

Economic Growth and International liquidity in the Post-Keynesian Perspective: the Brazilian experience

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The literature investigating the link between capital flows and economic growth is very divergent, in terms of both empirical results and theoretical approach. It is conventionally believed that the rate of domestic investment grows with the use of foreign savings. The underlying idea is that undeveloped economies with low domestic savings levels and scarce capital (low capital-to-labor ratio) benefit from capital inflows because the return on capital is higher in such economies.

Arguments contrary to this conventional wisdom can be seen in Gourinchas and Jeanne (2006) and Aghion *et al.* (2006). Gourinchas and Jeanne (2006) understand that the reasons for low per capital income levels in poor countries lie in low productivity and higher productivity distortions, rather than low capital-to-labor ratios. Access to foreign capital in and of itself is incapable of generating additional growth in poor or less developed countries, requiring productivity gains therein to draw foreign capital. Aghion *et al.* (2006) understand that the presence of domestic savings is crucial for a country to attract foreign savings.

Beyond the more traditionally-oriented literature, we find Thirlwall (1979), who takes up the side of aggregate demand in explaining national economic growth. Thirlwall (1979) provided an economic growth model that takes account of balance-of-payments constraints — arising from unfavorable income elasticities. The idea is that the causes of different growth rates among countries have to do with different rates of demand growth, not the accumulation of capital stocks (physical and human), technology and other supply-side factors (McCombie & Thirlwall, 1994).

According to this approach, in peripheral countries — Brazil included —, the main constraint on the rate of growth of demand is the Balance of Payments (BP), more specifically the ratio of foreign demand for exports to the domestic demand for imports. For this approach, the foreign constraint is crucially important for the growth of countries like Brazil and others in Latin America, which still displays an unfavorable ratio between the income elasticity of the demand for imports and the income elasticity of the demand for exports, despite significant changes in the exports pattern.

This study analyzes the growth with foreign constraint approach to the Brazilian economy in 1971-2005, emphasizing the role foreign capital flows play in the financing of Brazil's economic growth. Using *IPEADATA* and *Central Bank of Brazil* databases, Brazil's economic performance in 1971-2005 went hand in hand with the positive evolution of international liquidity. Therefore, the Thirlwall (1979) simple rule is extended to take into consideration international liquidity and several

pieces of empirical evidence are shown using time series analysis. Considering the role foreign capital play in the growth of developing countries, Thirlwall and Hussain (1982) added the capital flows variable to the original Thirlwall (1979) model. According to Thirlwall and Hussain (1982), most developing countries incurred current account deficits financed by foreign capitals, which, to a point, did not compromise Balance of Payments equilibrium. We thus expect to show that Brazil's economic growth in 1971-2005 took place under severe foreign constraints and that capital flows contributed to explain the country's economic growth in that period.

Contrary to the simple rule, where average fitted rates of balance-of-payments equilibrium economic growth fall below observed ones, fitted rates of growth using the rule extended to international liquidity are consistently greater than observed ones. On decomposing the average income growth rate estimated with the extended Thirlwall and Hussain (1982) model, we have a 1.86 percent negative annual growth of terms of trade (pure effect of the terms of trade on real income growth). The effect of exogenous changes on the world income growth rate was 4.24 percent, while the effect of real capital inflows growth was 9.82 percent. As a result, the average income growth rate estimated was 4.66 percent annually, while the average observed income growth rate in 1971-2005 was 3.82 percent annually. Comparing this average estimated growth rate with the average rate estimated with the simple rule (2.53 annually), we see that adding terms of trade and capitals to the simple rule contributed to reducing the difference between the average observed rate and the average rate estimated with the simple rule, from -1.29 p.p to .84 p.p, but the observed and estimated rates still diverged and this extended model overestimated the effective average income growth rate in 1971-2005.

Considering the role of net foreign interest payments and working with the hypothesis of non-explosive foreign debt accumulation – according to the Moreno-Brid (2003) model – the divergence between the rate of growth of income observed in 1971-2005 and the growth estimated with the simple rule has not been eliminated. The average estimated income growth rate was 2.10 percent annually, lower than the observed growth rate (3.82 percent per year) and also lower than the 2.53 percent average rate estimated with the simple rule. One possible cause for this low estimated rate is the influence of interest payment on the constraints to the Brazilian economic growth in 1971-2005. Therefore, in the initial analysis period, the ratio of Net Interest Payment to total spending on imports was 9.3 percent and the real average growth of Net Interest Payment was 9.1 percent annually, which contributed to reducing the estimated income growth rate in the analyzed period. In addition, another possible cause for the low growth rate estimated may lie in assuming a stable current account-to-GDP ratio, but such stability would be inconsistent with the analyzed data for the Brazilian economy.

Therefore, it is fair to conclude that, first, the Brazilian economy grows better in the presence of abundant international liquidity and, second, according to the Thirlwall and Hussain (1982) model, the economy under-utilizes this advantage and grows far less than it could. According to our point of view the use of foreign savings to grow is distant to be the best strategy a developing economy like Brazil should adopt to grow. Finally, a hypothesis worth investigating is if a large share of Brazilian international liquidity comes in the shape of currency loans, far more than as direct investments or even portfolio investments. Decomposing capital flows and their role in economic growth is an important future research topic.