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PEDRO PERFEITO DA SILVA

ESSAYS ON CAPITAL FLOWS MANAGEMENT AND FINANCIAL INSTABILITY

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Orientador Prof. Dr. André Moreira Cunha

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BANCA EXAMINADORA

Prof. Dr. André Moreira Cunha – Orientador

Profa. Dra. Daniela Magalhães Prates
UNICAMP

Prof. Dr. Henrique Morrone
UFRGS

Prof. Dr. Marcos Tadeu Caput Lélis
UNISINOS

ABSTRACT

This PhD dissertation contributes to the debate centered on the causes and consequences of external financial liberalization, focusing on the Brazilian experience. In terms of organization, the study is composed by three independent essays. The first one builds a longitudinal case-study analysis to assess on what extent Brazil's capital flows management has changed after the 2007-2009 Global Financial Crisis. The second essay employs fuzzy-set Qualitative Comparative Analysis to disentangle the determinants of capital account regimes around the world. Finally, the third essay relies on Vector Error Correction models to evaluate the effects of the interaction between capital account openness and financial integration on the Brazilian macroeconomic performance.

Keywords: Capital flows management. Financial instability. Political economy. Macroeconomics.

RESUMO

A presente tese de doutorado contribui para o debate centrado nas causas e consequências da liberalização financeira externa, com foco na experiência brasileira. Em termos de organização, o estudo é composto por três ensaios independentes. O primeiro constrói um estudo de caso longitudinal para avaliar em que medida a gestão dos fluxos de capital no Brasil mudou após a Crise Financeira Global de 2007-2009. O segundo ensaio emprega a Análise Comparativa Qualitativa para determinar os determinantes dos regimes de conta de capital ao redor do mundo. Finalmente, o terceiro ensaio baseia-se no modelo de vetor autorregressivo com correção de erros para avaliar os efeitos da interação entre a abertura da conta capital e a integração financeira sobre o desempenho macroeconômico brasileiro.

Palavras-chave: Gerenciamento dos fluxos de capital. Instabilidade financeira. Economia política. Macroeconomia.

SUMÁRIO

1 INTRODUCTION

According to Polanyi (1980), capitalism evolves around the tension between the self-regulating market principle and the social need for embeddedness. One of the main arenas of this pendular movement is the regulation of capital flows. For instance, the preponderance of economic interventionism in the first post-war decades relied on the pervasive cross-border financial restrictions that characterized the Bretton Woods System (EICHENGREEN, 1996). After the crisis of this monetary and financial order, in the late 1960s, the rise of global neoliberalism favored the progress of external financial liberalization, based on the removal of capital account regulations and the expansion of cross-border financial flows (KIRSHNER, 2014). The eruption of the 2007-2009 Global Financial Crisis added some nuance to this agenda, fostering the debate about costs and benefits of capital flows management measures (CFMs) (CHWIEROTH, 2010; GERKO; REY, 2017; OBSTFELD; TAYLOR, 2017; LANE; MILESI-FERRETTI, 2018).

Against this background, this PhD dissertation seeks to contribute to the debate centered on the causes and consequences of external financial liberalization. In terms of theoretical framework, the three independent essays build upon the Polanyian political economy, characterized by the attention to the destabilizing effects of liberalization as well as the capitalist diversity across and within countries (BOHLE, B.; GRESKOVITS, 2012; BAN, 2013; 2016; BLYTH, 2002).

Besides the theoretical foundations, the three essays also share the special concern with the case of Brazil. Among the emerging developing economies, the case of Brazil stands out for its historical adoption of price-based capital controls, its position as one of main destinies for cross-border financial investments and its pivotal role in the alliance of countries that pushed for the legitimation of CFMs (PAULA, 2011; BAN, 2013; FRITZ; PRATES, 2014; 2018; GHOSH; DAVID; OSTRY, 2017; MCKINSEY GLOBAL INSTITUTE, 2017; OCAMPO, 2018).

For instance, the first essay, *Global Financial Crisis and Capital Flows Management in Brazil: toward a Polanyian approach*, presents a longitudinal case-study on the evolution of Brazil's CFMs since democratization, focusing on what extent these policies have substantively changed after the Global Financial Crisis. This essay aims to contribute to the debate between the policy space, the scalar-relational critical and the financialization approaches (ALAMI, 2018;

2019a; 2019b; GALLAGHER, 2014; 2015; KALTENBRUNNER; PAINCEIRA, 2015, 2018; KALTENBRUNNER, 2016) comparing CFMs around their objectives, instruments, relationship with other policy arenas and sociopolitical underpinnings.

The contribution of the Polanyian approach to this debate lies in the capacity to capture both the change and the continuity underlying Brazil's CFMs after the Global Financial Crisis. In this regard, the change stems from the conflict between different political economy coalitions, which constitute movements that push for financial liberalization and counter-movements that demand an active regulation of capital flows. These social forces rely mainly on economic interests, but also forge the agenda of political parties. The continuity, on the other hand, is rooted in the shared acceptance of major objectives of neoliberalism by both political economy coalitions. Such pattern tends to circumscribe the set of CFMs to market-friendly capital controls such as price-based and cyclically-adjusted regulations.

The second essay, *The Political Economy of Intermediate Capital Account Regimes: a fuzzy-set Qualitative Comparative Analysis*, also builds upon the notion of capitalist diversity under global neoliberalism to investigate the determinants of capital account regimes around the world. Instead of evaluating the net effect of each determinant on the level of capital controls (EICHENGREEN; LEBLANG, 2008; MILNER; MUKHERJEE, 2009; STEINBERG; NELSON; NGUYEN, 2019; LI; SMITH, 2003; QUINN; INCLÁN, 1997; BEARCE, 2003), this essay aims to address how each regime stems from different combinations of determinants. As this institutional arrangement is less discussed in the literature based on statistical analysis, the essay focuses on the case of intermediate capital account regimes.

The main contribution of this essay is to explore the different foundations of one of the main Polanyian notion: the rise of counter-movements in response of economic liberalization. Specifically, the essay provides a discussion on how political institutions, economic interests, political parties and recurrent currency crises may foster these counter-movements. Such effort provides an illustration of the theoretical flexibility of the Polanyian approach, which allows analyzing global regulatory trends without overlooking the heterogeneity they produce at the national level.

The third essay, *Capital Account Openness and Macroeconomic Performance in Brazil: assessing the interaction with financial integration*, relies on time series econometrics to evaluate the effects of liberalization in Brazil. The main contribution of this essay is the analysis of the macroeconomic consequences that stem from the interaction between greater levels of financial integration and capital account openness. At the theoretical level, the attention to different perspectives that oppose external financial liberalization converges with the Polanyian concern with the dislocations caused by liberalization, especially considering the potential complementarity between Keynes and Polanyi.

In addition, the empirical findings of the essay shed light on the potential complementarity between Keynes and Polanyi (LEVITT, 2006; 2012) by exploring how further capital account liberalization amid greater levels of financial integration tends to be associated to currency overvaluation and lower levels of activity. Such conclusion contradicts the argument that financial integration is a precondition for benefitting from the removal of capital controls, while specifies the Polanyian nexus between liberalization and socioeconomic dislocations (MISHKIN, 2005; KOSE; PRASAD; ROGOFF; WEI, 2009; GHOSH; CROWE; KIM; OSTRY; CHAMON, 2011).

Finally, it is important to highlight that the discussion of external financial liberalization came back to the center of stage after the recent political changes in Brazil. In face of the commitment of the new government with economic liberalization, mainstream economists like Samuel Pessôa (2019) have demanded further progress toward full capital account convertibility, as proposed by Arida and Arida, Bacha and Lara-Resende (2003a, 2003b, 2005). Beyond the academic debate, this PhD dissertation also intends to shed light on the empirical evidences about the risks of this old-new strategy and the potential alternatives that still exist abroad and even in Brazil's recent past.

5 FINAL REMARKS

This PhD dissertation aimed at contributing to the debate about causes and consequences of external financial liberalization, focusing mainly on the Brazilian experience. Despite the independence between the three essays, the Polanyian political economy was the main theoretical foundation of this research, being characterized by the nexus between liberalization and destabilizing effects as well as by the notion of capitalist diversity even in face of the uniformizing pressures for market reforms.

These two Polanyian concepts also help to summarize the main conclusions of this research. Regarding the capitalist diversity, for instance, the first essay concluded that Brazil's capital flows management (CFMs) have substantively changed after the Global Financial Crisis, diverging from the regulation deployed in the 1990s and early 2000s. This conclusion relied on the analysis of four interrelated factors. In terms of objectives and instruments, besides lengthening the maturity of capital inflows, the post-crisis regulations also intended to reduce their volume, combining capital controls with prudential financial regulations and restrictions over FX derivatives. The new CFMs were part of a broader policy reorientation, which attempted to replace neoliberalism by neocorporatism and build an alternative political economy coalition.

In the second essay, the same opportunities for diversity in face of the pressure for liberalization were present in the cross-country analysis. Specifically, this essay relied on Qualitative Comparative Analysis to conclude that countries have adopted intermediate capital account regimes as a mean to conciliate heterogeneous pressures from political institutions, economic dislocations, economic sectors and political parties. In the absence of this heterogeneity, countries were able to build extreme regimes like open or closed ones.

The third essay, on the other hand, focused on the destabilizing effects of external financial liberalization on Brazilian economy. Relying on Vector Error Correction models, the empirical evidence showed that an increase in the degree of capital account openness amid higher levels of financial integration does not have significant macroeconomic effects in the short run. Additionally, it was found a long-run association between this interaction and negative macroeconomic developments like currency overvaluation and a retreat of the level of activity. It is also important to note that such finding contradicts the mainstream argument that takes a high degree of financial integration as a precondition for benefitting from the removal of capital controls.

As mentioned in the Introduction, this PhD dissertation gained relevance in face of the renewed debate about full capital account convertibility in Brazil. In this regard, the presented empirical evidences about the risks of these strategies can motivate alternative paths, inspired by the experiences of other emerging countries or even Brazil's recent past.

As observed in any research, the conclusions of this study were also characterized by some shortcomings, which can be addressed by complementary research designs in the future. For instance, the empirical findings are contingent to the methodological foundations of each essay, opening the way for testing the proposed hypotheses through different methods. In the first essay, for example, the proposed theoretical framework can be used to build a comparative case-study centered on other Latin American countries. In the second essay, for example, it is possible to employ process-tracing techniques as mean to disentangle the causal mechanisms underlying the sufficient paths. In the third essay, it is worth assessing if alternative econometric strategies find similar results.

Another aspect that deserve attention is the period of analysis. For instance, none of the essays investigated the period that follows the 2015-2016 political crisis in Brazil. In this sense, future contributions should discuss the implications of the 2016 impeachment and the subsequent rise of the far-right in the country. As mentioned in the introduction, this context seems to favor the progress of capital account liberalization. However, in line with the Polanyian notions underlying this research, the political and economic dislocations caused by this process may also open an opportunity for new counter-movements, capable to replace the subordinated financialization of the Brazilian economy by alternative patterns of integration into the global markets.

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