Development through international economic integration: Institutional Change to accommodate Foreign Direct Investment in Brazil and China

Henrique Estides Delgado

ABSTRACT

Foreign Direct Investment (FDI) that was mainly flowing to developing countries before the Second World War, became increasingly concentrated among developed economies since the aftermath of the war. A similar increase in the concentration of other capital flows and trade followed suit during the many decades in which the liberal post-war international order was far from being global. In the late 20th century, increased international willingness to expand global markets was matched by changes in the economic policy of developing countries, originating a process that started to reshape economic geography and reorient FDI flows and other economic flows. Eventually, in the wake of the 2008 global financial crisis, developing countries would again receive the bulk of global FDI flows. This paper argues that the primary reason for the new distribution of FDI is the way that institutional change at the global level interacted with institutional change within countries. As such, this interaction will also define the endurance of this reorientation. To sustain this point, the paper takes the cases of China and Brazil and demonstrates that the change in the incentive structure provided by the international environment around the end of the Cold War and the creation of the WTO, was accompanied by major institutional transformations in Brazil and in China along which greater integration with the global economy was pursued. FDI that was always present in Brazil gained a new relevance, while in China it would emerge during the reform era in a way that is responsible for a large part of the unprecedented growth experienced by the country. This study also shows that well defined policies are critically important to harness FDI to further induce higher goals of development at large.

KEYWORDS

FDI, Multinationals, Institutional Change, International Political Economy, New Institutional Economics, Globalization, Global Governance, Emerging Markets, Brazil, China.

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INTRODUCTION

This is a study about how international investments inform and are informed by institutional and economic changes at large. Essentially it seeks to shed lights on how a country's development strategy can benefit from the interests of transnational corporations in order to foster convergence in a globalized environment. Most specifically, it deals with the rationale of the economic activities of multinationals operating overseas under institutional frameworks of countries that are pushing forward with reforms meant to increment industrialization, diversification of its economic activities and growth through international economic integration. Beginning with a general conceptualization and a historical account of foreign direct investment (FDI), it then focuses on the cases of China and Brazil, which are respectively the first and second largest emerging economies in the world by 2016, and are also placed in the same positions with respect to the amount of inward FDI stock.

The study of FDI merges concepts applied to understand the international flows of capital, goods and location theory. By intertwining the reasoning applied to comprehend global flows of capital and commerce with the decisions taken at the firm level, the analysis of FDI determinants and its consequent pattern of distribution across regions and industries is the very account of one of the most crucial and distinguishing features of the present stage of capitalism. Never the economic forces were so freely unleashed to expand "the scope of entrepreneurial control" (Dowrick and DeLong, 2003, p. 191) across the globe. Transaction costs have shrunk immensely during the last decades and with them there has occurred a renewed surge in the mobility of commodities, manufactures, capital and information. Accordingly, international economic integration has been increased by all these means, but none is as symbolic and as all-encompassing as the apparent omnipresence of multinationals.

Furthermore, FDI is directly related to the evolving division and use of economic power resources within the structure of international relations. If the operationalization of international trade by modern nations as means of power building is formally studied at least since the path breaking contribution offered by Hirschman (1945), and the critical importance of disposing of capital resources for guaranteeing independence and influence has also filled shelves and more shelves with carrots and sticks literature, the study of FDI also lies in the intersection of these approaches with those presented in the previous paragraph. And still it offers an extra challenge due to the multifaceted aspects embedded in FDI flows as chapter one further explores. As Feenstra (1998, p.1) points out, FDI “combines aspects of both international trade in goods and international financial flows, and is a phenomena more complex than either of these”.

Nevertheless, FDI is an extremely straightforward operation, and multinational enterprises are one of the most evident standard-bearers of globalization. Indeed, one can fairly distinguish the cultural, political, technological and social aspects often associated to globalization embedded in the operations conducted by these corporations whose businesses and interests spread over different countries across the globe. From an economic perspective their centrality as “the most important driver of globalization” (OECD, 2010, p. 9) is even more evidenced by two complementary facts. First, over the last decades the surge in international trade - which is the foremost measure of global economic integration - has gone hand in hand with the internationalization of capital and the establishment of global value chains. That is to say that an increasing amount of international trade involves corporations placed at both ends of the commercial transactions. Second, multinationals respond as well for an increasing share of the transactions within domestic markets. Indeed, an important and growing fraction of one country’s GDP is composed by multinationals. Accordingly, most of the trade taking place across countries occurs within and between such structures.

Yet, reticence regarding this process – quite widespread throughout the world – has been incarnated several and repeated times in the form of confronting the establishment and/or the permanence of foreign-owned businesses in some countries. Moreover, dissatisfaction with multinationals also arises in their home countries due to uneasiness with delocalization. And in both home and host countries issues are raised regarding remittance of profits: in the latter just because it leaves the country while in the former because it sometimes does not return but goes to third countries offering advantageous tax treatments. Quite characteristically, in times of crisis in the rich economies resentment towards multinationals and globalization at large has gained momentum.

Conceding that in a historical perspective a country's interaction with foreign actors either through trade or finance has been prone to be accompanied by suspicion and uneasiness, these feelings have been often more intractable in the case of inflows of foreign capital directed to acquire or set businesses that are meant to be directly run by the capital providers. Nonetheless, FDI has been growing steadily over the last decades. Such phenomenon is underpinned by broad and altogether crucial geopolitical and technological changes as well as some critical institutional changes both in the international stage and within countries that were chronically playing much below their potential. Probably the most significant and doubtlessly the most famous example is China. However, alongside the East Asian giant many are the countries also benefiting from this mixture of favorable international environment and effective domestic reforms to accelerate catching-up and move up the ladder of socioeconomic development.

During the last decades a vast literature was formed defining, assessing and projecting expectations on emerging markets. This study will analyze in three steps how FDI has entered in the life of the two largest economies by nominal GDP within this rather diverse group. The first task, presented in sections 1 to 3, is to explore data and facts about FDI and relate them with the concept of economic change through institutional change. Following that, sections 4 to 6 describe how the international environment evolved after the Second World War affecting patterns of FDI distribution. Then the later sections focus the analysis in the cases of China and Brazil highlighting policies involved in attracting FDI as well as those meant to integrate such flows in the domestic economy in a way that boosts development.

In order to achieve its goal, this study is framed as an "analytical narrative". Borrowing the definition from Alston (2008, p. 103) here as well the "term 'analytical' conveys the use of a theoretical framework or set of theoretical concepts and the term 'narrative' conveys the use of historical qualitative evidence". A considerable amount of hopefully convincing strong evidences is analyzed here.

1. Institutions, organizations and their place in economic change

There was no clearly perceptible accumulation of wealth in short lapses of time before the Industrial Revolution in the manner country after country would experience since then[1]. It is also true that the periods during which wealth has been amassed more intensively after the industrial revolution are those when one observes the expansion of global markets and the increase in the bonds between countries[2]. If one is able to adopt what we should concede is a rarely adopted perspective of global benefits distributed to the average human being regardless of national borders, one can only praise the overall rise in living standards brought about by greater global markets and multiple interdependence between countries, let alone the consequent effects fostering peaceful coexistence on the one hand and competitive innovation in a wider scope on the other. Of course if there is, however, one entity more prone to be at ease with such an advantage point and even be keen to stimulate it, it is a MNE.

Adapting the well known cornerstone reasoning provided by Adam Smith, it is not from the benevolence of these organizations that we expect them to favor and induce the enlargement of markets and the mobility of capital – in all its forms – beyond their original borders, but from their regard to their own interest. In a similar manner, countries hosting multinationals do so because arising from the latter's activities there is a set of benefits which are reaped by the former, benefits that are greater than the ones envisaged in autarky. The equilibrium occurs at the intersection of each party's interests, which are realized through the institutional interaction present in the transactions in which they are involved. MNEs are the institutional embodiment of the economic activity through which some of the most critical elements of international convergence reach foreign soil, be it through technology transfer, spillover effects or factor-price equalization.

The empirical results amassed so far for each one of these features provide diverging results. The simple fact of being there does not assure that the MNE, with its technologies and organizational competences, will add to the country beyond the operation itself. It can also be the case that it will only be beneficial to a particular

[1] Rather recent and providing a thorough statistical reference for such affirmation one may find Maddison (2001, 2005). His efforts to quantify very long term trends and changes occurring in the world make clear how growth prior to 1820 was mostly extensive: population grows and production grows to accommodate such grow. One may concede here, however, that some booming increments in wealth originated time to time from war spoils and the result of mercantilist trade or exploitation taking place in foreign lands. Which were not, nevertheless, by any account, able to provide something similar to the altogether intensive growth turned possible since the Industrial Revolution.

[2] See Section 2.1 for differences between the first and second waves of globalization.

group, thus, making little difference for the majority of the society, and even sometimes worsening the preceding equilibrium. Therefore, it is something that will definitely depend on how the institutional framework of the country absorbs the MNE and harness its presence in order to enhance some of its own traits. It depends on the institutions in place and the overall willingness of the society to improve and change dysfunctional constraints and, especially, it depends on punctual decisions performed by those controlling formal institutions, something that may be complicated in the face of vested interests.

It is worth emphasizing that this thesis draws on the definition of institutions provided by Douglass North, one of the preeminent scholars in the field of new institutional economics. According to him:

> Institutions are the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights). Throughout history, institutions have been devised by human beings to create order and reduce uncertainty in exchange. Together with the standard constraints of economics they define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity. (North, 1991, p. 97)

Furthermore, as North (2005, p. 59) argued, “institutions are the rules of the game, organizations are the players; it is interaction between the two that shapes institutional change”. Therefore, most of what will be in evidence here are the relationships between the host-country institutions and organizations with the arriving MNEs. Of course, institutional change and hence economic change do not need the presence of a foreign organization to occur. That is out of the question. Nonetheless, what is argued here is that foreign organizations may be cooperating to catalyze a desired change that otherwise would be costlier to achieve.

As earlier stated, this study is framed as an "analytical narrative". Borrowing the definition from Alston (2008, p. 103) here as well the "term 'analytical' conveys the use of a theoretical framework or set of theoretical concepts and the term 'narrative' conveys the use of historical qualitative evidence".

2. **What is the role of FDI in the process of economic change? The case for case studies**

The operations of MNEs help to improve resource allocation throughout the globe and they do so mainly, in a first moment, by circumventing market failures (Dunning and Lundan, 2008, p. 85) and in a second perspective by inducing institutional change in the fashion proposed by North (1990) in a way that often results in a better economic performance. More than trade in goods and services, or portfolio investments, FDI is the most profound form of international economic integration. An integration that has rescued many lives from extreme poverty and deprivation in many corners of the world that were until recently economic backwaters. This is an important discussion nowadays, because one can easily notice strong political forces agglutinating and strengthening themselves within developed nations against globalization.

Nevertheless, a careful approach needs to establish very early that the operations of multinationals are no panacea whatsoever to the improvement of global living standards. If the MNE is keen to expand its access to resources and markets by operating abroad, the way it will implement its plan, and whether it will foster consequential economic change or not, depends largely upon the manifest interests of the host country's constituted power. It depends upon the interaction of the MNE's interests, the host country's interests and the system of incentives that is leading the relationship. As in every game it depends on the matrix of interests of both players, in this case the host country on one side and the foreign organization on the other. What is more important is that the set of interests ruling each party is a function of each one’s constituent institutions. The MNE, as an organization, is an institution by itself. On the other hand, a country is a composite of institutions, and, as a sovereign, it has the capability to frame most of the relationship. As a result, the quality of the outcome in terms of social well being in the host country depends on how these relationships are built and how the MNEs are harnessed by the host country to further its development goals. In the end, the process of economic change depends upon a country's factor endowment and the institutions governing them. Once the necessary institutions are in place a country will be able to reap the benefits of integration. Otherwise, the incentives for opportunistic behavior tend to be too strong, thus perverting the relationship. The transition to becoming a thriving modern economy is a daunting challenge for countries with rather dysfunctional institutional framework and delicate governance capability.

As pointed out by North (1995, p. 18) "institutions are formed to reduce uncertainty in human exchange". But that does not imply that any predictability is good enough. Some may indeed be very harmful. Correspondingly, one should agree that institutions are also changed to reduce the prevailing dysfunctional stagnation, thus fostering human exchange. That is what this study takes by institutional development. And here one may find the narrative of the changes that were performed in order to enhance international economic integration in Brazil and China. In this study the primary measure of international economic integration is inward and outward FDI, but the implications of FDI in further international integration will also be briefly covered.

China and Brazil: two case studies on the role of FDI

It is already well established how valuable a comparative analysis of Latin America and East Asia is for assessing two different models of industrialization applied across the last decades in a more or less uniform fashion. Indeed, despite undeniable differences within each region one may fairly ascribe, for the sake of generalization, import-substituting versus export-oriented practices as a suitable and coherent advantage point to compare, respectively, Latin America versus East Asia in their struggle to forge industrialization after World War II. This study proposes a narrower focus within these two regions that will make emerge the characteristics of their two biggest countries by area and population – and more recently by GDP as well. Furthermore, instead of focusing on industrialization, growth, and development at large, here one will find an analysis of the characteristics of FDI flowing in and out of these countries and how such activities inform and are informed by the institutional framework present in each one of them. This study shows that despite the fact that both are large recipients of FDI independently of categorization as well as large sources of FDI among emerging economies, there are contrasting characteristics in the kind of FDI flowing to and from China and Brazil during the last decades. Although straightforward geographical features and factor endowments are an insurmountable part of the explanation, different institutional frameworks also play a critical role.

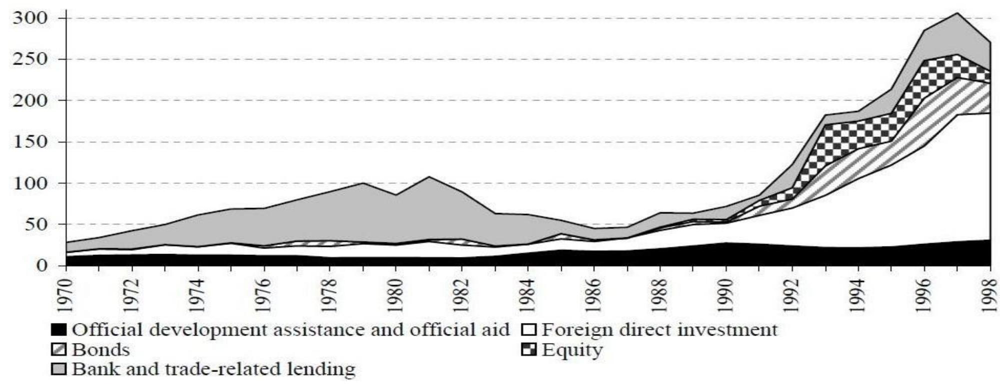
Considering that both countries have been experiencing a great deal of economic change during the last few decades, this study proposes an account of the role of FDI within such process as a factor that on the one hand responds to the set of institutions encountered in these countries while on the other increasingly informs the process of institutional change either by their own action within the host-country borders or by the growing willingness on the part of these countries to comply with what is perceived as an attractive environment and set of incentives for alluring foreign multinationals and promoting the international expansion of national ones.

As Moran (2011) points out, there is a need for more investigation on the political economy of multinational investors and host-country policy-making. As he concludes, a new and more desirable framework of "research about the relationship between FDI and development cannot simply ignore the real-world political economy of host-country policy formation" (p. 142). This study originates from this understanding and adds the broader institutional framework underpinning policy formation as a means to analyze economic change.

3. Historical trend of capital flows

From the different ways that capital may flow across countries FDI has been receiving increasing attention after the Second World War, but it was not until the early 1990s that it started to have a trajectory that would give it the largest share among capital flows to developing economies (figure 1.1). FDI took the place of loans, which since the 1970s had been accounting for the majority of private flows. Indeed, private flows would boost total capital flows and become by far the major source of foreign capital.

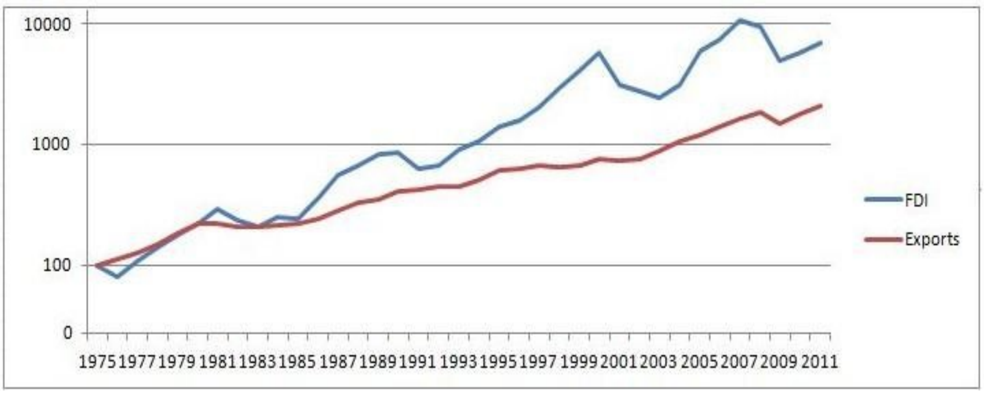
Figure 1.1 Net Capital Flows to Developing Countries 1970-1998: By Type of Flow (in billions of constant U.S. dollars)



Source: Schmukler and Zoido-Lobatón (2001)

The sharp increase of FDI occurred on a global scale. And since the second half of the 1980s FDI has skyrocketed, consistently increasing in a pace much greater than international trade, even if the former tends to be more affected by crises than the latter (figure 1.2). If FDI has increased much faster than world trade since 1985, the latter has in turn increased much faster than the world's GDP. Indeed, average export growth has been around twice the average GDP growth[3].

Figure 1.2 Index of current value of exports and FDI inflows, 1975-2011, 1975=100 (log scale)

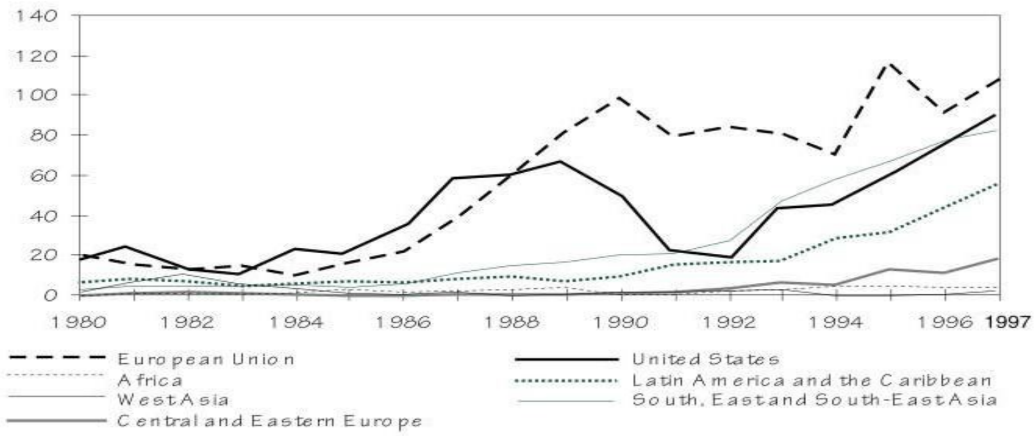


Source: World Development Indicators (World Bank)

Initially this boom in FDI was concentrated in developed economies. Within this group, flows within the EU that were gaining momentum in the second half of the 1980s are responsible for a large share of the total amount (Figures 1.3 and 1.4).

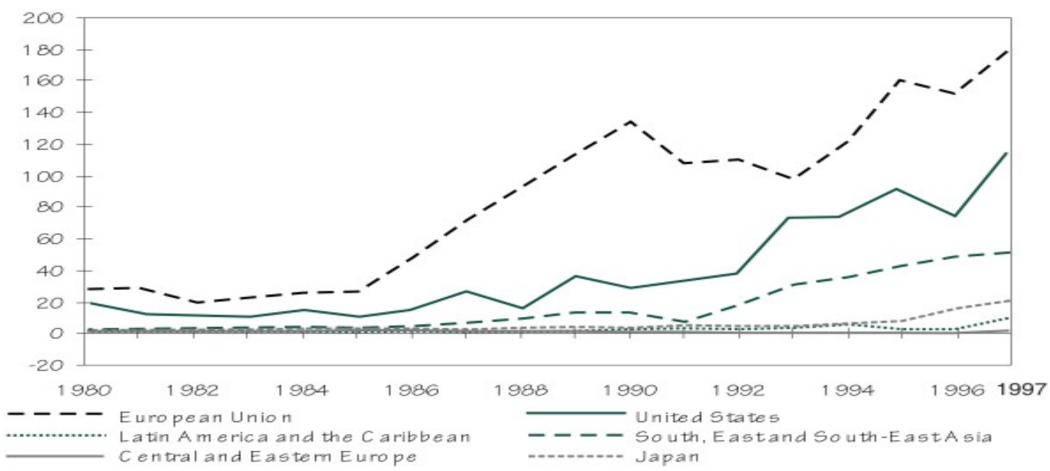
[3] One can observe this pattern on the statistics released by the WTO in its annual World Trade Report.

Figure 1.3 FDI inflows, by major regions, 1980-1997 (Billions of dollars)



Source: UNCTAD (1998)

Figure 1.4 FDI outflows, by major regions, 1980-1997 (Billions of dollars)

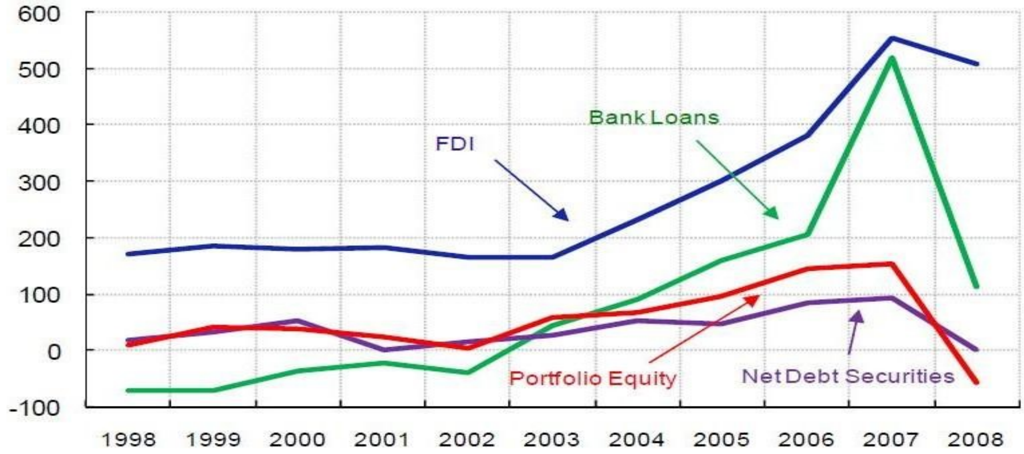


Source: UNCTAD (1998)

However, a surge of FDI to emerging markets, especially from Asia and Latin America, becomes discernible from different starting points during the 1990s, something that will be explored in the following chapters.

In the first decade of the twenty-first century bank loans increased again, but they never went beyond FDI (figure 1.5) and were deeply affected by the crisis.

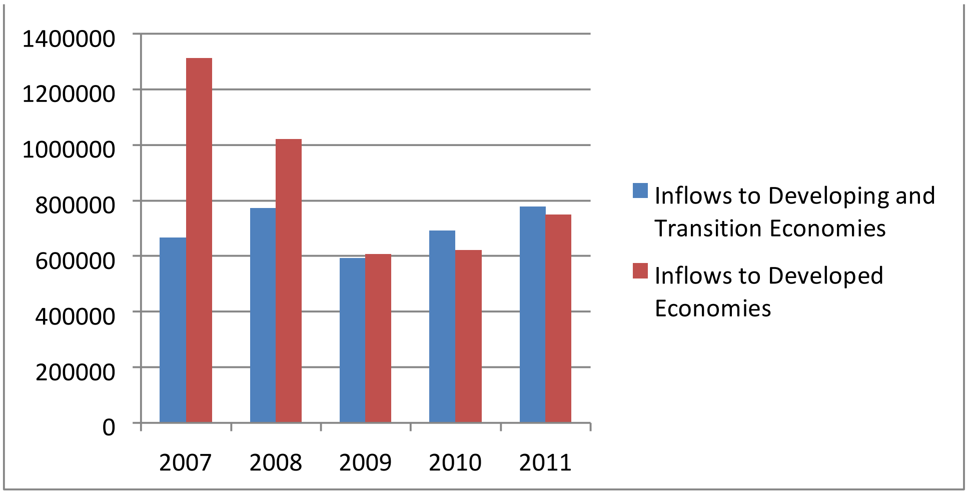
Figure 1.5 Private Capital flows to Emerging Markets, 1998-2008, billions of US$



Source: Cetorelli and Goldberg, 2009.

On the other hand, FDI toward emerging markets has demonstrated resilience after the crisis. While global FDI flows to developed economies have halved in the immediate aftermath of the 2008 financial turmoil, FDI toward emerging economies was not deeply affected (figure 1.6).

Figure 1.6 FDI inflows by group of countries, 2007-2011, millions of US$



Source: UNCTAD, 2012.

The world that emerged from World War II (WWII) was a place relieved from the ultimate fascist challenge to humanity on a global scale. But it was also a world heading to a period of continuing atrocities springing from authoritarian rulers, remaining and surging fascist states of all stripes, and violent fractious groups within many societies. Associated with an unprecedented worldwide feeling of unsafety and fear inspired constant political ideological patrolling and harassment arising from the Cold War, the economic consequences of this ideologically divided and conflagrated world - increasingly subsumed under the sway of a security first rationale in world politics - would be the unbalanced distribution of the great expansion and modernization of production taking place.

Indeed, economic integration informing and informed by economic change would have to wait until the last decades of the century to start decisively reaching the bulk of humanity. Before that, the capitalist "Golden Age" (1947-73) rapidly reconstructed Western Europe, impelled Japan and West Germany towards the economic status their societies had long and stubbornly aimed at, and catapulted the United States to the pinnacles of power and plenty. Concurrently, it was contended by industrial prowess in the USSR in a dispute observed and avoided as much as possible by the non-aligned world. This study will soon focus on the cases of Brazil and China during the more recent period of their histories starting from the 1980s. But before that, this chapter reveals the historical antecedents to such events. That is, the global political and economic environment in which globalization was reborn . Accordingly, before spreading to a wider number of nations, the process of international economic integration has increased divergence rather than convergence on a global scale not only from a political economic point of view, but also in the more mundane measurement of income and participation in global trade, as well as other transnational flows that bring countries together. There was a core and a periphery that were very much delineated by politics, translated into institutions. Globalization is not ending with the periphery, unfortunately, but diversifying the distribution of cores and peripheries in a more comprehensive global scale.

This chapter begins by defining waves of globalization while pointing out the place of FDI in these waves. Then it identifies the position of our two countries within the wider context of late-industrializing economies in their struggle to develop themselves. Once these two critical definitions are provided this thesis will develop an account of the contextual difficulties and inherent idiosyncrasies informing the period between the aftermath of WWII and the final blows of the Cold War. For the beginning of the covered period it is easier to establish the end of WWII as the starting point. However, its conclusion is not completely straightforward as different events in the

1980s and early 1990s compete for the place of the most decisive one as it comes to this narrative on FDI. For this very reason some overlapping will occur with the time frame proposed for the next chapter, although the analyses will cover different issues. This chapter finishes by exploring the current distribution of FDI in the world pointing out the shares of Brazil and China.

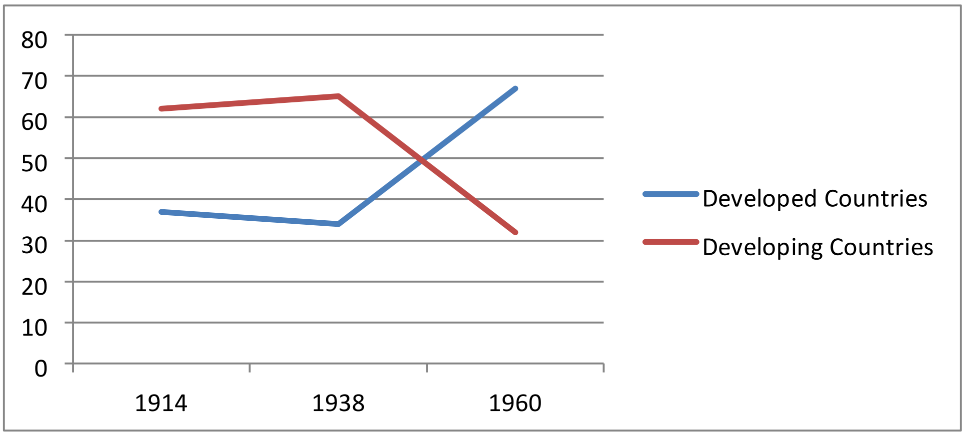
4. Waves of globalization and capital flows

In the first wave of globalization (1820-1914) most of the capital flows followed the trajectory predicted by neoclassical theory. That is to say that they flowed from relatively capital-abundant countries into relatively capital-scarce countries, where assumedly the returns to capital would be higher. If on the one hand MNEs during this period were explicitly used as arms of the most powerful states in the process of overall competitive expansion sought by them, on the other hand their investments have critically contributed to a large amount of infrastructure building and some local provision of industrialized products, thus kick-starting industrialization in many countries. Concurrently, a significant number of entrepreneurs would also flow mainly from Europe into the New World, some of them leaving the former for good. Even if this is not something one may consider a MNE by today's standards, "it had many of the features of [today's] FDI" (Dunning and Lundan, 2008, p. 150) insofar as it regards the contributions to the host economy. By the end of this period (1914), 62% of the international stock of FDI was located in what are today's developing countries. China alone would count on 7.8% of total FDI, while Latin America had 32.7% (Dunning and Lundan, 2008, p. 175).

The second wave of globalization, which is the subject of this chapter, does not reproduce such a pattern. Quite the contrary, it produced a paradoxical result of capital not flowing from wealthy into poor countries famously examined by Lucas (1990). Indeed, capital was not only dismissing what neoclassical models predicted, but they would, decades later, start to flow massively from poor to wealthy countries. Before that, in 1960, the share of FDI stocks in developing countries had shrunk to 32.3%. Latin America had half of this amount (15.6%) and the then decade-old People's Republic of China had already closed its doors, ideologically and legally, and no FDI could be counted there.

That would demonstrate the maturation of a trend initiated after WWII. Accordingly, international investments that collapsed during the war, once the war had finished would be directed mainly to developed countries (see the switching positions in figure 2.1). Such pattern would persist for several decades, in which intra-industry trade has grown at a faster pace than its inter-industry variant. A phenomenon accompanied by a surge in FDI widely concentrated among developed countries. Accordingly, in this novel pattern, US firms invested massively in Europe. European firms then started to massively invest in America, while the Japanese invested in both once they had caught up with them. Doubtlessly, intra-industry trade is even more reinforced through such pattern.

Figure 2.1 Estimated stock of FDI in developing and developed countries, 1914-1960 (in percentage).



Source: Dunning and Lundan (2008, p. 175) and UNCTC.

The next sections examine the patterns of distribution of FDI during this period when the Lucas paradox, related to capital flows in general, was consistent for FDI as well. As stated by Jones (2010, p. 16), “during the 1960s and 1970s there was a general exodus from developing countries”. Investors would rush to concentrate their resources in the triad composed by the United States, Europe and Japan, where growth was much more rapid and less exposed to uncertainties. The pragmatic and strategic rationale behind this exodus would be crowned by a set of considerations on the pattern of innovation and world distribution of production and consumption that may be found, for example, in Ohmae (1985). Rational enterprises in search of consolidating relevant market shares and guaranteeing access to the latest innovations should, the idea goes, find their way to become a “true Triad power” in order to “enhance their global competitive position” (p. 150) and only as a second step “choose a few developing nations” in which to build “strong operations” and act responsibly to “help solve the otherwise unmanageable problems between the northern and southern countries” (pp. 163-164). Interestingly enough, Ohmae defended the case that the construction of this improved and profitable relationship “should not be left to political governments, which […] have a tendency to get involved in unrealistic diplomatic exercises” (p. 164).

In the 1980s FDI increased far more rapidly than both world output and world trade, and the amount of intra-triad FDI nearly tripled (UNCTAD, 1991). Nevertheless, things would start to change in the late 1980s, gain substance in the early 1990s, be confronted and matured in the late 1990s and then kick off in the 2000s. This long cycle would give signals that may be coming to an end in 2010, when for the very first time since modern measurements were established “more than half of global FDI inflows” would be absorbed by developing and transition economies (UNCTAD, 2011, p. xii). Such pattern has been confirmed in the last data released by UNCTAD concerning 2014. Indeed, when the global financial crisis came, from the perspective of FDI, a new world (re)emerged with non-developed countries consistently receiving what is set to become the bulk of world inflows of FDI. The arrival of the crisis a bit latter in China and especially in Brazil has proved relatively equally strong but almost didn’t change the amount of FDI inflows.

Decades of massive inter-developed countries’ FDI flows have caused, however, a big difference in FDI stocks, which are nowadays by far accumulated among them. Therefore, by the end of 2011 developed countries had slightly less than twice the amount of stocks located in developing ones.

5. From the Santiago dissension to the Washington Consensus

In the discourse on development, the Economic Commission for Latin America and the Caribbean (ECLAC), a United Nations body established to encourage development in the region, won recognition in the very first decade of its existence for its endeavors to encourage industrialization to reverse the legacy of underdevelopment in the region. The historical-structural analysis, seminally developed by Raúl Prebisch to explain the barriers to peripheral development and offer solutions, confronted a division of production and foreign trade, legitimized by the theory of comparative advantage developed by David Ricardo, and further explained by the Heckscher-Ohlin model, among others. Prebisch's study was based on an observation of business cycle effects on the price relationship between the central countries' industrial products and the peripheral countries' primary products . He tested the hypothesis that this system would evolve over time to form a balanced relationship and concluded that this should be rejected because “in the course of the cycles the gap between [the prices of primary and industrial products] is progressively widened” (Prebisch, 1949, p. 13).

The challenge launched by Prebisch was aligned with a formulation that denies the theorem of equalization of factor prices enunciated two decades earlier by Heckscher, as well as its softer variation according to which there would occur a convergence rather than equalization as amended by Ohlin . Undoubtedly, this line of thinking has ardent supporters to this day, despite the remarkable structural change in the world that led to a surge of commodity prices over the last years. Such reasoning stresses the complicated side of liberalization. According to this view, even if the overall gains are positive, the sacrifice within a country is not compensated for. An earlier example of this argument goes back to a review of Eli Heckscher's book Swedish Production Problems:

> From the point of view of the world economy nothing is more beneficial than that those parts of the earth best suited to the production of raw materials be devoted to that purpose, even if their population is thereby rendered sparse; for the Swedish people as a nation, it is a different matter (Wicksell, apud Findlay, 1995, p. 2)

As Findlay (1995) then points out this discussion would reappear decades later in the face of the “Dutch Disease”, where worries about depopulation were substituted by deindustrialization.

During most of the twentieth century, countries saw free trade regime with disdain and suspicion. Frequently, highly charged national issues led to a quest for maximum production within national borders. Therefore, governments regulated international trade to encourage local industrialization. In Brazil, government ministries rather than civil society decided what to buy and sell in the external market. The taxes, trade barriers, and quotas imposed were so severe that the market no longer had much space for maneuver. Only imports that would assist internal production were encouraged, for they would increasingly allow for a further decrease in trade or - as the argument goes – reduced dependency.

In his groundbreaking work on economic structures, Douglass North, while analyzing the intricacies of institutional evolution, emphasizes the importance of the historical formation of a country to explain both created and lost opportunities. He warns that, depending on the establishment of a certain institutional apparatus that provides low stimulus to efficiency, there may be a skewed spread of ideologies entangled, even if not objectively, to maintain existing restrictions on true development.

Who is to blame for the poor economic performance of developing countries is a widely debated topic. Obviously, it is often easier, and self-justifying, to blame the external agent and understate the precariousness of the domestic institutional framework. Indeed:

> Both the writings of the ECLA and dependency theory explain the poor performance of Latin American economies on the basis of the international terms of trade with industrial countries and other conditions external to those economies. Such an explanation not only rationalizes the structure of Latin America economies, but also contains policy implications that would reinforce the existing institutional framework. (North, 1990, pp. 99-100)

The promotion of import substitution strategies in order to industrialize, then seen as key to development, was implemented in Brazil, as in many other countries, in an obstinate (but contradictory) way that was not spared from critical reviews, which argued that this would result (and indeed resulted) in a kind of isolationism that aroused not only technological backwardness, but also income concentration in the hands of a privileged few. Given the size of its economy, Brazil was more successful than others in the intent to raise a diversified industrial park within its highly protected economic borders. However, by isolating its economy from many technological advances in the core countries, insofar as it exaggerated the dose of protectionism, the country would be plagued by many dysfunctions widely exposed when faced by external shocks that hammered the sustainability of that strategy. Sooner or later scholars and pundits realized this. Bielschowsky (2000), in a review of Fajnzylber (1983, 1987), stresses how he pointed out such "weaknesses in the industrialization model of the past, which was insufficiently responsive to technical progress and often hampered by rentier attitudes of local business classes." Prebisch himself, already in the mid-1960s, recognized that Latin America was configured as a whole "industrial structure virtually isolated from the outside world" (Prebisch, 1964, p. 89).

Either way, the isolation often derived from the international context of a polarized world split between capitalists and socialists, on the verge of a conflict that could be tragic. There was no space on the agenda of world industrial powers (especially the U.S.) to discuss and remedy the alleged chronic disadvantage of the North-South dichotomy. In many senses the overwhelming pressure towards an almost obsessive idea of wide-ranging national industrialization was born from the very lack of harmonious world governance, which discouraged full-fledged interdependence and, consequently, specialization in the world economy as a whole. Symptomatically, a proposal to create the International Trade Organization, which would complement the International Monetary Fund (IMF) and the World Bank, was repeatedly barred by the American Congress and was then abandoned altogether. What remained was the General Agreement on Tariffs and Trade (GATT), something far short of the expectations of the South.

> A group of twenty-three Northern "like-minded" countries began tariff-cutting meetings in Geneva. (…) Instead of the universal membership foreseen for the ITO, the GATT addressed the interests of the advanced powers: lowering trade barriers in industrial goods and services where they had a comparative advantage, while ignoring agriculture and textiles where developing countries had an advantage. (…) Instead of a single global trade organization as envisaged in 1945, a fissure had opened up in the international community between the GATT and the rest. (Dosman, 2008, pp. 379-380)

Indeed, “until the Uruguay Round of trade negotiations began in 1986, multilateral trade deals tended to be limited to the industrial countries” (IMF, 2006, p. iii). Thenceforth, with the replacement of the GATT by the World Trade Organization (WTO), a great deal has been achieved with respect to international arbitration on trade matters.

Convincing the developed world of the need to establish a New International Economic Order (NIEO) was indeed a hard task. Developed countries were satisfied with the GATT and its operation. On the other hand, developing countries were increasingly aware of their right to development and knew that the speed of this process was dependent on a more favorable access to international markets. With the intention of establishing multilateral agreements favorable to their causes, they acted as a group, addressing the demands of underdeveloped countries in a more resounding manner. In this context, the Group of 77 was formed in 1964 in the wake of the first United Nations Conference on Trade and Development (UNCTAD), led by Raúl Prebisch in Geneva (Dosman, 2008).

Since then other groups would be formed with the intention of coordinating the interests of developing countries (like the G-24) and developed countries (like the G-7) in multilateral bodies. And in due course the cleavage between developing and developed countries would start to be replaced by a concept based on the size of the economies, with the G-20 being created in 1998 and finally becoming an important component of the global governance architecture one decade later . But this idea of a more comprehensive forum to discuss global governance would only come after decades in which the cleavage between developing and developed countries was strongly marked. In this scenario, developing economies pushed for the creation of specific organizations at regional level and at global level, like UNCTAD, where they could pass their agendas.

UNCTAD was idealized and conceived in a period in which the problems of the Third World were articulated with a relevance that was rare during the Cold War. With the tragic death of Dag Hammarskjöld, U Thant, a Burmese, became the first representative of the Third World to hold the post of UN Secretary-General. It was the time when the U.S. was ruled, until his assassination in 1963, by John Kennedy, who, desiring a better relation with Latin America, launched the “Alliance for Progress,” which promised much but, although designed to last 10 years, foundered in neglect after his death. This regional initiative would come hand in hand with a broader “determination to do great things, to be a conscious shaper of the history of his times” (Plank, 1962, p. 800).

However, even when apparently seeking to shed the spotlight on and engage in the pursuit of equity in the global scenario that often separates the exploited and the exploiters, the confrontational tone with respect to the USSR eventually permeated actions and directed priorities. This was the big reality: there was a question of first order to be treated, cared for, and if possible resolved. And this was not the development of peripheral countries, regardless of the speech.

The growing conviction that there was a disregardful and biased treatment by the central countries over those who were eager to overturn a trend of increasing strong discrepancy between the haves and the have nots, reinforced the spreading of theories that focused on the center-periphery dynamic. The bitter fatalism of narratives like the one proposed by Cardoso and Faletto (1973 [1970], p. 32), which argued that it was “clear that from its beginning the capitalist process implied an unequal relation between the central and the peripheral economies, one among the former and a different one between them and the latter” would set the pace for reactions on globalization in poorer countries. As time went by and people became aware of alternatives that consciously seized the opportunity of international economic integration as a means to more effective and sustainable development such approaches became rather dated. As Bhagwati (2004, p. 445) points out:

> Many poor countries that bought into these fearful ideas and turned away from using international trade and investment flows as opportunities to be seized turned out to have made the wrong choice. Their failures, and the example of the success of the countries of the Far East that used international opportunities to great advantage instead, have proven salutary. The result has been a turn by the South toward more globalization. The sociologist Cardoso, who had warned of dependency, became President Cardoso of Brazil, seeking to take Brazil into more, not less, globalization.

The East Asian experience with export promotion and the place of FDI in it will be further assessed in the next chapter. By now, regarding import substitution industrialization (ISI) in the early case of Brazil, what introduced different dynamics in this relationship was the establishment of MNEs in the Brazilian industrial sector on a large scale, in a trend that started at the beginning of the second half of the twentieth century and matured over the years. Doubtlessly, foreign investments, especially American, were already flowing into the industrial sector since the 1920s when it was still incipient in a country that had four-fifths of its population in rural areas. But after WWII, industrialization accelerated vertiginously, increasing 8% per year on average between 1945 and 1980 when it resulted in the seventh largest industrial sector in the world. In this process FDI contributed with roughly one third of total investments on average (Fritsch and Franco, 1991, p. 25). Despite persisting structural shortcomings, an increasing diversification took place targeting the national consumer durables market to an extent that would foster growth in overall demand in an increasingly urbanized country willing to uphold such a trend.

The leading international groups are well represented in the entire industrial structure, having complete control over the consumer durable goods sector. They are also decisively present in capital goods sectors, where they represent more than 50% of the production value represented by the sample of large enterprises. They share the leadership of non-durable goods markets with national enterprises.

> (…) They share the leadership of the strategic sectors of basic inputs with public enterprises. (…) Irrefutable evidence of leadership by national enterprises is only found more frequently in typically competitive markets. (Façanha e Tavares, 1980 [1977], p. 346)

In this moment of strong industrialization through FDI, Brazil began to increase its list of industrial exports. As thoroughly examined by Fritsch and Franco (1991), FDI was a decisive part of two distinct phases in the Brazilian process of industrialization and the orientation of its production. Before the early 1960s the first (and often the only) goal of the multinationals in Brazil was the domestic market. Overseas sales had always been only complementary. The only activities decisively focused on foreign markets were those related to extraction and agriculture, as it has always been the case due to strong natural comparative advantages in these areas.

However, industrial exports did in fact increase after the mid-1960s, changing the level and diversifying the design of Brazilian foreign trade.

Nevertheless, this new orientation faced many hurdles, of economic struggles and of will, and the fact is that there was never a decisive orientation towards industrial exports as in the case of the East Asian countries. The ongoing process of internationalization of production within Brazil occurred similarly in other corners of Latin America and the world. Brazil, however, stands out for having been able to implement a more successful model of partnership with foreign capital compared to many other countries. Certainly, much of this resulted from the larger size of its domestic market, which allowed more favorable negotiations due to intrinsic locational earnings — as MNEs were guaranteed a satisfactory means to settle down and have access to the expanding market. These were effective allurements indeed.

Regardless of the degree and form of the country's dependence on multinationals, however, their impact on the structural changes that would take place can hardly be overstated. Once installed, they cooperated for economic growth and helped change the mindset about relating to the world. They have also raised competition, and therefore competitiveness, in many crucial areas where national enterprises were already well established, especially among non-tradables. However, there are also many cases in which the route followed resulted in high market concentration resulting in some inefficiency. These would later highlight the need for change in the model, which, on the one hand, was extremely receptive to foreign capital in the form of FDI and, on the other, maintained a very high level of protection for the economy. The level of fragility was widely exposed when the international scenario entered turbulent waters. The oil shocks and the subsequent debt crisis worsened by the American decision to raise interest rates hampered growth, ignited an inflationary spiral and retracted FDI. As Cooper (1992) points out, the hardship during the 1980s – which was a reality for debtors and creditors alike – raised two opposing views, both of which indulged in "a natural human penchant for finding a scapegoat" (p. 128), a scenario that is very telling for today's world as well. One blamed the banks that engaged in a folly of lending in subprime conditions, while the other has conversely pointed the finger to the debtor countries, whose uneconomic projects sustained by debt were irresponsible and hazardous.

The political situation in Brazil changed significantly in the late 1980s, at a time when new economic policy doctrines were gaining prominence in Latin America. These culminated in the reform period eventually labeled as the “Washington Consensus” (Williamson, 1990). Among other things, it highlighted the need for liberalization of imports, with exchange rates determined by the market and the elimination of non-automatic import licenses.

Despite the exaggerated criticism that this “Consensus” represented the diktats of the central countries, the fact remains that the perceived need to open up the economy had been increasingly felt even within the “non-adherent” circles such as ECLAC. One should not underestimate the paramount importance that local ideas play in the goals of the different regions of the world.

> In the post war era, the pronouncements of the Economic Commission of Latin America (ECLAC) have been accorded the status of gospel truth. When it advocated dirigisme, that became the policy for most of Latin America, when it finally endorsed economic liberalism in the early 1990s that has become the new gospel (Lal, 1998, p. 9)

To gain access to the markets of developed countries, developing countries agreed to follow the trade liberalization path since the Uruguay round, which was the most important round since the 1940s, in the sense that it was at the same time comprehensive and effective, converting most of its ambitious goals into practical resolutions. However, many issues affecting the interests of developing countries were left for the Doha Round, which began in 2001 but is still stalled, mainly over negotiations on agriculture.

In fact, what would impress a candid observer was the shift of technical opinions endorsed by the core countries (which dealt with the urgent need to reduce barriers in order to attain more positive conditions) and their protectionist performance in acquiescing to the demands of less competitive sectors of their own economies. And that is something present not only in the Doha round, but in the whole process of globalization. As Stiglitz (2003, p. 6) points out:

> The Western countries have pushed poor countries to eliminate trade barriers, but kept up their own barriers, preventing developing countries from exporting their agricultural products and so depriving them of desperately needed export income.

Curiously enough, the WTO, that was finally created to conclude the trio of institutions originally thought at Bretton Woods, and is praised for having been constituted in a far more legitimate structure, inasmuch as on a broader and more balanced basis than its earlier peers, has been having trouble to deliver the goods through its truly multilateral and rather democratic modus operandi. The profusion of regional trade agreements that circumvent the broader liberalization process under the auspices of the WTO is a clear issue, and indeed constitutes a harbinger of what is to come. Some realistic observers (see Subramanian, 2013) call even for a de-democratization of the WTO in order to restore its effectiveness and guarantee its own survival as a meaningful forum. The fact is that promoting global governance through multilateralism is an intricate construction dependent on values which can only arise through an appropriate set of incentives. And as such it may be faced by rebounds, especially potentiated by crises: such as the one we are living today worsening the possibility of "a retreat from multilateralism", as warned by Pascal Lamy (2012).

Even considering that the world has experienced remarkable institutional harmonization throughout the last decades, especially since the collapse of communism - "with regard to trade policy, legal codes, tax systems, ownership patterns, and other regulatory arrangements" as discussed in Sachs et al (1995) – one cannot say that countries that have reformed themselves in order to pave the way for and foster their international economic insertion are all like-minded with regards to the way such integration should occur.

Even though Brazil and China have participated in rather different manners in the pre-1980s arrangements they share some fortuitous similarities during this booming FDI era. Beyond the fact that both are big recipients of FDI – indeed consistently the two largest among emerging economies – both of them also share the willingness to harness their international economic integration for clear purposes of economic change within their borders as well as institutional change in the world at large. Their differences are in the policies governing the way FDI fits in their strategies, and how it is used in their economies, something this study will explore in the next chapter. But before that, let's explore the present distribution of FDI in the world focusing in the regions of Brazil and China.

6. International Distribution of FDI

Of the US$ 20.4 trillion FDI inward stocks spread throughout the world in 2011, 63.9% was in the developed world, 35.6% within the European Union, 32.4% in developing countries, 17% in the USA, 11.2% in East Asia, 3.5% in China, and 3.3% in Brazil. 2007, the year before the worst global financial meltdown since the 1930s, was also the year when FDI flows attained their historical peak: US$ 1.8 trillion (UNCTAD, 2009), an amount roughly equivalent to 2012's Canadian GDP. Over the last five years, however, FDI flows were also shaken by the global economic crisis and have reached at maximum an amount 23% below their 2007 record (UNCTAD, 2012). However, China and Brazil remain not only as top destination for FDI, but also the FDI flows to these countries defy the crisis and keep rising, confirming expectations that under a liberal international environment "recessions in industrial countries are likely to increase FDI flows" to best positioned developing nations (Levy-Yeyati et al, 2003).

China plus Hong Kong and Macau had in 2010 a total of US$ 1.868 trillion FDI inward stock. That makes for 81.4% of the total US$ 2.292 trillion FDI inward stock present in Eastern Asia. China mainland alone has 31%, while Hong Kong concentrates almost half (49.6%). On its turn, Brazil's US$ 669.670 billion in inward stock represents a 32% share of total inward FDI stocks in Latin America, an amount that rises to 43% if one excludes the Caribbean islands from the count. This percentage is roughly equivalent to the country's 47% share of the total GDP of the region.

As long as gravity equation is always present at the top of FDI determinants in empirical analysis, the first unifying characteristic accounting for the top positions of both Brazil and China is the incremental GDP amassed during the last years. From the market perspective incremental GDP is the "defining variable that signifies the growing importance of the Emerging Markets" (BBVA Research, 2011, p. 9). From 2000 to 2010 China and Brazil are placed respectively in the first and third positions in terms of incremental GDP. Over the period China added US$ 4,679.779 billion to its GDP while Brazil increased its own GDP by US$ 1,447.896 billion (IMF). Between them lies the United States which added roughly the same amount as China.

7. **Brazil and China: two paths to prosperity**

China has arrived at the year of 2012 with a population of 1.35 billion and a GDP of 7.318 trillion in current US$. In its long, rather constant, and resoundingly successful march towards the four modernizations[4], China exceeded expectations, dismissed several dire predictions about the sustainability of its institutions and development models and finally arrived at the positions of top world's exporter by 2009, second largest economy in the world by 2010, number one manufacturing country by 2011, and largest trading nation by 2012. If nothing decisively disrupting occurs, either originated within the giant country or impacting it from the outside, the future will bring what the most authoritative statistical scenarios forecast and China will surpass the United States to become the largest economy on earth sometime during the next decade.

After lifting an altogether unprecedented number of people from extreme poverty and freeing its immense society from the shackles of repeated disastrous economic mismanagements, today's China has become an upper-middle income country and a leading economic powerhouse to the world. Of course the Chinese scenario is not all rosy, for years of economic expansion have resulted in deep imbalances and social fractures. Moreover, it is not wrong to say that in great part the expansion itself was underpinned by such imbalances, which were managed through policies that were either applied or postponed depending on how they got along with the country's core interests. As a result the country has experienced – hand in hand with its unprecedented growth secured by macroeconomic stability and high investment rates - an increase in income inequality that is deepened by regional disparities, legal fragilities, and persistent distortions in a vast set of markets that are

4 Originally the flagship of Zhou Enlai's propositions, the Four Modernizations would be later espoused and bolstered up by Deng Xiaoping who would turn it into the core of its policy agenda alongside, and hand in hand, with the open door policy.

somehow controlled by vested interests[5]. These are troubling shortcomings that the country knows it will need to address in order to keep a sustainable trajectory. Indeed, “the case for reform is urgent … and the calls for reforms within the country have never been louder” (World Bank[6], 2012, p. 65).

But if the planned market economy that was put in place has delivered the main objectives that were stipulated, it did so by skillfully adapting its society and the economic mechanisms of commerce and investment in a way that intensified the obtainment of increasing levels of technology, for “the rate at which lagging economies catch up is determined by their ability to absorb ideas and knowledge from the technology frontier” (Rodrik, 2011, p. 3). Quite decisively, 1978 marks a watershed for the country, when critical reforms started to be implemented opening the doors to economic success.

Brazil, in turn, arrived in 2012 with a population of 197 million and a GDP of 2.477 trillion (current US$). This country, with the fifth largest area as well as the fifth largest population on earth, is now in the process of consolidating its position as the sixth largest economy before it reaches the proportional fifth position, as it is likely to happen still in this decade. Although the last decade was a good one and has helped to increase and solidify the weight and importance of the Brazilian economy, the country is indeed, differently from China, stuck in a characteristic pattern of middle income trap since a long time ago. Indeed, already by 1960 its economy was the tenth largest in the world and presented the characteristics of a middle income country. Since then the country experienced an erratic pattern of growth, in which periods of enthusiasm were followed by the inability to sustain outstanding growth for more than a handful or sometimes a couple of years. Between 1960 and 2012 the country experienced 6 years of recessions and 8 years of growth between 0% and 2%. In the half century between 1961 and 2011 the average growth rate was 4.47%[7]. In the midst of one the most chaotic economic experiences the country had ever lived, a variety of important reforms and institution-building took place starting in the mid-1980s, which,

5 Vested interests that were not plaguing the country when the reform era begun (Coase and Wang, 2012, p. 79).

6 This thorough and ambitious study was conducted with the Development Research Center of the State Council, P.R.C.

7 Data from the World Bank.

even disorderly and spreading through a long time span chastened by a series of incoherencies, reinvigorated the country's democratic experience and considerably increased its chances of sustainable development in the long haul.

This final section examines how FDI enters in the recent histories of these two countries. First it covers what here is labeled the *normalization period,* when most of the critical reforms meant to integrate these countries in the world economic system were passed. It will provide some indicators of increasing international exposure for these nations that had spent many decades in isolation, one way or the other, from the world, especially when one compares them with other regions. A second section offers a general description of each country's development strategies, dealing with the different implications for FDI under the model of import substitution industrialization (ISI) followed by Brazil during long periods[8] versus the export-oriented industrialization successfully implemented by East Asian countries in general and skillfully adopted by China. Subsequently, it analyzes the recent evolvement of Brazilian and Chinese economies starting from the 2001-2002 milestone period. It will explain the relevance of those two years for each country as well as for their bilateral relation.

Normalization

Normalization is what is called when countries enter in a process of reestablishing normal diplomatic relations between themselves. If the global economy was a sovereign entity – as some like to think, or wish, place hardcore sovereignists and those who are not the abundant factor in their own economy and thus are afraid of what the Stolper-Samuelson theorem predicts – one could easily identify periods in which given countries withdraw partially or in a rather complete way from their relations with this 'entity'. In a similar manner other periods would bring them back to a more active economic relationship with it. As well as in its diplomatic form, this 'normalization' process would be paved by reevaluations, and the setting of a new path meant to bring into fruition the best of what this association may provide. The previous chapter approached the global economy as a set of interactions molded by sovereign states and the economic interests they represent evolving in a certain international environment, discussing how unbalanced these interactions may turn out to be through

8 Something that would eventually tend to neutrality, but never to an overt and consequential export-oriented strategy like the one found in East Asia.

this conjunction of world politics and global markets where some countries may have difficulties to fit in. Therefore, for the nation state - and what they make of their international relations and the multilateral agreements they decide to propose and take part – the international environment is doubtlessly critical, for if the overall environment does not help, there is no way to maximize a country's returns through international integration.

Yet, this section approaches this global economic system from the perspective of the possibility of rethinking and reshaping a country's place in the system while benefiting the most from others. How a country may brush up its skills and play by the rules of the game up to the point that it may partake in their design. Then it will be playing somehow by its own rules, now diluted in the system. The set of possibilities is determined by the environment and the technological frontiers are a stubborn reality, fighting this is very often costly and inefficient. Much more effective is to skillfully balance the use of others' ideas with the increasing development of your own (Romer, 1993a and 1993b). That is after all that every single society in the whole world has done since the dawn of times.

The ultimate impediment to opt in to this broader association with what is evolving at the technological frontier is intrinsically placed by the prevailing institutional framework favoring groups that are suspicious of what would be the outcome of such move for their present situation in which they are able to extract rents. When a country stumbles into a bad equilibrium in which power-holders dispose of many rents to be extracted, the overall economic outcome is slashed through by a configuration that distorts economic incentives and constraints. Such configuration makes the unnaturally high gains of some well represented groups come at the expenses of the majority of economic actors unable to coherently express their preferences. Additionally, the centripetal force of such equilibrium may be strong enough to catch new groups that accede to power, which instead of altering the equilibrium will only work to rearrange rent-extraction within it, or in a slight modification of it. This pattern of path dependency is strong because the horizon of political actors is normally captive of a short-term understanding of what are the possibilities, even those projected for the long term, something accompanied by the reinforcing fact that the most fundamental reforms that would create a new and more efficient set of possibilities are often time inconsistent. As Acemoglu et al (2004, p. 12) points out, “some ways of organizing societies encourage people to innovate, to take risks, to save for the future, to find better ways of doing things, to learn and educate themselves, solve problems of collective action and provide public goods. Others do not.” The problem again is that as inefficient institutions may constitute an equilibrium, this situation may have as a result that even when a country opens itself to the use of cutting edge ideas, through FDI flows for instance, it is likely to do so in a sub-optimal way framed to guarantee the persistence of rent extraction.

Bearing in mind that both “institutional persistence and institutional change are equilibrium outcomes” (p. 79) the idea here is to show how these very flows are likely to act as termites in this sub-optimal structure, thus providing room for institutional change leading to better economic performance. Incidentally, this is something that is only strengthened in the face of a globalization process anchored in the increase of cross-border flows and wider access to information. As a result, ‘normalization’ is the process of institutional change that is put in place in order to reconcile the countries with the opportunities offered by this globalized economic system. Last chapter dealt with the importance of the international environment both in creating a stalemate and in offering a path out of it, this one deals with the national underpinnings and pains of the stalemate and the solutions sought to placate it.

Two paths to prosperity

The processes of ‘normalization’ both in Brazil and China, regardless of their specificities, share some similarities. For both countries the 1980s were the watershed between exhausted models and new social contracts that would forge their ways to increasing development under modernized economies. In the world as a whole it was indeed a period of critical trends toward “normalization”, here taken as the resuming of a more liberal and less militarily tense world order. As discussed in the previous chapter, the importance of the influence exerted by the international environment over domestic moods and deeds should not be underrated. Even though history would not delay on dismantling such line of interpretation, whose foremost example may be found in Fukuyama’s (1992) paean to capitalist liberal democracy[9] and the philosophical

9 The famous – and sometimes infamous, depending on the circle - *The End of History*

roots that would rationalize institutional convergence to it, the fact is that there was an overall worldwide mood tensioning towards convergence at least as it comes to sharing the same interconnected global market presumably settled to increase overall wealth and, hopefully, well-being. And in countries like Brazil and China this momentum realized itself through a set of reforms meant to create more predictable, efficient and world-friendly economies, in which many areas were increasingly liberalized as far as this was perceived as a precondition to better position themselves to reap the fruits of globalization. If many suspicions and reservations were kept alive, they were overmastered one way or the other, for both Brazil and China bought the idea that globalization had desirable fruits to provide, and that isolation would only cause harm and perpetuate stagnation. Sure enough, none of these countries would dream of becoming a pure capitalist state. If for no other reason, just because such thing does not exist, at least since the traumatic experience of the 1930s.

As Fitoussi (1997) points out, what exists since then is an assortment of “middle ways” that are being constantly forged and that are not deemed to vanish just because communism is no more. As such the ‘normalization’ process in China is one in which it had forged its own ‘middle way’ since markets were reintroduced in the economy, while in Brazil is one in which it has deeply reformed its modus operandi and set a different direction for its economy. In both cases, international economic integration is a crucial element of the agenda pursued.

In China the consolidation of Deng Xiaoping’s leadership would secure the deep and widely consequential process of reforms initiated in 1978. Indeed, Chinese experience since then constitutes an outstanding example of how to skillfully balance crude capitalism with iconoclastic behavior to achieve vigorous economic growth. The “socialism with Chinese characteristics”[10] is based on an outstanding level of liberal

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started as a lecture at the University of Chicago and then an article published in *The National Interest* magazine. Its whole concept was based on the idea that like previous progressive thinkers that believed in a coherent path of modernization that would lead societies to better forms of social organizations in which their peoples would have a larger life - something that Marxian tradition argued was a kind of utopian communist society - it too embraced such understanding of history in a progressive way, but its end would bring some form of market based democratically ruled society instead of the previous hypothesis.

10 Deng Xiaoping architected this rather ambiguous concept in order to explain (and defend) pro-market reforms in a still authoritarian “socialist” state: in fact it meant deep economic reforms without sudden and potentially destabilizing political change.

market economy in many sectors coexisting with authoritarian state intervention and an unclear legal system widely subordinated to an all-powerful one-party structure. In this picture, communism in China persists as a legal framework due to the autocratic characteristic of the state. It is a motto that generates political cohesion through a very adaptive understanding of its meaning.

The paths taken by the People's Republic of China, with their varied economic experimentations before it decided to seek greater integration with the world market, go a way beyond this study's goal. Table 3.1 succinctly points out some of the most significant events related to the Chinese Communist Party (CCP) and the country it governs since 1949.

Table 3.1. Major events concerning the CCP up to 1978

1921	CCP foundation
1945	VII Congress: Mao controls the party
1949	The PRC is founded
1950	Cessation of the Civil War
1958-1961	*Three Years of Natural Disasters*
1958-1961	*Great Leap Forward*
1966~1969 (1976*)	*Cultural Revolution*
1976	Zhou Enlai's death
1976	Mao Zedong's death
1977-1978	Deng Xiaoping returns to power

*The broadest and most disrupting phase of the Cultural Revolution ended in 1969, but many of its features remained until Mao's death and the subsequent arrest of the Gang of Four in 1976. Source: Elaborated by the author.

The XI National Congress of the CCP, held in August 1977, marked the return of Deng Xiaoping to the center of the decisions in the PRC. The resilient Deng was once more rescued from a purge. And this time for the beginning of a long period of revolutionary influence that would be consolidated, as generally recognized, during its third plenum, held one year later. In the summer of 1977, Deng Xiaoping offered the closing speech for the most high-level party event in which he still publicly compromised with some lines of thought promoted by Hua Guofeng – Mao's anointed successor – a position due, according to official Party historians, to the restricted "historical conditions at that time"[11]. That would not be the situation in the next year's winter, when Deng was able to push forward with his views regarding the necessity to promote reforms and move away from mistakes committed in the then-recent past. Power has turned to Deng's hands in a rather unexpected way that, in the words of MacFarquhar, illustrates "the mysterious nature of power in the PRC" (2011, p. 314). China, following the steps of the USSR, had brought to life a planned economy less efficient than its inspirational model. Under Deng, especially since the Third Plenary Session of the 11th CCP Central Committee, it would start a long march toward becoming a market economy that, despite its particularities or maybe because of them, is not only highly efficient but sometimes almost unbeatable. In retrospective, three decades past, one may distinctly observe how this event in the end of 1978 is a crystal-clear turning point for the Chinese economic history.

Theoretical categorizations aside, the fact is that the Chinese model works for what it was architected: generate strong and fast economic growth, something that is a prerequisite to "make the struggle over rewards less contentious" (Nee, 1989, p. 678) in the process of market transition. Underpinning the plan for economic change launched by Deng was an important role for FDI.

> Our country is now implementing an economic policy of opening to the outside world and using funds and advanced technology from abroad to help our economic development. (…) While pursuing the policy of opening to the outside world, we must stick to the principle of relying mainly on our own efforts. (…) Of course that doesn´t mean we shouldn´t seek outside help, but the main thing is to rely on our own efforts. Through self-reliance we can unite the people, inspire the whole country to work hard for prosperity, and thus make it easier to overcome the many difficulties in the way. (Deng Xiaoping, 2001 [1982], p. 385)

11 http://english.cpc.people.com.cn/65732/4445902.html

Although taking inspiration from the set of export-oriented industrialization tactics undertaken by its neighbors, Chinese endeavors did not follow, at large, preconceived models. They pushed forward with localized experiences of liberalization, made possible through a decentralization of decision-making “that allowed entry barriers to be reduced and market forces to grow” (Naughton, 2007, p. 90). In due course, as far as they proved successful, such policies would be adopted in a better structured manner. For FDI this process was characterized by the “proliferation of special investment zones” which “permitted incremental progress within a rigid system” (p. 406).

Although the gradualist approach resulted in a rather multiple set of policy experiences for the organization of production, when it comes specifically to international trade, which doubtlessly informed most of the new industrial organization in China, the importance of the framework of industrial organization in a regional basis known as the flying geese (FG) model ought not to be minimized. Accordingly, the region did not only supply the idea, but also opened the space that absorbed China in such model that provided a shortcut for export-oriented industrialization and thus, the absorption of new technologies through FDI. As a result, the pattern of regional distribution of the economic activities within the country has largely benefited coastal areas, which in turn have developed much faster than the inner regions. This was true in the 1980s and 1990s and is still true today. The total amount of inward FDI has been increasing for all regions, but still the attractiveness of the coastal regions remains very strong. In 2010 83.5% of the total number of FDI projects was destined to the East region, where coastal cities like Tianjin, Shanghai, Guangzhou, Xiamen, Shenzhen, Zhuhai and Shantou[12] have long spearheaded this development strategy. After four Special Economic Zones (SEZs) were established in Guangdong and Fujian provinces in 1979-80, and fourteen coastal cities were declared open in 1984 much of the economic activity, especially the tradable sector, would concentrate on the East. For those cities were all “in a favorable position to import, digest, and transfer advanced technologies and modern scientific information for the country” (Yeung and Hu, 1992, p. 9). A comprehensive set of policies was introduced to stimulate Joint Ventures (JVs)

12 The last four are the original SEZs while the three first are among the fourteen 1984’s open cities.

as the preferred vehicle. For it was understood to be an instrument to induce partnership and collaboration between foreign and local entrepreneurs.

The FG pattern has theoretical underpinnings that both predated and drawn on Vernon's 1966 paper on the product cycle discussed in chapter 2. Akamatsu framed the concept (*Ganko Keitai* in Japanese) during the interwar period[13]. The political appropriation that followed and the distorted application through imposed international expansion of such ideas was disastrous and it took decades until it could come back reshaped in a non-authoritarian and non-militaristic way. After WWII one country after the other was lured by the market implications of such understanding, and the FG pattern could spread in a civilized manner that really promoted what for Kojima (2000, p. 383) was a "catching-up product cycle" in which "borrowed technology and capital" increased "international competitiveness", thus enabling "catching-up with the advanced world". The international segmentation of production processes would deeply penetrate in East Asia, and the Chinese coast would become a major part of it.

Everything started in 1979, when, after decades in which FDI was forbidden, China issued the Equity Joint Venture Law, its first legislation opening a place for FDI in the country. As soon as 1985 FDI already accounted for 1.5% of the Chinese GDP. Five years later this ratio had risen to 4.8%, and in 1996 it jumped to 24.7%. Ten percentage points more than the 14.2% found in the same year in Brazil, which was always receptive to FDI, but was just starting to recover from more than one decade of macroeconomic disorder. Coincidentally, 1996 was also the year when the Chinese GDP, at US$ 856,084,729,312, would definitely pass the Brazilian GDP, than at US$ 839,682,618,645, to become the largest economy of the developing world (see comparative graphs in the appendix).

As Hu (2011, p. 10) puts it, China has been "the beneficiary of the type of timing, geographic location, and popular sentiment necessary for an economic take-off and eventual ascendancy to super power status". Something that is profoundly linked to the way China was able to promote its insertion in the global economy, a process that was accelerated by the inflows of FDI and their spillover effects. Doubtlessly, FDI has been the major way of gaining access to technology in China,

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13 It would gain the world stage with English versions of his papers that would appear in the 1960s. See Akamatsu (1961, 1962).

something that they further harness very competently with an enormous effort in promoting R&D. Both things associated generate a lot of spin-offs that in due course may catch-up with the technology frontier and innovate further from there.

The Chinese authorities took this multifaceted importance of FDI so seriously that throughout this process FDI was maybe even in "abnormally high demand" as pointed out by Fu (2000, p. 174). As the incentives offered to FDI were so broad, and thus there was a big unbalance between foreign-invested firms (FIEs) and domestic firms, many Chinese investors engaged in round-trip investment (usually through Hong Kong) in order to access those benefits. Consequently, a considerable part of *de jure* FIEs are *de facto* owned only by Chinese. Another possible explanation for this preference for being a FIE was the "uncertain property rights in the Chinese economic system" (Huang, 1998, p. 63). It is hard to find good statistics about the amount of round-tripping FDI, and the few studies that are available are based on estimations. But they demonstrate how inflated FDI figures for China and Hong Kong are due to such practice. Huang (1998, p. 63), for instance, argues that in 1992 22.5% of total inflows of FDI to China was round-tripping FDI (or "about 32% of the officially recorded" FDI from Hong Kong and Macau).

Concurrently, in Brazil, regime changed in 1985 with the bureaucratic authoritarianism[14] led by the military giving place to the New Republic, something that sparked a wider process of reform that would be implemented by increasingly opening the economy and becoming a responsible actor in the international stage. As the Brazilian economy was already capitalist, the "normalization" process is embodied in this country's long path toward a more efficient market economy in which regulation increasingly replaces distorting interventions that were invariably appropriated by a rather concentrated few. Brazil has betted on a full-fledged democracy, which abandoned years of overall strict import substituting industrialization[15] (ISI). With the benefit of hindsight one may recognize that the economic environment that pushed the country toward political reforms in the 1980s and the unfolding set of critical policy reforms spreading out until the 1990s is widely associated to the hardship that started to be generated with the 1973-74 oil crisis.

14 See O'Donnell (1973) and O'Donnell et al (1986).

15 Though comparatively less strict than other LDCs (Stopford and Strange, 1991, p. 11).

At that time, Brazil was far from having sufficient domestic oil production[16] and the rise of the international prices of this crucial commodity left the country in a rather fragile situation. Brazilian terms of trade deteriorated sharply while the government opted to spend its way out of that challenging situation. A new and reinforced ISI program was applied financed by loans from international private banks that had become flush with petrodollars – the apparently "positive" output of the OPEC's price hikes. A decade later the results of this program would materialize in less imports and an expansion of the country's exports, but by that time the country would find itself completely entangled in its debt burden, and starting in 1978 it would have to spend more than 50% of its exports revenues to service its debt. Brazil, given the large size of its economy, was by this time the foremost example among developing countries of a stylized fact "indicating that countries tend to borrow in good times and repay in bad times" (Kaminsky et al, 2004, p. 26). The second oil shock, in 1979, that would be already profoundly disruptive by itself, was followed by a massive increase in international interest rates originated in the readjustments pushed forward by Paul Volcker as the chairman of the FED. That would immediately worsen the Brazilian crisis insofar as most of its debt was based on floating interest rates, and from then on would raise, much beyond feasibility, the cost of maintaining such type of financing. Brazil amassed foreign debt in a spiraling cycle that would put it in the top position among developing countries within the rather big group of heavily indebted countries. The Mexican default in 1982 "alerted the IMF and the world to the possibility of a systemic collapse" (Boughton, 2001, p. 281), a diagnosis that ignited a panic that would close financial markets for developing countries. As Stopford and Strange (1991, p. 47) put it:

> This would not have mattered if the US government, instead of giving special bilateral help only to Mexico had taken earlier, bigger steps to ease the pain of adjustment for all the major debtors. The Baker Plan of 1986 was a move in the right direction but came only after what the IMF called the painful adjustment phase of 1983-4 was over. Besides, the Plan was not big enough to convince the banks that the risks of co-financing were acceptable.

16 Something it would start to obtain in 2006 when it produced more oil barrels than it consumed, even though it still is a net importer of oil derivatives.

The overall contamination and the weak response resulted in a lost decade for Latin America. The region would take decades to recover and resume its catching up course, and is indeed still in the process of full normalization when it comes, for instance, to financial markets. In a country like Brazil, with a burgeoning middle class anchored to a solid and diverse set of economic activities, financial deepening is still very limited due in part to disarrangements unleashed over that period, which fomented an incorrigible short-term focused financial system. Inflation, that had reappeared in Brazil's horizon since the 1973-74 oil crisis, would surge with the second oil shock in 1979. Concomitantly, in one of those tricky consequences generated in a globally integrated financial market, Volcker's policy of rising interest rates in order to tackle inflation in the US would conversely release further inflationary pressures in Brazil. In 1982, when the Mexican crisis erupted, Brazil had to pay US$ 10 billion out of its US$ 20 billion exports just in interest on its accumulated debt. Adding the amortizations, the total debt service that year represented 83.3% of the country's exports. Brazil entered 1983 with negative international reserves and an inflation rate that would accelerate to 210%, and all that topped with dire perspectives of refinancing the debt[17].

A whole set of unfortunate circumstances and trends, domestic and global, would take their toll on the economy. Mistakes from the past, persisting misjudgments and political turmoil, all combined to make sure the task was not a simple one. Ultimately, the whole 1980s period was marked by successive attempts to stabilize the economy plagued by a coalition of mutually reinforcing ills: its unsustainable domestic fiscal situation, an acute international indebtedness, and an out-of-control inflation fueled by indexation and inertia[18]. Indeed, between 1979 and 1991 ten different stabilization plans were tried unsuccessfully (Bresser-Pereira, 1992). And the

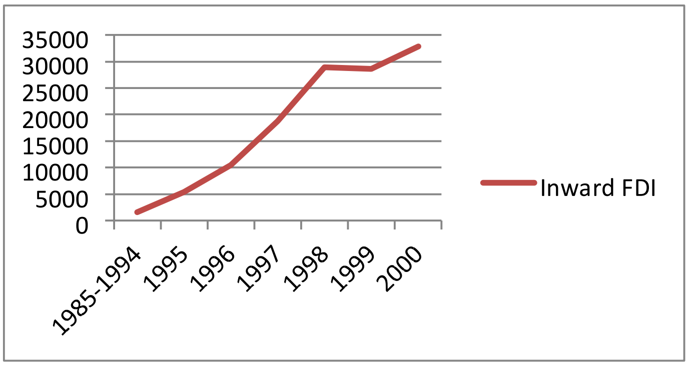
17 Data from Baer (1995), Ipeadata and World Bank.

18 See Cardoso (2007) for a concise discussion on the long history of inflation in Brazil and the different diagnoses (orthodox and heterodox) with their corresponding approaches used in the hope of taming it until a successful strategy would be reached through the Real Plan of 1994. Although the original theoretical underpinnings for what once would become the Real Plan can be traced back to Arida and Lara-Rezende (1985), the proposed approach would later have some of its features transformed to include not only the original use of the URV (Unit of Real Value), but also of a nominal exchange rate anchor (crawling-peg), which, together with other reforms, was meant to open the economy, a process directly related with our discussion here.

beginning of the 1990s would see the inflation skyrocketing until it got finally tamed in 1994[19].

The final stabilization of the Brazilian economy achieved with the Real Plan was intrinsically associated with further reforms that would increase the pace of FDI inflows to Brazil (Figure 3.1 and Table 3.2). Indeed, the conquest of the stabilization by itself was responsible for the FDI to bounce back from the cautious position it had remained throughout the 1980s and until the mid-1990s. The annual average of inward FDI in the years between the restoration of democracy and the end of hyperinflation was US$ 1 659 million. In the first full year of curbed inflation that amount had tripled. In the year after it was almost 7 times larger than the decade-long average, which, by 1998, was exceeded by a ratio of 17:1, and in the year 2000 it got to a peak, with inflows of US$ 32.78 billion, an amount almost 20 times larger than the US$ 1 659 million benchmark.

Figure 3.1 FDI inflows to Brazil, (1985-1994)[20]-2000 (millions of US$)



Source: UNCTAD, various years.

While Brazil was resuming its attraction of FDI, China was increasing its inward FDI at a breakneck pace in the midst of "the boom phase" started in 1992 after "the experimental phase from 1979 to 1991" (Chen, 2011).

19 See Franco (1996) for an early appraisal of the plan.

20 The value applied to the beginning of the series is the average annual amount for the time span 1985-1994.

Table 3.2 FDI inflows to Brazil and China, 1986-2000 (millions of dollars)

Host economy/ Period	1986-1991 (average)	1992	1993	1994	1995	1996	1997	1998	1999	2000
Brazil	1 258	2 061	1 291	2 590	5 475	10 496	18 993	28 856	28 578	32 779
China	3 105	11 156	27 515	33 787	35 849	40 180	44 236	43 751	40 319	40 772

Source: UNCTAD, 1998, 2000 and 2003.

By the year 2000 foreign investors had amassed US$ 122 billion in FDI stocks in the Brazilian economy. This was the end of the first cycle of booming FDI during the New Republic. The level of FDI inflows would remain quite high, but would only start a new cycle of ascendant flows in 2007 something covered in section 3.3.

As for the first cycle, this surge of FDI is connected to the last decisive act of this normalization process. Something resulting from the retreat of the state from enterprises such as Usiminas, Acesita, CST, Açominas, CSN, and Cosipa, from the steel industry, Copesul and Copene, from the petrochemical industry, and Escelsa, Light and Gerasul, from the electric power industry. Other three main privatizations were the ones of CVRD, now simply Vale, which is by now the second-largest mining company in the world, of Banespa, a bank, and of Embraer, one of the four largest aircraft manufacturers in the world in which the government maintained a golden share. Quite strikingly, Vale and Embraer have improved a lot their competitiveness after privatization, becoming big MNEs and achieving a prominent position in their respective industries.

According to the Brazilian Development Bank (BNDES), in the period between 1990 and 1994, most of the companies were sold to domestic investors (95% of the resources obtained through the program came from nationals). In the period between 1995 and 2002, however, FDI would take the upper hand, representing 53% of the total revenue from the sales[21]. Indeed, inflows of foreign investments directed to

21 In an aggregate level they became "more efficient after privatization" (Anuatti-Neto, 2005, p. 168). For an earlier study with similar overall conclusions see Pinheiro (1996).

the acquisition of SOEs at auction account largely for the surge of FDI presented above.

In China, as well, economic reforms in the way that they were (or were not) performed throughout the 1990s have also accounted for the surge of inward FDI. There, however, FDI has less to do with privatization of big SOEs[22] than with the obstinate protection with which government endowed champion SOEs, as critically assessed by Huang (2003). The policy of “grasping the large and letting go of the small”[23] decided in the end of 1997 by the 15th Party Congress was at the same time a privatization program for small SOEs and a blueprint for enhancing the power of big SOEs. The result of the plan can be grasped by official numbers about the composition of the Chinese economy by 2008: although SOEs where the state is the biggest shareholder represent only 3.1% of all enterprises in China they control 30% of the total assets in the industrial and services sectors, and over 50% of the total assets in the industrial sector alone (National Bureau of Statistics of China, 2009). In the industrial sector the biggest is Sinopec[24], followed by the “Big 3” automakers (Dongfeng, SAIC Motor, and FAW Group), then Baosteel, and CSGC, the conglomerate controlling among other companies the country’s leading military industry. The top private manufacturer in China by 2010 revenues comes in the 14th place and is Huawei. It is important to highlight that all the above SOEs have joint ventures with foreign MNEs through subsidiaries.

Since the early 1990s China saw the emergence of a leadership that was more linked to the urban reality and that assessed this reality through the lenses of the organizational power of the state and its SOEs. They would reorient throughout that decade some of the path-breaking policies experimented in the 1980s in a way that at the same time enhanced the controlling power of the state and opened larger and larger spaces to FDI. Political stability would be maintained, state control strengthened, while foreigners would partake even more in the benefits of astoundingly fast growth.

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22 Many SOEs that were not considered national champions, however, became FIEs. Moreover, a big part of them suffered the process of “fire sales” of their assets because of the previously discussed benefits of becoming a FIE.

23 抓大 放小 (zhuda fangxiao).

24 Sinopec is the largest Chinese company and is immediately followed by another oil and gas SOE, the China National Petroleum Corporation. Furthermore, all the major enterprises in the services sector are also state-owned. [62] Huang (2008, p. 111).

Something epitomized by the city of Shanghai, where the two preeminent leaders of this period, the "consummate technocrats"[62] Jiang Zemin and Zhu Rongji, have built their careers and connections.

The development of the Shanghai's Pudong area clearly serves to portray this period. A great number of joint ventures (JV) would set up there following a legislation promulgated in 1996[25]. General Motors, for instance, signed a JV with the Shanghai-based SOE SAIC Motor in 1997. The business started to run and a couple of years later turned into a startling success. By 2003, GM earned almost 16 times more for each vehicle sold in China than in the US (McKinsey & Company, 2003).

Returning to the privatization process, in a certain sense the Brazilian state also kept some of the brightest jewels of its crown. Indeed, the largest Brazilian company and also its largest MNE by assets abroad is Petrobras, an SOE. The largest bank in the country, Banco do Brasil, is also state-owned. Together with Eletrobras, a power utilities enterprise, and another bank, Caixa, they form the bulk of what remained of enterprises in the hands of the state: nothing comparable with the plethora of SOEs in China. Therefore, more than the presence of big SOEs what really approximates Brazilian and Chinese strategies is the role of their development banks (BNDES in the former and the CDB in the latter[26]) in channeling funds to specific projects and enterprises considered to be national champions or presenting potential to become one. The influence of these banks cannot be overstated. For instance, both banks have loan books much bigger than the World Bank's and are able to direct the pace and directions of entrepreneurial activity with their subsidized and politically decided financing.

Deciding to move out of a bad equilibrium

Unfortunately, the extenuating coexistence with inflation is often necessary to produce the necessary political will to push forward with policies to tackle entrenched

25 Namely: the "Interim Methods for Establishment of Chinese-Foreign Joint-Ventured Foreign Trade Companies".

26 China has other two policy banks, the China Exim Bank (中国进出口银行) and the Agricultural Bank of China (中国农业银行), while Brazil also uses the Bank of Brazil (Banco do Brasil) for several of its funding programs, among which here it is important to highlight the PROEX (Export Financing Program).

distortions (Drazen and Grilli, 1993). Brazil needed to travel a long road until inflationary distortions were tackled in earnest and still is morosely walking hand in hand with other socio-economic distortions that consistently reduce the country's potential and its average citizen's real welfare. If fiscal indiscipline was attacked from many sides in order to secure the Real Plan's survival until the final act could be accomplished through the Fiscal Responsibility Law of 2000, and Brazil's reluctance in operating major reforms in other critical areas is accompanied by its constant resorting to palliatives, one can only hope a time will come when the vicious distortions suffocating the country will also be tackled in earnest. Hoping that Brazil's procrastination is rather in the form of a gradualist approach in which it knows where it wants to go than in the Drazen and Grilli (1993) form, in which resolution may only be triggered by a long and deep crisis. As Wei (1998, p. 281) concludes "a gradualist approach may be politically more sustainable than a Big Bang approach" given that such reforms let people that were worried of whether they will be winners or losers. Even though the overall result for the country would be much better with the reforms and even for the immediate losers in the long run, reforms that deal with very clearly defined interests in countries as big and diverse as Brazil and China are better not taking place in haste, for they are likely to create instability and distrust.

However, a resolution may also be achieved if the country traces a plan that is not domestically focused with its back to the rest of the world. A plan in which such reforms are imperative steps into that grail. Hirschman once wrote that inflation served to ignite fiscal reforms in Latin America like wars did in other corners of the world, Brazil could designate another and more inoffensive substitute for either inflation, war or other baleful event, instead of waiting for one to naturally emerge. That was exactly what China has done. And it did so step by step, or like the old Chinese saying goes, “crossing the river by feeling the stones”.

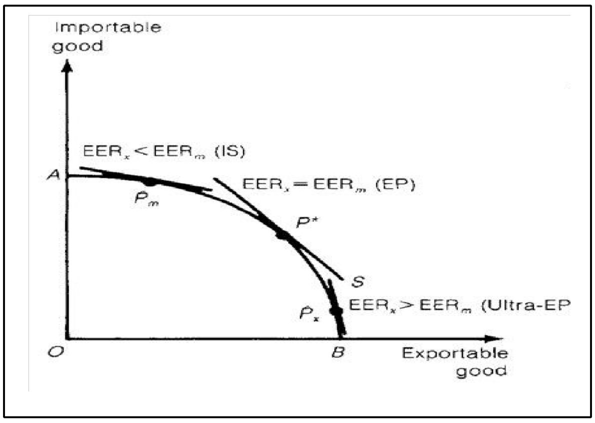
It is necessary to place the aims and the targets of the state in a more distant place. That helps to overcome minor hurdles that may appear immense if the state's horizon is a short one. Brazil's reluctance to embrace an open attitude to the world is costly exactly because it helps to exacerbate distortions that are only possible if there is no serious preoccupation in being in the best possible shape to endure a global dispute. Therefore, competition for world market shares is a good objective if the country realizes that it needs better rules and norms that tackle distortions that operate against its interest. Chinese success is explained by their obsession with achieving an international respect congruous with their size and history. The change introduced by Deng Xiaoping was just that this respect and relevance would only come through economic performance.

In 1978, the release of an article titled "Practice is the only criterion for testing truth" backed by the Central Party School would have important doctrinal effects. For this article at the same time reconciled what was allegedly Mao's thought with the new approach desired by the new Party elite keen on testing new concepts and ideas, and it did all that with a hint of Chinese traditional daily philosophy given that the very title of the article closely resembled an old Chinese saying that was often used by Mao (Coase and Wang, 2012, p. 25). This rather eclectic kind of approach would resonate through the Chinese power structures and is indeed the way argumentation is since then constructed as one may note in the official literature bearing the flag of the Communist Party since then. The ideas that would reach the CCP cannon and thus be enshrined in the party's constitution, respectively the Deng Xiaoping theory, the thought of the Three Representatives proposed by Jiang Zemin and the Scientific Outlook on Development designed by Hu Jintao, all merge Mao and the other traditional Communist traditions embraced by the CCP with modern day necessities of Chinese capitalism giving an overall flavor of ancient Chinese philosophy.

8. Import-substitution versus export-promoting strategies

The difference between import substituting (IS) and export promoting (EP) industrialization is all about incentives. Both strategies are based on the assumption that in order to guarantee growth and development a country needs to put in place policies meant to create dynamic comparative advantages. One way or the other, their overall belief is in the importance of forging industrialization as the means to achieving those goals. As Bhagwati (1988) points out, incentives may be summarized in the differences between the effective exchange rate for a country's exports (EER_x) and the one for its imports (EER_m). He goes on and proposes the following graphic interpretation:

Figure 3.2



IS strategy: $EER_x < EER_m$
EP strategy: $EER_x \approx EER_m$
Ultra-EP strategy: $EER_x > EER_m$

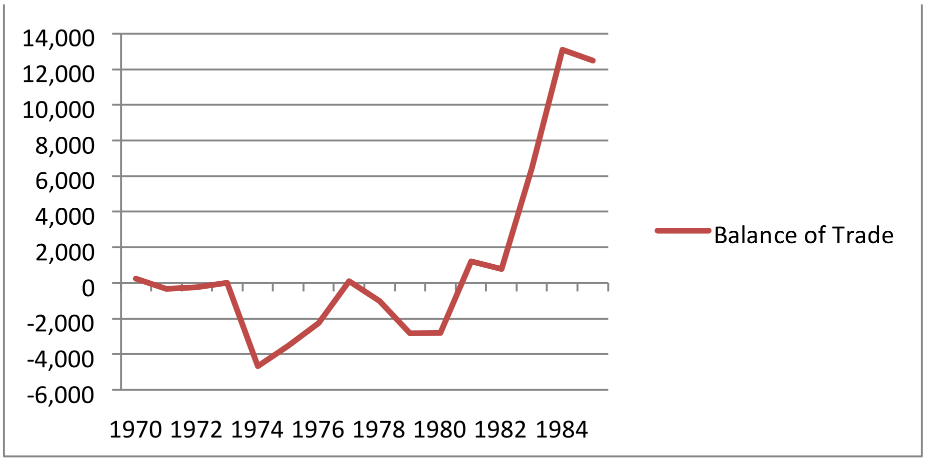
In the aftermath of WWII, in order to push forward with its IS strategy Brazil adopted multiple exchange rates and other trade mechanisms that invariably resulted in discrimination against export activities and in a tight control over which imports were to be made. Balassa (1971) exposed the extent by which Brazil favored manufacturing vis-à-vis primary activities and also how it created distortions benefiting certain imports while not stimulating its exports. Quite characteristically, the only active policy related to its exports prior to the 1970s was one in which, benefiting from its monopolistic power in the international coffee's market, Brazil imposed taxes on its main exporting product in order to raise international prices and reap the higher returns resulting from this strategy that is only effective in monopolized markets. Evidence shows that despite all distortions it created Brazil was much more successful than other late-industrializing countries in its ISI strategy. Something intrinsically related in its early phase to the overall success of its coffee exports and all over the time to its large domestic market.

Brazil's relative large domestic market has been both a help and a hindrance to the development of its

> manufacturing industries. The larger Brazilian market has made import substitution less uneconomical than in smaller developing countries and has facilitated the backward integration of Brazilian industry to capital goods and intermediate products. But the large domestic market has also made most Brazilian manufacturers content with their home market, and has contributed to a live-and-let-live attitude that breeds inefficiencies and does not provide inducements for technological progress. (Bergsman and Malan, 1971, p. 135)

Around 1970 Brazil had already concluded a large part of its industrialization process and almost all its consumption of manufactured goods was supplied domestically[27]. Throughout all the 1970s and until the Mexican crash of 1982 Brazil ran successive deficits on its trade account. Only reversing this pattern when the debt crisis impeded further imports and the country became in desperate need of exports revenue in order to pay the debt, as exposed in the previous chapter and is observable in figure 3.3.

Figure 3.3 Brazil's Balance of Trade, 1970-85 (millions of US$)



Source: IPEADATA.

Both in 1984 and 1985 Brazil exported more than China. And most of its exports were industrialized products. 1986 was the year in which Chinese exports

27 In 1967 of the US$ 16,361 million in consumption of manufactured goods only US$ 1,036 came from imports (Balassa, 1971, p. 29).

surpassed Brazilian ones for good. In the same year China issued its first law regulating the establishment of Wholly Foreign-Owned Enterprises (WFOE)[28], an specific vehicle for FDI that would increase in importance over the years and become the principal FDI vehicle in the years following Chinese WTO accession[29]. The amplification of Brazilian exports of manufactures in the 1980s was a clear offspring of its IS strategy. Sadly enough it came too late and coupled with many problems previously discussed.

Brazil applied IS strategy in a way that somehow did not deviate a lot from what Johnson (1965) remarked about the inducement "to set up local facilities" that such strategy would give to foreign enterprises used to (or willing to) export to that market, consecrated as tariff-jumping FDI. Accordingly, such strategy would not create "a domestically owned and operated industry capable of competing successfully with its foreign rivals". If that was true in some aspects, for indeed, first, a lot of tariff-jumping FDI was attracted to the economy, and, secondly, the international competitiveness of domestic industry turned to be always limited to quite a few, in other aspects, however, it was doubtlessly successful in achieving industrialization in a process in which a large amount of domestic enterprises (state-owned but also private) were created. If industrialization was the goal per se, IS strategy in Brazil may be regarded as generally successful. However, if one considers that the goals were sustainable growth and development at large, the results are quite mixed to say the least. For growth, sometimes very strong, was hardly sustainable. And full-fledged development remained elusive.

The kind of dirigisme that we had in Brazil has consciously attracted FDI through its IS strategy. In the way it was designed, the work of the government was perceived as designing policies that put together the domestic private capital, the state capital and the foreign capital, each one in a specific place. Under such architecture, the Brazilian government believed that FDI and state investments would crowd in

28 Before 1986 WFOEs had been existing in an experimental form which did not secure foreign investors confidence.

29 The whole process would resonate positively in the population view and by 2010 a survey conducted by GlobeScan would show 67% of Chinese either strongly of somewhat agreeing that free market economy is the best system. The Chinese optimism toward free markets equals the opinion expressed by Brazilians, a percentage that is even higher than the average found in the United States (59%).

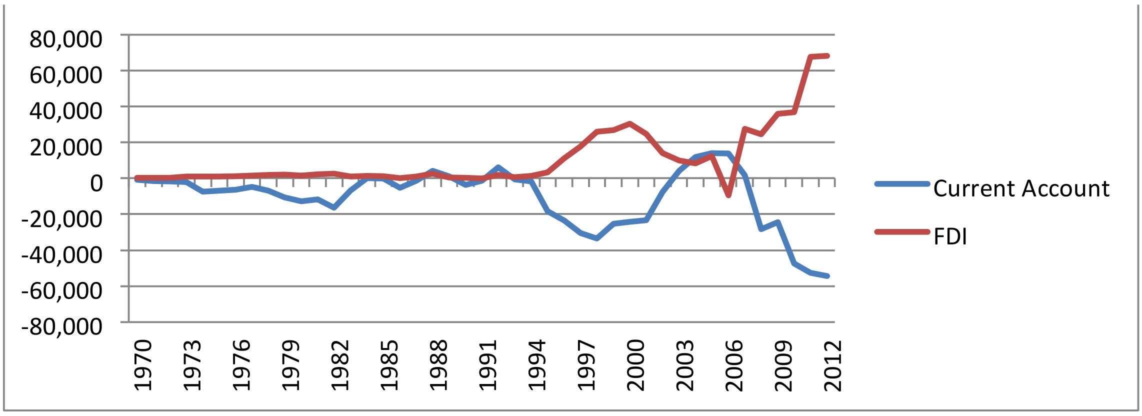
private investments in subsidiary areas rather than detrimentally crowd them out, as it is sometimes associated both with inflows of foreign capital and state investments. Agosin and Mayer (2000) provide a theoretical model of investment with the participation of FDI. Keeping in mind the "over-simplification" involved - for FDI is not always an investment in the sense of investment as a real national account variable because FDI may be channeled to operations that are not investment, and MNEs may invest through mechanisms other than FDI - one may approximately measure whether FDI crowds in or crowds out domestic investment by measuring the relationship of MNEs investments (I_f) with the total investment (I). If the variation of I_f (ΔI_f) equals the variation of I (ΔI), then FDI had a neutral effect. If $\Delta I > \Delta I_f$ then FDI crowded in domestic investment (I_d). Conversely, if $\Delta I < \Delta I_f$ FDI crowded out I_d. Once more the real effects were much more dubious. Regarding Brazil's experience in the 1970-1996 time span Agosin and Mayer (2000) found that FDI had an overall neutral effect. To understand why it is so, one may delve deeper into the IS policies in place, which placed FDI in a position that on the one hand stimulated domestic investment, but on the other created a pattern that turned making investments very costly. Despite the multiplication of domestic businesses, the overall cost of the strategy was very high and prone to instability, as far as its underlying structure was rather fragile and unbalanced. Very few of the forged dynamic comparative advantages were provided with strong underpinnings, something one cannot hide for too long. Characteristically, education and productivity levels, strongly associated one to the other, did not converge to OECD levels.

FDI inflows throughout all this period, however, did not have trouble to find their way into the economy and participate actively in the strategy traced conjointly with domestic private capital and state capital. In which each sector of the economy related to the manufacturing process would be under the responsibility of one of the three. Basically, the public sector would take care of those activities which Lenin, with his militaristic verbiage, once labeled the "commanding heights" of the economy. Then, the foreign capital would bring with it the technology and the know-how to do the more complex manufacturing that either did not exist or were rather backward up to that date in Brazil, while the private domestic capital would provide the set of remaining soft inputs necessary to the production of the complex manufactures, as well as they would control the lion share of the more downstream activities existing after the final product left the factory plant. As it is normally the case in any country, the services sector remained in the hands of nationals. This was the kind of strategic coordination promoted by the Brazilian government which was rather receptive to FDI, doubtlessly, but in a very specific way.

Under this framing they would go there to fill very specific spots in a way that would be orchestrated with the state capital and the private domestic capital as well, in an arrangement that would be called the triple alliance (Evans, 1979). One of the most accomplished examples of this orchestration provided by the government is the Brazilian automotive industry. In which state owned enterprises (SOEs) produced the heavy inputs necessary to the foreign-owned manufacture of cars, trucks, and buses, while the domestic private sector was constituted of most of the network of component suppliers for the factories ran by the MNEs. Later on, in the 1990s, when the Brazilian government started to sell most of the "commanding heights" of its economy under its Privatization Program[30] discussed above, the framework persisted, but now with a diminished participation of the state.

The further liberalization of the economy increased the presence of FDI, strikingly changing the way the country finances its deficits in the current account (Figure 3.4).

Figure 3.4 Current Account balance and FDI in Brazil, 1970-2012 (millions of US$)



30 Launched in 1990 through the law 8,031, later on substituted by the law 9,491 of 1997.

Source: IPEADATA

China, on the other hand, is unmistakably a country with two well-marked and different periods. The exchange rate practiced in China under Mao was one of IS strategy. The Chinese currency was kept artificially overvalued in order to help its soviet style industrialization. With the reform era, however, it clearly turned into a country that consistently adopted an export oriented strategy, aggressively supporting its exports through a set of policies that compelled enterprises to dispute foreign markets. The country, having already developed a varied industrial base during its decades of autarchy, decided to focus on trade expansion. Rather than concentrating their forces in building a national industry through IS, China has exploited masterfully its natural comparative advantage, using the returns to progressively invest in the creation of dynamic comparative advantages.

As Bhagwati (1988, p. 33) reminds us, “the pursuit of either the EP or the ultra-EP strategy does not preclude import-substituting in selected sectors”. Nonetheless there is an overall trend constantly verging toward exports promotion.

> By publicly supporting the outward-oriented strategy, by even bending in some cases toward ultra-export promotion, and by gearing the credit institutions to supporting export activities in an overt fashion, governments in these countries appear to have established the necessary confidence that their commitment to the EP strategy is serious, thus inducing firms to undertake costly investments and programs to take advantage of the EP strategy. (Bhagwati, 1988, pp. 33-34)

The case of EP in China became so aggressive in the eyes of other countries that several voices were raised to compel China to let its exchange rate appreciate. That became an ever greater issue during the last decade when the RMB started to strongly depreciate in 2002 accompanying the fall of the dollar to which it was pegged since 1995. This critical period for the global economy in which the increasing importance of the emerging markets spearheaded by China was altogether imposing is further examined in the next section.

When countries are moving from an inward-oriented - or IS - strategy into an outward-oriented - or EP - one, it is very likely that they will face political constraints in doing that for all the economy at once. In countries as big and diverse as Brazil and China that would be even more exacerbated and prone to instabilities, thus keeping a uniform ultra-EP strategy in all their geographical areas is not always feasible. Therefore, a recurrent strategy is to demarcate certain areas in which the state creates differentiate regulations meant to stimulate exports without contaminating the rest of the country. China has used actively such strategy, Brazil has not. Why so?

Brazil's flirt with Export Processing Zones (EPZs) started in the late 1980s, but very little of concrete was put in place. Arguably, it all started with Brazil's amaze with Chinese application of such strategy. However, the proposition of doing a similar thing in Brazil as proposed by the government suffered fierce opposition[31] and the strategy remained constrained to very few actions, which were much more pork barrel politics than a coherent national plan of development through such means. On the other side of the world, however, China implemented a wide number of EPZs which served as stepping stones for China's EP strategies. Independently of the hypothetical results that are difficult to predict, the fact is that for its very particularities, starting from the main source of FDI, the Chinese experience was likely to be difficult to replicate in Brazil.

Both the SEZs and the "Open Cities" that were previously mentioned are geographically located in strategic areas meant to facilitate connections with the foreign world. The four original SEZs (Hainan island would later receive the same status in 1988) were placed right in front of the territories with which China had the deepest connections. Two of them were in the Pearl River delta, where Shenzhen was right in the border with Hong Kong, and Zhuhai was right in front of Macau. Both Hong Kong and Macau, which were set to return to Chinese control within some years, would since then serve as vehicles for FDI to reach China. Most specifically Hong Kong would solidify as a major financial center, channeling a lot of FDI into and out of China. Including a considerable amount of operations involving Chinese citizens that used Hong Kong based financial mechanisms in order to get into China as FDI, thus having all the benefits accorded to such operation, as previously discussed.

31 See, for instance, Serra (1988).

In due course the Pearl River delta turned into one of the busiest, most dynamic and thriving areas in the world economy, and Guangdong, the Chinese province containing Shenzhen and Zhuhai, became the one with largest GDP in China, while at the beginning of this process it was an economic backwater, much less developed than the comparatively more thriving areas of China. The numbers of this development process are remarkable. The value of Shenzhen's industrial output, for example, increased at an annual rate of 87.3% between 1980-1988 (Yeung and Hu, 1992, p. 307). The other two SEZs, one of them, Shantou, also part of the Guangdong province, were also situated in a very special place. On the shores of the Taiwan Strait, Shantou and especially Xiamen were directly facing Taiwan and shared with it cultural and historical links that would facilitate Taiwanese FDI there. Incidentally, that is all FDI is about in this beginning of the open door policy. The first investments were made by the Chinese diaspora spread in the world that had grown rich outside the mainland. These "foreign Chinese" were specifically concentrated in places like Hong Kong, Singapore and Taiwan. Then would come the other closer neighbors, outstandingly Korea and Japan. From the many determinants of bilateral FDI flows listed in the empirical literature, culture is something that often defies the iron rule of gravity models. In this sense, beyond the balance between the forces of attraction that are increased with the increase of the countries GDPs and decreased by their distance, cultural distance also plays a significant role. With countries sharing the same language or other trait of culture that may facilitate interaction and mutual understanding presenting higher flows of FDI (and trade: the field where such approach is better developed) than what the simple gravity model would predict. In the East Asian case they had all the forces impelling for deeper flows between them once the institutional barrier was down. The essential was to restore confidence among the family. And that is a task for institutions and about institutions.

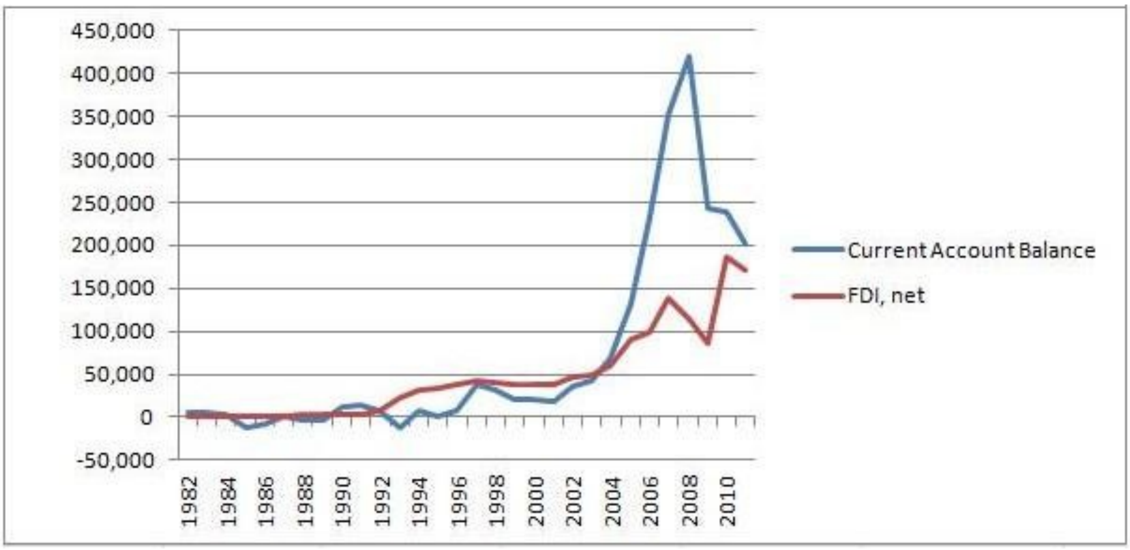
The overall process of relaxation of tensions that was necessary to enable full fruition of cross border partnership was carried out with visible consequences, as investments started with those foreigners with whom China had less political tensions and evolved up to the point that even countries towards whom China kept deep resentment, like Japan, become main providers of FDI. Take for example the illustrative case of Xiamen. When it was established most of the FDI would come in mainly from Hong Kong and to a lesser extent from Singapore on an experimental basis. With the upgrading of the available infrastructure and the rising consensus regarding the seriousness of the PRC's commitment to a business-friendly environment, the consistency and size of the investments not only surged, but also the origin of investors have diversified, with an increasing amount of Taiwanese establishing businesses in that SEZ. Considering that most Taiwanese are familiarly linked to Fujian, the province whose capital is Xiamen, they were likely to become natural investors in that SEZ if only they could feel assured their capital would be safe. And such was the case to the extent that Chinese officials sent ever clear signals showing their will to appease the situation and focus on mutual benefits. Consequently, Taiwanese rushed to Xiamen and already by 1988 they displaced Hong kongers as the largest providers of FDI to that SEZ (Li and Zhao, 1992).

In the wake of the Tiananmen Square incidents of 1989, China was faced with many sanctions. Even though most of them expired soon and had little direct impact given the size of the economy, they could have the ability of somehow "delaying the processes of modernization" (Yeung and Hu, 1992, p. 316) as far as they created international uneasiness with China. Even through other means, and in a rather oblique manner, China would need to address the issue and reassure the international community and when it did so, it was again by demonstrating its commitment to further liberalizing its economy and spreading its partnership with foreign investors to new areas of the country and new sectors of the economy. Economic compromise was offered in exchange for avoiding stronger pressures over political issues while securing its strategy to keep growing in even deeper symbiosis with the global market.

As a consequence, the overall positive trend of its exports was maintained throughout the 1990s, thus guaranteeing its economic vitality, but the country, then already one decade in this process of economic normalization, felt the possibility of a set back and realized that with integration comes an acute interest of international actors over its domestic situation: something that could only increase in the years to come.

Since the second half of the 1990s China has been experiencing at the same time current account surpluses and huge FDI inflows: an upward trend that skyrocketed with its accession to the WTO in 2001 (Figure 3.4), which will be covered in the next section.

Figure 3.4 Current Account balance and FDI in China, 1982-2011 (millions of US$)



Source: World Bank

9. From 2001-2002 onwards

If the many reforms and institution-building that Brazil and China went through were meant to strengthen their economies and consequentially their overall international clout, a real taste of this would come in the first decade of this new millennium. When, at the end of 2001, Jim O'Neill of Goldman Sachs released his insight about the BRICs, many thought of it as only another catchy acronym among the many regularly sorting out from investment banks. Against all odds, however, it finished the decade as an official association of those countries plus South Africa, and in retrospect one may note that the general lines presented in that paper turned out to be fulfilled.

Unfortunately, the decade that was propelled by a logic unleashed there in the early nineties and that had already showed signs of its unsustainable structure during the 1998 financial crisis (Aglietta and Berrebi, 2007) came to a sobering and hazy end. A scenario that would call for a deep reformulation of the governance structure monitoring market mechanisms and providing the world with some necessary coordination to avoid both beggar-thy-neighbor activities and uneconomic policies that cancel one another in the world stage, generating a situation shrewdly described by "the stadium metaphor": where people start to stand up to have a better vision of the match, but as everybody repeats the expedient no one can watch the match better, and they all end up worse off than under the previous equilibrium.

The staggering growth the Chinese economy has experienced over the last three decades was in the beginning something most people would just hear about occasionally. Then turned into something that would make them impressed, but still, did not mean a lot for most of them. In due course, however, its persistence and the ever expanding breadth of its consequences finally caught the entire world's attention. Most of this growth that was once confined to labor-intensive and low-value-added goods is increasingly coming from more capital-intensive activities in which some of the technological breakthroughs are home-made. By 2009, China became the second biggest spender on R&D in the world, while by 2011 it was the country with the largest number (526,412) of patent fillings (WIPO, 2012).

Pundits used to refer to the case of 1980s Japan in order to admonish that maybe there is much ado for nothing, and that the Chinese constant increase in power resources will stabilize before reaching the overall top of the pecking order. Such argument may be comforting to those who feel discomfort in picturing a world with a different distribution of influence, wealth, and power, but it is at odds with the fundamentals at stage. For most of what is in march is just the ultimate spread of the capitalist industrial revolution and its successive technological revolutions, whose uneven and erratic distribution since its beginning some 250 years ago created an enormous gap separating those countries who fully participated in it from others who either were not able to adjust to it or bluntly denied its desirability. The pace of change is sometimes hard to grasp, for "dynamics and thinking about rapid, accelerating, and permanent change is conceptually harder and more than slightly unsettling for most of us" (Spence, 2011, p. 17). And the pace of change in China and many other emerging markets with potential sizes that are much larger than most mature developed countries adds an extra challenge to this understanding.

Quite appropriately, another side of the analogy with Japan starts by recognizing that Japan as well - and Korea also for that sake - has started by producing low-value-added goods and now many of the most well known brands developing state-of-the-art products are Japanese – and Korean. A pattern that China seems able to repeat in its own way through companies like Lenovo and Huawei. Then one should go on and perceive that when it comes to power resources at large the fundamentals underpinning and propelling Japanese growth were and are very different from those encountered in China. Due to the size of its population and its strategy of geographically unbalanced growth, China has become the second largest economy in the world with only 20% of the American per capita GDP in PPP. Consequently, China is a microcosm in which still there is a lot of catching-up to do, while at the same time state-of-the-art industries are evolving. Also, in a broader perspective, China has the impetus to develop its might in many other areas. Japan, let alone its many idiosyncrasies, finished its catching up below the United States if for no other reason just because the former has a population that is one third that of the latter. When its source of easier growth petered out, the difference in the fundamentals between Japan and the United States by itself remained as the straightforward explanation for why it was an easy bet that neither Japan nor Germany, nor any other smaller country experiencing 'growth miracles', would challenge the overall economic dominance of the US. Their highest expectation is to be able to evolve graciously in the technological and wealth frontiers. In order to go beyond that, fundamentals would have to change; as they did indeed try to do so in a different time of our history. In the Chinese case, on the other hand, fundamentals are already in the power of the state, which only needs to make sure they can come to full fruition.

If the reforms initiated in the late 1970s were critical to provide China with the adequate means of economic ascension, and from there to power in all its guises, one might ask whether there would be the right incentives if it was not for those critical steps that culminated in the travel, in 1972, of Richard Nixon to China. The ultimate symbolic gesture of what Waltz (1979, p. 130) calls "the greatest act of creation since Adam and Eve". There the United States was reaching a hand to recognize China as a power, but more decisively, to demonstrate the former's will to create the latter in its own image. Characteristically enough, America cannot help but hope that China will not bite the fatidic fruit that opens the gate to outside present paradise.

Even though today's China is still extremely behind the US in terms of military and soft power (Nye, 2011), and economic might not necessarily translate into military might nor geopolitical influence in a one-for-one basis (Krauthammer, 1990), in plain economic terms the fundamental weight of China is set to far exceed those of any other national superpower (with the only possible exception of India in the long haul) in a period in which there still will be room for catching-up. Consequently, the conjugation of convergence and gravity are the “key drivers of future economic dominance” (Subramanian, 2011, p. 79), and all that is fundamentally necessary, though not sufficient, to guarantee that is domestic and international stability. The trend is there. You have convergence and you have gravity reinforcing convergence. A trend like this one neither easily explodes, nor peters out. But it is only fulfilled if stability can be maintained in a dynamic environment through dynamic adaptation. And this presumes reforms and institution-building both domestically and internationally.

As long as Brazil is still not showing a discernible convergence pattern it is clear that its domestic stability around the present development model is not satisfactory. As such, the row of economic reforms that the country needs are not meant to maintain its trend but rather to unleash its economic forces historically undermined under extremely high transaction costs caused by uneconomic policies meant to satisfy a plethora of vested interests, that are not congruent with high and sustainable economic growth. Putting the country on a trend in which gravity and convergence become self-reinforcing is the first necessary condition.

When China joined the WTO in December 2001 after long years of adaptation starting with reforms passed in 1993, among which an institutional amendment changing its status from “planned economy on the basis of socialist public ownership” into “socialist market economy”, it definitely received an endorsement that it was not only welcomed in the international economic system, but that its normalization efforts were acceptable and credible. WTO accession was a watershed. If its growth was impressive before that, after 2001 it would reshape the balance of the world. Consider, for instance, the question of each country’s contribution to global economic growth. Nowadays with China presenting a GDP that is half the one of the United States, an annual increase of 8% in China has the same overall effect as if the American GDP was increasing by 4%[32].

32 The IMF forecasts China growing 8.2% in 2013 and 8.5% in 2014, after 7.8% in 2012. On the other hand the American GDP does not grow beyond 4% per year since the year 2000.

Around this critical date of 2001, China enshrined in its constitution the importance of the private sector in 1999, and in 2002 its ruling party absorbed the Three Represents thought that was being expressed by Jiang Zemin since 2000[33]. Although somehow blurry, the Three Represents was a critical step in which the governing CCP assumed itself not anymore as a dictatorship of the proletariat in constant class struggle, but rather as a party that should represent and accept the membership of peasants, workers and capitalists alike. As Chen (2009, p. 102-03) puts it, the Chinese acceded to the WTO in a time following the Asian financial crisis during which FDI to China was negatively affected. From then on, however, FDI would regain its positive steep trend whilst China implemented the agreed reductions in barriers to FDI and trade.

Also in that period, 2002 offered the last Brazilian political crisis with international disturbing consequences regarding the behavior of the markets and investors as they accompanied the lively political environment of the South-American giant. The workers' party (PT) inveterate presidential candidate, Luiz Inácio Lula da Silva, was running a successful campaign and all the polls started to predict his victory in the October 2002 elections. The prospect of having Brazil governed by Lula, who was recurrently depicted as the boogeyman of free markets, was raising deep concerns among investors. In such circumstance interest rates would soar to record levels as capital started to leave the country. In the end of July a Brazilian delegation was dispatched to Washington where a loan would be negotiated with the IMF in order to calm the markets by showing that the IMF trusted the Brazilian institutions and that fears of irresponsible policy changes after elections were exaggerated. The outcome of the negotiation was the largest loan ever made by the IMF until then. One month earlier in Brazil, Lula had released the Letter to the Brazilian People (Carta ao Povo Brasileiro) where he stated, alongside several criticisms of the economic model in place, that the general and most critical points of macroeconomic policy guaranteeing stability would be preserved. The letter was taken as a demonstration of maturity and compromise that would find sympathetic interlocutors that would work to spread confidence in the message: something synthesized by the declaration of the American

33 It would then be part of an amendment to the country's constitution in 2004.

Ambassador to Brazil during the campaign that Lula was the “embodiment of the American Dream”.

Following Lula’s election, the unprecedented environment of transparency and collaboration in which the transition between one government and the other has occurred served as a striking demonstration of institutional soundness. When Lula was sworn in as president of Brazil none of the nightmare prospects turned into reality. Quite on the contrary, the country would keep macroeconomic prudence and the US$30.4 billion loan from the IMF would be paid in advance in 2006. The path that was chosen would further result in the country being able to lend US$10 billion to the IMF in 2009.

After this, the markets and investors became so confident that future political crises in the country - and they were many and very consequential, by the way – would not turn into economic disarray, that political strife would occur without significantly altering the behavior of the markets. Brazil had finally achieved the status of a normal democracy in which institutions were above political disputes and, as such, were able to guarantee reasonable levels of predictability in the economy while enforcing and protecting contracts. Market-oriented economic reforms were kept and deepened while, at the same time, a wider social agenda meant to promote income distribution and poverty alleviation took place.

CONCLUSION

FDI is the most consequential tool of international economic integration. A process that is resulting in accelerated economic change that is reshaping the global economy. As we have seen, the role of FDI in both countries analyzed in this study is quite pronounced. From its macroeconomic relevance in the structure and management of the Balance of Payments to its microeconomic gains realized through transfer of technology, knowledge and managerial skills, which are increased by the demonstration effect and other spillovers, FDI has above all things helped to promote international economic integration, which is a driver of global economic growth. A growth that comes, as usual, through creative destruction: thus resulting in profound rearrangements that are prone to generate instability. However, increasing international integration leads to an equilibrium more likely to be managed in a way that increases global peaceful coexistence than would otherwise be the case.

Clearly, the role of FDI is even more explicit in China due to the sort of historical natural experiment observable between the periods before and after 1979 where the contrast could not be more striking. In Brazil – that has never retreated completely from the relationship with foreign investment, but has rather searched it through different levels of contact with the global economy over the post-WWII era - the qualitative improvement over the last two decades is also altogether impressive. To be sure, in both countries there were significant institutional changes without which they would not be able to reap the fruits of this period of outstanding economic expansion that followed the end of the Cold War, expansion to which they both are main contributors.

This study highlighted the interaction between changes in international and national institutions and how economic competition led by firms in the international stage is prone to provide a good opportunity for development strategies that are based in international economic integration. Yet, as it was discussed, this positive outcome depends a lot on the set of institutions present in each country. They must be able to, at the same time, offer enough perspective of gains to the MNE and place it within a framework that will induce the greatest number of possible positive spillovers from it.

Having a healthy economic environment in which returns from investment are easier to predict increases the bargaining power of the host country. Indeed, a lot of what China was and is able to obtain from foreign investors is born from the perception that potential profits there are, are just too high to let them slip away. The incentive structure created by the competition for global market shares among firms takes care of the rest. Having a big market where returns to investment are potentially higher than in saturated markets makes all the difference if the *potential* is not hindered by uneconomic distortions. If China and Brazil are places where many of such distortions are in place, the fact is that both engaged in a trend to reduce them over the last decades.

The importance of institutions that facilitate the organization of economic activity by reducing transaction costs and inducing the creation of firms engaged in productive activity, furthermore letting them benefit from the comparative advantages of the country, while in parallel the country secures their competitive advantage by well managing the economy, is a clear recipe that insists to remain elusive in many cases.

Moreover, respecting the comparative advantages and harnessing them with competitive advantages is the best way for shaping the dynamic comparative advantages into the upward course envisaged by every country. The way that China is moving up the value chain is a clear example of such strategy. It is once more all about interaction between institutions and organizations. And including MNEs in this process serves not only to accelerate economic change, but also to secure its alignment with the global economy, something that is becoming more and more imperative.

If institutions are the rules of the game and organizations are the players, as supported in an earlier part of this work, then the latter are divided between mainly political organizations which have direct influence over institutions, and mainly economic organizations which have indirect influence over institutions. It was further demonstrated that political organizations, like governments, do respond to economic incentives, but are intrinsically constrained by a larger set of political interests that may serve to push for inclusive institutions that promote development and cooperation or may not. As for economic organizations, like firms, the constraints of political interests are overruled by economic interests because of the very nature of the firm, therefore they respond to economic incentives in a straightforward manner.

It was then demonstrated that this structure is applicable to domestic and international interactions alike with marginal differences. Accordingly, in both arenas the strongest political organizations have the power to create and shape institutions that alienate specific organizations that operate under given sets of institutions considered undesirable by the strongest organizations. Within a given sovereign state that basically creates segregation between those who abide by the law and those who are outlaws, while in the present international stage the segregation is traced between those who are within the rules-based market system enjoyed by the majority of states and those who decide to stay outside. The difference is that within the sovereign state the law can be enforced by the organization that holds the monopoly of legitimate force, while in the international stage the legitimate use of violence is not a settled issue even though it is clear that some organizations are monopolists in the field. Thus, although their presence is theoretically accepted, the fact is that the system does not like outsiders, for they are believed to be the focus of instability. As a result, the international system wants to become global because it claims that its own security and survival depends on its expansion. Quite characteristically, the process of expansion is unstable because it implies moving to new equilibriums in which power resources are redistributed.

On the economic side this politically underpinned process of globalization is spearheaded by organizations that are the multinationals. Having proliferated in industries with different sources of entry barriers, their very development increases even more than such barriers, making clear the difference between firms that are globally competitive and firms that are not. Little wonder that M&As represent a big part of global FDI (oscillating between 20.8% and 51.7% in the last 7 years), in a pattern reinforced by strategic asset-seeking investment. Moreover, the spread of the activities of multinationals ignited a process of accelerated economic change having direct impact on economic performance, and thus exacerbating the gap between countries that are well connected in the network of international production and trade, and countries that are not.

Inasmuch as these definitions hold true, the strongest organizations in the world are those who will shape the institutions of international interaction. In a context in which political ideology had diminished as a source of instability and the rules of the game of international economic interaction expanded to almost the entire world, economic organizations with interests abroad were able to expand their influence, for through them a compromise of interdependence is strengthened by the increase in the importance of economic flows performed by them. And if these flows increase the mutual dependence when they are constituted by trade or financial assets, they are much more consequential for this project of an interdependent world when they occur in the long-lasting and multifaceted form of FDI.

The most interesting thing of institutional change is that in the origin it may seem to be just a small deviation: a sentence that is altered in a law, the confidence that is built that things will go this way and not the other way, a possibility that is included and another that is excluded from the realm of socioeconomic relations, a habit that is modified. However, those few degrees of deviation end up generating pervasive changes. In the concrete cases of Brazil and China, recent institutional change made these countries more adapted and adaptive to changes in the world.

Undeniably, international institutional constructs that allowed for wider global integration and interdependence boosted national institutional change driving towards this necessary adaptive efficiency that is nonetheless still a work in progress.

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