The 1999 Brazilian financial crisis:
how to create a financial crisis
by trying to avoid one

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1 An earlier version of this paper was published in Eatwell and Taylor (2003). I would like to thank Alice Amsden, Edna Armendáriz, Paul Davidson, Geoff Harcourt, Daniel Hahn, Jan Kregel, José Antonio Ocampo, Arturo O’Connell and Lance Taylor for their helpful comments. Participants at various seminars and conferences also made very useful suggestions. Table 1 is the result of joint work with Carlos Lopes; I am also extremely grateful to him for many lengthy discussions on the subject before his sudden death. I dedicate this paper to him. The usual caveats apply.
“The problem is that [...] the theories embedded in general equilibrium dynamics [...] don’t let us think about [issues such as ...] financial crises and their real consequences in Asian and Latin America [...]”

**Robert Lucas**

“We will never use capital controls: we want to be a First-World nation”.

**Fernando Henrique Cardoso**

“Globalization opened up opportunities to find new people to exploit their ignorance. And we found them.”

**Joseph Stiglitz**

[Latin America] has a narcissistic tendency to use reality as a mirror for self-contemplation. [...] human history is the product of discontent.  

**José Ortega y Gasset**

Today the appeal to newness, of no matter what kind, provided only that it is archaic enough, has become universal. 

**Theodor Adorno**

“[...] and, above all, let finance be primarily national.”

**John Maynard Keynes**

1. Introduction

This paper attempts to understand the Brazilian financial crisis mainly from an ‘endogenous-failure’ perspective. It argues that the general mechanisms that led to this financial crisis were in essence endogenous to the workings of an economy facing a sudden liberalisation, a surge in capital inflows, ineffective regulation and weak governance. This paper will also argue that within this general framework, there is a very specific ‘Minskyian’ feature to the Brazilian crisis, which made it different from other financial crises both in Latin America and in East Asia: how a particularly radical monetary policy led to a major financial fragility in the financial sector and State finances, and to an unmanageable Ponzi finance in the accounts of the Federal Government.

In Brazil, the absorption of inflows and the dynamic that it generated were uniquely conditioned by an environment characterised by excessively high and unstable domestic interest rates. These were the result of the Brazilian government’s attempts to sterilise inflows and defend the exchange rate and its stabilisation programme from continuous external shocks, especially those of the Mexican, East Asian and Russian crises. These high interest rates -- sometimes the Brazilian authorities chose to set deposit rates over 20 percentage points above international interest rates plus country risk -- and the peculiar (and self-defeating) way in which
the Federal Government and Central Bank dealt with the financial fragilities of the financial sector and State Governments that these high interest rates created, meant that among the Latin American and East Asian crisis-countries of the 1990s it was only Brazil that saw its public sector sleepwalking into a major Minskyian ‘Ponzi’.²

From this perspective, the Brazilian financial crisis seems to contradict one of the key propositions of the ‘moral hazard’ literature. As is well known, one of the characteristics of this literature is to blame artificially low interest rates for the financial crises in developing countries during the 1990s. Low rates would have created a general macro-micro dynamic which ultimately rendered both lenders and borrowers unable to assess and price their risks properly -- leading them to accumulate more risk than was privately (let alone socially) efficient. It was not that under a special set of circumstances international and domestic lenders were intrinsically unable to assess and price their risk properly. It was that artificially low interest rates took away most of the incentives to do so. These low rates were the result of the combination of moral hazards (created mostly by government guarantees on deposits), and of the near-certainty in international financial markets that, as in every old Western, the cavalry, in the form of a vast international rescue operation, could be counted upon to arrive in the nick of time should the ‘natives’ threaten to default or close their capital account. In short, if only these moral hazards had not existed, interest rates would have been higher, the over-lending and over-borrowing would have been averted, and the financial crisis could have been avoided.³ What the case of Brazil shows us is the dangers of the alternative scenario: excessively high interest rates can just as easily lead to financial fragility and ‘Ponzi’ finance.

This paper concentrates on the period between the beginning of the Brazilian experiment with financial liberalisation and economic reform proper and the outbreak of the financial crisis -- i.e., between the Cardoso ‘Real Plan’ of mid-1994 and the financial crisis of January 1999. However, some attention will also be given to the period between the 1990 ‘Collor Plan’ and the 1994 ‘Real Plan’, since it was with the ‘Collor Plan’ (or ‘New Brazil’ programme) that economic reforms first began to be implemented. Throughout the paper, the mid-1994-January-1999 period will be compared and contrasted with similar periods (between financial liberalisation and financial crisis) in Latin America and East Asia, in particular the cases of Chile (1975-82), Mexico (1988-94), Korea, Malaysia and Thailand (1988-97), and Argentina (1990-2001).

² According to Minsky, an agent runs into ‘Ponzi’ finance when it is forced to borrow to keep up with payments on its existing debt obligations; i.e., the agent has to capitalise interest and thereby add to its total debt. See Minsky (1982).
³ See, for example, McKinnon and Pill (1997).
2.- The Brazilian reforms

Brazil’s long pre-1980 economic growth period was brought to an abrupt end by the 1982 debt crisis. The country first experienced a severe recession, made more acute by inexorably rising inflation and a heavy debt burden; it then expanded again, but this time only slowly and erratically until the end of the decade. As events of the 1980s placed the model of state-led development under considerable strain, in March 1990 the incoming President, Collor de Mello, announced a set of reforms in his ‘New Brazil’ Programme: the removal of subsidies for exports and phased reductions in tariffs. In addition, a privatisation programme was begun in 1991, the fuel market was deregulated (ending years of state support for ethanol production), and the dissolution of the coffee and sugar trading boards was announced. The most contentious measure was the temporary freezing of virtually all financial assets (with limits of US$ 1,000 on bank and savings account withdrawals), but by the middle of the year this was subject to increasingly corrupt evasions and was subsequently abandoned.

Despite the political weakness of Collor de Mello’s short presidency, its unsure handling of macroeconomic policy and the humiliating way in which he was thrown out of office, the initiatives he launched radically changed the direction of Brazilian economic development.

In 1992, escalating corruption charges and several extraordinarily bizarre private scandals led to the forced resignation of President Collor de Mello. His deputy, Itamar Franco, became Acting President in September and President in December. Economic policy continued largely unchanged during the first year of President Franco’s Government, with its principal objectives being the liberalisation of most prices, control over public expenditure and a strict monetary policy. However, political and economic uncertainty continued after the change of president and inflation increased in late 1992, reaching almost 2,500% in 1993.

In May 1993, after several changes of finance minister, President Franco appointed senator (and well-known sociologist) Fernando Henrique Cardoso to the position. Together with a group of economists, including Edmar Bacha and Pedro Malan, Cardoso devised an all-encompassing stabilisation plan, which came into operation on 1 July 1994 (the ‘Real Plan’, which took its name after the new currency, which it introduced, the real -- the fourth in 9 years!) The main characteristic of this new plan was that, as opposed to most of its predecessors, it intended to avoid ‘shock treatments’, price freezes or surprise announcements. The Plan took a long time to be prepared and was announced in detail several months in advance of its

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4 Tariffs would halve in three years, with no nominal tariff exceeding 35% by the end of that period. Of equal significance was the commitment to remove the cumbersome system of import licensing.
implementation. It was an attempt to reduce prices gradually by reducing both inflationary expectations -- through the real being ‘pegged’ to the US dollar at a rate of around one real to US$ 1 (but allowed to move in a narrow band) --, and inflationary ‘inertia’ (indexation); simultaneously, there was the aim of a progressive achievement of internal and external macroeconomic equilibrium. One of the main strengths of this new Plan was the fact that it succeeded in gathering an overwhelming degree of consensus and public support. Its initial successes in mid-1994 significantly helped Cardoso’s own campaign for the presidency.

In terms of growth, after the 1982 crisis Brazil first experienced a severe recession, and then expanded slowly and erratically until the beginning of the ‘Real Plan’, when growth briefly accelerated rapidly, reaching a rate of 10.4% in the first quarter of 1995 (vis-à-vis de same quarter the year before). The main growth-stimulus was brought about by the massive reduction of the ‘inflationary tax’ that followed the implementation of the new stabilisation plan. See Figure 1.

FIGURE 1

BRAZIL: quarterly GDP growth, 1993-1999
(% variation with respect to the same quarter in the previous year)

- **Source**: Macrometrica.5

5 Unless otherwise stated, all the data in this paper have as source either the official government statistics (reproduced in the monthly bulletins of Macrometrica), the Central Bank data bank, DataStream, the Statistical Division of ECLAC, or the data banks of the IMF (2004a and b) and World Bank (2004a and b).
However, as growth accelerated with price stabilisation, the balance of payments deteriorated rapidly; at the same time, the 'Tequila effect', which followed the Mexican crisis of December 1994, began to bite. This forced the government to curtail aggregate demand rapidly. The annualised growth-rate of the economy fell by nearly 12 percentage points between the first quarters of 1995 and 1996. As monetary and fiscal conditions then eased, growth began to recover again in the second quarter of 1996, but after the East Asian crisis monetary policy was tightened again and growth fell once more. This fall accelerated in 1998 as a result of the repercussions of the Russian devaluation and default; finally, the political crisis following the default declared by the newly-elected Minas Gerais State Governor (former President Itamar Franco) on the State debts to the Central Government brought Brazil into its January 1999 financial crisis.

Thus, one of the most important peculiarities of the January 1999 crisis is that repeated external and internal shocks brought down the growth rate long before the financial crisis. In fact, this crisis is unique among those in Latin America and East Asia during the 1990s not only in that it took place during a period of recession, but also in that growth actually picked up almost immediately after the crisis -- in fact, in 1999 Brazil posted an overall small positive growth figure for the year (0.8%). As will be discussed below, the continuous external shocks and the resulting downward growth trajectory of Brazil are directly associated with the other peculiarities of Brazil’s experiment with economic reform and liberalisation, especially with its much higher interest rates, its growing public sector deficit and, in particular, its public sector ‘Ponzi’ finance.

Initially, the ‘Real Plan’ achieved a budget surplus in 1994 (equivalent to 1.1% of GDP), but by 1995 even the deficit that was acknowledged had already turned into a massive figure equivalent to 4.9% of GDP. This deficit increased to 5.9% in 1996, 6.1% in 1997 and 8% in 1998. In the meantime, total net public debt (that is, total debt minus international reserves and other financial assets of the public sector) nearly doubled during this period, from 28.5% to 50% of GDP. This amount, although not excessively large as a share of GDP compared with other countries, became unmanageable due to the remarkably high interest rates. As the ‘primary’ accounts of

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6 In the other crises the opposite was the case. In Latin America, in the year before their financial crisis Chile was growing at 4.8% (1981) and Mexico at 4.6% (1994); this was also true of Argentina before its first financial crisis after financial liberalisation, when its economy grew at 8.5% (1994). In East Asia, Korea grew at 7.1% in 1996, Malaysia at 8% and Thailand at 6.4%. In all these countries output fell massively after their financial crises.
7 See below for the less than transparent way in which the Central Bank acknowledged the real costs of the bailouts of private and state banks and state finances.
8 About 80% of this net debt was domestic.
the Federal Government were never in any significant deficit throughout this period, (see Figure 11 below), this large increase was exclusively a consequence of what was happening in the financial accounts of the public sector; and these reflected the cost of the financial fragilities created by the policy of high interest rates. In particular, it was the huge cost to the public sector of the repeated rescue operations of the domestic banking system (both private and public) and of State Governments by the Federal Government and Central Bank via the absorption of large amounts of bad debt.

Contrary to what is usually understood, it was these continuous rescue operations -- rather than the cost of sterilisation, the acknowledgement of financial ‘skeletons’ from the past or the financial cost of the previous Constitutional reforms -- that led the Brazilian authorities to sleepwalk into their ‘Ponzi’ finance (see Table 1 below).

As mentioned above, the main peculiarity of the ‘Real Plan’ is that it was implemented during a period in which Brazil had experienced three major external shocks, which had severe implications for its external accounts (and fiscal position). As a direct result of the ‘Tequila effect’ that followed the sudden devaluation of the Mexican peso, 1995 saw a reduction in capital inflows into Brazil. The stock exchange suffered a similar problem -- in the first three months there was a net outflow of US$ 2.0 billion. The figure for the same period in 1994 had been a net inflow of US$ 5.0 billion. Foreign reserves also fell by US$ 7 billion in early 1995.

However, these problems did not last long, and from the second quarter of 1995 there was a rapid return of private foreign capital (following Clinton’s US$ 50 billion Mexican rescue package and the remarkable increase of domestic interest rates; see Figure 13 below). This continued in 1996, aided by changes in the legislation regulating foreign investment, as well as the ending of state monopolies (such as in the petroleum and telecommunications sectors) and the privatisation of other public assets (particularly in the electricity sector). In this year, foreign direct investment nearly trebled, to US$ 9.1 billion (see Figure 2).
In March 1990 the incoming President, Collor de Mello, began the process of reforms with his 'New Brazil' Programme; also around that time, the crucial 'Brady initiative' was taking shape in many Latin American countries.\(^9\)


As is often the case in Latin America (but not in East Asia), a capital surge of this magnitude tends to 'crowd out' national saving and to revalue the real rate of exchange (see Figure 3).

\(^9\) On the Brady plan, see Ffrench-Davis (2005); and Palma (2003a).
A decrease in the index signifies a revaluation.

[Cl] = Chile; [Mx] = Mexico; [Ar] = Argentina; [Br] = Brazil; and [KMT] = average of Korea, Malaysia and Thailand.

The rapid revaluation of the real exchange rate was exacerbated by the economic authorities' use of the nominal rate of exchange as one of their main anti-inflationary mechanisms (i.e., as a price 'anchor'). In fact, the real exchange rate fell by nearly one-half between mid-1992 and mid-1996. In 1997 and 1998, this trend began to be reversed, but at a rate that eventually proved to be too little, too late.

The reversal of the rapid revaluation of the real began with the new upheaval in international financial markets owing to the crisis in many of the Asian economies; this brought the net quarterly inflow into Brazil down from US$ 10 billion (in the third quarter of 1997) to just over US$ 0.7 billion (in the fourth quarter). However, the sharp fall in net inflows at the end of 1997 was drastically reversed in the first quarter of 1998, when total net inflows reached US$ 22.5 billion.10 This was followed by another large net inflow in the second quarter of 1998, amounting to US$ 10.6 billion, but then, due to the impact of events in Russia, the figure for the third quarter dipped to a massive outflow of US$ 15.9 billion, followed by another net outflow in the fourth quarter.

10 Ironically, there is evidence that a substantial proportion of these new inflows was made of funds brought into Brazil by foreign investors that had just been rescued in East Asia by the US
quarter. As these net outflows proved unsustainable, the government had no option but to devalue the real in January 1999. Thus, 1998 posted both the all-time record for net inflows (first quarter), and for net outflows (third quarter)! This exemplifies the difficulties confronted by economic authorities in the implementation of their macro-policies when they voluntarily operate with a liberalised capital account in a world of highly volatile flows, a high degree of ‘contagion’, and asymmetric information. Chile's and Colombia’s experiences in the 1990s with controlling short-term capital flows via price mechanisms, or Malaysia’s short experiment with quantitative inflow-controls in 1994 seem to be among the few options open to policy-makers wishing to minimise this kind of instability but still operate with a relatively open capital account (see Ocampo and Palma, 2005). Initially, the Brazilian monetary authorities tried to play down their reaction to the East Asian crisis, increasing their deposit interest rates by just one percentage point between July and October (from an annualised level of 20.98% to 21.99%, respectively). However, as the fundamentals deteriorated rapidly, they switched tactics later in November and increased the deposit rate to a remarkable 43% -- and as the consumer price index in the following twelve months only reached 1.3%, from this perspective deposit rates in real terms reached a similar exorbitant level (ERM). The government also significantly increased some import tariffs and took measures to facilitate the inflow of foreign capital.

The short-term effect of this monetarist shock was to decrease the pressure on the exchange rate and help the return of foreign capital. However, short-term successes often led to complacency. By mid-1998, particularly due to the renewed inflows of foreign capital in the first half of the year, the East Asian crisis appeared to have been forgotten; and so was the large cost to the public sector of yet again having to rescue the heavily indebted State Governments from the negative effects of the soaring interest rates, and the domestic banking sector from the effects of their rapidly growing non-performing portfolio -- not surprisingly, few banking assets could perform after November when lending rates for working capital (in this practically inflation-free economy) reached 70.4% and for consumer lending 82.7%.

In fact, even before the Russian devaluation, Brazil already needed to borrow at a higher interest rate than many other Latin American countries while coping with reduced demand for its exports from Asia and Argentina. Its public-sector accounts were also already out of control. Furthermore, 1998 was a year of presidential, state government, and municipal elections. Not surprisingly, little was done, especially in relation to sorting out the public accounts -- in fact, the political manoeuvres to negotiate the constitutional reform that would allow the President to run for a second
term were already responsible for a long political stalemate and huge subsidies to state
governments (in particular those controlled by opposition parties whose support was
needed to approve the constitutional reform that would allow a President to run for re-
election). This political and economic inaction of the government and huge subsidies
to state governments may have helped Cardoso’s re-election, but did little to
strengthen the Brazilian economy; as a result, the Russian crisis of mid-1998 hit it
very hard. The Central Bank reacted the only way it seemed to know how to react,
and increased deposit rates from 19.2% (August) to 41.6% (October); in this inflation-
free economy this led lending rates for working capital to jump to an annualised rate of
60% and for consumer credit to an staggering 117%.

Once again it became evident that no matter how large the levels of reserves,
and no matter how high interest rates, they can never be large enough and high
enough to withstand a sudden collapse in confidence and withdrawal of funds by
restless international fund managers in an economy with a liberalised capital account.
By the end of the year, the Central Bank had acknowledged the loss of half its reserves
and had a substantial proportion of those left committed in forward operations to
support the real. Therefore, the government had little option but to devalue.

To contain the subsequent crisis, the Central Bank initially reacted as it had
before, increasing deposit rates yet again to 43.3%. However, by then it had become
rather obvious that a monetary policy that reacts to external shocks in this exuberant
way almost inevitably leads to an interest rate ‘trap’ and in particular to banking sector
fragility and an unsustainable public sector ‘Ponzi’-type finance. Furthermore, the
President of the Central Bank -- and later his successor too -- had to resign in the
midst of corruption scandals. To calm the markets Cardoso appointed Arminio Fraga
(Soro’s right-hand man) to the Presidency of the Bank. Almost immediately, he
decided to abandon the policies of ‘exuberant monetarism’ that had characterised
monetary policy since the beginning of the Real Plan for a softer monetary policy
mostly aimed at maintaining the stability of the exchange rate.

3.- The dynamics of how Brazil sleepwalked into a public sector 'Ponzi' finance

If we compare the financial crises in Chile (mid-1982), Mexico (December 1994),
Argentina (beginning of 1995 and December 2001), East Asia (mid-1997) and Brazil
(January 1999), what most distinguishes the Brazilian period between its own financial
liberalisation and financial crisis in terms of economic policy is its already mentioned
high domestic interest rates, both for the deposit and lending rates. See Figures 4 and
5.
LATIN AMERICA and EAST ASIA: domestic real deposit rates between the beginning of financial liberalization and respective financial crisis

- [Cl] = Chile; [Mx] = Mexico; [Ar] = Argentina; [Br] = Brazil; and [KMT] = average of Korea, Malaysia and Thailand.

FIGURE 5

LATIN AMERICA and EAST ASIA: domestic real lending rates between the beginning of financial liberalisation and respective financial crises

- [Cl] = Chile; [Mx] = Mexico; [Ar] = Argentina; [Br] = Brazil; and [KMT] = average of Korea, Malaysia and Thailand.

• Sources: For Latin America, ECLAC Statistical Division; for Korea, Malaysia and Thailand, World Bank (2004b).
The Brazilian authorities certainly used extremely high interest rates not only to defend their exchange rate and stabilisation programme from the continuous external shocks which they were experiencing, but also to avoid the worst excesses that had characterised previous experiences of financial liberalisation in Latin America. In short, previous experiments with financial liberalisation and economic reforms had also attracted massive amounts of foreign capital; however, their absorption had led (mainly via increasing liquidity, high expectations, and declining interest rates) to a Kindlebergian mania-type credit expansion, and an unsustainable consumption boom and asset bubbles.11 As a result, the Brazilian authorities (whose successful price stabilisation and its financial liberalisation coincided with the 1994 Mexican crisis) became determined to prevent that the massive inflow of foreign capital ended up being transformed into a credit boom to the private sector. Figure 6 shows how successful they were in preventing this, mostly via the sterilisation of foreign inflows and high interest rates.

**FIGURE 6**

EAST ASIA and LATIN AMERICA: credit to private sector between the beginning of financial liberalization and respective financial crisis

- [Cl] = Chile; [Mx] = Mexico; [Br] = Brazil; and [KMT] = average of Korea, Malaysia and Thailand.

High interest rates and the successful control of credit expansion, together with a more

11 For an analysis of this cycle see Kindleberger (1996), and Palma (2000b).
moderate policy of trade liberalisation, also succeeded in restraining the rate of growth of imports of consumer goods. Also, in Brazil high interest rates avoided a Kuznets-type cycle led by the construction sector; meanwhile in Chile, Mexico, Malaysia and Thailand, large inflows of foreign capital, the liberalisation of domestic finance and low interest rates did set in motion a construction mania boom, led by rises in real estate prices. See Figure 7.

**FIGURE 7**

LATIN AMERICA and EAST ASIA: real estate price indices between the beginning of financial liberalisation and respective financial crisis

- [Mx] = Mexico; [Br] = Brazil; [Ma] = Malaysia; and [Th] = Thailand. The percentage shown in the graph is Mexico’s average annual rates of growth.
- **Sources:** DataStream for Mexico and East Asia and 'Jonas Lang LaSalle Index' for Brazil. The Brazilian average is a mixture of some price-increase in Rio, price-stagnation in São Paulo and a price-fall in Brasilia. Neither index provides data for Chile between 1975 and 1981; however, Chilean Central Bank statistics, though using a different methodology, show an increase similar to that of Mexico (Chile, 1988; an analysis of these data can be found in Palma, 2000b).

Finally, and despite large inflows and a radical privatisation policy, Brazil also avoided the other asset bubble (stock market) that characterised the similar period in Chile and Mexico (as well as those in Malaysia and Thailand). In fact, the only period of rapid stock-prices growth between the first quarter of 1996 and the second quarter of 1997 was almost entirely led by just one sector (telecommunications).

12 See Palma (2003a).
13 In Brazil, the stock price index of the construction sector actually fell in the four years between financial liberalisation and the January-1999 financial crisis.
Although high interest rates were able to check the development of a Kindlebergian mania (via credit expansion leading to a consumption boom and asset bubbles in construction and the stock market), which in particular characterised other experiments with financial liberalisation in Latin America, this ‘success’ came at a huge cost: high interest rates created an ‘interest rate trap’, which equally led to a financial crisis but via a different route. Therefore, the Brazilian policy-making during this period created a financial crisis precisely by trying to avoid one!\textsuperscript{14}

In relation to the domestic banking system, tight monetary policy led to such remarkably high lending rates that hardly any banking asset could perform -- in fact, in this practically inflation-free economy, towards the end of 1998 interest rates paid for consumer credit peaked at an annualised rate of 123% and those for credit for

\textsuperscript{14} There were obviously further problems with the banking sector and public finance, which there is no space to expand on here. The most important ones were the effect of rapid price stabilisation on banking profitability and on public finances, and the delicate political balance between Federal and State Governments’ finance.
working capital at 63%. That is, high interest rates may have helped to reduce the growth of the credit exposure of the financial system to the private sector, but they certainly did little to help improve the quality of this exposure; so it is hardly surprising that the banking system had problems with non-performing assets. In fact, the ease with which the government could finance its domestic debt was due primarily to private banks falling over themselves to buy public paper, as this was just about the only asset that could perform in such a high interest rate environment. As for the rest of their portfolio, private banks tried to increase profitability by the self-defeating policy of ever-increasing spreads.¹⁵

FIGURE 9

LATIN AMERICA: spread between lending and deposit rates between the beginning of financial liberalisation and respective financial crisis

In fact, spread-data on their own are able to indicate in which countries (in both regions) the crisis of the domestic banking system came before the overall financial crisis, and was a major component that led up to it (Brazil, Argentina and Thailand), and in which it only came after the crash (when bank-portfolio became non-performing due to falling incomes and asset-price deflation, at the same time as banks’ foreign liabilities were soaring due to sharp devaluations).

¹⁵ On the double-edge effects of increasing spreads, see in particular Stiglitz and Weiss (1981).
¹⁶ For the special case of Malaysia, see Palma (2000b) and Ocampo and Palma (2005).
As the Brazilian government chose continuously to rescue private and state banks in difficulties (adding an additional component of moral hazard by not making any serious investigation into how these banks had got into trouble in the first place -- not even when the bank in question belonged to a senior minister),\(^\text{17}\) this policy contributed substantially to the public debt. High interest rates were also at the core of the worsening of the other components of the public sector finance. In fact, while Chile and Mexico had at least managed a significant improvement in their public accounts, being either in equilibrium or in surplus at the time of their financial crisis (as well as East Asia), Brazil shows a growing deficit from practically the very beginning.\(^\text{18}\) See Figure 10.

**FIGURE 10**

LATIN AMERICA and EAST ASIA: public sector balance between the beginning of financial liberalization and respective financial crisis (%GDP)

- \([\text{Cl}]\) = Chile; \([\text{Mx}]\) = Mexico; \([\text{Ar}]\) = Argentina (consolidated public sector); \([\text{Br}]\) = Brazil; \([\text{KMT}]\) = average of Korea, Malaysia and Thailand.
- *Sources*: ECLAC Statistical Division for Chile, Mexico and Brazil; Damill, Frenkel and Juvenal (2003) for Argentina; and World Bank (2004b) for Korea, Malaysia and Thailand.

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\(^\text{17}\) In 1997, for example, the Banco Bamerindus, owned by the then Minister for Commerce and Industry, went bust in a very `untransparent' way, leaving a shortfall of about $ 5 billion. The government took over this bad debt without any investigation; it then sold what was left of the bank to the Hong Kong & Shanghai Banking Corporation.

\(^\text{18}\) In a way, in Ffrench-Davis’s characterisation, the key role of the public sector deficit in Brazil’s 1999 crisis makes this crisis one that still has some elements of the `old’ type of crises; see Ffrench-Davis (2005).
Obviously, the key question in Brazil's case is whether what was happening in the private and the public sector balances were inter-related phenomena, or whether the growing imbalance in the public sector was simply the result of a typical weak, 'populist' government unable or unwilling to keep its house in order.

One of the difficulties that those working under the 'Washington Consensus' paradigm have had in explaining other (non-Brazilian) financial crises is that these crisis-countries, particularly in Latin America, had both opened up their economies and implemented economic reform and done it by the book (including the small print). Furthermore, their public sector had managed to reach balance and their accounts had then been kept in order. Under these conditions, it was not easy to explain following the neo-liberal creed why the private sector had run wild, creating such large private macroeconomic imbalances, and accumulating so much financial risk, as to make a financial crisis almost inevitable. As a result the Washington Consensus type of crisis-explanation seems to have had little choice but to fall back onto well-rehearsed arguments of 'exogenous' market interference by governments and international institutions, thus switching the whole debate towards issues such as 'moral hazards' and 'cronyism'.

However, Brazil's financial crisis (and later Argentina's in 2001) seems to be an exception; apparently, these are crises easy to 'explain' and easy to dismiss -- the growing public sector deficit provided a familiar way out. Under these conditions reforms are not 'credible': in a financially liberalised economy within a growing globalised world, either governments understand that they have to be serious about the way in which they implement their reforms and make the necessary efforts to do so -- i.e., keep their accounts at least in balance -- or the neo-liberal 'model' will have little chance of success.19

Nevertheless, the logic that led to Brazil's 1999 crisis is (as is so often the case) more complicated than a typically simplistic 'Washington Consensus' one: the obvious issue that so far is missing from the traditional explanations is precisely an understanding of the economic and institutional dynamics that led to this growing public deficit, and its relationship to the radical-monetarist economic policies devised to keep the credit in the private sector, the private sector consumption and the asset prices under control. The first point to note is that the growing public deficit was almost entirely the result of interest payments on the public debt.

19 See, for example, World Economic Outlook (May, 1999)
Other than for a small deficit in 1997, Figure 11 shows that the 'primary' accounts of the public sector were in surplus or balance throughout the period, and that it was only the growing interest payments that brought the public sector into deficit. This seems to be the obvious 'other side' of the high interest rates coin. However, the problem is more complex than that.

First, the true 'primary balance' was not anywhere as healthy as the government statistics suggested. Not only were large privatisation receipts -- US$ 58 billion up to the January-1999 crisis -- accounted as 'ordinary' public revenues, but also the huge costs of the bailouts of bank and state finances were disguised using a long lag between the actual bailouts and the proper acknowledgement of the associated costs in the public sector accounts. Regarding the latter, although the government did register the debt issued for the bailouts of banks as new liabilities on the balance sheet of the Central Bank, it registered at the same time the non-performing debt it had absorbed as an increase in 'assets'. In this way, from an

20 At least this method was less 'post-modernist' than that of Mrs. Thatcher, who accounted for privatisation receipts as reduced public expenditure (rather than as increased public revenues!) As one of her election promises had been that she would reduced the share of public expenditure
accounting point of view, there was initially very little immediate ‘expenditure’ to register in the accounts of the Federal Government and Central Bank -- leading to members of the government and journalists in some of the friendly financial press at the time even boasting that there were no significant fiscal costs associated with the bailouts! Of course, these 'assets' never performed, a fact that was only gradually acknowledged as public 'expenditure' later on by slowly reducing the value of these 'assets' in the Central Bank balance sheet through provisions for 'credit losses'.

In this way, the government not only made the cost of bank bailouts less transparent, but was also able to transfer the fiscal impact of the bailouts to the future: at the time of the October 1998 elections, the Central Bank accounts showed 'assets' specifically associated to the bailing out of private banks equivalent to US$ 24 billion, and 'assets' associated with both the bailout of state banks and other state debts equivalent to US$ 72 billion.

Second (and as distinct from the 1982 debt crisis) in the case of Brazil in the 1990s it was the service of the public domestic debt that accounted for most of the interest payments paid by the public sector. Thus, while the external net debt of the government fell by more than half between 1993 and 1998 (from 14.4% of GDP to 6.3%), the internal net debt (despite the under-reporting of the bailout costs via 'asset inflation') doubled -- from 18.5% to 36.1%.

Third, within the internal net debt, it was only the Federal Government and Central Bank component of this debt that was booming. See Figure 12.

\[\text{in national income, this novel accounting practice was a rather useful devise in that direction.} \]

21 The exception to this accounting-trick rule was the re-capitalisation of Banco do Brazil, which was acknowledged as such from the beginning (i.e., there were no ghost ‘assets’ added to the Central bank accounts).

22 The Central bank accounts are done in such a way that it is not possible to separate these two items.
The reasons for the growth of the net debt of the Federal Government and Central Bank are apparently not completely straightforward. First, as they had a relatively low stock of debt to start with at the time of price stabilisation and financial liberalisation - in July 1994, the net domestic debt of the Federal Government and the Central Bank (although already rising) was equivalent to just 8% of GDP -- it is difficult to blame the effect of high interest rates hitting the initial debt for this extraordinary growth. Obviously, in order to get into an uncontrollable ‘Ponzi’ situation one needs to have large debts to start with! Second, throughout the period between financial liberalisation and financial crisis there were (apparently) no significant ‘primary’ deficits in the public accounts that needed to be financed. So, the crucial issue that needs to be explained is where did the ‘Ponzi’ take off? Why did the stock of debt of the Federal Government and Central Bank increase in the first place?

For many Brazilian analysts, the usual suspect to blame is the high cost of the policy of sterilisation followed by the Central Bank in the hope of avoiding ‘another Mexico’. Others blame the ‘skeletons’ from the past -- such as the need to recognise previously unconsolidated public liabilities, and the under-capitalisation of public sector...
banks (especially the Banco do Brasil).\textsuperscript{23} Finally, it has also been common to blame the new Constitution for bringing about a delayed increase in public expenditure.\textsuperscript{24}

However, although the cost of sterilising foreign inflows and of acknowledging ‘skeletons’ from the past was high, as is shown in Table 1 below, the bailout of banks and of State governments made a far larger contribution to the increase in the public domestic debt. These constant rescue activities may not have been properly accounted for in the ‘primary’ balance, but there was no way of hiding their impact on the gross stock of debt of the Federal Government and the Central Bank (which is where the public sector ‘Ponzi’ finance took off.) Table 1 presents an attempt to breakdown the increase of this domestic debt into its main components between the beginning of the Real Plan and the month before the January 1999 financial crisis.

\begin{center}
\textbf{TABLE 1}
\end{center}


All figures in US$ billion (December 1998 value) *

\begin{center}
\begin{tabular}{lcc}
\hline

Initial domestic debt (July 1994) & 72.5 \\
'Securitised' domestic debt in December 1998 & 266.9 \\
(Increase in ‘securitised’ domestic debt) & 194.4 \\
Total increase in domestic debt ('securitised' or not) & 229.5 \\
\hline
\end{tabular}
\end{center}

- increase due to bailout of banks and of State Governments \hspace{1cm} 146.2
  - private banks \hspace{1cm} 42.8
  - State banks \hspace{1cm} 48.0
  - State Governments \hspace{1cm} 43.6
  - Banco do Brasil\textsuperscript{25} \hspace{1cm} 11.8

- increase due to initial stock of debt \hspace{1cm} 53.3

- increase due to sterilisation of reserves \hspace{1cm} 30.0

Total increase in domestic debt ('securitised' or not) \hspace{1cm} 229.5

\textsuperscript{23} See for example Goldfajn (2002), who blames almost everything on irresponsible behaviour by previous Federal and State governments. Furthermore, some authors insist that despite extended recognition of previously unconsolidated liabilities, at the end of the second administration of Cardoso in 2002 there were still unconsolidated public liabilities equivalent to another 10 per cent of GDP. See J. P. Morgan (2002), and Favero and Giavazzi (2002).

\textsuperscript{24} For a detailed and critical analysis of these issues, see Lopes (2003); see also Sainz and Calcagno (1999).

\textsuperscript{25} The re-capitalisation of the Banco do Brasil is showed separately from the cost of rescuing other public sector banks because it is usually argued that this was just an acknowledgement of a ‘skeleton’ from the past; however, a significant part of its problems were created during the Real Plan. In particular, its large exposure to the agricultural sector became rapidly non-performing due to high interest rates and the unwillingness of the government to put pressure on farmers to pay.
The 'initial' domestic debt (July 1994) was first transformed into reais of December 1998 before being expressed in terms of US$ (using the exchange rate of that month). The domestic debt of December 1998 was changed from reais into US$ also using the exchange rate of that month. All other figures were initially taken in local currency of the time of the expenditure; then, to these figures, was added the interest payments that were actually capitalised until December 1998 (the 'Ponzi' finance); finally, December 1998 totals in reais were changed into US$ in the same way as above. To calculate the increase in domestic debt due to the capitalisation of interest payment on the 'initial' stock of debt (that of July 1994), 'primary' surplus (deficits) were first deducted (added) to the 'initial' stock of debt before adding the cost of capitalising interest rate payments; i.e., it was assumed that the 'primary' surpluses (deficit in 1997) were used to pay this part of the domestic debt (as mentioned above, these 'primary' balances included privatisation receipts). From the cost of sterilising increases in foreign exchange reserves was deducted the interest received for foreign exchange reserves (expressed in local currency and assumed equivalent to returns on US Treasury Bills; see Figure 14). For a detailed explanation of the methodology used in this exercise, see Lopes and Palma (2005).

The key issue that those working under the Washington Consensus type of economics do not seem to understand, is that in a financially liberalised economy the government constantly has to face 'damned-if-you-do, damned-if-you-don't' types of choices in relation to interest rates. For example, as in Brazil during this period, a rapid surge in inflows tends to overvalue the currency; then, as long as this overvaluation is expected to continue (commitment to a 'peg'), this becomes an incentive to substitute borrowing in domestic currency with borrowing in foreign currency. Soon there are domestic exposures that require interest rates to come down, but there are also external exposures that require that the currency remain overvalued (i.e., interest rates need to stay up). In other words, from the point of view of the domestic financial system, interest rates are soon stuck between the needs of banks’ foreign-currency liabilities, and those of the banks’ domestic assets. In the case of Brazil, policy-makers opted for trying to avoid bankruptcies on banks' foreign-exchange exposures, at the cost of bankruptcies on banks' domestic assets exposures -- and then they opted to foot the bill for the latter. In this interest rate 'trap', it is the choice between one type of bankruptcy and the other, (and given the attitude of the government) between one type of government rescue operation and the other. Either way, the public sector debt would swell -- and, given the character of the present international financial market, from then on the economy is just one-step away from speculative activity of the partly self-fulfilling, partly 'truth-telling' type that tends to end in financial crisis.26

In sum, in Latin America a financial liberalisation (at a time of high international liquidity) with declining domestic lending rates (as in Chile, Mexico and Argentina; see Figure 5) seems to unleash a private sector credit explosion, leading to an unsustainable consumption boom and asset bubbles. The alternative case, Brazil, which tries to avoid these processes via high interest rates, tends to destabilise the

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26 See Kuczynski (1999).
domestic financial system and public finances in a way that leaves the government having to choose between a rock (absorbing large amounts of bad debt created by under-performing banking assets and deficits in the State governments due to the high interest rates they have to pay on State debts) and a hard place (allowing the collapse of State’s finances, and of the domestic financial system because of its foreign-exchange exposures). The Brazilian government chose the route of high interest rates leading to both high State-government bad debt absorption, and high financial sector bad debt absorption.27

Related to this, of course, there were two crucial factors fuelling financial fragility: first, in Brazil financial liberalisation was implemented with a particularly inadequate system of regulation and supervision of the domestic financial sector. Furthermore, the Federal Government exacerbated this problem by overlooking and covering up cases of wrongdoing and corruption in financial institutions. Second, a weak government is a recipe for problems of the ‘Federal government versus State governments’ type; it is also bound to lead to political stalemates such as that between the government and parliament over much needed public finance reforms.

And once the stock of debt of the Federal Government and Central Bank began to swell, the high interest rate-related ‘Ponzi’ finance took over. See Figure 13.

27 The main banks that had to be rescued were (in chronological order) Econômico (1995), Nacional (1995), Banco do Brazil (1996), Mercantil, Banorte (1996), Bamerindus (1997), State Bank of São Paulo (Banespa, 1997), State Bank of Minas Gerais (1998), and State Bank of Rio Grande do Sul (1998). Other state banks whose rescue initially cost the Federal Government and Central Bank less than those above but still more than US$ 1 billion were those of Bahia, Pernambuco and Paraná. Besides these, there were other fifteen state banks that needed bailing out.
[1] = Interest rate paid by the government on its domestic paper (annualised monthly rates); and [2] = growth of public revenues (annual rates).

[a] = Interest rate increase following the Mexican crisis; [b] = following the East Asian crisis; [c] = following the Russian crisis; and [d] = following the State of Minas Gerais' default and the January 1999 crisis.

Two crucial phenomena of the public sector ‘Ponzi’ finance are evident in Figure 13. First, the violation of one of the most important financial ‘golden rules’: interest rates paid on public debt were systematically higher than the growth of public revenues (and, even worse, much higher than that of the practically stagnant income per capita). Second, each external and internal shock led to a sudden rise in this interest rate. This provoked a similar (but augmented) phenomenon in lending rates, which (in ‘Minskyian’ terminology) increasingly turned private sector finance from ‘hedge’ into ‘speculative’, and then from ‘speculative’ into ‘Ponzi’ finance (see Minsky, 1982). Finally, Figure 14 shows yet another side of the public sector ‘Ponzi’ finance -- the well-known high cost of sterilisation.
Again, until the January 1999 crisis, interest payments on public liabilities due to sterilisation of foreign inflows were systematically larger than revenues from related assets (foreign exchange reserves).

Finally, not every aspect of Brazil’s 1999 crisis was of course unique. Although an internal public sector ‘Ponzi’ was unique to Brazil among the 1990s-crisis-economies discussed in this paper, Brazil also had to face three problems common to all other crisis-countries: (i) constantly changing composition of the large private inflows; (ii) progressive shortening of the term structure of their debt; and (iii) the constant danger that in a financially liberalised economy the attack could also come from ‘within’.

Regarding the first, Figure 2 showed that in Brazil there was an erratic changing composition of inflows; this is also found in the other crisis-countries (but in East Asia it took a less extreme form). The changing composition made the already difficult matter of effectively absorbing massive inflows even more complicated. Regarding the term-structure of inflows, in Brazil these shortened significantly over the period -- the ratio of short-term debt to total debt jumped from less than 20% in 1994 to nearly
60% in 1998. As a result, the ratio of foreign exchange reserves to short-term debt collapsed from about 130% in 1994 to 30% in 1998. Obviously, this added further fragility and heightened uncertainty in an already difficult situation by making the economy extremely vulnerable to a sudden collapse of confidence and withdrawal of finance.

Finally, of course, in a financially liberalised economy, the ‘attack’ could also just as easily come from ‘within’. Brazil (as Mexico and Korea before it) did not have significant defences against internal attacks on their exchange rates, as their ‘reserves-M2’ ratios were also particularly low.29

In sum, the path to financial crisis in Brazil started with a massive surge in inflows, but the scene was soon dominated by the high domestic interest rates initially necessary for price-stabilisation but later becoming permanent to avoid ‘another Mexico’ and to respond to continuous external shocks. These high interest rates were successful in avoiding a repeat of ‘Mexico’, in consolidating price-stabilisation and in partially insulating Brazil from external shocks in 1995 and 1997, but soon created massive domestic financial fragility in the banking sector and in state-government finances, leading to an increase in public debt through continuous private banking and State-government rescue activities. And this public debt exploded due to high interest rates, which became systematically higher than both the growth in public revenues and the returns on reserves. In the meantime, the real economy imploded because of these rates, affecting the growth of public revenues even further; but high interest rates became even more necessary as a (poor) substitute for missing public-sector reforms and as a price for political stalemate, and to defend the ‘peg’, so as to avoid both further domestic banking crises due to high foreign-exchange liabilities, and a stampede by restless international fund managers. And the ‘Ponzi’ finance in the public sector ballooned out of control as a result of this high interest rate ‘trap’. Again, it did not take much (the Russian devaluation and default in August 1998 and a relatively minor internal political crisis at the beginning of January 1999) for Brazil to end up in a major financial crisis.

29 See Palma (2000b).
4.- So, how can one explain that most of the economic profession, financial markets and the financial press still insist that the Brazilian and other financial crises in the 1990s were mostly ‘undeserved’ and ‘unpredictable’?

As discussed in detail elsewhere (Palma, 2012), it is difficult to understand the mainstream insistence that most of the blame for these crises, as well as for the current global financial crisis, should lie on very specific and supposedly avoidable ‘exogenous’ issues — i.e., external to the spontaneous working of highly liquid financial markets. And in some cases, just on ‘chance’. The more liberalised financial markets are, the more they have the intrinsic ability to supply effectively the credit intermediation and payment services that are needed for the real economy to continue on its growth path. So, if unmanageable financial instability occurs one of two things tends to be the excuse: either a ‘missing’ market is creating a market ‘failure’, or something ‘foreign’ is meddling in these markets. On the whole, the second alternative tends to be favoured in the position of culprit. In the case of Mexico-1994, for example, most of the attention in mainstream literature has been diverted towards a relatively expansionary macro-policy in an election year; in Brazil-1999, towards the political stalemate that delayed endlessly a necessary fiscal reform (a ‘Waiting for Godot’-type story); in Korea, towards a supposedly ‘moral-hazard driven over-investment-cum-corporate-debt’ story; and in Thailand, towards a ‘crony-capitalist driven unbalanced-balance-sheet’ story’. In a way, this mainstream attitude of barking up the wrong tree is no different from what happened after the 2008 financial crisis, when the usual suspects blamed everything on China and/or Greenspan, or pointed at ‘liberals’ for the 1977 law that helps low-income people get mortgages. Anything would do (including the fall of the Berlin Wall, excessive testosterone in trading rooms, or even sunspots! — see Palma, 2009a for the ‘blame list’), except the possibility that the autonomous outcome of the free interaction of supposedly utility-maximising agents, interacting in (excessively) ‘friendly-regulated’ and over-liquid financial markets, could be an endogenous financial crisis (rather than some sort of ‘equilibrium’).

So, how can one explain this attitude from most of the economic profession, financial markets, and the financial press? The answer to this complex question has at least four components. The Wall Street Journal provides a good insight into the first one regarding the current financial crisis; in an editorial soon after the beginning of the ‘sub-prime’ crisis it stated that: “The recent market turmoil is [...] raising the stock of one person: a little-known economist whose views have suddenly become very popular [...] Hyman Minsky.” (WSJ, 18 August 2007). Perhaps had they read (and, more importantly, had they read and understood) such obscure economists as Keynes,
Minsky, Kindleberger and so many others (including Stiglitz, and the later work of Krugman) the *Wall Street Journal* (otherwise known as the *Pravda* of Wall Street) could have become more effective at predicting financial crises — and at realising how ‘deserved’ they usually are. They might even have learnt how avoidable they could become under a revamp set of FDR/Keynesian-Bretton-Woods-type arrangements.30

This also applies to the ‘new’ left which, when in government, often follows extreme versions of the mainstream orthodoxy (both in developing and developed countries). In terms of ‘friendly’ regulation of financial markets, for example, nothing beats ‘purity of belief’ of New Labour in the form of Gordon Brown’s Financial Service Authority (FSA). When in 1997 he created a new regulatory body for the financial industry (the FSA), he set it up not only as an ‘independent non-governmental body’ (i.e., a company limited by guarantee), but also as one that was actually financed by the financial services industry. Furthermore, he appointed ex-bankers as Chairman, Chief Executive Officer and non-executive directors. That is, he set the FSA up as operationally independent of Government, funded entirely by the financial corporations it was supposed to regulate, and led by financial-industry insiders. Thus, New Labour found a rather ingenious solution to the problem of ‘regulatory capture’; if, supposedly, lobbyists inevitably succeed in capturing the regulators, why not make them the regulators in the first place?31

With this (‘limited-touch’) attitude towards financial regulation, perhaps it is not surprising that at the beginning of the current financial crisis the first bank failure took place in the UK (one year before Lehman’s Brothers) — becoming the first UK bank in 150 years to suffer a traditional bank run. In fact, in the UK the regulatory failings in the lead up to the current financial crisis were such that for many observers it came as no surprise that its new Chair tried to regain ‘the moral high ground’ with his speech at the 2011 annual Mansion House banquet hosted by the Lord Mayor of London (see epigraph at the beginning of the paper).

In fact, I sometimes wonder whether mainstream economics today is just shorthand for ‘nothing left to decide’ — and, of course, ‘nothing left to think about critically’ (Palma, 2009b). Indeed, the attitude of many mainstream economists towards policy-making (before and after the current crisis) resembles Lord Kelvin’s attitude towards physics at the end of the 19th century, when he famously declared that in physics “there is nothing new to be discovered now. All that remains is more and more precise measurement.” (Kelvin, 1900) From this perspective, the incapacity

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30 See, for example, Epstein and Pollin (2011).
31 Probably this is what Brown meant when he famously declared that his policy on financial regulation was “… not just a light touch, but a limited touch one” (see http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/ee59d1c32ce4ec12802570c70041152c/).
of mainstream economists to consider alternative points of view is such that even the
so-called ‘New Keynesians’ still work within a ‘complete markets’ paradigm, and with
the strongest version of the efficient-markets hypothesis (Buiter, 2009).

Along this line, perhaps the most amusing definition by a mainstream
economist of what ‘heterodox economics’ is all about is found in a Working Paper of the
Chilean Central Bank (that analyses the post-1982 banking crisis in Chile); according
to the authors, “[t]he Chilean solution to the crisis was heterodox in the sense that
many policies appear to have been arbitrary, and policy mistakes were made […] along
the way.” (Barandiarán and Hernández, 1999). This attitude towards alternative points
of view can only be explained by the usual dynamics of idealisation: when there is an
unremitting need to sustain the idealisation of something (in this case, that of a
remarkably simplistic view of markets in the face of so much evidence against it the
form of recurring ‘endogenous’ financial crises), what is needed is simultaneously to
demonise something else (in this case, anything to do with alternative views). In fact,
the more evident the flaws of what is being idealised, the stronger the demonisation of
the alternative view has to be.32

Second, another (closely related) part of the answer to the above question is
that in LA, as in most of the Anglo-American world, economic reforms were carried out
with a peculiar political ideology — what I like to call the ‘Anglo-Iberian’ neo-liberal
fundamentalism — where ‘toxic ideas’ were as damaging as ‘toxic assets’ in the lead up
to the many financial crises discussed in this paper.33 A case in point is Gustavo
Franco, the President of the Brazilian Central Bank who led Brazil into the 1999
financial crisis; for him, ”[the alternative for Brazilians today] is to be neo-liberal or
neo-idiotic [neo-burros].” (Veja, 15 November 1996). And, of course, “burros” (and
‘obscure’ economists, such as Minsky) belong in intellectual Gulags. In fact, for
Franco, his main task in government was to help “...undo forty years of stupidity.”34
With this Anglo-Iberian ‘reverse-gear’ attitude, LA’s experiment in economic reform
and financial liberalisation almost inevitably ended up as an exercise in ‘not-very-
creative’ destruction.

This reminds me of what Keynes once said (discussing Say’s Law) about Ricardo
conquering England as completely as the Holy Inquisition conquered Spain. Something
similar has happened in LA, where neo-liberalism has conquered the region, including

32 For an analysis of the process of idealisation, see Sodré (2009).
33 In fact, we now know that Greenspan was even against tightening regulation against financial
fraud, as (supposedly) rational markets can take care of themselves in this front as well. (http://
34 For Keynes, instead, the opening-up of an economy ”... should not be a matter of tearing up
roots but of slowly training a plant to grow in a different direction.” (1933; 759)
many in its left-wing intelligentsia, just as fiercely as the Holy Inquisition conquered
Spain. In fact, this process has been so successful that it has actually had the effect of
‘closing the imagination’ to conceptualising alternatives.

Third, another part of the answer to the above question is the way in which
many within mainstream economics, international financial markets and the financial
press have interpreted economic news along the cycles that have led to a financial
crisis. Following Steiner’s (1993) psychoanalytical understanding of the difficulties of
the human mind to recognise reality when faced with particularly complex and
emotionally charged problems — and of its failure to live with them, and suffer their
consequences — I distinguish three stages in the ‘problem (or bad news)-awareness’
cycle: an initial ‘lack-of-awareness’ phase, which is eventually followed by a (short-
lived) ‘sudden-awareness’ stage, and then by a ‘new form of lack-of-problem-
awareness’ scenario. In the first (mania) phase of each financial cycle, which could be
called the initial ‘turning-a-blind-eye’ stage, good news is often overstated and bad
news simply ignored. And if eventually some bad news can no longer be ignored (e.g.,
in the current crisis, when in August 2007 HSBC announced increased provisions for
non-performing sub-prime mortgages), this is reluctantly acknowledged but in the
clear understanding that ‘everything is still under control’ — even though most of the
pieces of the crisis-puzzle are (or should be) already evident (see, for example, Table
1, and Figures 13 and 14).

The second stage of the ‘bad-news-awareness’ cycle comes to the fore when a
catastrophic event suddenly reveals what so far has been denied (e.g., in the current
cycle, Lehman’s demise) — and reality sets in. Now there is an abrupt turn towards
total panic, to total dismay. Suddenly, bad news is felt as devastating (and sometimes
is even exaggerated) and everybody seems completely overwhelmed by the
catastrophe. According to Greenspan, for example, this happened to him after
Lehman’s, and his reaction was one of ‘shocked disbelief’; he then famously
acknowledged to a Congressional Committee that what he found was nothing short of
“...a flaw in my economic ideology — in the conceptual framework with which I dealt
with reality.” And he was “…very distressed by that fact.” And when asked “[i]n other
words, you found that your view of the world, your ideology, was not right, it was not
working?” He replied “[yes] — precisely. That’s precisely the reason I was shocked,
because I had been going for 40 years or more [...] [with the idea that my view of the
world] was working exceptionally well.” (http://www.pbs.org/newshour/bb/business/
july-dec08/crisishearing _10-23.html)

However, this second stage in the ‘problem-awareness cycle’ seems to be short-
lived because it is often followed by a further twist (at the time of writing, what is
currently going on in the global financial crisis). Basically, soon after the ‘sudden-
awareness’ stage there is a turn towards a new form of ‘lack-of-awareness’ — a retreat from the (unbearable) shock into a new form of omnipotence. In a nutshell, the extent of the crash and its (ideological and analytical) repercussions are so devastating that they cannot any longer be acknowledged. When in the second stage ‘truth’ is recognised, it is found to be unbearable. Its sustainable recognition would involve a loss of what kept us going, and the mourning of this loss is too difficult. So, the ‘shocked disbelief’ begins to fizzle out, and reality begins to be evaded, misrepresented, distorted and covered up in a new ‘lack-of-awareness’ scenario. The most important issue here is that (very conveniently) it is as if nothing needs to be properly mourned — especially the economic ideology responsible for the crisis (the ‘toxic ideas’ that lead to the financial crises). After all, the current global financial crisis is (or should be) to the grandiose Reagan & Thatcher neo-liberal counter-reformation, what the fall of the Berlin Wall was to the Communist paradigm. Only a new form of ‘lack of awareness’ can help avoid this. This new attitude can best be described as “actually, I can take all this on my chin; no need to have my economic ideology knocked down.” In any case, this must be the fault of the ‘usual (and more familiar, and less threatening) suspects’! That is, in order to sustain the status quo after the crash there is a new need to cover up, evade and distort. So, the focus of attention quickly (and conveniently) switched from the distressing idea of the self-destructive nature of unregulated and over-liquid financial markets, to the more familiar terrain of problems relating to China (how could it not be China!), labour ‘rigidities’, uncontrolled immigration, excessive regulation, and (for sure) ‘big government’.35 And in the UK, of course, the European Union! What ‘shocked disbelief’?

35 In terms of distortions of reality and cover-ups to keep the status quo, few beat New York City mayor and media tycoon Michael Bloomberg when he criticised the ‘occupy-Wall-Street’ protesters because their complaints were ‘misplaced’: “...some of [their] complaints [...] are totally unfounded. It was not the banks that created the mortgage crisis. It was, plain and simple, Congress who forced everybody to go and give mortgages to people who were on the cusp (sic.).” (http://www.outsidethebeltway.com/bloomberg-dont-blame-banks-for-mortgage-crisis/). I wonder who is the one barking up the wrong tree, as FED data now shows conclusively that it was private mortgage brokers, not Fannie and Freddie, who created the subprime housing bubble. In fact, “the predominant players in the subprime market — mortgage brokers, mortgage companies and the Wall Street investment banks that provided the financing — aren’t covered under CRA [the 1997-Community Reinvestment Act]. [...] In all, 94 percent of high-cost loans were totally unconnected from government homeownership laws.” (http://thinkprogress.org/economy/2011/11/01/358482/bloomberg-mortgage-crisis/).

Also, Steve Forbes (the Chairman of Forbes Media and a former Republican candidate for President) argued along the same lines — that the causes of the financial crisis are simple: "over-sized government and over-burdensome regulation.” Therefore, not only “the protesters should be occupying Congress and not Wall Street”; but also the solution to the financial crisis is straightforward: “If we shrank the government and got our fiscal house in order [...] inequality and joblessness that is fuelling the social frustration would begin to ease of its own accord.” (http://finance.yahoo.com/blogs/daily-ticker/steve-forbes-wall-street-protesters-occupy-congress-instead-182232426.html?l=1).
In other words, first, if until the ‘shocked disbelief’ those involved (politicians, mainstream academics, financial markets and financial press) are unable to acknowledge the existence of a fundamental problem, why is anybody going to fix it? And if after the shock the new urgency is about moving away from the unbearable awareness, and into a new (omnipotent) phase in which the main concern is not the further revelation of truth, but the cover up of truth, what is the hope for a proper understanding? The key issue here seems to be the difficulty (perhaps impossibility?) for those involved in creating the economic environment that led to the crisis of sustaining their full awareness of what has happened. For example, although many things have already been said regarding the speed, the size, and the nature of the rescue operations after each financial crisis (including the urgent need to stop the rot, as well as old-boys’ networks at work, corruption and so on), perhaps an additional component of these rescue operations (particularly their urgency) is that they are a fundamental component of the ‘cover up’. When Clinton quickly intervened after the Mexican crisis with his more than $70 billion rescue package (in 2010-US$), he was not just saving his mates from Wall Street (who had been caught badly exposed in Mexico); most probably, he was also trying to turn the page as quickly as possible — so that one could turn a blind eye to the evidence emerging from that crisis regarding the risks associated with full financial liberalisation (especially of the capital account) in middle-income countries. The same happened with the massive IMF intervention in Brazil and East Asia. And in the case of Chile, when the government was happy to spend more than 50% of GDP rescuing the banking system after the 1982 crisis, and when most governments in industrialised countries were all too happy to shower financial markets with trillions of dollars following Lehman’s downfall — bringing the concept of a ‘soft budget constraint’ to a totally new dimension — perhaps (among other things) they were also trying to cover up quickly their unbearable ‘shocked disbelief’. And, inevitably, some eternally optimistic Keynesians were bound to mistake the soft budget constraint for a “…vast, Keynesian, fiscal stimuli [...]” (http://www.guardian.co.uk/business/2009/jan/18/economic-depression). That is, instead of being part of a cover up, keeping financial dinosaurs on life support was definite evidence that ‘we are all Keynesian again’!

Moreover, in the case of the seven financial crises in middle-income DCs during the 1990s, as opposed to the current global financial crisis, the relatively rapid recovery of the economies (non faster than brazil) involved greatly helped the cover up. In fact, perhaps Argentina is the only country of the ones discussed above where (despite the rapid recovery) there was at least an effort to learn from the pre-crisis mistakes.

Also, often the cover up extends to personal responsibility. A clear example is
that of Larry Summers who, as Clinton’s Treasury Secretary, led the financial deregulation brigade that created the conditions under which financial sanity was left to depend entirely on ‘self-regulation’ and ‘market discipline’. Summers, for example, led the repeal of the 1933 Glass–Steagall Act, and he also vehemently opposed the regulation of derivative contracts. And then, nearly a decade later, as Obama’s Director of the National Economic Council, he had the task to undo a mess that to an important extent was his creation. So, it should probably come as no surprise that when he devised Obama’s (so-called) ‘fiscal stimulus’ plan, almost all funds were diverted to keep financial relics afloat (and save his own tarnished reputation) rather than to create a proper fiscal stimulus on output and employment.\(^{36}\) Furthermore, when he was asked about the collapse of A.I.G. Summers’ response was typical of this third stage in the ‘awareness/lack-of-awareness’ cycle. He answered: “[t]here are a lot of terrible things that have happened in the last eighteen months, but what's happened at A.I.G. [...] the way it was not regulated, the way no one was watching [...] is outrageous.” (http:// www.bbc.co.uk/blogs/nickrobinson/2011/04/i_told_you_so.html).

Could it be that this is the same Summers who in 1998, in his testimony before Congress, had argued against the regulation of all types of derivative contracts (including A.I.G.’s credit default swaps), because “[t]he parties to these kinds of contract are largely sophisticated financial institutions that would appear to be eminently capable of protecting themselves from fraud and counterparty insolvencies. [...] To date there has been no clear evidence of a need for additional regulation of the institutional OTC derivatives market, and we would submit that proponents of such regulation [i.e., Brooksley Born, the chairperson of the Commodity Futures Trading Commission, who became strongly in favour of regulation in derivative markets after the LTCM debacle] must bear the burden of demonstrating that need.” (Ibid.) Some would argue that Summers’ ‘outrage’ at the lack of regulation in derivative markets was just sheer hypocrisy, but I would not be at all surprised if by then he had basically lost touch with his own past, and he actually believed what he was saying.

Moreover, in this latter, post-crash, stage (as is often the case in this phase of the ‘awareness-cycle’), typically a new narrative of each crisis begins to emerge in which ‘chance’ is often used as a (convenient) validation of the new turning of a blind eye. Again, Greenspan provides an example; after having acknowledged the dreadfulness of his initial ‘shocked disbelief’, and the major flaw in his economic

\(^{36}\) Six months into Obama’s ‘stimulus plan’, while over a trillion dollars had been spent (or committed) on subsidising financial markets — together with the defence sector, the leading welfare recipients in the country — less than 1% had actually been made available for highway and environmental cleanup projects.
ideology, he soon began to argue that, after all, the 2008 crisis might well have been a ‘one-in-a-hundred-year’ event. That is, it was still possible that the crisis was undeserved and unpredictable after all. Even if everything was pointing in the opposite direction, there was still a chance that it was a fortuitous event. In the same spirit, in most analyses of the 1997 East Asian crisis (especially in third-generation models), the fundamental ex post assumption is that this crisis started with a bank-run that occurred in Thailand by chance — financial markets turning their attention to south-east Asia with some trepidation due to the British transfer of Hong Kong to China (Chang and Velasco, 2001). In turn, second generation models want us to believe that the ERM crisis in the UK was just a ‘self-fulfilling’ shock in an economy that was fundamentally sound — speculators who believe (rightly or wrongly) that other speculators were about to attack, were themselves encouraged to do so. The same happened in the 1998 Brazilian crisis; it was all supposed to be bad luck: contagion from unrelated events far away — literally, at the other end of the world (in Asia and Russia). And in the case of Korea, the crises supposedly occurred due to a random event: a sudden flight of capital from another economy that was also fundamentally sound. And so on (see Appendix 1). After all, Sophocles had already warned us a long time ago (via one of his characters) that “our mortal life is ruled by chance. There is no such thing as foreknowledge” (quoted in Steiner, 1993).

However, as Žižek explains,

Repetition, according to Hegel, plays a crucial role in history: when something happens just once, it may be dismissed as an accident, something that might have been avoided if the situation had been handled differently; but when the same event repeats itself, it is a sign that a deeper historical process is unfolding. [...] The same holds for [...] financial crises. (2011; 1)

Therefore, the convenient use of the idea of ‘chance’ helps preserve the status quo. This ‘cover up’ makes it possible to continue living in the phantasy world of the supremacy of unregulated ‘free’ markets. The key point here is that if after the shock (and the unbearable awareness) the new urgency is not about the further revelation of truth, but the cover up of truth, there is little hope for a proper understanding.

And fourth, particularly as far as LA is concerned, yet another part of the answer to the above question is a specific element in the genesis of recent financial crises: the peculiar politico-institutional framework in which financial liberalisation and economic reform were carried out in the region — as opposed to the way in which they were implemented in Asia (see Palma, 2011a). Part of this framework is the ‘original sin’ of LA’s economic reforms: the bizarre collection of ‘first-generation’ heads of state that initiated these reforms. Although not unfamiliar to Latin American political

history, Pinochet, Salinas, Collor, Menem, Fujimori, Alemán, Bucaram (and many others) certainly deserve several entries in *The Guinness Book of Records*, particularly under the headings of opportunism, corruption, human rights abuses, electoral fraud, and petit-bourgeois parvenu-populism. Almost invariably, after having initially got into power using an *anti*-neo-liberal discourse (even Pinochet’s initial discourse was closer to that of 1930s’ Franco than to 1970s’ Friedman), their sudden eagerness to switch to the neo-liberal camp was in part related to the opportunity to create a new structure of property rights from which massive new rents could be extracted. And, of course, the more successful they were in selling the neo-liberal programme, the more extravagant the predatory capitalism that followed could be.

From the perspective of this paper, there are two sides to this story. One is that with these ‘first-generation’ individuals running the show to begin with, economic reforms (particularly privatisations) never stood much of a chance. As Stiglitz has summarised it (rather politely):

> [Is financial liberalisation] being designed on the basis of the best available economic theory and evidence, or is there another agenda, perhaps a special interest agenda? (Stiglitz, 2000; 1085)

The other is a more complex (and usually forgotten) aspect to this phenomenon. Basically, in their eagerness to support the process of economic reform in LA, those associated with the Washington Consensus somehow succeeded in turning a blind eye to the Russian-style, predatory nature of these reforms, especially the process of privatisation. In fact, it is quite remarkable how in these circles what was going on in this respect was basically ignored — from the ‘Chicago-Boys’ in Chile dismantling the huge state apparatus for their own benefit (Mönckeberg, 2001), to Salinas’ privatisation extravaganza — where one privatisation alone (a telephone company) made one individual (practically overnight) the fourth largest billionaire in the world (he then began his rapid ascent to become the World’s number one).37  In fact,

37 See especially Wolf (2007), and Winter (2007). As if that was not enough, Salinas handed over to Telmex exclusivity in Mexico’s fixed-line market — when one of the most repeated aims of privatisation was, supposedly, to encourage competition. And this has continued afterwards — Fox, for example, appointed someone from Telmex as his Minister for Telecommunications. In fact, despite several adverse WTO rulings, Slim still has over a 90% share of the Mexican telephone market. Not surprisingly, in the latest OECD report on broadband download speed (reported above), Mexico (accompanied by Chile) had the slowest internet service among all its members (with less than 10% the OECD average). In all, Slim’s share of the Mexican telecommunications market is much larger than the combined one of AT&T, MCI, Quest, Sprint, and Verizon in the US (Winter 2007). Furthermore, for a US citizen to have the same share of the US economy as Slim has of Mexico’s, she or he would have to own assets of about US$1 trillion. (Ibid.) According to Forbes, this is more that the combined fortune of the top 100 US billionaires (http://www.forbes.com/forbes-400/list/). And Slim is not alone; according to a recent study (quoted in Winter, 2007), of the top 10 Mexicans on Forbes’ billionaires list in 2011 (with a total net worth of US$124 billion, about five times the US$25 billion that Mexican Forbes oligarchs had in 2000), half of them are ‘creatures of the State’. Basically, they got there a-la Douglas North’s ‘limited access order’ — as they first jumped from the millions to the billions
probably never in the history of the region success or failure in business has depended so much on political connections as during the first stages of the neo-liberal era. All this gives Marx’s concept of ‘primitive accumulation’ a new meaning. And despite Menem having run a privatisation circus no different from Salinas’, as late as 1998 (i.e., when the Argentinian economy was already at the edge of the abyss), in the annual meeting of the IMF and the World Bank Michel Camdessu (then Head of the IMF) still introduced Menem as ‘the President with the best economic polices in the world’ — which is rather like praising Al Capone for the orthodoxy of the business model in his beverages venture...

And by opting for such a blatant ‘turning a blind eye’ to corruption and mismanagement, those associated to the Washington Consensus became unable to have a clear vision (let alone the capacity for critical analysis) of other aspects of the process of reform — which were also contributing in bringing these economies to their respective financial crises. In other words, by turning a blind eye to the region’s worst ever ‘government failures’ their analytical judgement was also impeded in relation to the understanding of the huge ‘market failures’ unfolding in front of their eyes. Under these circumstances, all that mainstream academics and the financial press could do ex ante-crash was to keep repeating the traditional narrative of the desirability of the reforms (i.e., how they were the necessary and practically the sufficient conditions for economic success). And in the ex post-crash ‘lack-of-awareness phase’, instead of looking at the key lessons emerging from these financial crises (see conclusions), all they could do was to come up with such uncontroversial recommendations as ‘optimal sequences’, or (surprise, surprise) the need for ‘good governance’. That is, mainstream economists slowly began to recommend supposedly optimal policies for closing the stable gates only well after all the horses had bolted...

Conclusions

The legacy left by the military regimes to their civilian successors was (at best) a complex one. The Brazil of 1985 was very different from that of 1964. Brazil’s economy had improved significantly, but the lot of the majority of its people certainly had not followed suit. The Sarney Government proved unable to deal with the pressing problems of stagflation and debt. President Collor de Mello’s attempt to bring about a significant shift in the character of the economy and its integration into the world economy and to put a gradual end to over 50 years of state-led development thanks to a process of privatisation which was obscure even for the remarkably low standards of other privatisations in the region.
failed. Short-term economic problems and the emergence of massive corruption and bizarre private scandals as major issues in 1992 revealed the fragility of his political base. This threatened not only his liberalisation programme, but also the survival of the administration itself. After Collor’s forced resignation, his successor Itamar Franco also proved unable to deal with Brazil’s major political and economic problems, but did manage to achieve some recognition in the last year of his government with the appointment of Fernando Henrique Cardoso as his finance minister. President Franco allowed Cardoso and his team freely to devise and implement a highly ambitious stabilisation programme. The ‘Real Plan’ succeeded in dramatically reducing inflation and resulted in the election of Cardoso to the presidency.

Although until the end of 1998 the Real stabilisation plan had been succeeding in its inflation objective, this success had come at a growing cost. In fact, the crucial issue about Cardoso’s stabilisation programme was that it followed the oldest (‘two-stage’) macroeconomic law: one can only solve one macroeconomic imbalance by creating another, and then by hoping that the ‘invisible hand’ of the market will sort out the newly created imbalance... The problem is that although the first ‘stage’ of this macro-law sometimes can be achieved (particularly when international financial markets are happy to oblige), seldom is there such luck regarding the second. In Brazil’s case, although there was ample success with the Real stabilisation plan, what was needed regarding the second ‘stage’ was firm government action to deal with the newly created imbalances and macroeconomic and financial fragilities; instead, the government opted for the belief that the invisible hand and continuous access to international finance would eventually sort these problems out. As soon as inflation was tackled in mid-1994, tight and tough regulation and supervision of the private and public banking system and of state finances was needed; and as soon as inflation was conquered by the end of 1995 or beginning of 1996, a relaxation of the ‘quasi-peg’ leading to a managed real devaluation, a decrease in interest rates, an effective mechanism of capital controls on short-term flows, and the long-delayed public sector reforms were the only sensible options for dealing with the massively overvalued exchange rate, a fast growing deficit in the current account, the growing fragility of the domestic financial system, a domestic debt that was increasing at an unsustainable pace, and an ever-growing public-sector deficit. However, as so often happens in politics, risk-averse inertia took over -- particularly at a time when the government’s main political preoccupation was how to achieve a Constitutional change that would allow the President a second term in office. As a result, a successful set of economic policies that brought inflation down from four figures to single digits in a few months

38 For Brazil’s remarkable degree of income inequality, see Palma (2002).
(the 'Real Plan') was then kept in place after it had accomplished its objectives, run its full course and long passed its 'sell-by' date. As a result, the same policies that had been the solution to the previous problem (hyperinflation) began to be the very problem of the new cycle; and the longer the policies were maintained, the more difficult it became to change them. In the meantime, the only thing the government seemed to be able to do was to try for high and volatile interest rates, and to cut the already low levels of public investment to absurd new lows.39

In this sense, the January-1999 financial crisis in Brazil was clearly more due to 'weak governance' than in other crisis-countries of the 1980s and 1990s. In fact, the financial problems of the public sector demanded so much attention that some important new policy initiatives (in health and education, for example), some industrial restructuring, some major productivity growth in unprocessed commodities, and some modernisations in the public sector (e.g., PETROBRAS) went almost unnoticed.

One of the strengths of the Brazilian economy in the past had been that its economic authorities (of different political persuasions) did not allow its domestic inflation, interest rates, exchange rate and external balance to become a constraint on economic growth. As this policy, after long periods of sustained growth, ended in the 1980s in 'hyper-stagflation', the Cardoso government reversed it into a new policy in which economic growth, interest rates, and the need for external balances were not allowed to become a constraint in the fight for price stability. Although inflation was successfully controlled (even after the huge devaluation in January 1999, the consumer price index for that year increased by just 8.6%), this created major economic problems, not least the 'Ponzi' finance of the public sector.

A domestic deregulated but badly supervised financial market, closely linked to a highly liquid, under-regulated and unstable international financial market (mostly made up of jittery and sometimes under-informed fund managers prone to oscillating between mania and panic), coupled with a domestic economy characterised by large imbalances, a weak state, and an even weaker government coalition, made a sudden collapse of confidence and withdrawal of funds a real possibility. When in 1998 the Brazilian policy-makers finally realised that they had sleepwalked into a public sector 'Ponzi' finance and some drastic policy changes were necessary, it was unfortunately an election year -- again not the most propitious time to take major risks.

Initially, the Cardoso Government had greatly benefited from the Brazilian people's disillusionment with previous development and economic policies -- in fact,
this had been the ultimate condition required for the success of the ‘Real Plan’ in its initial stages.\textsuperscript{40} However, by the end of 1998 the government found out that this was ‘political capital’ from which they could not continue to depreciate endlessly.

\textsuperscript{40} Diaz-Alejandro always insisted that popular support was the most important component of a stabilisation package; see (1989).
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