy diffusion. First of all, the year the central bank gained important authorities was not only at the end of bureaucratic authoritarianism, but also just at the beginning of central bank independence becoming a major issue within economics. As we have seen, it was only in 1985, three years prior to the monetary policy programme in question, that Ken Rogoff started advocating for independent central banks as a means of fighting hyperinflation. In 1988, many countries' governments were in fact still in direct control of their national currencies, especially in the developing world.[165] Second, despite the early exclusive authority to conduct monetary policy, to this day Brazil's central bank is still not fully independent. At the very least, central bank independence is not granted in the constitution of the country, which would be a crucial step were we to assume that Brazil would want to implement central bank independence as a result of foreign influence. Last but not least, quantitative research by political economists points in the same direction. A regression analysis by Covadonga Meseguer specifically covering South America finds no significant correlation between international economic trends and central bank independence in the region. Meseguer assesses that looking at South America, neither

[165] Meseguer p. 165

learning from others, nor coercion or emulation "explains the decision to grant independence to central banks".[166]

As mentioned, despite the early granting of extensive monetary authority, Brazil's central bank is still not fully independent according to the country's constitution. Especially through the instance of bureaucratic rings, elected governments seem to have possibilities to influence monetary policy in their favour. According to Brazilian economists Helder Ferreira de Mendonça and José Simão Filho, "the political business cycle in Brazil was evident" during the elections of 1989 and 1998.[167] The fact that despite formally having authority over monetary policy, governments can still exert influence on the Brazilian central bank, points to the *strategic use of knowledge* described in the literature on political learning. What also aligns very well with this concept is the prioritisation of leaders of their own political goals, perfectly describing what Mendonça and Filho identify as the political business cycle of Brazil during elections.

Summing up, in this chapter I have first sketched out the political history of Brazil from the Vargas period to Jair Bolsonaro's election in 2018. I have identified certain ruptures, but also the important continuity of bureaucratism in the Brazilian institutional setting. Departing from such continuity, I have then built upon it my first argument regarding the influencing mechanisms on monetary policy in Brazil. I have argued that, in alignment with quantitative research of the region, Brazil's policymaking process towards an independent central bank cannot be traced to policy diffusion but should rather be considered as path-dependent learning. In particular, I have found that the Brazilian central bank's evolution towards independence has been largely characterised by political learning, as corrupt "bureaucratic rings" seek to maximise their own legitimacy and power. In the next chapter I depart from Brazil's political history towards a broad account of the country's economic development and its connection to residual capital flight.

[166] Meseguer p. 175
[167] Ferreira & Filho p. 119

§2.2 – Brazil's Economic History – Substrata of Capital Flight?

After having discussed Brazil's political and institutional history, before directly analysing its history of monetary policymaking, it is important to also sketch out a history of Brazil's economic development in general. In the following chapter I combine the effort to do this with an analysis of Brazil's residual, "slow" capital flight in the past 50 years. I argue that economic policymaking in Brazil has historically not managed to inspire trust in its citizens, causing capital flight and thus complicating monetary policymaking. This is significant as it seems like capital flight can be ascribed yet again to Peter May's conceptual process of political learning.

Starting off, Brazil's geographic setting is rather diverse. While it occupies over 65 % of South America's landmass, most of its 210 million inhabitants live in the urban centres in the south-eastern and southern regions. The massive Amazon region in the north on the other hand is populated sparsely, is made up of thick rainforest and has an abundance of tropical fruit and valuable minerals. There are also large lowland swamps in the western states as well as vast extents of desert-like badlands, called the Sertão, in the northeast. Finally, while in the south of the country there are some deposits of iron and coal, offshore there are significant sources of petroleum. Although the extent of these sources is not yet fully clear, they are estimated to become even more significant in the near future.[168]

Given these geographic conditions as well as the extractive elements of the Portuguese colonial system, it is no wonder that up to the middle of the 20th century, Brazil's economy was characterised by the export of agrarian products and the import of industrial goods.[169] This changed in the period of Import Substitution Industrialisation (ISI). During this period, which lasted from the late 1940s to the early 1980s, an economic concept based on previously unorthodox interventionist policies and state-led industrial development strategies outlasted the different stages of Brazil's political history described in §2.1.[170] ISI featured protectionist trade policies and an overvalued exchange rate as well as a considerable increase of

[168] Montero p. 359
[169] Montero p. 360
[170] Eryar in Epstein p. 220

productive capacity, especially in the sectors of heavy industry, energy and capital goods.[171] This happened via investments made either directly by the state or by the private sector under the supervision of the state. However, during the overlapping political period of Bureaucratic Authoritarianism, the domestic industrial capital required for those investments was "under the protection of the military regime", which furthered possibilities for corruption.[172] In addition to this, the increasing dependence of this system on external funds, and especially considering the inadequate proportion of Brazilian exports to said funds, made this system rather unsustainable.[173] A positive account of Brazil's ISI period is provided by Matias Vernengo, who points to the high GDP growth rates in the post-war era when compared to the subsequent period of liberalisation.[174]

Nevertheless, after the 1973 international oil shock, the government's attempts to sustain the ISI development process became yet more difficult in the face of significantly higher oil bills. In 1975, president Geisel introduced the "Second National Development Plan". Rather than engaging in an austere adjustment programme in order to cope with the significantly worsened terms of trade, this focused once again on aggressively stimulating growth by state-led investments. Brazil's resulting debt became a problem first in 1979 when interest rates dramatically increased, and then even more so during the Latin American debt crisis in the 1980s, which was triggered by a Mexican default of its debt in 1982.[175]

The subsequent economic period was dominated by policymakers' attempts to cope with the previously accumulated debt, which was characterised by stagnant growth rates and high levels of inflation. The years 1981 to 1989 are thus often referred to as Brazil's "Lost Decade".[176] According to Deger Eryar, what deserves particular attention is the problematic "transfer of external liabilities from the private sector to the government and capitalist sector during the crisis of accumulation".[177] Then, in order to cover interest, the state had to reduce its industrial and social expenditures, essentially making the economy shrink. All in all, the

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[171] Palma p. 393
[172] Eryar in Epstein p. 220
[173] Ibid
[174] Vernengo p. 4-5
[175] Eryar in Epstein p. 221
[176] Ibid
[177] Ibid

investment rate as percent of GDP fell from 24 percent to 16.7 percent in the period 1980 to 1989.[178]

After this period of stagnation, the Collor presidency in 1990 marked the start of a new era not only for Brazil's politics, but also for its economic policy. Gradually, policymakers introduced neoliberal economic policies, including an ambitious programme to reduce the chronically high inflation as well as the high public deficits and to thereby stimulate growth. This coincided with a process of trade liberalisation, more specifically a reduction in tariffs and a removal of subsidies for exports. In order to maintain inflation at healthy rates, a rather drastic measure was adopted; a freeze on wages and prices as well as on the withdrawal of domestic capital. However, due to a lack of public support for these measures, the actual programme only lasted two months. In addition, pressure from various socio-economic groups forced the Collor government to release abovementioned financial assets even further ahead of schedule. The immediate impact of the uncertainty these developments brought with them was a significant rise in capital flight in the early 1990s. Although there were some successes regarding the reduction of the public deficit, empirically these were insufficient for a reversal of investors' expectations, which would have been crucial for an effective programme of stabilisation. In addition to this, when president Collor faced an ever larger amount of corruption charges and therefore had to resign in 1992, the Brazilian public's confidence was further reduced. Thus, while international capital started to be more available during this period due to the new administration's pledge to liberalise, paradoxically the new international capital "induced residents to initiate a new wave of capital flight", leading to a rise in capital flight as share of GDP to above 3 percent.[179]

When Collor's finance minister Cardoso was elected president in 1994, he furthered the attempts at financial stabilisation via the Plano Real. This programme, which was surprisingly successful and in fact saw Brazil's residual capital flight turn negative for a short period of time, meaning unregistered capital returned to the country, was also the reason Cardoso was so successful politically. The centrepiece of the Plano Real was the determination to fight inflation, assessing that this was key in creating a more attractive investment climate for

[178] Eryar in Epstein p. 225
[179] Eryar in Epstein p. 226

foreign investors. Departing from this assumption, only increased foreign capital was then assumed to provide long-term domestic growth.[180]

The main tool through which the inflationary targets were reached was a new currency, the Real, which was strictly pegged to the US Dollar to reduce inflationary expectations. Although that worked, it soon became clear that the peg was set too ambitiously and the Real was in fact overvalued. This worsened Brazil's trade balance by making exports more expensive and imports cheaper, resulting in continuously high trade deficits between 1994 and 2000. This created new problems, as Deger Eryar explains: "The combination of a widening trade deficit and the need to build up foreign reserves to protect the overvalued currency against speculative attacks required the support of massive inflows of capital that necessitated high interest rates as a permanent rather than a temporary feature of the Real Plan".[181]

This dependence on foreign capital combined with the high interest rates that the debt had to be serviced at soon became clear to be quite a source of vulnerability for the Brazilian economy. As Eryar puts it, "a crisis in any part of the highly integrated world economy could create a panic, leading to the withdrawal of external funds", a risk dynamic I have in §1.2 discussed for developing countries in general, but which came to be particularly descriptive of Brazil's situation in the second half of the 1990s.[182] And with the 1997 Asian financial crisis and the 1998 Russian financial crisis it turned out to be sooner rather than later that Brazil's economy had to face that challenge. Financial collapse was avoided only by increasing the interest rates to astronomic heights. In fact, according to the IMF, the average interest rate in Brazil between 1995 and 2000 was at 18 percent, which, for comparison, is about three times that of Mexico in the same period.[183] But capital flight and renewed speculation against the currency in late 1998 still drained the central bank's reserves.[184]

The exchange rate peg did finally collapse in 1999, yet hyperinflation was avoided by the implementation of a floating but managed exchange rate regime, a strict focus on inflation targeting, and high targets for fiscal discipline.[185] As Paul Krugman points out, the fear of policymakers and economists both in Brazil and abroad had been that while a 20 percent

[180] Eryar in Epstein p. 226
[181] Eryar in Epstein p. 227
[182] Eryar in Epstein p. 228
[183] Eryar in Epstein p. 229
[184] Alami p. 102
[185] Alami p. 102-103

devaluation of the Real might have been appropriate, this would not have been realistic, as the consensus was that "for developing countries, there are no small devaluations".[186] In the end, the Cardoso administration's implementation of tight fiscal and monetary policies was above all aimed at restoring market confidence both abroad and at home. The high interest rate was necessary because even though due to Brazil's favourable policies the IMF agreed to supply Brazil with reserves, without high interest rates "this money would soon be gone unless something could be done to stop capital flight".[187]
Nevertheless, as foreign investors did react favourably to the reform programme, the main pillars of the Plano Real policy framework have remained in place. Despite the change to a more left-wing government in 2002, which as we have seen in §2.1 has lasted under a changing set of leaders until 2016, the country continued to embrace liberal, open economics and a focus on providing an attractive climate for foreign investors while at the same time furthering attempts at export-oriented growth. Actually, Brazil showed remarkable fiscal discipline in the second half of the 2000s. Once it had recovered from its 1999 currency crisis, there were sustained fiscal surpluses of 4% on average in the years 2005 to 2008.[188]
Finally, current president Bolsonaro has also made it clear that he is in favour of economic liberalism. For the sake of relevancy to this chapter's main argument, I remain at this abbreviated historic account of Brazil's general economic history for now, as the economics of the PT rule and the implication of possible policy coercion are more specifically discussed in §2.3. The remaining parts of this chapter on the other hand attempt to deduce the phenomenon of illicit capital flight in Brazil from its history of economic policymaking.

As can be seen in Figure 5, residual capital flight was a problem all the way from the end of Import Substitution Industrialisation through the crisis-stricken 1980s to the reform programmes of Collor and Cardoso in the 1990s. While there were periods of higher and lower capital flight, there is only one year in which unregistered capital actually returned to the country, namely in 1995, right after the successful Plano Real. According to Deger Eryar, this reversal "deserves special attention".[189]

[186] Krugman p. 112
[187] Krugman p. 113
[188] Alami p. 140
[189] Eryar in Epstein p. 230

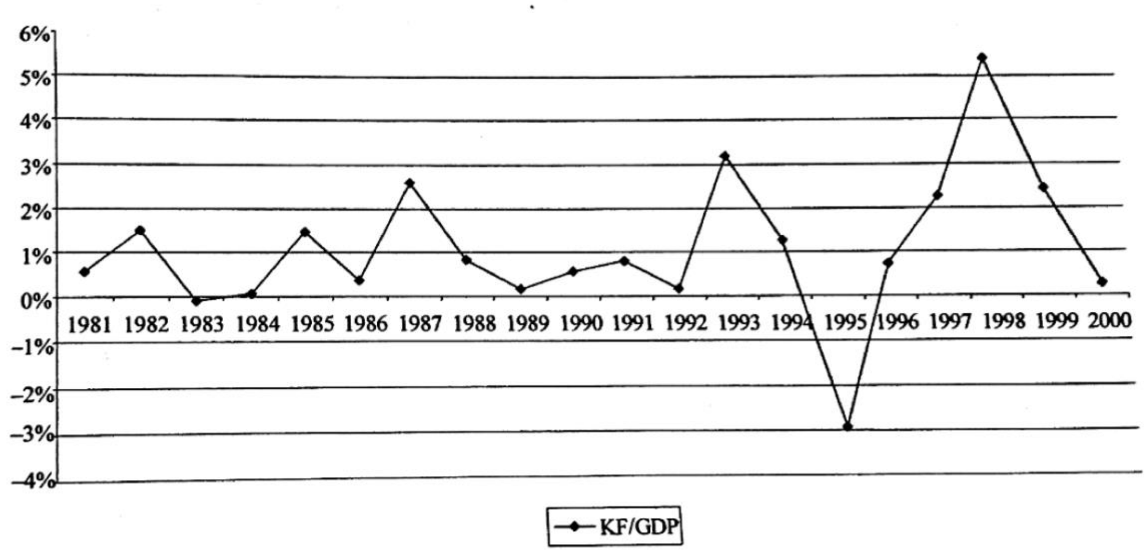

Figure 5 – Brazilian residual capital flight as percent of GDP in the years 1981 to 2000. Source: Deger Eryar's chapter in Gerald Epstein's "Capital Flight and Capital Controls in Developing Countries", p. 218

When in December 1994 the Mexican crisis unfolded right after the introduction of the Plano Real, an immediate consequence of this for Brazil was a speculative attack on the newly established Brazilian currency. This was countered by the Cardoso government by dramatically increasing the real interest rate, almost doubling it from already high 22 percent to 40.6 percent, as well as by depleting Brazil's foreign exchange reserves. The fact that Cardoso had managed to maintain the new currency's value earned him the trust not only of foreign investors, but also of the residents of Brazil, who sold their unregistered foreign assets in order to profit from the new economic climate in their home country. However, as discussed above, a problematically high interest rate, while temporary in this intensity, was in some form now a permanent companion of Brazil's monetary policy. This "paved the way for future macroeconomic instability by generating huge public deficits from 1995 onwards", as the government's reaction to the subsequent financial crises of the 1990s was of the same nature.[190]

[190] Eryar in Epstein p. 230

Due to these dynamics, the Asian and Russian crises at the very end of the 20th century triggered residual capital flight of new dimensions, peaking in 1998 at over 5 percent of Brazil's GDP. Although illicit outflows of capital decreased from such astronomic figures in the 2000s and 2010s, according to a 2014 report by former IMF economist Dev Kar they remained at a problematically high average per year of 1.5 percent of Brazil's GDP in the years 2000 to 2012.[191] Finally, in light of Brazil's economic history of the last decades, Deger Eryar's analysis of capital flight being "stimulated by growing macroeconomic instability" seems reasonable.[192] The question that remains on my part is what stood behind the economic policies that triggered capital flight.

In my analysis of this question, three decisive instances of Brazil's history of economic policymaking discussed above come to mind. First of all, I want to revisit the 1975 "Second National Development Plan" of military president Geisel. Clearly, the military government was not planning particularly long-term in their decision to expand the state-led ISI investment programmes rather than cutting it in the face of higher oil prices. Instead, they were strategically adapting their policies in a way that would increase their power based on the public's expectation of ISI. Such a strategic use of policy knowledge once again reflects Peter May's concept of political learning.

The second instance is when president Collor had to give into demands to dismantle his government's freeze on financial assets ahead of time in 1991. Collor, who led an increasingly fragile first attempt at democratisation was desperate to gain political power, therefore withdrawing his reforms as a result of unfeasibility. While this points to another aspect of political learning, namely the judgment of political feasibility of policy proposals, it still very well illustrates May's concept.

Last – and possibly least – is the insistence of president Cardoso to maintain the Real's peg to the dollar despite strong pressure to depreciate it and a devastatingly high interest rate slowing down the economy as a result. The peg to the dollar, one of the centrepieces of Cardoso's Plano Real, was necessary to maintain foreign investors' trust in the Brazilian economy. However, as we have seen regarding the return of unregistered capital as a result of these measures in 1995, as well as regarding Cardoso's unexpected re-election in 1998, the

[191] Kar p. 3
[192] Eryar in Epstein p. 231

measures were also popular among Brazilians, thereby furthering Cardoso's political power in Brazil. As already insinuated at the beginning of this paragraph, this instance is the most difficult to be linked to the concept of political learning, as it is probably a combination of several influencing mechanisms. The fact that the measures were originally kept due to foreign investors, as well as the fact that in the end the plan could achieve some economic successes, suggest that Cardoso did not enact policies out of political interest, at least not solely. As Paul Krugman phrases it, it almost seemed as if Brazilian policymakers "had to show their seriousness by inflicting pain on themselves – whether or not that pain had any direct relevance to the immediate problems – because only thus could they regain the market's trust".[193] However, the rigour with which the currency's value was defended, as well as the fact that in the end the peg did prove unsustainable in 1999 and the move to a floating exchange rate happened without hyperinflation, do allow for the possibility that Cardoso was influenced in his economic policymaking at least partly by political motives.

Summing up, this chapter has linked Brazil's history of residual capital flight to mechanisms of political learning in its economic policymaking regarding capital flight. While it has graced upon Brazil's economic development from the end of WW2 to the 70s and from the 2000s to today, its focus has been the period from the late 1970s to 2000, as these years saw two fundamental changes in the economic policy paradigm of Brazil. The next chapter shifts the focus towards more recent developments, while still referring to relevant information of the 20th century. Furthermore, it aims to specifically address Brazil's policymaking regarding regular cross-border finance management.

[193] Krugman p. 116

§2.3 – Monetary Policy and Cross-Border Finance Management in Brazil 1973 – 2018

As we have seen in §2.2, for much of the second half of the 20th century, Brazil's economy was dominated by Import Substitution Industrialisation. Regarding the management of capital flows, this system implied capital account controls, which even included restrictions on private foreign borrowing and private outflows of capital. The public sector on the other hand was using foreign capital to finance its extensive state interventions.[194]

However, when the government was drowning in debt in the 1980s, monetary policymakers saw themselves confronted with the need to reform the system to be more integrated in the world economy. While at first they only liberalised the current account in order to regain access to foreign exchange via trade, they soon initiated "a deep process of capital account liberalisation that would continue until the mid-2000s" as an additional measure to "restore access to foreign finance".[195] This process was initially characterised by significant monetary policy reform from 1987 to 1991. First, bond and equity portfolio inflows were enabled by the establishment of official companies and funds for foreign investment. Second, as already discussed, the central bank of Brazil received full monetary authority, and started its attempts to tackle the decades-long inflation problems the country had previously faced. Then in 1991, under the Collor administration, monetary policy officially shifted to high interest rate targets, which was to stimulate demand for public bonds and attract foreign finance.[196] Finally, an "agreement with international creditors under the framework of the Brady Plan" enabled Brazil to "return to international financial markets and take advantage of abundant global liquidity".[197]

Still, as Matias Vernengo points out, in terms of private finance, Brazil was "a late convert" to financial globalisation.[198] Although, as described above, there were efforts at capital account opening, Brazil did not fully follow the policy set of deregulation, privatisation and liberalisation promoted by industrialised countries' policymakers and economists at the time

[194] Alami p. 96
[195] Alami p. 98
[196] De Paula p. 32
[197] Alami p. 98
[198] Vernengo p. 2

known as the “Washington Consensus”.[199] This is well illustrated by Figure 6, which shows the Net Capital Account of Brazil as well as its different components from 1970 to 2014. Following these graphs, which are based on data by the Brazilian central bank and put together by Ilias Alami, large fluctuations in the capital account and its components only started in the early to mid 1990s. We can also see in the data that the 1990s marked an important change with regards to the composition of capital inflows. While before they were almost exclusively made up of sovereign debt flows, which Ilias Alami includes under “Foreign other investment”, under the Cardoso presidency the capital account became driven by Foreign Direct Investment and portfolio investments.[200]

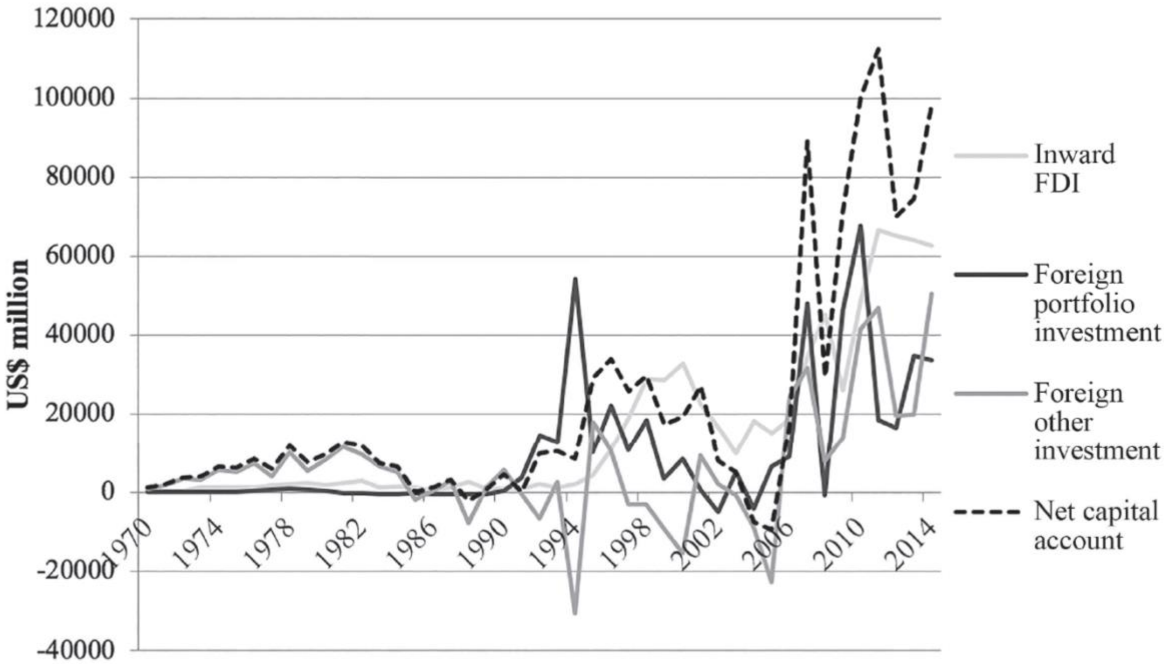

Figure 6 – Brazilian net capital account and its composition of inflows in the period 1970-2014. Source: Ilias Alami p. 99, based on Banco Central do Brasil data.

[199] Vernengo p. 3
[200] Alami p. 98-99

Thus, big steps towards financial integration only really came with the Plano Real, which in addition to its aforementioned general economic significance was also crucial for Brazil's monetary and financial policy. In monetary terms, in addition to price stabilisation under the newly introduced Real and increased interest rates, this implied the liberalisation of Brazil's balance of payments, very tight monetary policy, the establishment of channels for Brazilian investment abroad, as well as the admission of international banks in Brazil's domestic markets. While these measures did open up the capital account, at the same time there were measures to support the financial system, such as the "Programme to Support the Restructuring and Strengthening of the National Financial System".[201] This was crucial for reshaping markets "in such a way as to strengthen the power of public regulators and institutions, particularly the central bank".[202]
In essence, this meant that the Cardoso administration did attempt to deploy controls on more speculative financial flows, for instance through a transaction tax or an increased minimum maturity for investments. Yet after two external shocks in short order, in 1999, a deep currency crisis struck the economy, which shook Brazil's financial sector to an extent that rendered the currency peg to the Dollar impossible. The floating exchange rate regime that came as a result of this brought with it a general change in macroeconomic policy, in alignment with Krugman's monetary trilemma explained in §1.1. As the country gave up on a stable exchange rate, it could, according to economic principles, abandon the remaining barriers to the free movement of capital. And so it did. In early 2000, Brazil passed a land-mark law that allowed for the unrestricted access of foreign investors to "all segments of the domestic financial market, including the derivatives market".[203]

As discussed in §2.1, for the first time in the new democratic history of Brazil, there was a power shift to the left with the 2002 election of PT candidate Lula da Silva. Lula was supported by major social movements and Brazil's trade unions, and had a track record of promoting strong leftist ideals, as the former factory worker had been the PT leader for over 10 years at the time of his election. Lula's promising outlook at winning the election triggered a major crisis of confidence among foreign investors. This is best illustrated by the well-known

[201] Alami p. 100
[202] Torres Filho, Macahyba, Zeidan p. 6
[203] Alami p. 103

American investment bank Goldman Sachs' "Lulameter", a report series that measured Lula's chances of winning the election and the correspondingly increased risk for foreign investment in Brazil in the run-up to the election.[204] Though while international investors were very outspoken about their worries of a shift in Brazil's economic policies, domestic capital was calling for calm, as Simon Romero from the New York Times was pointing out at the time. According to his research, Brazilian bankers and investors strongly disagreed with Goldman Sachs, J. P. Morgan Chase and others that the Brazilian economy was in danger due to the looming political changes, pointing out that the crisis climate was in fact the result of these investment banks' decision "to advise clients to reduce their exposure to Brazil".[205]

In addition to this, there was political pressure by the IMF to continue the reform programme initiated in the 1990s.[206] They had agreements with Brazil that they demanded were kept. This combination of pressure from international finance and international monetary institutions resulted in Lula issuing the "Letter to the Brazilian People", in which he declared that his government would continue servicing foreign debt on schedule and enforce policy programmes previously agreed upon with the IMF.[207]

After they finally came to power, the PT actually followed through on Lula's declaration to continue Cardoso's reform programme. In Alami's words, in order to ensure a continued inflow of external finance would take place, the PT's financial policies "displayed much continuity, if not deepening, with those deployed by the Cardoso administration over the previous decade".[208] Lula's administration continued to lift the abovementioned barriers to international capital, which was in fact due to the agreements with the IMF that the "Letter to the Brazilian People" had referred to. This is best illustrated by the removal not only on inward capital flows, but also of controls on outflows.[209] Finally, fiscally the PT was just as disciplined as the Cardoso administration before it. In fact, to signal their commitment to the IMF they even increased their budged surplus target from 3.75 to 4.25 %.[210] Although the PT's decision to keep to its agreements with the IMF was on the one hand a victory for the realists

[204] Ibid
[205] The New York Times; October 12, 2000: Wall Street and Brazil Are Far Apart on Outlook. By Simon Romero.
[206] Alami p. 103
[207] Morais & Saad Filho p. 34-35
[208] Alami p. 103
[209] Goldfajn, Minella p. 376
[210] Alami p. 103

within the party, it is undeniable that there was some degree of horizontal coercion on the part of international finance and the IMF.

The ambitious fiscal aims of the Lula administration were in fact possible due to the Brazilian economy finally recovering from the 1999 financial crisis in early 2003. In the years that followed, continuous budget surpluses, reduced public debt and lower interest rates allowed the PT to finance many of the social programmes it had advocated for prior to Lula's election without drastic change in economic policy. In addition to this, the new government used the newly available surpluses to subsidise Brazil's industry, a system that has been referred to as "neo-developmentalism".[211] Thus, in the years 2003 to 2007, although the government maintained its fiscal aims and monetary discipline, Brazil once again became increasingly dependent on foreign capital, which goes far to explain Lula's continued commitment to dismantling the country's capital controls in this period.[212]

Anyway, this trend crucially changed in 2007, on the eve of the global financial crisis, when the Brazilian government started to introduce a tax-based capital control series it called Imposto Sobre Operações Financeiras (IOF), which translates to "Financial Transaction Tax".[213] This happened as Brazil's monetary policymakers became concerned with the unusually sudden appreciation of the Real as well as the general volatility of the exchange rate. These IOFs were quite flexible in their design, and were lifted again in the immediate pre-crisis weeks, when global liquidity finally started to tighten. In addition to this, the Brazilian central bank conducted important exchange rate interventions, providing capital market liquidity and smoothing short term fluctuations of the exchange rate. What was also crucial in shielding the country from the unfolding international crisis was that Brazil had put its banking sector under strict supervision, a policy that had directly resulted from its own financial crisis in 1999. All of these policies were crucial in limiting the impact of the 2008 financial crisis, however what deserves particular attention is how financial transaction taxes, the abovementioned IOFs, have been "deployed, adjusted, or scaled back, depending on the availability of global liquidity on the world market".[214] Ilias Alami concludes from this that

[211] Alami p. 103-104
[212] Alami p. 105
[213] Ibid
[214] Alami p. 106

"financial and monetary crises" in Brazil have "profoundly shaped the cumulative rounds of policy-making in the matter".[215]

In other words, Brazilian policymakers have learned from past experience and adjusted their policy frameworks accordingly. And, at least in this case, policy learning paid off. Brazil's financial system averted serious impacts from the global financial crisis due to high central bank reserves as well as strict banking regulations and consequentially little involvement with toxic mortgage risks and assets.[216] In fact, as Torres Filho et al. point out, "for the first time in modern history when facing an international crisis, the Brazilian economy managed to avoid a long recession and an external debt problem".[217]

However, the real danger for developing countries was yet to come, and it did so in the form of the US Federal Reserve's Quantitative Easing and the subsequent Taper Tantrum. Quantitative easing refers to a central bank's purchase of securities, particularly its sovereign bonds, which increases the money supply in order to provide the banking sector with liquidity.[218] The Taper Tantrum on the other hand was when the Fed announced that it was going to begin the reduction of the amount of bonds it was going to buy, thus in essence tightening the money supply.[219]

Contrary to the immediate 2008 financial crisis, Quantitative Easing had a very profound impact on Brazil's capital account. As international investors borrowed cheap Dollars available through the Fed's monetary stimulus programme and invested them in Brazil among other emerging markets due to their high interest rates, Brazil saw "unprecedented volumes of financial capital" flowing into the country in 2010 and 2011.[220] In fact, when Lula's successor, Dilma Rousseff for the first time visited the United States in spring 2012, she complained about a "liquidity tsunami" being unleashed onto the developing world by the advanced countries' central banks.[221] And even earlier than that, several financial officials of emerging markets, with the Brazilian central bankers taking on a leading role, had already scolded the US for Quantitative Easing at the Seoul G20 summit in November 2010.[222]

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[215] Alami p. 107
[216] Alami p. 131
[217] Torres Filho et al. p. 7
[218] Tooze p. 210
[219] Tooze p. 472
[220] Alami p. 132
[221] Original: „tsunami de liquidez", Alami p. 1
[222] Tooze p. 475

According to Adam Tooze, their worries were understandable especially in light of the toxic subprime assets of the 2007 US bank collapses having similar quantitative dimensions as the new capital flowing into Brazil.[223] Without doubt, these large volumes of capital "flooding" in, while representing opportunities, clearly bore the downside effect of increased vulnerability for developing countries' financial systems, as discussed in §1.2.[224]

By the time of Rousseff's liquidity tsunami speech, Brazil had in fact, similar to some other emerging markets, "gone beyond the war of words to adopt capital controls".[225] The IMF, which had previously – in the period of the "Washington Consensus" mentioned earlier in this chapter – held a rather strict stance towards developing countries' policy moves away from financial liberalisation, reacted differently this time. Already in 2010 had Olivier Blanchard, the IMF's chief economist at the time, informally encouraged Brazilian monetary authorities to use more active policies to maintain financial stability.[226] Later, after Brazil enacted quite heavy capital control policies, the IMF endorsed the measures also formally. This was revolutionary, as Adam Tooze illustrates by quoting from the "Economist" that this was "as if the Vatican had given its blessing to birth control".[227] However, as Ilias Alami clarifies, "the influence of the IMF should not be overstated: Brazilian policy-makers waited neither for the new institutional view of the IMF", nor on the formal endorsement of their IMF country team, since as we have seen this has taken place after the measures were actually enacted.[228] Thus, this time around, if policy coercion or diffusion did take place, it most likely did not happen horizontally from the IMF towards Brazil.

When the Taper Tantrum was finally unleashed in 2013 after Federal Reserve Chairman Ben Bernanke announced the eventual end of Quantitative Easing, capital controls did not prevent massive outflows of capital, however "they limited the scale of the damage".[229] At the same time, Brazil's interest rates had to go up on a scale similar to the late 1990s to counter the effect of Fed policy. As one policymaker of Brazil's central bank remarked, "we knew this was going to come, and we prepared ourselves".[230]

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[223] Tooze p. 474
[224] Alami p. 1
[225] Tooze p. 475
[226] Alami p. 157
[227] Tooze p. 475
[228] Alami p. 157
[229] Tooze p. 477
[230] Ibid

The measures applied in said preparation were quite complex and arguably revolutionary. Brazil brought back a first one of its 2007 IOFs in October 2009, specifically a 2% tax on non-resident portfolio inflows, which was increased a year later to 4% on equity and 6% on fixed-income investments.[231] When, fuelled by continuous rounds of Quantitative Easing, large volumes of capital continued to flow in, policymakers realised that they needed to on the one hand finetune and on the other hand intensify their policy response. Thus, in March 2011 an external loans IOF was extended first to loans of a maturity of 360 days and then to 720 days, as well as increased from 2 to 6 %. In 2011 the government also brought IOFs of 6.3 % on foreign credit card operations. When financial volatility and currency appreciation continued, they decided to design a new, more drastic IOF, namely one on regular foreign exchange derivatives. This finally came in July 2011 and was set to 1%. Crucially, according to central bank policymakers, these tax tools did not have the objective to create state revenue, but rather to "provide a disincentive for highly leveraged positions", by "making market agents pay a premium on the externalities they generate in terms of systemic risk".[232]

When the Taper Tantrum hit and capital flowed out of Brazil, it was difficult to assess how successful the regulative policies imposed by Brazilian monetary authorities had been. While there was a general decrease in global liquidity in 2013 and 2014, there are some quantitative studies that do find that the policies were moderately successful, especially in shifting the composition of capital inflows from short-term speculative capital to longer-term securities.[233] Daniela Prates argues that it was especially the drastic measure of taxing foreign exchange derivatives that was the most significant, as it managed to reduce the returns on carry trade strategies.[234] Yet the degree of success of these measures, while important and interesting for further analysis, does not necessarily determine the degree of policy learning applied in this case, as the finetuning of these complex policy programmes clearly indicates attempts at trial and error learning.

Anyway, Brazil's economy finally started to deteriorate in 2014 due not mainly to the taper tantrum, but mostly due to non-finance-sector reasons. What hit Brazil particularly hard was

[231] Alami p. 157
[232] Alami p. 158
[233] These studies include but are not limited to Prates and de Paula 2017, Baumann & Gallagher 2015, Prates & Fritz 2016.
[234] Alami p. 159

the shift in China's economic development to a new stage of industrialisation and urbanisation and as a consequence thereof the end of the global commodity boom, which Brazil had massively profited from in terms of its trade balance. Brazil's deteriorating economy since 2014 led to the end of PT rule with the 2018 election of Jair Bolsonaro, a populist and former military officer who, as discussed in §2.1, has been categorised as belonging to the political right to far-right.[235]

This chapter has given an overview of Brazil's monetary policy in the period analysed by this thesis, aiming at linking policymakers' decisions to the different influencing mechanisms of policy learning and policy diffusion set out in §1.3. It has established, based on a series of accounts by economists and historians, that there was a period of policy diffusion from the late 1990s to the eve of the global financial crisis of 2008. As was laid out in §1.2, this aligns with the literature on financial globalisation in developing countries. That being said, outside of this period, monetary policy decisions in Brazil were predominantly subject to institutional continuity and path dependence, particularly with respect to the interests of the political elites. Building upon these findings, my final part goes on to give a more comprehensive analysis of learning and diffusion mechanisms influencing Brazil's monetary policymaking by summarising and tying together the theoretical assumptions of §1 and the historical findings of §2.

[235] Alami p. 2

§3 – Analysis and Conclusion

This thesis has looked at Brazil's monetary policymaking and its different influences in the period 1973 to 2018. While §1 has established that regarding monetary and financial policy, the end of the Bretton Woods system has created a changed situation for policymakers, §2 has more specifically investigated the implications of those changes for Brazilian governments and policymakers.

§1.1 has initiated the theoretical part by assessing that global financial flows have vastly increased since the end of the Bretton Woods system and even more so since the 1980s. After discussing the economic fundamentals behind this increase, namely the movement of most industrialised countries towards floating foreign exchange rate regimes and the resulting liberalisation of the capital account, it has looked at various crises that have originated in the global financial sector. As this chapter has still focused on financial globalisation in general, and thus to a big extent on industrialised markets, the crisis that has featured most prominently in this discussion has been the 2008 global financial crisis. The chapter has concluded that the increased volume of international financial activity, while having certain positive aspects, brings with it a new kind of monetary and financial volatility.

§1.2 has proceeded to specify this volatility for developing economies. It has demonstrated that developing countries are confronted with special situations regarding global financial volatility. These include weaker monetary institutions of developing countries, the dimensions of global capital flows relative to emerging markets' smaller GDP, and the fact that investors are more prone to panic when it comes to emerging economies. By referring to the Lucas Paradox, it has also established that capital flight can be a big problem for emerging markets.

In §1.3 the methodological tools of my research have been introduced. The chapter has reviewed the literature on policy learning and policy diffusion as well as their various subcategorisations and has discussed them in the context of financial liberalisation in Latin America. It has also given an overview of how §2 intended to apply said concepts.

§2.1 has reviewed Brazil's political history from the 1930s to the present day, identifying a significant continuity of bureaucratism throughout changes in leadership and even changes in political systems. This tradition of bureaucratism can be traced back all the way to the beginning of the 20th century and has continuously been present in Brazil's state apparatus to varying degrees. Based on that, the chapter has argued that the institutional history of Brazil's central bank has to be understood in this context, meaning that the policymaking regarding central bank autonomy and independence has been path-dependent and influenced by political learning.

§2.2 has departed from Brazil's political history to the country's economic development in the past half century. It has aimed to look at how economic policymaking has influenced Brazil's money market through capital flight. Since many policy decisions regarding monetary and economic policymaking have been applied with leaders at the time having in mind their own popularity, one can speak of a certain strategic application of knowledge by policymakers. This has manifested itself for instance in president Geisel's Second National Development Plan 1975 after the international oil crisis, in president Collor's abandonment of reform programmes in 1991, and in president Cardoso's long hesitation to loosen the currency peg on the evidently overvalued Real from 1997 to 1999.

Influencing Mechanism	Origin	Characterisation	Empirical Instances in the History of Brazil
Policy Learning	Endogenous (Policy Learning)	adapt policies "based on learning processes and experiences"	-) handling of 2008 global financial crisis -) preparing for the 2013 Taper Tantrum
Political Learning	Endogenous (Policy Learning)	"use knowledge in a more strategic way" regarding the "political feasibility" of policies, difference between action organisations and political organisations, the latter use their knowledge "in an instrumental way"	-) central bank history -) Geisel's Second National Development Plan (1975) -) Collor abandoning reform programme early (1991) -) Cardoso's insistence on currency peg in the late 1990s
Social Learning	Mixture	changing the interpretation of a problem, changing the "policy paradigm", based on an altered perception of the issue by both internal and external actors, i.e. by academics, experts, the press, etc.	-) shift from ISI to export-orientation in the 1980s -) Brazil being a "late convert" to financial globalisation -) maybe a new "Zeitgeist" after financial crisis 2008?
Policy Emulation	Exogenous (Policy Diffusion)	"social construction of appropriate behaviour on the basis of relevant peer nations"	-) Plano Real (1994)
Policy Coercion	Exogenous (Policy Diffusion)	Policy adaptation as a result of horizontal or vertical external pressure	-) "peculiarly" strict reforms in the late 1990s (Krugman) -) international pressure 2002 (Goldman Sachs' "Lulameter")

Table 2 – Conceptual Influencing Mechanisms and empirical instances that can be attributed to them. Source: Own based on research findings in §2 and methodological definitions set out in §1.3.

Finally, §2.3 has specifically looked at Brazil's monetary policymaking and cross-border finance management in the period 1973 to 2018. As can be seen in Table 2, this has diversified the impression set in §2.1 and §2.2 that Brazil's monetary policy has been solely influenced by policymakers' strategic application of knowledge to further their own political goals, i.e. an unbroken predominance of political learning as influencing mechanism. In fact, while political learning remains an important element of Brazil's monetary policymaking throughout the entire period discussed, with growing study of Brazil's monetary policy decisions, a tentative yet interesting periodisation starts to show.

Such a periodisation would rest on the rather clear period of policy diffusion from the mid-1990s to just before the global financial crisis in 2007. During this period, which has been dubbed the "heyday of the Washington consensus", different Brazilian governments were subject to strong exogenous influences.[236] While, following the diffusion definition of Diana Stone, the Plano Real 1994 was arguably still a voluntary emulation, as it was born out of the genuine motivation to mimic industrialised countries' and certain developing countries' successful efforts to fight inflation, coercive mechanisms soon became more dominant.[237] And although Paul Krugman's argument that the policies Brazil imposed on itself were "peculiarly extreme" as well as against the "Keynesian compact", and must therefore have originated from outside pressure, can be countered by referring to Cardoso's personal conviction of financial austerity, the same is not true for Lula da Silva.[238] On the contrary, the international pressure exerted on Lula in 2002 to continue the austerity reforms of his predecessor is beautifully illustrated by the infamous "Lulameter" of US investment bank Goldman Sachs.

This predomination of policy diffusion as main influence on Brazil's monetary policy ended with the global financial crisis of 2008, or interestingly enough, just before it. The way Brazil introduced IOFs to shield its money market from overheating is certainly impressive and has been linked by many observers to the country's experiences of financial crises in the 1990s. As argued in §2.3, this points to textbook application of policy learning and has earned the country praise from foreign policymakers and economists alike. The attempts at preparing for the Taper Tantrum 2013 ("We knew this was going to come, and we prepared ourselves")

[236] Tooze p. 475
[237] Stone p. 491
[238] Krugman p. 112

would just as clearly qualify for a process of policy learning were it not for the country's eventual economic decline from late 2014 onwards.[239] Yet as argued already, the degree of success of pre-Taper Tantrum IOFs does not necessarily determine whether policy learning was at work in this instance.

Finally, the fact that Brazilian central bankers took on a leading role in pointing out the problems of Quantitative Easing and advocating for caution regarding unbending capital account liberalisation in the face of such financial turbulence, on the one hand points to a changed international paradigm of financial policy, and on the other hand illustrates a truly new trend in the literature on policy diffusion. As Ilias Alami criticises in his 2020 book, much of the literature on policy diffusion "relies on a diffusionist model of policy transfer which sees the diffusion of cross-border finance management parameters as a unidirectional process, characterised by a top-down (and outside-in) imposition by global financial markets".[240] In such a model, the "spatio-historical contexts of emerging markets have little or no bearing on the constitution of global parameters concerning the management of cross-border finance".[241] However, while in the days of the Washington Consensus this framework would have sufficed to a large extent, the efforts of the Rousseff administration to shield Brazil from the dangerous abundance of global liquidity during Quantitative Easing inspired interest and commendation not only among other emerging market economies, but also among the industrialised world. In fact, as we have seen in §2.3, the IMF approved of Brazil's unorthodox IOFs after they had been imposed, something that would have been unthinkable 10 years prior. So although it is difficult to judge history from a close-up angle, since the global financial crisis 2008 there appears to be a new paradigmatic Zeitgeist emerging in the field of monetary and financial policymaking that sees financial liberalisation as differing from trade liberalisation in its potential dangers.

Returning to Sarah Brooks' and Marcus Kurtz' argument introduced in the beginning of this thesis that policy diffusion is overstated in the context of Latin American financial policy change, I can only partly subscribe to such claims. This is because there clearly has been a period in Brazil's history of monetary policymaking that has been characterised by policy diffusion. However, my research has also shown that Brazil's policymaking has been

[239] Tooze p. 477
[240] Alami p. 198
[241] Ibid

characterised by durable elements of path-dependent policy learning processes. On a final note, I agree with Ilias Alami's notion that the study of policy diffusion should extend its framework to allow for the better analysis of how emerging economies like Brazil shape the global thinking and practice of cross-border finance management and monetary policy.

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