BRAZIL: MIXED IMPACT OF FINANCIAL CRISES ON MANUFACTURING AND FINANCIAL SECTORS

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Abstract

This paper analyzes the position of foreign interests in Brazil in the aftermath of financial crisis from the mid 1990s onward. We study the financial and manufacturing sectors more generally, but also draw on a closer examination of two specific cases - the banking sector and automotive parts industry - to get a more nuanced picture of the presence of and opportunities for foreign interests. Our analysis shows that foreign penetration in the years following financial crises had different impacts on the two sectors: in the case of the financial sector, domestic banks reacted to foreign entry by actively taking part in the mergers and acquisitions (M&As) wave, thus, maintaining their hegemony in the Brazilian banking system; in contrast, in the automotive parts industry, there was a rapid process of 'denationalization' with the demise or foreign acquisition of many domestically-owned firms and the growing presence of multinational enterprises. However, we found little evidence of foreign opportunism as a result of financial crises. Finally, we also note that FDI (especially via M&As) had an uneven impact on manufacturing industries: some domestic firms in some industries (textiles, apparel, shoes, tiles and ceramics) successfully reacted to limit the scope for foreign entry; other domestic firms (food processing, household white goods) competed even with the growing presence of foreign firms.

Resumo

Este artigo analisa a posição dos interessses estrangeiros no Brasil a partir da crise financeira de meados dos anos 1990. Para tanto, avaliamos o setor financeiro e o setor manufatureiro de modo geral, mas também examinamos mais detalhadamente dois casos específicos - o setor bancário e a indústria de auto-peças - de modo a obter um quadro mais exemplificado da presença e das oportunidades relacionadas aos interesses estrangeiros no Brasil. Nossa análise mostra que a penetração estrangeira nos anos que seguiram as crises financeiras teve diferentes impactos sobre os dois setores: no caso do setor bancário, os bancos domésticos reagiram à entrada dos bancos estrangeiros tomando parte ativamente da onda de fusões e aquisições (F&As), e mantendo seu predomínio no sistema bancário nacional; de modo distinto, na indústria de auto-peças houve um rápido processo de "desnacionalização", com a extinção ou aquisição estrangeira de muitas firmas nacionais e a presença crescente de empresas multinacionais. Entretanto, nós encontramos poucas evidências de oportunismo estrangeiro com resultado das crises financeiras. Finalmente, destacamos que o investimento direto estrangeiro (principalmente via F&As) teve um impacto desigual sobre as indústrias manufatureiras: algumas firmas domésticas em algumas indústrias (têxtil, vestuário, calçados, azulejo e cerâmica) reagiram de forma bem sucedida limitando a entrada estrangeira; outras firmas domésticas (processamento de alimentos, eletrodomésticos) tiveram que competir com a presença crescente de firmas estrangeiras.

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1. Introduction

The Brazilian economy was hit by three financial crises between 1994 and 2005, only one of which could be described as having mainly domestic origins. The first was triggered by the Mexican Crisis in 1994-95 and came shortly after Brazil's successful stabilization under the Real Plan; the second, more of a slow-drip crisis, began with contagion from the Asian (1997) and Russian (1998) crises, but then became a full-blown local crisis, which led to the maxi-devaluation of the currency in January 1999; the third crisis, of mainly local origin, was the 2002 capital and currency market instability triggered by the up-coming presidential elections. The origins, sequence and fallout for the domestic economy differed in each crisis as did its impact on foreign interests in the Brazilian economy.

Much of the academic literature on financial crises was initially pre-occupied with ascribing blame, whether on bad domestic policy or financial panic in international capital markets (Chang 1999). Much less was written about the medium- and longer-term impact of financial crises on the prospects for economic growth and development. What little there was, depending on one's view of foreign participation in developing country economies, tended to focus either on the 'opportunism' of foreign responses or on more benign external 'intervention' (whether in the form of advice and funding or via the positive externalities generated by market activities of private firms). As evidence of the former interpretation, many pointed to the significant increase in foreign firms' presence in the 1990s, where local businesses were bought up in what were described elsewhere as 'fire sales' in the aftermath of financial crises. Undoubtedly, in Brazil, inward foreign direct investment (FDI) stocks as a percentage of gross domestic product (GDP) rose appreciably from 6 percent in 1995 to 17 percent in 1998 (UNCTAD 2000). However, when looking more closely at evidence in the Brazilian case, we found that this was an over-simplified, if not self-important, view on the part of foreign/Western interests and analysts.

Robertson (2007) proposed six perspectives for analyzing the position of foreign interests in the aftermath of financial crises. Given constraints of space, this paper focused on four aspects – two of which emphasized the domestic and the other two the role of foreign interests in Brazil. These were: resistant domestic politics, domestic winners, uneven foreign involvement and efficiency enhancing foreign investment. We found that the consequences of financial crises must be examined in a disaggregated manner – both in terms of the degree of impact relative to other processes in the wider economic conjuncture as well as in terms of specific sectors and type of financial flows. Thus, our more nuanced picture first considered the general economic policy and market context during and after the financial crisis. Next, it distinguished between types of capital flows (portfolio capital and foreign direct investment) and types of economic activity (financial services and manufacturing industry), with the analysis focusing on the latter distinction.

Our argument is presented in two steps. First, we argue that at the micro-economic (firm and industry) level, whether in the financial or productive sectors, domestic economic processes and policy-making, discussed in section two, had a much greater impact on the changing ownership structure and investment pattern than did the fall out from international financial crises. Secondly, we show that among the various financial crises in the 1990s, the Mexican crisis had a much deeper and longer-term impact on Brazilian firms than did the Asian crisis (notwithstanding the drastic devaluation and switch to an inflation-targeting monetary regime, as explained below).

The paper is organized in five sections. After the introduction, section two examines the general economic context in terms of macro-economic reforms and industrial restructuring; section three considers the impact of crisis on foreign and domestic firms in financial services, specifically the banking sector; section four analyses the impact on firms operating in the manufacturing sector, specifically the automotive parts industry; finally, section five discusses the overall impact of the crises on foreign and domestic firms in the context of greater internationalization of the Brazilian economy.

2. Economic Context and Financial Crises in Brazil

2.1. Financial crises and macro-economic policy responses in 1994-2005

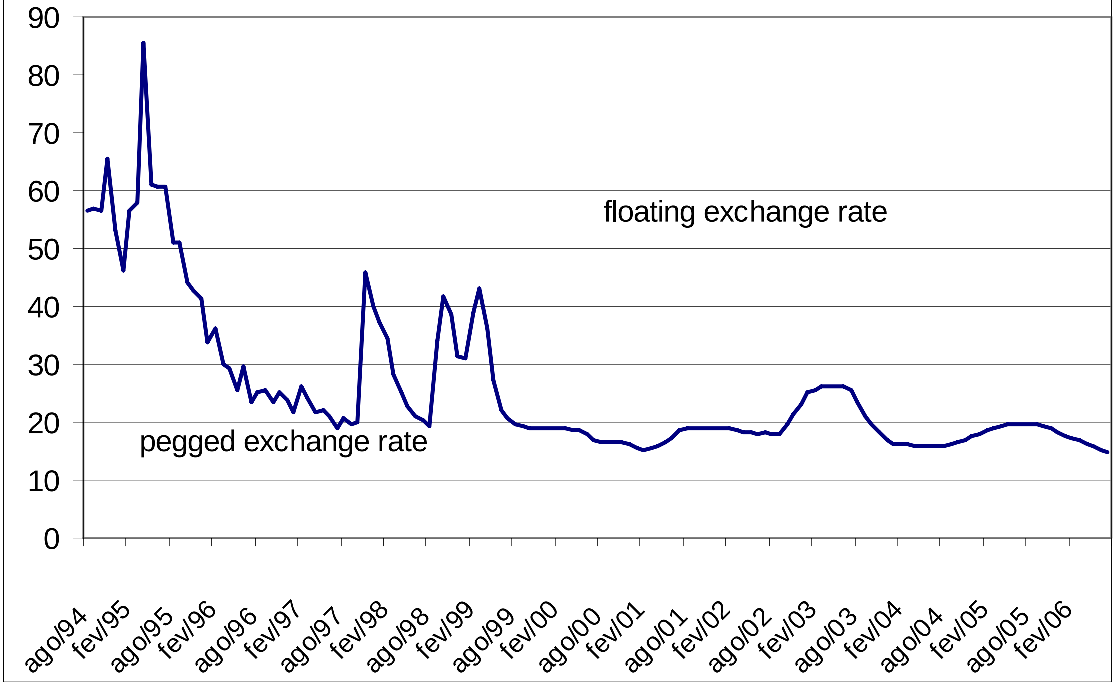
Since the beginning of the 1980s, high inflation was a major problem and indexation contracts spread all around the Brazilian economy. By 1993, inflation was almost 3,000 percent. Starting in 1994, after the failure of a number of previous price stabilization programs, Brazil finally implemented a successful new stabilization program, the Real Plan.[1] This plan differed from Argentina's Convertibility Plan in that it adopted a more flexible exchange rate anchor. The Real Plan was successful in bringing inflation down fast, due to the combination of exchange rate appreciation, high interest rates and a huge reduction in import taxes. However, the expansion of demand, and the overvalued exchange rate created immediate difficulties for Brazil's external sector. From 1995 to 1998, the trade balance accumulated a deficit of around US$ 22.3 billion and the current account registered a deficit of around US$ 105.6 billion (Table 1). The Brazilian economy's high degree of external financial fragility left it susceptible to short-term changes in the international situation. This untenable trend in its foreign accounts kept Brazil vulnerable to currency crises.

[1] For an analysis of the Real Plan, see Ferrari-Filho and Paula (2003).

The Mexican crisis in 1994-1995, made clear that sooner or later the consequence of Brazil's external vulnerability would be a currency crisis. As a result of the 'Tequila effect', foreign investment declined, thereby reducing Brazil's foreign reserves. In order to face off a speculative attack on the Brazilian domestic currency (*real*), the authorities introduced a crawling peg system to operate the exchange rate flexibly, moved tariffs upwards in some specific sectors (including the automotive industry) and increased the interest rate to nearly 65 percent in an attempt to entice international capital. These measures were effective in preventing a speculative attack on the *real* and Brazil managed to avert a currency crisis. However, the increase in the nominal interest rate (Figure 1) slowed growth and increased net public debt. Such a policy also caused difficulties for businesses and the financial system suffered serious distress due to a rapid increase in the number of bad loans.

After a period of some economic normality, but with an increasing external fragility due to the current account deficit (3.8 percent of GDP at the end of 1997), the *real* suffered another speculative attack in October 1997 because of contagion from the East Asia crisis. Once again, the annual nominal interest rate was raised from 24.5 percent in October to 46.5 percent in November 1997. The government also announced the implementation of a fiscal package in the hope of inspiring more confidence in economic agents. These policies were well received as evidenced by a reduction in capital outflows during the first semester of 1998 and by the fact that foreign reserves rose to US$ 70.0 billion by the end of July 1998 (up from US$ 40.0 billion at the beginning of July 1994).

Figure 1. Brazil: nominal interest rate (% p.y.)



Source: Central Bank of Brazil

However, in the third quarter of 1998, another speculative attack on the *real*, a mix of contagion from the Russian crisis plus perception on the part of market operators that Brazil was experiencing serious macroeconomic imbalances, clearly demonstrated that foreign reserves were no protection at all against speculation. The monetary authorities insisted on maintaining the semi-fixed exchange rate. Further fiscal belt-tightening was announced, and the Central Bank of Brazil (BCB) raised the nominal interest rate to 43 percent. However, disappointment with slippage in fiscal adjustment during 1998 plus a growing public debt contributed to the general feeling that Brazil remained vulnerable. The continuity of the Real Plan, at least as originally conceived, became ever less sustainable.

Given macroeconomic imbalances and uncertainties about the Real Plan's future, capital started flowing out of the country and foreign reserves fell rapidly. Between September and December 1998, foreign reserves plummeted by 38 percent. Although the IMF put together a US$ 42 billion rescue package, financial markets were unconvinced, and as a result, Brazil was unable to defend its currency. Thus, in January 1999, after continuing losses in foreign reserves, the exchange rate regime was finally changed. A floating exchange rate regime supplanted the semi-pegged exchange rate anchor (the main pillar of the Real Plan). Some months later, the Brazilian government adopted an inflation-targeting regime as the new anchor for prices, inspired by the British model.

The 1999 devaluation raised expectations of explosive inflation and a dramatic recession. Surprisingly, a few months after the initial economic turbulence brought about by the devaluation, Brazil's economy rallied quickly and began to show signs of recovery. Indeed, in 1999 and 2000, GDP increased 0.8 percent and 4.4 percent, respectively, and the inflation rate (IPCA) rose by no more than two digits, that is 8.9 percent in 1999 and 6.0 percent in 2000; and the medium- and long-term inflows of portfolio capital as well as FDI rose.

However, in 2001, owing to a number of international shocks (the slow-down in the U.S. economy, and the Turkish and Argentine crises) the Brazilian economy again began to flounder. Economic growth fell to 1.3 percent and inflation ran at 7.7 percent. The already high level of external debt rose from 24.0 percent of GDP in 1997 to 41.2 percent in 2001. Although the current account balance fell from US$ 33.4 billion in 1998 to US$ 23.2 billion in 2001 (Table 1), the ratio of the current account balance to GDP was over 4.0 percent. Thus, Brazil remained vulnerable to the mood in international financial markets.

In mid-2002, when the Workers' Party (PT) candidate, Luiz Inacio Lula da Silva, began leading in opinion polls for the October presidential elections, investor fears triggered capital flight, pushing down the exchange rate. Brazil suffered a 'sudden stop' in capital inflows, when a large segment of financial investors refrained from purchasing public securities maturing after 1 January

2003 (the start of the new presidential term). As a result of the pre-election macroeconomic instability, the inflation rate (measured by the IPCA) reached 12.5 percent and GDP growth slowed down to 1.93 percent in 2002. Once installed in office, President Lula's new government moved to reassure markets and limited further damage. The BCB increased interest rates in 2003 and the government raised the primary fiscal surplus (fiscal balance before interest payments) to 4.25 percent in 2003 and 4.59 percent in 2004. Inflation was 9.3 percent and GDP growth a meager 0.54 percent in 2003.

In subsequent years, favorable international conditions that included both greater economic growth and increasing liquidity in the international financial markets resulted in an up-surge of capital flows to emerging countries, which had positive impacts on the Brazilian economy: an increase in both demand for and prices of commodities saw the trade surplus rise from US$ 24.9 billion in 2003 to US$ 44.8 billion in 2005; and exchange reserves were boosted up from US$ 37.8 billion to US$ 53.8 billion in the same period. As a result, various indices showed a reduction in the external vulnerability of the Brazilian economy. However, in spite of the better international conditions, GDP growth took a 'stop-go' pattern during Lula da Silva´s government: 0.5% in 2003, 4.9% in 2004, 2.3% in 2005 and an estimated 3.0% in 2006. Growth rates were very low for Brazilian needs, and also very low when compared to other big emerging countries over the same period.[2]

Table 1. Brazil - some macroeconomic data - 1991/2005

Year	Consumer Index Price (IPCA)	GDP growth - annual %	Investment rate (percentage of GDP)	Trade balance - US$ million	Current account US$ million	Net public debt-over-GDP	Real average income - Sao Paulo urban region (1985 = 100)	Formal unemployment rate* - Sao Paulo urban region (%)
1991	472.5	1.03	18.11	10,580	-1,408	38.1	58.5	6.7
1992	1,119.1	-0.54	18.42	15,239	6,109	37.1	61.3	8.0
1993	2,477.1	4.92	19.28	13,299	-676	32.6	68.4	7.6
1994	916.5	5.85	20.75	10,467	-1,811	30.0	65.9	7.8
1995	22.4	4.22	20.54	-3,466	-18,384	30.6	69.9	8.7
1996	9.6	2.66	19.26	-5,599	-23,502	33.3	71.5	9.2
1997	5.2	3.27	19.86	-6,753	-30,452	34.4	72.4	10.2
1998	1.7	0.13	19.69	-6,575	-33,416	41.7	71.5	10.8
1999	8.9	0.79	18.90	-1,199	-25,335	48.7	65.9	10.5
2000	6.0	4.36	19.29	-698	-24,225	48.8	62.3	10.0
2001	7.7	1.31	19.47	2,651	-23,215	52.6	56.9	11.6
2002	12.5	1.93	18.32	13,121	-7,637	55.5	51.6	11.4
2003	9.3	0.54	17.78	24,794	4,177	57.2	53.5	12.0
2004	7.6	5.18	19.58	33,693	11,669	51.8	52.3	10,0
2005	5.7	2.30	19.93	44,748	14,193	51.0	54.1	9.7

Source:IPEADATA

Note: (*) Formal unemployment rate does not include informal unemployment

To summarize, the 1999 switch from an exchange anchor to a floating exchange rate regime plus inflation targeting brought no significant improvement in macroeconomic variables (GDP growth, inflation rate, unemployment rate, etc; see Table 1). However, in terms of balance of payments, the 2003-05 accounts improved mainly due to increases in the trade surplus. Interest rates did not fall as quickly as might have been expected after floating the exchange rate. They increased in 2001 due to turbulence in international markets, and again in 2003 due to market unease at the beginning of Lula's government.

The *modus operandi* of an inflation-targeting regime plus the adoption of a floating exchange rate under conditions of full opening of the capital account resulted in greater instability of the nominal exchange rate. Thus, in 2002-03, capital outflows induced a sharp exchange rate devaluation with knock-on effects on domestic prices and the BCB's inflation target. Under these conditions, BCB was compelled to increase the interest rate to avoid both capital outflows and pass through effect. The BCB's reaction to exchange rate movements caused a decline in output and employment, while also increasing the volume of public debt. During 'tranquil times', when capital inflows were abundant, the interest rate served to attract capital and the resulting exchange rate appreciation helped to meet inflation targets.

Thus, in Brazil, it is worth pointing out that high interest rates performed multiple functions, which had important implications for the presence and influence of foreign interests. First, it was designed to influence and achieve inflation targets, in the context of various macroeconomic constraints. High interest rates also limited exchange devaluation, attracted foreign capital, encouraged roll over of public debt, and reduced trade deficits by curbing domestic demand (Bresser-Pereira and Nakano, 2002). However, on a less positive note, and also of relevance to our analysis, high interest rates in Brazil: (i) constrained economic growth, through the price of credit (loan rates) and entrepreneurs' negative expectations; and (ii) increased the public deficit due to high interest payments on bonds indexed to the overnight rate (Over/Selic). Indeed, the robust demand for hedges against exchange devaluation and interest rate changes in turbulent periods not only strongly affected Brazil's internal public debt, but also compromised the viability of longer term productive investments. In 1998-2005 period, more than 50 percent of the federal domestic securities were indexed to the overnight rate. Almost 30 percent of securities were indexed to the exchange rate in 2002 (Table 2), but this decreased sharply thereafter.

[2] GDP growth in China, India and Russia was in 2000-2004, on average, 6.8%, 5.7% and 8.5%, respectively (Ferrari Filho and Paula 2006).

Table 2. Brazil: federal domestic securities - percentage share index (portfolio position)

	Exchange	TR	Inflation(IGP)	Over/Selic	Preset	Inflation(IPCA)	Other	Total
Jun-00	21.1	5.4	5.4	54.7	13.3	0.0	0.1	100.0
Dec-00	22.3	4.7	5.9	52.2	14.8	0.0	0.1	100.0
Jun-01	26.8	5.0	7.2	50.2	10.8	0.0	0.0	100.0
Dec-01	28.6	3.8	7.0	52.8	7.8	0.0	0.0	100.0
Jun-02	29.9	2.2	7.5	50.4	8.6	1.4	0.0	100.0
Dec-02	22.4	2.1	11.0	60.8	2.2	1.6	0.0	100.0
Jun-03	13.5	2.0	11.3	67.2	4.5	1.6	0.0	100.0
Dec-03	10.8	1.8	11.2	61.4	12.5	2.4	0.0	100.0
Jun-04	8.9	1.8	11.9	57.5	16.8	3.0	0.0	100.0
Dec-04	5.2	2.7	11.8	57.1	20.1	3.1	0.0	100.0
Jun-05	3.6	2.5	10.6	57.1	23.0	3.3	0.0	100.0
Dec-05	2.7	2.1	8.2	51.8	27.9	7.4	0.0	100.0

Source: Central Bank of Brazil

Note: IGP means 'General Price Index', prepared by FGV foundation.

IPCA, that means 'Extensive National Consumer Index', is the official inflation index, calculated by IBGE.

2.2. Financial Crises and Industrial Restructuring in 1994-2005

In addition to the high inflation mentioned in the previous section, decades of protectionism, state intervention and under-investment had created major problems related to low productivity and competitiveness in the Brazilian economy. However, in the 1990s, Brazil's industrial and service sectors underwent a profound and thorough restructuring as a result of five distinct, but mutually reinforcing processes: globalization, regional integration, privatization, market liberalization and stabilization. The interaction of these processes resulted in the disintegration of the long-standing basis of Brazil's import substitution industrialization (ISI) developmentalist model, which was the "*tripé*" (or tripod) of state-owned, foreign-owned and domestic family-owned enterprises (Evans 1979).

Although most of these processes and policies pre-dated the 1994 Real Plan, price stabilization was the crucial condition necessary to round off the virtuous circle that was already creating a new dynamism in the economy with the promise of modernization, greater competitiveness and sustained growth (Mendonça de Barros & Goldenstein 1997). Globalization not only expanded access to technology, finance and markets, but also offered opportunities for Brazilian firms to integrate into global markets and participate in global productions chains. Regional integration not only expanded the size of the regional market, but also brought benefits in terms of reform lock-in (Devlin & Ffrench Davis 1999). Privatization not only divested the highly indebted public sector of productive assets, but also opened opportunities for investment in infrastructure and services that would contribute to increasing overall economic efficiency.

Market liberalization initially had a negative impact on the performance of local firms long accustomed to market reserves and high levels of protection. From 1990 onwards, both foreign and domestic owned firms were increasingly subject to the rigors of competitive markets forcing them to focus on reducing costs, up-grading technology and increasing productivity, all of which implied enhancing investment in order to survive. Trade opening also had a redistributive impact in that it transferred income from producers to consumers. Together, the above changes ensured that market liberalization had a more positive medium- and long-term impact on those firms that managed to restructure successfully.

Finally, stabilization (i.e. controlling inflation and keeping a close watch on other macro-economic fundamentals) not only provided concrete benefits for the lowest income groups, thus increasingly overall demand and consumption, but crucially had the lateral effect of increasing credit availability, which made it more feasible for firms to consider medium- and long-term investment plans.

The massive restructuring of Brazilian industry in the 1990s was triggered by the above processes and policies, and not by financial crises. Moreover, as Mendonça de Barros & Goldenstein (1997) pointed out, the restructuring process was driven forward by substantial changes in the mentality of private sector managers, who for the first time were forced to grapple with issues of productivity and competitiveness. It is also worth emphasizing Brazilian policy-makers' pre-occupation with macro-economic fundamentals, mainly after the 1999 exchange rate devaluation, which meant that tight monetary (high interest rates) and fiscal (large primary surplus) policies were the order of the day. Micro-economic and/or industrial policies were given scant attention.

In this type of policy setting, international capital flows were encouraged because of their beneficial impact on economic fundamentals.[3] In addition, foreign capital (with its access to cheaper sources of financing in international financial markets) provided the dynamic for investment in restructuring and modernization, and by 1998, FDI inflows accounted for 17% of gross fixed capital formation (GFCF) (UNCTAD 2000). Meanwhile, many domestic firms were squeezed out of capital and credit markets. Given their difficulties of access to capital and its high cost, many domestic firms either entered into foreign partnerships/joint ventures or were forced to sell out (usually to foreign buyers). Again, contagion from international financial crises was less relevant to merger and acquisition (M&A) activity than was the shifting profitability of firms forced to adjust to structural reform policies (especially trade opening).

In addition, given Brazil's fairly open investment regime for foreign manufacturing enterprises, the expansion of market opportunities (due to globalization, regional integration and the post-stabilization consumption boom) also attracted greenfield FDI (most notably in the automotive, consumer electronics and food processing industries). Rules were more restrictive in

[3] Sarti & Laplane (2002) note that increasing FDI and greater efficiency in manufacturing paradoxically resulted in aggravating Brazil's external vulnerability due to the tensions that arose between the macroeconomic and microeconomic logic of the internationalisation process. Thus, FDI improved the current account, but initially dampened the trade account via increased imports in the absence of a concomitant rise in exports.

the financial sector and foreign bank entry could only be undertaken with prior authorization of the BCB or by Congressional decree. Although the 1988 Brazilian Constitution prohibited the installation of foreign banks, it allowed entry on a case-by-case basis through authorizations resulting from international agreements, from reciprocity or from the interest of the Brazilian government. Within this legal context, Legislative Intent no.311 of 23 August 1995 allowed the President to exceptionally authorize, case-by-case, the entrance of foreign banks in Brazil in response to the need to strengthen the financial system after the 1995 banking distress and also to help incorporate international experience of banking supervision into the domestic financial system.

To summarize, this section argued that when examining the impact of financial crises on the dominance of foreign interests in Brazilian firms, one must take into account the wider context of change. Our argument gave central importance to the evolution of domestic economic policy-making and its impact on macro-economic variables in understanding economic activity in the past decade. In the next two sections, we show that at the micro-economic (firm and industry) level, whether in the financial or productive sector, the above-mentioned domestic processes had a much greater bearing on the changing ownership structure and investment pattern than did the consequences of financial crises (e.g. currency devaluation, recession, etc.). We also show how the burden of adjustment in the aftermath of the various financial crises in the 1990s was more significant post-Mexican crisis than post-Asian crisis. Of course, this argument, while relevant at firm or industry level, was not applicable to the macro-economic scenario. Here, contagion from the Russian crisis not only led to a drastic devaluation, but more importantly, to a switch from an exchange rate anchor to an inflation-targeting monetary regime.

Finally, crises were not necessarily all bad news: some analysts argued that the 1999 devaluation even generated some favorable surprises for the Brazilian economy (Amann & Baer 2003), evidence of which could be gleaned from the quick recovery of the economy (growth was 4.4 percent in 2000) with no 'explosion' of inflation (8.9 percent in 1999 and 6.0 percent in 2000). Furthermore, in macroeconomic terms, the 1999 crisis helped correct some of the downsides of the Real Plan. The devaluation not only contributed to boosting export competitiveness and expanding trade surpluses, but it also led to changes that reduced opportunities for speculation. This spelled longer-term benefits for Brazilian growth and development.

3. Foreign Penetration in the Banking Sector

3.1. Banking Consolidation, Foreign Entry and Domestic Resistance

In recent years, foreign bank entry increased a great deal in emerging market economies (EMEs). Latin America and the transition countries of Central Europe, where in some countries foreign banks already controlled over fifty percent of total banking assets, were quickest to permit foreign participation in banking. Progress towards foreign ownership of banks was more modest in Asia, Africa, the Middle East, and Russia. On the one hand, the drastically changed landscape of the banking industry worldwide was a consequence of external processes of banking internationalization as a result of both financial deregulation and technological changes. On the other hand, foreign bank penetration, particularly in EMEs, was the result of increased flexibility of domestic legal rules concerning the treatment of foreign bank entry. The policy motivation was mainly related to possible benefits of foreign bank penetration in terms of modernization and strengthening of the domestic financial system.

Banking consolidation in Latin America was the most advanced among the EMEs, where there was a remarkable rise in the quantity of banking institutions and a concomitant increase in banking concentration (IMF 2001). The main 'forces of change' for this process was the banking crises triggered by the 1994 Mexican crisis and the consequent encouragement of foreign bank entry:

> 'Financial crises and the need to (re-)establish functioning banking systems created a one-time set of opportunities to invest in financial institutions and to expand business in EMEs in the second half of the 1990s. A standard response to crises by EME government, encouraged by the international financial institutions, was to accelerate financial liberalization and to recapitalize banks with the help of foreign investors. This was the case in Latin America in the years following the 1994 Mexican crisis.' (CGFS 2004: 6)

Overall, the share of bank assets held by foreign banks in EMEs increased considerably since 1990. Foreign ownership of the banking sector is substantially higher in Latin America and Central and Eastern Europe than in Asia. (Table 3) While in Central and Eastern Europe foreign banks now control more than 60 percent of total banking assets, in the major countries of Latin America, except Brazil, the share of assets owned by foreign banks was over 30 percent. In 2004, in Mexico and Argentina, the market share of foreign banks (in terms of total assets) was 48 percent and 82 percent respectively.

Table 3. Share of bank assets held by foreign banks[1]

Countries	1990	2004[2]	in per cent of GDP	in billions of USD
Central and eastern Europe				
Bulgaria	0	80	49	13
Czech Republic	10	96	92	99
Estonia	...	97	89	11
Hungary	10	83	67	68
Poland	3	68	43	105
Emerging Asia				
China	0	2	4	71
Hong Kong	89	72	344	570
India	5	8	6	36
Korea	4	8	10	65
Malaysia	...	18	27	32
Singapore	89	76	148	159
Thailand	5	18	20	32
Latin America				
Argentina	10	48	20	31
Brazil	6	27	18	107
Chile	19	42	37	35
Mexico	2	82	51	342
Peru	4	46	14	11
Venezuela	1	34	9	9

[1] Percentage share of total bank assets. [2] Or latest available year.
Source: Domanski (2005, p. 72), based on data from ECB and national central banks.

3.2. Merger and Acquisitions Activity and Domestic Winners in the Banking Sector

In Brazil, as in the case of other major Latin American EMEs (Argentina and Mexico), one of the key effects of the 'tequila crisis' in 1994-95 was that it triggered the liberalization of the financial system. All the same, Brazil was somehow a special case among EMEs in terms of domestic resistance to foreign banks penetration, especially when compared to other Latin American countries. Indeed, although three European banks (the British HSBC, the Spanish Santander and the Dutch ABN-Amro) made significant banking acquisitions during the nineties, domestic banks remained dominant in Brazil.

Before 1995, the Brazilian banking sector adapted very well to the environment of high inflation, taking advantage of the inflationary revenues to make profits. It did this by applying non-remunerative deposits (sight deposits) in government securities, which combined liquidity with high rates of interest. This was only possible due to the existence of a broader domestically-denominated indexed money and also the early development of a modern clearing system to support clients' demands for immediate information and the clearing of checks. Inflation made the Brazilian banking sector dynamic and technologically sophisticated. As a result, the decrease in M1 (cash plus sight deposits) – that is the conventional definition of the means of payment in an economy - did not result in a loss of funds in the Brazilian financial system as happened in the Argentine high inflation experience. In the latter case, an extensive process of dollarization was followed by an enormous decrease in financial deepening.[4]

Inflationary revenues accounted, on average, for 38.5 percent of banks' value added between 1990 and 1993. When inflation fell sharply after July 1994, its rapid decline eliminated these inflationary revenues to the banking sector. However, low inflation and re-monetization of the economy stimulated some increase in consumption spending, inspite of the increase in the BCB's interest rate. In this new context, banks earned most of their profits from credit operations due to the rise in demand for loans and high interest rates. Therefore, when BCB sharply tightened monetary policy (short-term interest rate rose from 20 to 65 percent per annum) in response to the Mexican financial crisis, banks came under severe pressure as 'bad' loans increased quickly.

The 'tequila effect' threatened the banking sector as a whole, but in particular some of the national retail banks with problems that pre-dated the crisis, as was the case of Banco National and Banco Economico. In 1995, the likelihood of a systemic crisis in the banking sector increased when BCB, as regulator of the financial system, first decided to liquidate Economico (August 1995) and later Nacional (November 1995), the seventh- and the fourth-largest private banks, respectively. However, to avoid the spread of systemic risk, BCB implemented a special program - the Program of Incentives to the Restructuring and Strengthening of the National Financial System (PROER), under Provisional Measure No. 1179 issued in November 1995. This program aimed to preserve the solvency of the financial system by removing distressed banks and bolstering those that remained. An important feature of the program was that the former controlling owners had to abandon their controls over the assisted bank. Furthermore, PROER provided a system of tax incentives and credit facilities to encourage rapid consolidation of the banking system through M&As. [5]

PROER financing backed some of the most important banking acquisitions in the following years, including the acquisition of Nacional by the domestic Unibanco, Economico by the domestic Excel, and the sale of Bamerindus to the British HSBC. PROER, and the provision of liquidity to the banking sector by BCB and other federal banks (Banco do Brasil and Caixa Econômica Federal (CEF)) succeeded in averting a full-blown crisis banking crisis. According to International Focus of EconSouth (Third Quarter 2001),

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[4] According to Bresser-Pereira and Ferrer (1991:10), in Argentina both M1 and M4 (which includes M1 plus financial assets) decreased since the late 1970s. In February 1990, M1 was less than 3 percent of GDP, while M4 was less than 5 percent of GDP, because economic agents reallocated their portfolios to the dollar. Alternatively, in Brazil, accelerating inflation decreased M1 from the early 1970s, but M4 remained stable as a consequence of the supply of domestically-denominated indexed money. According to data from BCB, the ratio M1/GDP and the ratio M4/GDP were 9.2 percent and 25.1 percent in 1980, respectively, while in 1993 they were 1.3 percent and 23.1 percent, respectively.

[5] The acquiring (healthy) bank took over all the deposits of the insolvent bank, and other assets that it chose to take with PROER credit making up the difference. All PROER credits were guaranteed using public bonds whose value exceeded the credit by 20 per cent. The acquired (insolvent) bank was liquidated and its balance sheet included the PROER credit as a liability. For more details, see OECD (2001, Box 15).

> '[a] notable feature of the Brazilian banking system is that it did not experience the sort of devastating banking crises suffered by many other countries during the 1990s. Serious problems were clearly evident in some Brazil's bank by the end of 1994, but the magnitude of these problems did not pose a threat to the banking system as a whole.'

The banking distress in 1995 provided the Brazilian federal government with the opportunity to privatize state banks and to allow the entrance of some foreign banks within the domestic banking sector. However, as discussed in section 2:2, the 1988 Constitution restricted foreign bank entry, and financial liberalization after 1995 was carried out on a case-by-case basis, that is it depended on BCB authorization. Moreover, compared to Argentina and Mexico, banking sector opening was much less dramatic in Brazil. Comparing Brazil and Mexico, Martinez-Diaz (2005: 34) concluded that

> 'one of the most important differences between the two cases is that Mexican policymakers had clearly articulated beliefs about the nature and degree of liberalization they saw as desirable, while Brazilian official were more
> improvisational and had few a priori expectations of how liberalization should proceed. Brazilian policymakers also appeared less concerned with the ostensible long-term benefits of foreign bank presence and were far more interested in the short-term benefits of foreign participation, namely higher prices for privatized state banks and lower costs to the central bank for recapitalization'.

The first foreign acquisition was the sale of Bamerindus to HSBC in April 1997. At the time no other large Brazilian bank was interested in acquiring the bank. Bamerindus, one of the five largest private banks, showed signs of severe distress in 1996-97, and BCB put it under intervention in March 1997. The transfer to HSBC was heavily assisted by PROER, which injected R$ 5.8 billion into Bamerindus. This operation triggered a wave of foreign bank entry, which resulted in the quick expansion of foreign participation in the Brazilian banking sector: from 1997 to 2000, the Spanish Santander bought the middle-sized banks Banco Geral do Comércio (1997), Noroeste (1997) and Meridional (2000) and, finally the big state-bank Banespa (2000), at the time the sixth largest bank in Brazil. Thus, Santander became the major foreign bank in Brazil. The Italian-French Sudameris acquired America do Sul (1998); the Spanish BBV bought Excel-Econômico (1998); the Dutch ABN Amro acquired Banco Real (1998), at the time the fourth biggest private bank. This last operation was a point of discontinuity, given that it was the first instance when the government authorized the sale of a healthy bank to foreign investors. After 2000, foreign bank appetites slacked off, partly due to the impact of the 2001-02 Argentine crisis as well as a global shift to risk-aversion post-2001. In Brazil, only foreign banks already present in the market made new acquisitions, as in the case of the sale of Sudameris to ABN-Amro, and the sale of Lloyds Bank (including Losango) to HSBC.

Of notable interest was the high level of M&A activity on the part of some of the domestic private banks in operations that involved state-banks and middle-sized domestic private and even foreign banks. For example, among others, Itau acquired the state-banks Banerj, BEMGE, BANESTADO and BEG, and the private banks Fiat and BBA; Bradesco acquired, among others, BCN/Credireal, Boavista, Ford, Mercantil de Sao Paulo and BBV Banco; Unibanco acquired Nacional, Bandeirantes and Fininvest. Some studies comparing efficiency (measured in terms of operational efficiency or profitability performance) between foreign banks and private domestic banks in the recent period show that on the whole the latter performed better than the former.[6]

Table 4 shows market share in the Brazilian banking sector from 1994 to 2004. Between 1996 and 2004, foreign banks increased their market share rapidly from 4.4 percent of total deposits, 9.8 percent of total assets and 8.6 percent of total credit in 1996 to 21.1 percent, 27.4 percent and 25.2 percent, respectively, in 2000, but there was little change subsequently. Domestic private banks were still hegemonic in the Brazilian banking sector: they maintained more or less the same market share between 1994 and 2004, i.e. 39.4 percent of total deposits, 41.7 percent of total assets and 41.3 percent of total credit. More interestingly, Bradesco, Itau and Unibanco were respectively the first, second and fourth biggest private banks operating in Brazil. The two big federal public banks, Banco do Brasil and CEF, were still the largest banks, although their market share declined from 33.3 percent of total assets in 1994 to 28.9 percent in 2004. The biggest change was among state-banks, where as a result of the privatization program (PROES), their share in total assets shrank from 18.2 percent in 1994 to 5.5 percent in 2004.

It is also worth noting that even when Brazil suffered from the impact of contagion from successive currency crises in 1997-1999, and even when capital inflows suddenly stopped in 2002, the banking sector continued to perform very well. Indeed, as we have seen in section 2:1, during periods of macroeconomic instability, the Brazilian government offered the banking sector (which was the main buyer of public securities) hedges against exchange devaluation and interest rate changes, by offering them securities indexed to the exchange rate and overnight interest rate. Consequently, notwithstanding severely restrictive macroeconomic conditions, the banks could adopt a conservative financial posture, i.e. a high proportion of government securities in their portfolio, low levels of mismatch between assets and liabilities and low leverage levels. The share of public securities in total banking assets was around 40% on average in 1998-2004 period (Table 5). Therefore, banks were able to afford risk aversion strategies, thanks to the availability of high-

[6] See, for instance, Guimarães (2002).

yielding, relatively risk-free government securities as an alternative to private sector lending. The Brazilian banking sector never faced the classical liquidity-versus-profitability trade-off, as the institutional-macroeconomic context afforded an environment with scope for banks to combine liquidity and profitability. [7]

Table 4. Market-share in Brazilian banking sector

	1994	1996	1998	2000	2002	2004
	As percentage of total deposits					
Foreign-controlled banks	4.6	4.4	15.1	21.1	19.8	19.9
Private-sector domestic banks	39.4	34.1	33.1	33.9	36.6	39.4
Public-sector banks*	16.5	18.7	13.3	7.4	7.4	6.6
Caixa Econômica Federal	24.4	26.6	20.5	19.5	16.9	15.6
Banco do Brasil	15.1	16.0	17.4	17.1	17.7	17.1
Credit cooperatives	0.2	0.3	0.6	1.0	1.5	1.4
Total of banking sector	100.0	100.0	100.0	100.0	100.0	100.0
	As percentage of total assets					
Foreign-controlled banks	7.2	9.8	18.4	27.4	27.4	22.4
Private-sector domestic banks	41.2	39.0	35.3	35.2	36.9	41.7
Public-sector banks*	18.2	21.9	11.4	5.6	5.9	5.5
Caixa Econômica Federal	15.0	16.5	17.0	15.4	11.7	11.5
Banco do Brasil	18.3	12.5	17.4	15.6	17.1	17.4
Credit cooperatives	0.2	0.3	0.5	0.8	1.0	1.4
Total of banking sector	100.0	100.0	100.0	100.0	100.0	100.0
	As percentage of total credit					
Foreign-controlled banks	5.18	8.6	14.9	25.2	29.9	25.1
Private-sector domestic banks	35.35	32.7	31.0	34.5	39.7	41.3
Public-sector banks*	18.92	23.5	8.9	5.1	4.8	4.4
Caixa Econômica Federal	20.35	24.0	32.3	23.0	7.6	7.5
Banco do Brasil	19.87	10.6	12.1	11.0	16.2	19.4
Credit cooperatives	0.33	0.5	0.9	1.2	1.8	2.3
Total of banking sector	100.0	100.0	100.0	100.0	100.0	100.0

Source: COSIF/Central Bank of Brazil

To summarize, according to our analysis, domestic resistance in the Brazilian banking sector can be attributed to a range of factors, including:

(i) high inflation helped make the Brazilian banking sector dynamic and technologically sophisticated; in particular domestic banks acquired the capabilities necessary to take advantage of the volatile macroeconomic environment;

(ii) the relatively less severe impact of the 1994-95 crisis on Brazil (compared to Mexico and Argentina);

(iii) the rapid response of BCB taking action to avoid a banking distress becoming a systemic crisis;

(iv) relatively limited capital flight because of the government's management of contagion from the financial crises after 1997, and the ability of the banking sector as a whole to re-allocate its portfolio to minimize the impact of capital flight.

[7] For more on this analysis, see Paula and Alves, Jr (2003).

As a result, once domestic banks recovered and were performing well, they not only survived foreign bank competition, but also managed to lead in the wave of M&As.

Table 5. Banks Portfolio, Percentage Share

End-of-period	Total loans on total assets (1)				Total securities on total assets (2)			
	Total	FB	DP	FE	Total	FB	DP	FE
Jun-98	41.8	55.1	39.9	39.5	36.5	24.3	34.6	37.3
Dec-98 (3)	43.6	55.2	41.2	44.0	31.0	35.9	38.9	36.7
Jun-99	43.0	54	39.4	42.2	38.2	31.9	35.8	35.1
Dec-99	44.0	53.5	41.8	42.2	37.9	29.7	36.4	36.6
Jun-00	47.1	55.1	45.0	46.7	37.8	30.8	35.1	36.0
Dec-00	47.8	56.5	47.2	38.4	37.5	26.0	36.0	48.1
Jun-01 (4)	46.9	46.9	49.7	46.4	37.2	32.7	31.5	39.4
Dec-01	44.2	37.3	49.9	46.4	43.1	46.0	33.3	43.3
Jun-02	43.9	42.5	43.1	46.6	42.1	39.8	35.7	41.0
Dec-02	41.7	33.7	47.4	48.7	43.2	45.8	35.4	38.4
Jun-03	42.6	35.5	49.2	49.7	41.8	45.0	32.7	35.9
Dec-03	40.6	33.6	47.5	50.7	45.4	48.7	36.4	36.6
Jun-04	42.6	35.4	51.1	49.9	42.4	44.7	31.2	37.5
Dec-04	43.5	38.0	50.1	50.1	41.5	43.2	31.4	36.8

(1) Data includes other loans besides normal loans.
(2) Data includes also interfinancial operations.
(3) Data excludes ABN Amro because of the incorporation of Banco Real.
(4) Data excludes Santander because of the incorporation of Banespa.
DP: 4 major domestic private banks (Bradesco, Itaú, Unibanco and Safra); FE: 6 major foreign banks (Santander, ABN Amro, BankBoston, HSBC, Citibank and Sudameris); FB: 2 major federal state-owned banks (Banco do Brasil and CEF); Total: includes all financial conglomerates, public and private ones.
Source: Authors' elaboration with data extracted from financial conglomerations' balance sheet in www.bcb.gov.br.

4. Foreign Direct Investment in the Manufacturing Sector

4.1 Industrial Restructuring and Foreign Firms' Uneven Presence

Ever since the 1950s, the presence of foreign firms was part and parcel of Brazil's industrialization process.[8] Moreover, the characteristics of the Brazilian inwardly-oriented industrialization model, such as the *tripé*, placed emphasis on the different and complementary roles of domestic and foreign firms, as well as the state (including some state-owned firms in the production of intermediary goods and infra-structure), in the transformation of the economy. The typical configuration saw the foreign firm at the peak of the production chain, with backward linkages that encouraged the development of a network of local suppliers. The ideal type was the automotive industry chain, where foreign firms dominated vehicle manufacturing, but auto parts suppliers were often domestically-owned firms (Addis 1999).

[8] Amongst EMEs, Brazil had a long history as one of the most favoured host economies for large MNEs. This standing holds to date. For example, in 2003, Brazil was the most favoured host among developing countries/EMEs for the top

Although ISI awarded domestic firms protection, subsidies and incentives, it was these very policies that subsequently disadvantaged them, because it led to market fragmentation (lack of scale economies as well as low levels of specialization) and a weak ability to deal with the realities of global competition. Hence, once policy-makers embarked on the process of market liberalization (discussed in section 2.2), the high prices and generous profit margins of the ISI period actually became liabilities for firms. Manufacturing industry came under heavy pressure to restructure as a result of policies aimed at market opening and reduced state intervention in the economy.[9] Thus, already in the pre-crisis early years of the 1990s, domestic firms faced a number of challenges related to professionalization of their management, up-grading their technological capabilities and enhancing their productivity, efficiency and overall external competitiveness.

In the first instance, market opening had a differentiated impact on manufacturing firms present in the domestic market: it put foreign firms in a better position to respond quickly to the changing business environment. This was partly due to their easier access both to advanced technology as well as to low cost long-term capital for the investments necessary to restructure and modernize quickly (Mesquita Moreira 2000). Moreover, the foreign firm's initial advantage was subsequently consolidated precisely at the moment when domestically-owned firms came under even greater investment pressure, when sources of capital evaporated in the aftermath of the many international financial crises. These financial crises resulted in higher interest rates, exchange rate devaluations, drying up of bank credit, and shrinking of local capital markets, which hurt domestic firms more, because they had few alternative sources of financing and technology. The private productive sector's problems were compounded by a hungry public sector, whose borrowing needs crowded out business access to debt and equity markets in addition to raising the cost of capital. Thus, although financial crises undeniably exacerbated the situation, it was the government's own macro-economic policy that actually further exposed the shortcomings of local firms.

It is worth emphasizing that unlike in the case of Asian firms, high debt-equity ratios were not a problem for most Brazilian firms. In Brazil, there was neither cheaply available credit nor over-investment and under-regulation nor the maturity mismatch in industrial firms' assets and liabilities that were typically blamed for triggering the Asian crisis in 1997 (Poon & Thompson 2001; Chang 1999; Wade 1998). In contrast, in Brazil, manufacturing firms suffered from lack of access to both debt and equity markets; under-investment and over-regulation were bigger problem; and macro-economic volatility rather than poor internal financial management was more likely to trigger financial distress. It was these features (and weaknesses) of domestic firms that provided MNEs with the opportunity for FDI, especially in the form of acquisition of already existing assets.

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100 MNEs, 75 of which had affiliates in Brazil. To compare with other large EMEs: Hong Kong (67), China (60), S. Korea (42), India (38), Mexico (72) and Russia (45) (UNCTAD 2005).

Of course, there was also some limited market entry via greenfield investment.[10] Whatever the means of entry, the motivation remained largely market-seeking and inwardly-oriented, although the MNEs now operated in a new context of lower trade protection. Thus, these features of market entry and investment in turn had implications for the characteristics of Brazil's internationalization process.

Between 1994 and 2005, most indicators in the industrial sector pointed to an ever growing foreign presence. Thus, the stock of FDI expanded from US$ 42.5 billion in 1995 to US$ 164.1 billion in 1999 (UNCTAD 2000). FDI stock as a percentage of GDP also grew from 6 percent in 1995 to over 33 percent in 2000 (Sarti & Laplane 2002). The participation of MNEs in the top 500 firms in Brazil also expanded from 30 percent in 1990 to 46 percent in 2000. Since this internationalization process was seen as one-sided (i.e. there was no corresponding outflow of FDI by Brazilian firms), it was often declaimed as the denationalization of the productive sector. This trend, analyzed in the following section, raised much concern among local businesses as well as academics in Brazil in the early years of the new millennium (Gonçalves 1999; Lacerda 2000).

4.2 Mergers and acquisitions and the impact of efficiency enhancing foreign investment

Having set out the general context favoring foreign firm entry and the low capacity for resistance from domestic manufacturing firms, this section examines trends and features of the capital ownership structure in the past decade with a special focus on the impact of financial crises. Although a number of industries experienced a significant increase in FDI, especially in the form of M&As, nowhere was the growing presence and impact of foreign firms more marked than in the automotive industry, especially in the auto parts sub-sector. The impact of foreign interests aroused heightened concern among more nationalist commentators, because of the symbolic importance of the automotive industry for Brazilian developmentalism. The automotive industry was considered the model for industrial development via the *tripé,* with a recognizable division of labor and a balanced presence of domestic (auto parts) and foreign (vehicle manufacturers) firms, while the federal government provided the infrastructure (roads) necessary for the development of automotive industry. However, ten years of financial and trade liberalization eroded such distinctions, giving rise to a number of questions: Why did the automotive industry *tripé* disintegrate? What replaced it? Were international financial crises implicated in the process? Or were changes driven by other factors?

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[9] See Suzigan & Furtado (2006) for a good discussion of industrial policy's development impact in Brazil.
[10] Sarti & Laplane (2002) point out that the bulk (about 95%) of FDI inflows to China in the late 1990s were greenfield projects; while in Brazil almost 75% of FDI inflows were directed at M&A activity (mainly as a function of the government's privatisation programme).

MNE capital had always dominated vehicle manufacturing in Brazil, where no local brands were developed under ISI. The more balanced capital ownership structure of the auto parts industry saw successful and competitive locally-owned firms emerge (Addis 1999), often hailed as evidence of the successes of ISI. However, from the mid 1990s, the auto parts supplier network in Brazil was completely transformed as a consequence of a mix of government policy (mainly economic liberalization) as well as global trends in the industry. In Brazil, the auto parts industry evolved from a sector comprised of many small and medium sized firms, mainly family-run enterprises with the presence of only a few MNEs, to a sector dominated by approximately 40 large MNEs, and the continuing presence of a number of smaller firms relegated to second and third tier supplier status. SINDIPEÇAS, the Brazilian auto parts industry association, reported that there were 648 firms spread over nine states in Brazil in 2005.

Table 6: Internationalization of Auto Parts Industry in Brazil

	1994	**2005**
Assets		
Foreign capital	48.1%	79.2%
Domestic capital	51.9%	20.8%
Sales Revenues		
Foreign capital	47.6%	87.7%
Domestic capital	52.4%	12.3%
Investment		
Foreign capital	48.0%	76.9%
Domestic capital	52.0%	23.1%

Source: Sindipeças (2006)

In 1994, asset ownership, sales revenues, and investment were roughly equal between foreign and domestically owned firms (see table 6). Between 1994 and 1997, from the Mexican crisis to the outbreak of the Asian financial crisis, there was already evidence of a big shift in ownership patterns. There were about 60 M&As involving auto parts firms, of which 40 resulted in a foreign firm acquiring a local firm (Gonçalvez 1999). Other forms of partnership were also attempted, including nine joint ventures and four technological partnerships. Perhaps the most emblematic case was the sale of Metal Leve[11] to the German/Brazilian firm Mahie/Cofap in 1996, which in turn was later acquired by the Italian MNE Magnetti Marelli in 1997.

[11] Metal Leve's owner, José Mindlin, was strongly associated with the discourse of developmentalism and in many ways the firm was identified as a prime example of ISI success.

Data from a decade later, showed how the earlier balance, slightly tipped in favor of domestic firms, was overturned completely with domestic auto parts firms losing out to foreign interests. By 2005, 79.2 percent of assets, 87.7 percent of sales revenues, and 76.9 percent of investment came from firms with total or majority foreign ownership. An analysis of why and how this happened typically indicated a mix of domestic and international factors contributing to this shift. The growing presence of MNEs was due to two trends: On the one hand, trade opening generated a competitive shock, which forced many traditional local producers to close, while others with more attractive assets (e.g. brand recognition or export presence) were acquired by foreign firms. In some cases, foreign firms with minority share holdings up their participation to take control of management. By 1998, seven of the ten pre-1995 largest locally-owned auto parts suppliers were taken over by foreign buyers. On the other hand, a second trend favoring MNE entry was a result of the wave of new foreign entrants were attracted into the vehicle manufacturing sector in the late 1990s (Doctor 2007). Vehicle manufacturers often demanded that their global suppliers follow them into new markets. These auto parts MNEs set up their Brazilian operations on a follow client basis, and consequently, contributed to the rapidly changing capital ownership structure and the technological capacity of the auto parts sector.

Change was also driven by more general developments in the global automotive industry, specifically the trend towards trans-nationalization and modularization (Sako 2003). The growing importance of technological capabilities, scale and standardization of products spelled the end to idiosyncratic local relations between vehicle manufacturers and their suppliers. Although Brazil hoped to partake in the benefits promised to those economies that became involved in the global production chain, policy-makers and businesses seemed less prepared to acknowledge that this might be at the expense of a locally-owned auto parts industry. Moreover, even as Brazil became a prime location for experiments in new manufacturing processes and innovative types of client-supplier relations (Sako 2005), it was forced to accept that in most cases investments followed a market-seeking logic with only modest export orientation (Laplane & Sarti 2002).

Modular production also drove shifts in inter-firm relations globally, evidence of which emerged in Brazil when the number of direct suppliers to vehicle manufacturers fell from 500 to about 150. The greater technological and design capabilities required for modular production often disadvantaged local firms with their much weaker research and development (R&D) and design capacity. Thus, trade opening and the auto parts required for the new vehicle models manufactured in Brazil, saw sales of locally produced parts fall from US$ 17.46 billion in 1997 to about US$ 10 billion in 2002. Although auto parts exports rose from US$ 2.3 billion in 1992 to US$ 3.88 billion in 2002, imports rose even faster from US$ 1.25 billion in 1992 to US$ 3.98 billion in 2002. By 2002, more evidence emerged on the early impact of change in the industry. Employment was down from 193 thousand in 1996 to 168 thousand in 2002 (SINDIPEÇAS 2006) and there was a noticeable loss in value added and local development capacity due to the changing production strategies and requirements of the vehicle manufacturers (ECLAC 2004).

Finally, in the longer-term and notwithstanding a rather grim start in the new millennium, the auto parts sector subsequently saw a sharp turnaround in its fortunes. This more favorable scenario became increasingly apparent from 2004 onwards. The recent boom in vehicle production and exports boosted demand for auto parts to record levels. In 2005, the auto parts industry generated sales revenues of US$ 24 billion, exports of US$ 7.5 billion and direct employment of 197 thousand. Anticipating further growth, auto parts firms invested some US$ 1.4 billion in 2005 alone, and were expected to invest another US$ 1 billion in 2006 (SINDIPEÇAS 2006). Although much of this was generated by the presence of foreign-owned firms, domestic capital also participated in and benefited from the up-swing.

Thus, the story of the 1990s in the case of manufacturing industry (as illustrated with the example of auto parts production) on the one hand highlighted domestic losses and weak ability to resist international pressures, and on the other hand, show-cased foreign gains. Although foreign gains were apparent in a number of manufacturing industries (food processing, consumer electronics, domestic white goods, in addition to the automotive industry), these gains remained uneven since they were contingent on the specific dynamics of the sector in Brazil and on global conditions in that industry. Moreover, in most cases, increased foreign presence contributed to enhancing efficiency of the industry overall, not only due to MNE technology but also due to domestic efforts to keep up with the competition. Again, from the point of view of the main argument of the paper, we noted that although the outcome in manufacturing industry in many ways differed sharply from the situation in the financial services/banking sector, there was a broad similarity in that foreign presence triggered modernization, efficiency enhancing business practices and greater investment in the relevant sector. Moreover, in the case of manufacturing industry, the driving forces (even when of external origin) were seldom related to the type of "opportunism" referred to in the literature about foreign "interests" taking advantage of financial crises to acquire cheap assets in emerging economies. If anything, the macro-economic volatility ensuing from the crises served to deter investment.

5. Conclusion

This paper analyzed the position of foreign interests in Brazil in the aftermath of financial crisis from the mid 1990s onward. We studied both financial and manufacturing sectors more generally, but also used a closer examination of two specific cases - the banking sector and automotive parts industry - to get a more nuanced picture of the presence of and opportunities for foreign interests. Our analysis showed that foreign penetration in the years following financial crises had different impacts on the two sectors: in the case of the financial sector, domestic banks reacted to foreign entry by actively taking part in the M&As wave, thus, maintaining their hegemony in the Brazilian banking system; in contrast, in the automotive parts industry, there was a rapid process of 'denationalization' with the demise or foreign acquisition of many domestically-owned firms and the growing presence of MNEs. However, we found little evidence of foreign opportunism as a result of financial crises. Finally, we also noted that FDI (especially via M&As) had an uneven impact on manufacturing industries: some domestic firms in some industries (textiles, apparel, shoes, tiles and ceramics) successfully reacted to limit the scope for foreign entry; other domestic firms (food processing, household white goods) competed even with the growing presence of foreign firms.

Although different factors determined the reaction of domestic firms in each sector, it was clear that the management of economic policy in Brazil not only shaped opportunities for business (foreign and domestic) interests, but also had different impacts in each sector. On the one hand, the adoption of a very tight monetary policy - the main tool applied to protect against speculative attack on the domestic currency - favored the profitability and performance of the banking sector, including domestic banks. On the other hand, this tight monetary policy had highly negative effects on the manufacturing sector as a whole due to the impact of such policy on bank credit conditions. High interest rates affected both the supply and price of credit – that is the availability of funds and the loan rates. We also found that in many ways, an enhanced role for foreign interests coincided with a broadly similar positive impact across sectors, in that foreign presence triggered some modernization, efficiency enhancing business practices and greater investment in the relevant sector. Finally, we argued that notwithstanding these different fates for foreign interests, the financial crises themselves had much less influence on firm strategies and behavior than did macro-economic policy and the micro-economic investment climate.

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