

Macroeconomic flaws in the IMF's 'New' Institutional View: The case of Brazil

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Abstract

In 2012, the IMF issued its 'New' Institutional View to much praise since it endorsed using capital controls for international financial stability, given certain prerequisites. This paper argues that, like its predecessors, this 'New' View will be a failure because it mandates initially solving capital flow-induced macroeconomic imbalances through 'market-based' adjustment measures rather than by capital controls, thus relegating the latter to a secondary role. To support the reasoning, Brazil's recent history is used as a proxy for the IMF's current platform. This is because, despite explicitly not taking advice from the Fund, her actions have been nonetheless consistent with the 'New' View's prescriptions which culminated in the worst recession in the country's history. As a result, regardless of the revisions made in the wake of the Great Financial Crisis, the Fund's new stance is incapable of averting and stabilizing a crisis; indeed, the case of Brazil suggests it is instead a recipe for creating and amplifying financial macroeconomic fragility.

Keywords: IMF, Capital Controls, Financial Fragility

JEL Classification: F33; F38.

1. Introduction

With the onset of the 2008 Great Financial Crisis (GFC), the global economy encountered conditions not seen since 1929 and that mainstream portions of academic and bureaucratic institutions flatly denied could ever exist, let alone have a realistic chance of occurring. Starting with the failure of Lehman Brothers and later AIG, the American financial system collapsed, which radiated out to other advanced economies' financial institutions. Before long, the solvency and liquidity issues those regions faced caused the meltdown to crossover into the developing world- made possible by liberalized capital and current accounts, whose rationale are that deregulated international capital and goods and services markets, respectively, produce global Pareto optimal outcomes. At the time, the dominant DSGE approach to macroeconomics was presented with the option of reconsidering its entire 'microfoundations of macroeconomics' apparatus, given such inadequacies. Rather than do this, its leading figures chose to adjust some of the more superficial elements and, accordingly, mainstream macroeconomics will be unable to explain the origins of instability when it occurs next.

A similar choice with the same probable consequences was made by the IMF. In light of its own monumental failure- which purported the GFC would be contained to advanced economies- the Fund was forced to adjust its approach to capital flow governance. What came of this can be called the IMF's 'New' Institutional View, which has received a significant amount of fanfare, even among heterodox economists, because it endorses using capital controls in eras of volatility given certain prerequisites- seemingly representing a large break from the Fund's past.

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However, despite all the new accolade, what is unfortunately overlooked is that this 'New' View still retains the crux of the IMF's prior framework because it mandates solving capital flow-induced macroeconomic imbalances first and foremost through 'market-based' adjustment mechanisms, which then relegates controls to secondary importance.

This general strategy is essentially the same as the one Brazil pursued from 2008 onwards. Indeed, despite explicitly not taking advice from the Fund, her own 'market-based' attempts to solve capital flow-induced imbalances, ironically, followed the IMF's 'New' Institutional View to a 'T'- yet she is in a protracted economic crisis.¹ Hence, by using Brazil as a case study proxy for the IMF's 'New' Institutional View, this paper's main contribution is to demonstrate that the Fund's 'New' and 'improved' stance will nonetheless lead to financial instability and stop/go development since this is what happened in a nation that acted in accordance with its guidelines. To be sure, as it now stands, the IMF's framework is incapable of chaperoning a development process since Brazil highlights that the Fund's platform fails to restrain financial macroeconomic fragility and, rather, creates and amplifies it. Thus, instead of garnering praise, importantly, this paper shows that, like the DSGE mainstream macro approach, there is nothing novel about the IMF's 'New' framework but is rather a continuation of past positions disguised through cosmetic alterations.²

The structure of this paper is as follows. In Section II, we discuss the modifications the IMF made to its views on capital controls, which came together to form its 'New' Institutional View. In doing so, we examine how this platform interacts with an inflation targeting framework since Brazil has practiced the latter since 1999, meaning that if we are to argue her actions are consistent with the 'New' View it must be established that both prescribe to the same adjustment transmission mechanisms. Next, in Section III, an extensive set of descriptive statistics is used to cover Brazil's last decade of economic history. It is shown there that she tried to solve capital flow-induced imbalances through 'market-based' adjustment measures numerous times, only to repeatedly fail at doing so *and* while creating bigger imbalances in the process. This enables us to move onto Section IV, where the connection between her policy actions and those prescribed by the 'New' Institutional View is made. It is there that the most significant macroeconomic flaws in the Fund's framework are made plain and the thrust of the main contribution is asserted. In turn, Section V puts forward the main conclusion resulting

¹ It is true that Brazil successfully implemented capital controls on portfolio investment inflows from 2009-2011, which some may suggest invalidates our proposition that her actions were consistent with the 'New' Institutional View's emphasis on 'market-based' adjustment measures. Nothing could be further from the truth. While elsewhere authors (Gabel 2013; Gallagher, 2011) have identified how Brazil's portfolio investment inflow controls were effective and could serve as a model for how they should be adjusted over time, it will be shown that it was FDI that was more important, was left entirely uncontrolled, and created the initial capital-flow induced imbalances that policymakers tried to solve with 'market-based' adjustment mechanisms- just as in the 'New' Institutional View. Unfortunately, it was this approach that also led to the creation of additional imbalances, a host of rash policy decisions, and numerous unsuccessful attempts at further 'market-based' adjustment.

² It appears that what the IMF did was simply graft trivial, ad hoc addendums onto its base neoliberal theory to allow it to claim policy evolution- and therefore a newfound ability to ensure anything like the GFC could ever spread to the developing world again. Indeed, though it is sparsely mentioned in any of their official documents, elsewhere (2017) I have examined the IMF's underlying financial macroeconomic model and found it to still be extremely neoliberal because, among other aspects, it continues to endorse the Efficient Markets Hypothesis. What appears to have occurred is that post-GFC, the Fund hedged itself by evolving on the applicability of the *policy* of capital controls (and thus being in vogue), given certain conditions, for when the real world's experiences with financial instability (which it claims result from exogenous, government-induced shocks) might otherwise discredit its *theory's* incessant Pareto Efficient predictions. In this regard, the IMF chose the same route as the DSGE models mentioned above.

from this; namely, rather than stabilize international financial relations and development, the 'New' Institutional View destabilizes them. In addition, Section V identifies certain takeaways that are implied from recognizing Brazil's actions and resulting collapse were in line with the Fund's 'New' capital flow governance advisory, such as a) viewing capital controls as a proactive, primary, and permanent instrument for promoting financially sustainable macroeconomic development is vital while b) market-based solutions to capital-flow induced imbalances should be eschewed.

2. The IMF's 'New' Institutional View of Capital Controls

Starting with the East Asian Financial Crisis' (EAFC) fallout, the IMF began subtly reversing its prohibitive position on capital controls, noting they were a workable solution for some of the era's issues. In particular, the Fund stated they were permissible if temporary, 'market-conforming', only levied on inflows, and implemented after capital and current account liberalization was successful and showed the economy's 'fundamentals' to be 'sound' (Prasad et al 2003). Thus, despite these prerequisites being limiting in nature, the fact that capital controls now had a conditional acceptance at the Fund marked an enormous transformation in the latter's general attitude, even though they were to lay dormant for the next ten to fifteen years.

When the GFC occurred, the IMF leveraged this in a significant way. First, in February 2010, a Fund policy brief stated that the nations that used controls to guide inflows over the previous fifteen years were those least impacted by the crisis (Ostry et al 2010). Moreover, the same brief argued managing inflows allowed authorities to stretch liability maturity structures, reducing the probability of a near term financial crisis. Both of these propositions were more formally recognized when they were subsequently included in the 2010 Global Financial Stability Report, with this latter document, unfortunately, adding that controls should only be last resort (Grabel 2011).

The culmination of this post-GFC acceleration in the Fund's intellectual evolution came with its 2012 Executive Board Report entitled *The Liberalization and Management of Capital Flows: An Institutional View*, which laid out the 'New' Institutional View. Here, in a complete enunciation of its stance, the IMF reiterated that capital flows present the potential for financial instability, developing economies without properly 'sequenced' capital account liberalization are more vulnerable to this, and that even with successful 'sequencing' exogenous policy shocks may make it necessary to implement inflow and/or outflow measures (IMF 2012; Grabel 2013).

However, at the same time, the 'New' View kept a *significant* distance from wholly embracing capital controls. To be sure, the IMF remained adamant that prior to implementing such measures, authorities should first attempt to eliminate capital flow-induced imbalances through 'market-based' adjustment mechanisms. In fact, they went as far as to provide *specific recommendations* for how to correct individual imbalances. As an example, in the case of inflows leading to an overvalued exchange rate, the IMF advocates first lowering interest rates to slow/reverse appreciation, rather than use controls (IMF 2012). It is only *after* such adjustments have been tried *and* other, multiple imbalances open up that the Fund believes controls *then* become 'acceptable' policy instruments- basically once all other policy space has been eliminated. Hence, while technically incorporating capital controls into its framework, the IMF retained a heavy preference for market-based adjustment measures.

It followed that the Fund next had to elucidate what exactly its 'New' View saw as the 'proper' role for capital controls in its revised platform. The answer: they are a second-best option (with first-best being capital account liberalization) only to be used as a final recourse, that should be temporarily implemented, after the economy has accumulated 'significant'

reserves and allowed 'the market' to determine interest and exchange rates, that must be incapable of discriminating amongst investors/depositors based on their geographical location, and ought to be price rather than quantity-based (Gallagher et al 2011; Grabel 2013). Thus, despite its hype as 'the Fund turning a corner', the 'New' View possesses the same general precepts as its past neoliberal models.

2.1. Inflation Targeting in the 'New' Institutional View

To argue Brazil's actions have been consistent with the 'New' View, as is intended below, it is first necessary to explore how the latter interacts with inflation targeting frameworks since Brazil has been one from 1999. Indeed, to make the case that her recent past can serve as a case study proxy for the IMF's stance, it must be demonstrated that the intended strategies and mechanisms are the same in both paradigms.

In an inflation targeting regime, the governing authority, typically an independent (at least formally) central bank, chooses an 'acceptable' target level of inflation whose achievement becomes the sole objective. Next, the body selects a nominal anchor policy variable it controls that it believes will enable it to hit the target, commonly the overnight interest rate. If it does so, a Pareto optimal outcome is thought to result (Mishkin 2004; Epstein 2005).

The assumed intuition behind this neoliberal model is fairly straightforward: with the labor market producing full employment (or New Keynesian rigidities preventing it from doing so), a production function determining output, and Say's Law guaranteeing the full employment level of expenditure (or, once again, New Keynesian rigidities preventing it from doing so), the only responsibility the governing body is supposed to have is ensuring price inflation/deflation does not distort relative price signals so an efficient allocation of resources can be procured. Thus, in the case of above (below) target inflation with an interest rate anchor, policymakers raise (lower) short term rates, intending for this to carry over to the rest of the term structure, until investment is sufficiently choked off (spurred) and the economy is slowed (accelerates) to the point that the relationship between demand and supply is restored at a level consistent with the target inflation rate.

From this, it should be apparent that the intended equilibrating mechanism of an inflation targeting framework is a type of the 'market-based' adjustment measures the 'New' Institutional View promotes. In the former, all disequilibrium arise from a distortion of relative price signals caused by actual inflation deviating from target inflation. To reacquire general equilibrium, it is said the economy must undertake an adjustment path that uses the short term interest rate to calibrate the optimal level of inflation. Thus, to the extent that capital flows induce price instability, capital controls, if ever, would be endorsed only once all other 'market-based' adjustment options, such as changing interest rates, have been explored. To be sure, like with the 'New' View, controls would be appropriate only as a last resort, second-best, temporary policy that should not interfere with or rival the market's alleged self-adjusting mechanism.

It is worth highlighting a peculiar discrepancy between the purported transmission mechanism of an inflation targeting framework in developing economies and observed events. As compared to advanced economies, here the external sector is generally a relatively larger proportion of the total economy and, as a result, changes in the prices of imports brought on by exchange rate adjustments have a more significant impact on the overall price level. At the same time, because developing economy financial systems are less developed, any changes in net capital flows have a relatively larger impact on the exchange rate since such flows comprise a greater weighting in the overall financial system. Thus, rather than the *intended* inflation targeting adjustment scenario- where monetary policy seeks to change domestic

investment demand (and thus absorption) to attain a target inflation rate- in developing economies with open capital accounts the way the inflation rate commonly *does* end up adjusting is through changes in the short term interest rate altering the term structure, which influences net capital flows and that subsequently modifies exchange and inflation rates.

For example, during a boom, if actual inflation exceeds target inflation, the governing body would raise short rates, affecting the rest of the term structure, and *trying* to bring absorption and productive capacity into line consistent with the target inflation rate. The same train of thought would occur if actual inflation was above target inflation during a crisis. However, what *does* happen is that during a boom raising rates creates a larger positive risk-adjusted international interest rate differential, which tends to revise expectations upward and attract additional net capital inflows, which appreciates the exchange rate, makes imports less expensive, raises the cost of exports (and thereby curbs investment in tradables), and eventually lowers actual inflation relative to target inflation. On the other hand, during a crisis, in which expectations rapidly adjust downward for higher liquidity, raising rates tends to increase enterprises' costs, eliminate refinancing possibilities, and lower capital and financial asset prices- the combination of which strengthens capital flight, depreciates the exchange rate, lowers the real wage, and raises actual inflation relative to targeted inflation through both the distributive conflict and currency sell-off. Consequently, in developing economies with open capital accounts that practice inflation targeting, monetary and exchange rate policy are inherently interrelated since any changes in the former create new international interest rate differentials and sets of expectations to which net capital flows respond and subsequently impact the exchange and inflation rates (Ocampo 2016).³ As we shall see, the failure of Brazilian central bankers to grasp this divergence between theory and reality had dire consequences.

3. Brazil's Recent Macroeconomic History

It was stated at the outset that the purpose of this paper is to show Brazil's recent policy actions have been consistent with the 'New' Institutional View- intending to then use this as evidence that the Fund's 'improvements' promote financial fragility. Hence, the past decade of Brazilian economic history must now be chronicled, which is done by rehashing the historical record generally accepted within Keynesian/neo-Structuralist literature as well as through graphical correlations that display this explanation.

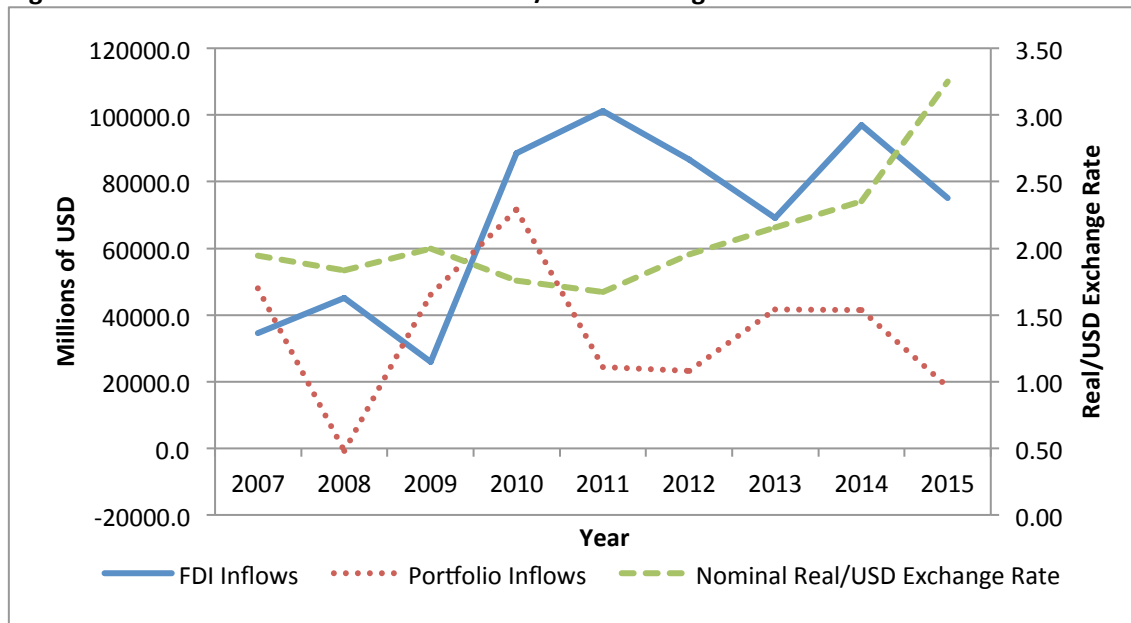
On the surface, the last decade of Brazil's economic history reads like a failed promise of development. However, upon closer examination one finds that the promise itself, enshrined in the commodities bubble, was hollow considering the latter revolved around a financial fraud engineered by American investment banks to drive up prices (Wray, 2008; Ffrench-Davis and Heresi, 2016). Since this meant the commodities boom's effects were mainly confined to increasing export prices, it should come as no surprise that the growth of Brazilian export quantities was essentially stationary in the GFC's run-up (and remained so until 2011) (Cypher 2015). At the same time, there was no domestic engine sustaining a development process: the share of investment in Brazilian output was not growing, its composition was moving towards FDI, and structural bottlenecks made inflation an omnipotent threat in a nation historically plagued by it (Cypher 2015).

³ It is suspected that the mainstream academic literature and/or bureaucratic institutions do not recognize this because if they did, they would not repeatedly endorse an approach that has resulted in high interest rates attracting sizeable inflows that appreciate the exchange rate, promote the carry trade, deteriorate micro and macro risk profiles, discourage investment in tradeables, and produce further inflows that culminate in medium term financial, banking, and currency crises.

These underlying structural factors left Brazil extremely vulnerable to external shocks. As a result, when the crisis hit, her future was thrust onto shaky ground. To counter this, and to their credit, authorities rapidly undertook extremely aggressive countercyclical actions, and real economic activity rebounded. Consequently, when the U.S. began its Quantitative Easing (QE) program in late 2008 and capital began searching for higher international returns, Brazil stood poised to attract it, given the appearance of a successful recovery and a legacy of extremely high interest rates.

As Figure 1 shows, this led to an initial surge of portfolio inflows, which authorities responded to successfully with inflow controls. However, they did nothing to slow the subsequent marked explosion of FDI that started in 2009, which caused the real to appreciate until policy intervention finally came in 2012 (Cypher 2015). It was this event, along with subsequent policy decisions made mostly by the neoliberal central bank, that set in motion a series of macroeconomic imbalances- with failed ‘market-based’ responses to them- which led Brazil into her crisis.⁴

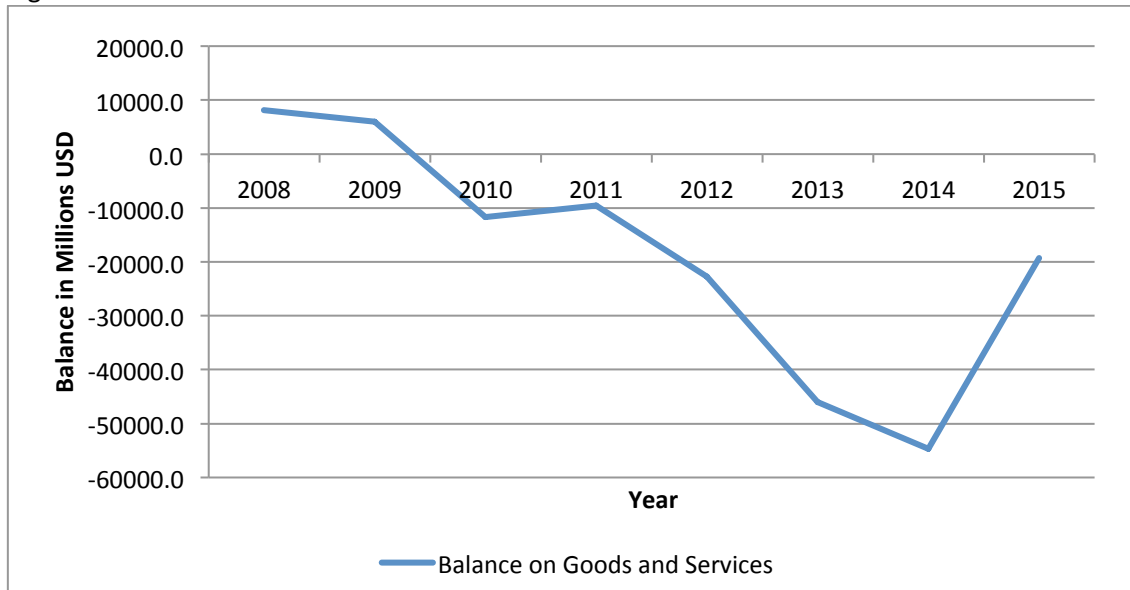
Figure 1: FDI and Portfolio Inflows and Real/USD Exchange Rate



Source: ECLAC

⁴ Some may argue that there is no compelling reason to regulate FDI since it represents stable financial flows to the recipient economy. This is incorrect. First, certain components of FDI increasingly exhibit volatility similar to portfolio flows, implying they present an equal threat to stability (Ocampo et al 2007; Ocampo 2016). Second, FDI inflows give rise to future payment commitments on the factor services portion of the current account, which Kregel (2004) has shown can destabilize international financial relations.

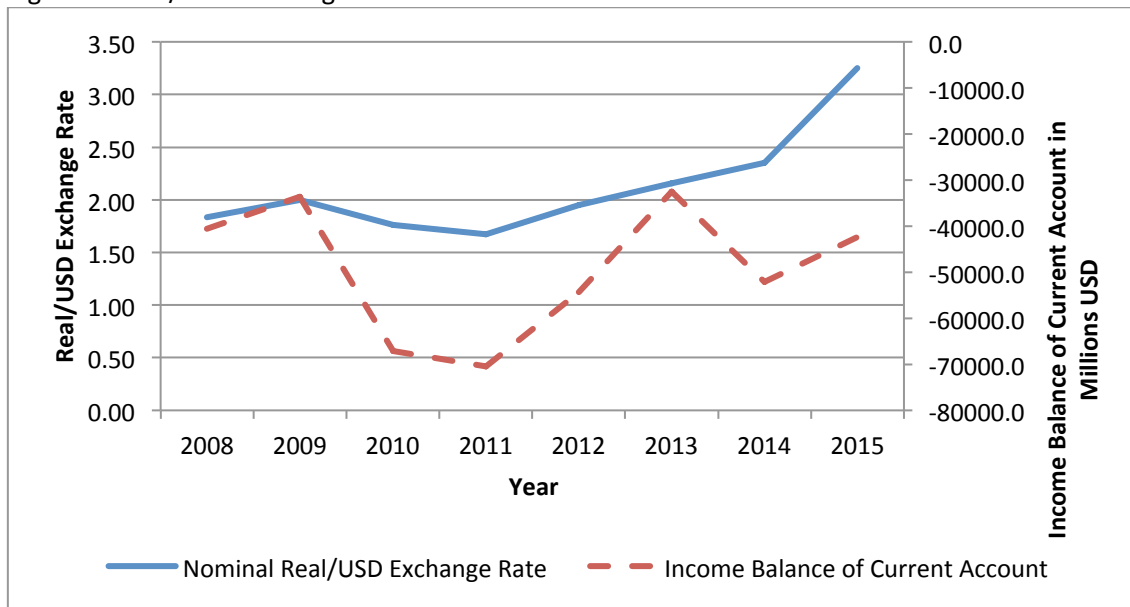
Figure 2: Balance on Goods and Services



Source: ECLAC

Once the commodities boom ended and the exchange rate appreciated, Brazil opened up a persistent deficit on the balance of goods and services by Q4 2009, as Figure 2 shows.

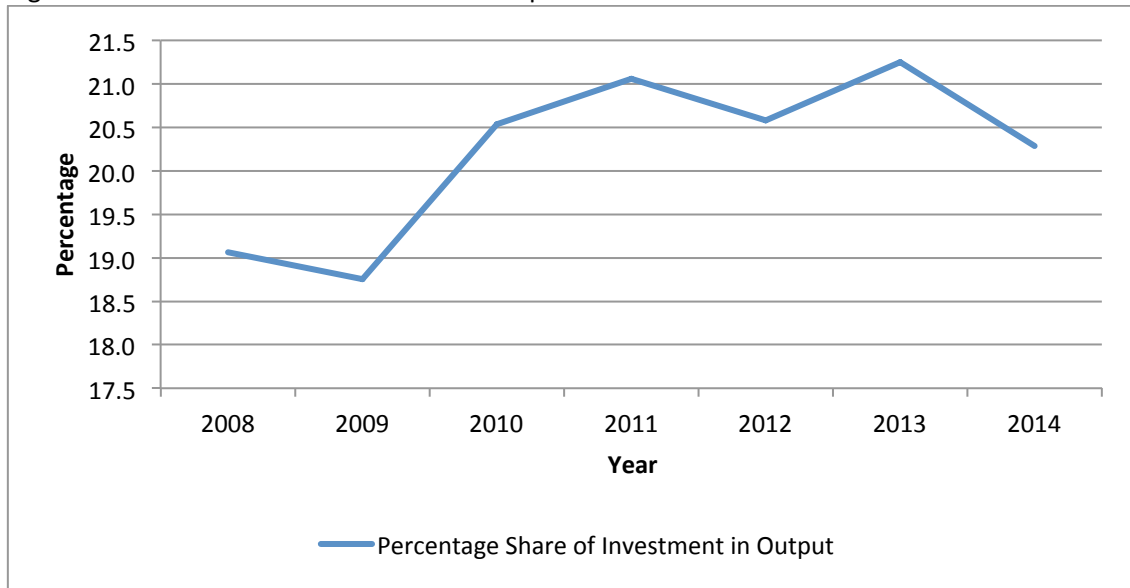
Figure 3: Real/USD Exchange Rate and Current Account Income Balance



Source: ECLAC

In addition, as Figure 3 spotlights, she began sizably increasing the existing deficit on the income balances portion of the current account, since the appreciating exchange rate allowed foreign enterprises to repatriate interest and profit income at more favorable ratios. Importantly, this latter feature had the structural impact of encouraging financial investment at the expense of net capital formation, which allowed an increasingly financialized development process to emerge (Cypher 2015).

Figure 4: Annual Share of Investment in Output

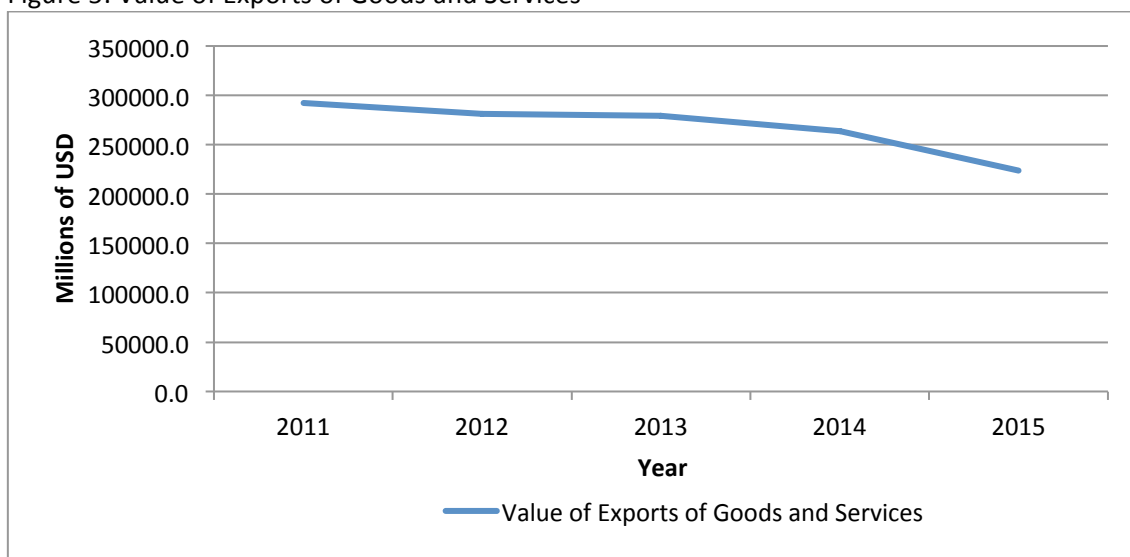


Source: ECLAC

In the meantime, as Figure 4 shows, throughout these external developments the growth of the share of investment in output remained sluggish, for two reasons. First, despite interest rates falling slightly until the middle of 2013, they were nonetheless still extremely high and within historical dispersion bands, meaning they were impotent to initiate any meaningful change in the rate of capital formation. Second, the previously mentioned sharp acceleration of FDI was really foreigners purchasing *existing* Brazilian enterprises, which simply transferred ownership rather than represent any net increase of capacity (Cypher 2015).

By the end of 2011, the result was an overvalued exchange rate, a growing current account deficit (that as a percent of GDP was in excess of the regional average), little expansion of sustainable domestic activity, and a development process increasingly centered on financialization. Needless to say, this left Brazil heavily dependent on the value of her goods and services exports.

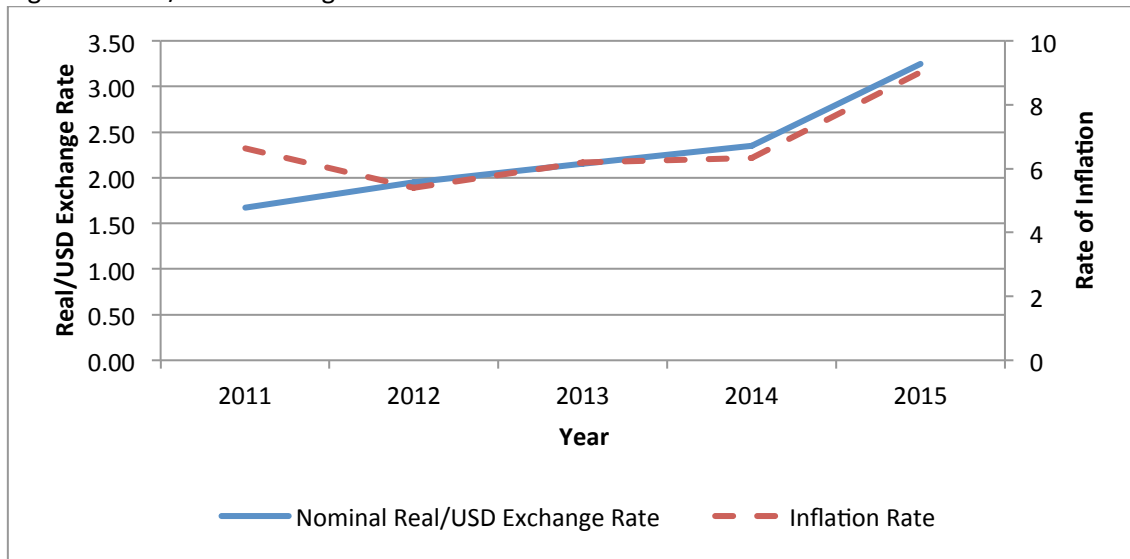
Figure 5: Value of Exports of Goods and Services



Source: ECLAC

However, as Figure 5 shows, this began to fall, dispossessing the export sector of any ability it might have had to close the current account deficit and produce external balance. Consequently, in 2012, officials finally decided to correct the overvalued exchange rate.

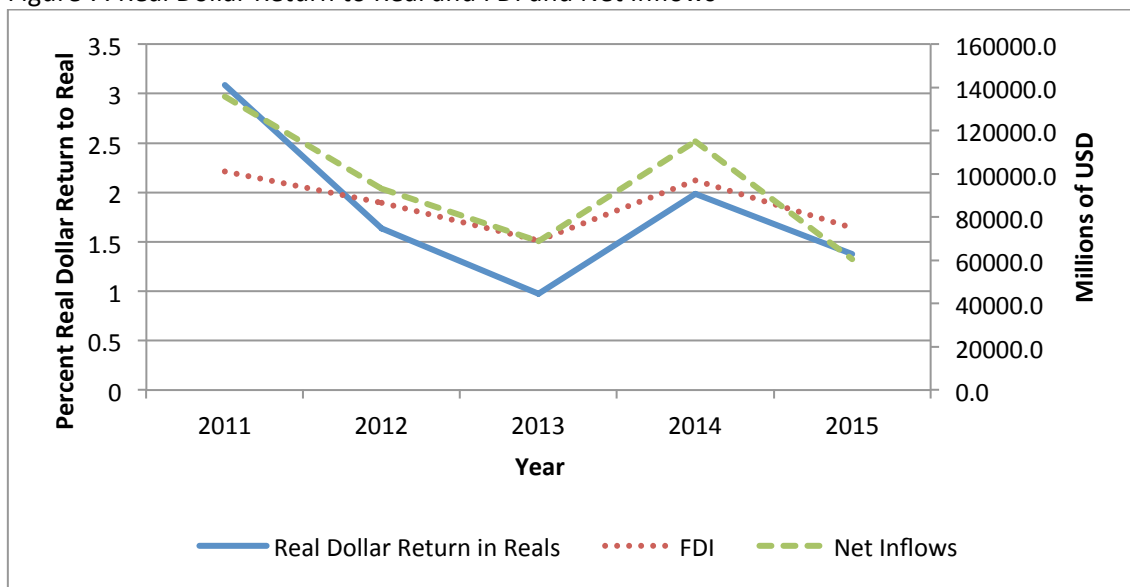
Figure 6: Real/USD Exchange Rate and Rate of Inflation



Source: ECLAC

Unfortunately, this was counterproductive. While depreciation did eventually decrease Brazil's import growth, it also accelerated inflation, as Figure 6 shows. Thus, in addition to structural bottlenecks from an historically poor domestic investment growth record (which were not disappearing because of high interest rates), a second inflationary mechanism was now introduced.

Figure 7: Real Dollar Return to Real and FDI and Net Inflows

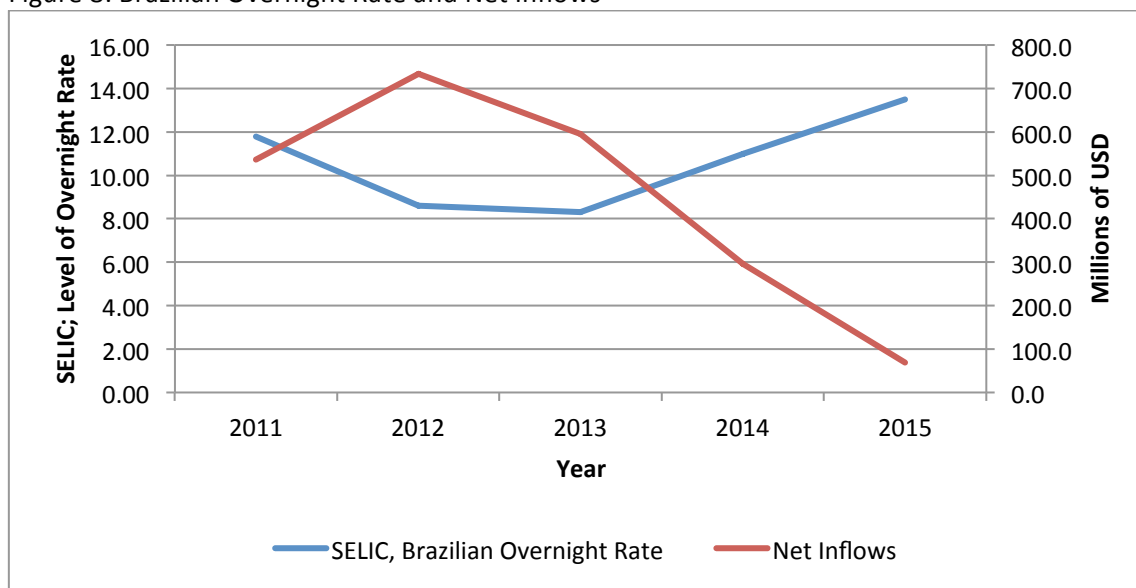


Source: ECLAC and Author's Calculations from ECLAC Data

As Figure 7 highlights, this led to the continual erosion of the real dollar value of investing in the real, which made the rate of FDI inflows (and net inflows) slow and the direction ultimately reverse. This added a new dimension to the depreciation strategy since

foreign investors now selling the real placed additional downward pressure on the currency, which reinforced inflation.

Figure 8: Brazilian Overnight Rate and Net Inflows



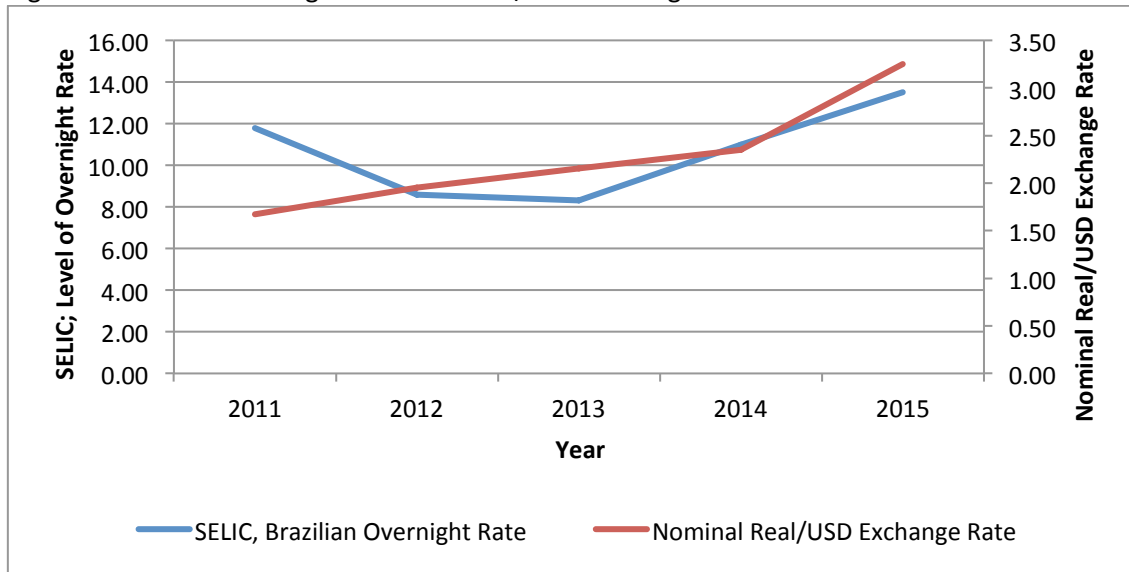
Source: ECLAC

Since the central bank’s policy framework was inflation targeting, it reacted to this by aggressively raising interest rates in 2013, as shown by Figure 8 (Cypher 2015). This did two things. First, through its inclusion on the National Monetary Council, it guaranteed that the central bank’s preference for ‘market-based’ adjustment measures, rather than capital controls, to solve what were capital flow-induced imbalances would lock Brazil into a vicious circle of high interest rates, high inflation, and capital flow reversals where a financial macroeconomic crisis was inevitable.⁵ Second, it demonstrated its neglect for remembering one of the many items the IMF bumbled during the EAFC in that changing interest rates during eras of fragility has significant impacts on existing enterprises’ costs, balance sheets, and future financing abilities (Kregel 1998). To be sure, what ended up happening is that, with interest as a cost, raising rates only heightened inflation (Figure 8), which further pushed down the real dollar value of investing in the real and caused additional FDI and net inflow reversals (Figure 7), which again depreciated the exchange rate and raised inflation (Figure 6), which the central bank resolutely met with higher rates (Figure 8) (Weisbrot et al 2016).

When recession was officially declared in mid-2014, the situation went from bad to worse. Because the depreciating exchange rate could not compensate for the fact that interest rates were far too high to spur domestic-based investment in tradables, it became clear sufficient export growth to balance the persistent current account deficit would never occur (Cypher 2015). It was also at this time the policy intervention to depreciate the exchange rate officially ceased, meaning the currency’s continued fall was now solely the result of foreign investors selling off the real.

⁵ The National Monetary Council is a body comprised of the Central Bank President, the Minister of Finance, and the Minister of Planning, Budget, and Management that must agree on all monetary and exchange rate policies.

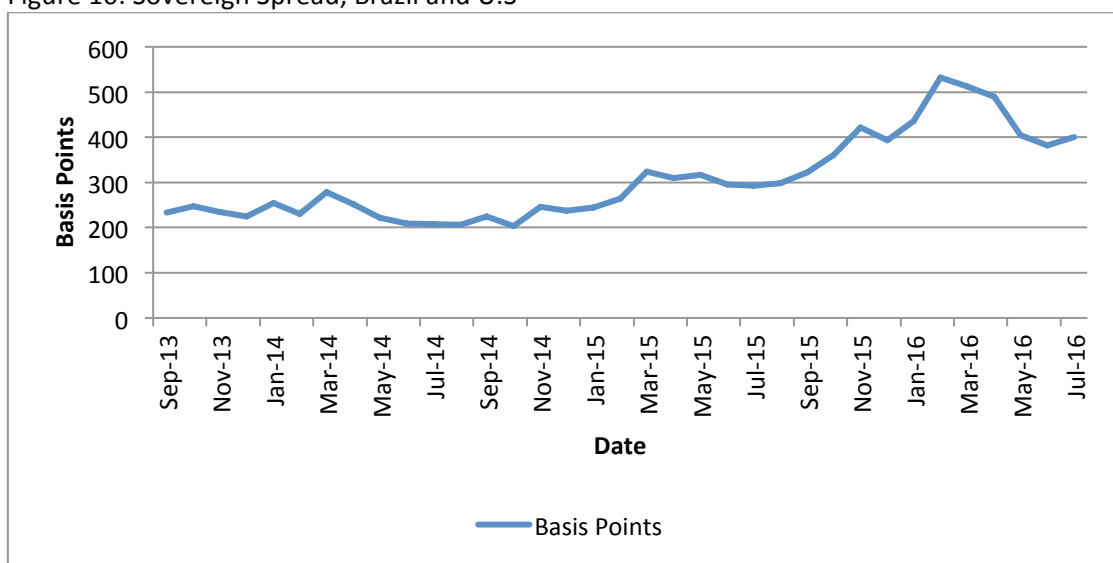
Figure 9: Brazilian Overnight Rate and Real/USD Exchange Rate



Source: ECLAC

As Figure 9 shows, when QE ended later that year, portfolio debt and equity flows (which had modestly returned temporarily following the initial interest rate hikes in 2013) joined the FDI reversal, which caused net inflows to tumble further and, when combined with Brazil's perpetually negative income balances portion of the current account, resulted in a plummeting rate of net resource transfers. Hence, leaving Lava Jato to the side (which certainly added complexities and made the situation more dire), Brazil was ripe for a full-fledged crisis: a depreciating exchange rate; unbroken inflationary bottlenecks; interest rates far too high to induce domestically-based investment in either domestic or tradable production, were complicating enterprises' refinancing possibilities, and were building a fiscal deficit through rising interest payments; rapidly reversing capital flows; a political economy that cast financialization as a legitimate, sustainable structural transformation; and, incredulously, the survival of the *original macroeconomic imbalances* that spawned each erroneous policy decision along the way.

Figure 10: Sovereign Spread, Brazil and U.S



Source: IPEADData.gov

The spark that lit the conflagration was a foolhardy S&P credit rating downgrade in September 2015, brought about by worries surrounding the fiscal situation.⁶ As Figure 10 shows, this had the effect of skyrocketing the sovereign spread between Brazilian and U.S. bonds. Since Brazilian debt was no longer investment grade, this meant money managers around the world were forced to close their Brazilian positions, which accelerated net inflow reversals, depreciated the real, and caused higher inflation. In keeping with its past history, the central bank revealed that it forgot a second lesson from the EAFC (and a central tenet of Chapter 17 of Keynes' *General Theory*) involving the fact that sometimes there is no level the interest rate can be pushed to that will acquiesce the liquidity demands of foreign investors (Kregel 1998). To be sure, it attempted to reverse course by again raising interest rates, which, expectedly, failed miserably because it only sharpened inflation, lowered the real dollar value of investing in the real, eliminated refinancing possibilities, and increased the fiscal deficit by boosting interest payments (Weisbrot et al 2016). When a second downgrade happened in February 2016 (for the same fiscal-related reason), Brazil was engulfed.

4. The Macroeconomic Flaws in the 'New' Institutional View Exposed by Brazil

At this point, the connection between the 'New' Institutional View and Brazil's experiences can be established to spotlight the Fund's contemporary proclivity for financial instability. Recall that in its 'New' framework, a nation is to eliminate whatever capital flow-induced imbalance(s) plague it through appropriate 'market-based' adjustments(s) before implementing capital controls. However, this is *exactly what Brazil did*, which only created additional imbalances and a financial macroeconomic crisis. There are five such imbalances and adjustment series, each of which discredits the IMF's 'New' Institutional View.

The first was the 2009 FDI surge that overvalued the real. As shown, this led to an initial external imbalance by opening up a persistent deficit on goods and services while increasing the deficit on the income balances portion of the current account. Consistent with the Fund's preference to undertake 'market-based' adjustment measures rather than implement capital controls, Brazil sought to correct the overvaluation and indirectly close this gap by (eventually) controlling a depreciation, rather than directly limit FDI.

This strategy failed, and led to the second and third imbalances in 2012, the former of which was increased inflation resulting from the depreciation strategy while the latter involved net inflow reversals once the real dollar value of investing in the real dwindled. However, consistent with the 'New' Institutional View, rather than implement controls, the central bank attempted to regain general equilibrium both times by raising rates, believing market-based adjustment would restore domestic price and currency stability.

It is at this point, if not already, that the Fund's 'New' Institutional View became entirely invalidated *and* it was made apparent that the Brazilian central bank was oblivious to the fact that monetary and exchange rate policy are inherently interrelated in inflation targeting frameworks in developing economies with open capital accounts. Indeed, when the central bank raised rates to lower inflation (to solve the second imbalance stemming from depreciation), believing the imposition of domestic price stability would incentivize international investors to return to Brazil (which would solve the third imbalance of net inflow reversals), its neoliberal ideology locked the economy into a vicious circle: the higher rates raised enterprises' costs, which tacked on to the already existing depreciation-related inflation,

⁶ The S&P's actions were foolhardy because the Brazilian government is the monopoly issuer of the real and, as such, has no financial constraint on the quantity of reals it can create. Thus, despite the fact that its economic conditions were deteriorating, when S&P and later Moody's cited Brazil's fiscal environment as the reason behind the downgrade, it became clear these ratings businesses do not understand how monetarily sovereign economies operate.

which further tapered the real dollar value of investing in the real, and, contrary to its design, led to additional net inflow reversals. This then, once again, strengthened depreciation and inflation pressures, which of course led to higher rates. Hence, instead of fixing the imbalances, the central bank did the exact opposite. Yet, at the same time, these actions were completely in line with the 'New' Institutional View since authorities spurned capital controls in favor of 'market-based' adjustment measures, with the result being that Brazil locked herself into prolonged collapse.

Next came the fourth imbalance, which involved how the central bank's decision to raise rates built a fiscal deficit into the budget by increasing interest payments. In turn, this caused the S&P downgrade to occur, which served as the spark to ignite the actual crisis. Despite the fact that the fault for this imbalance lay with the central bank, the federal government, in an era of inflation, tried to adjust by cutting expenditures (austerity) (Cypher 2015). This backfired, and guaranteed stagflation: the drop in expenditure took away from already lowering national income while inflation survived owing to the high interest rates a) preventing private investment from overcoming structural bottlenecks and b) by inflation-high interest rates creating further declines in the real dollar return to investing in the real with consequent depreciation. Now, even though austerity was an entirely inappropriate response, it was nonetheless consistent with the 'New' Institutional View- it tried to solve an imbalance in a way that would, in theory, avoid price distortions (which allegedly misallocate resources) by elevating market forces.

Fifth and finally, the last imbalance came after the S&P downgrade led to portfolio and FDI flight. Predictably, rather than stem the outflows by using controls, the central bank countered by raising rates- another attempt at 'market-based' adjustment. However, this made matters worse since it intensified inflation, further dropped the real dollar value of investing in the real, destroyed refinancing relations, widened the fiscal deficit (increasing the fourth imbalance), and led to another downgrade. Hence, while following the 'New' Institutional View to the letter, it was yet another fatal decision Brazil made.

What this adds up to is that in five separate instances, Brazil pursued an adjustment sequence consistent with the 'New' Institutional View. However, in all five instances, the pertinent issue failed to be corrected, the imbalances themselves were made larger, and new, separate imbalances were created in the process. In the meanwhile, the original problem of a trade deficit brought on by FDI surges that appreciated the currency stayed in place. In some instances- notably Cases 3 and 5 (raising rates to stem/reverse capital outflows)- Brazil implemented the *exact* policy the IMF recommends in such a situation, yet it still did not work. Thus, this makes it plain that a) Brazil is a good case study proxy for the 'New' Institutional View, b) the 'New' Institutional View will not create the conditions for a financially sustainable macroeconomic development process, and c) the 'New' Institutional View does not mark a significant break with the Fund's neoliberal past.

5. Conclusions on the 'New' Institutional View from Brazil

Despite being blindsided by the rapid transmission of the GFC to the developing world through capital flows, the IMF reacted quickly to this by building upon earlier revisions it had made to its platform after the EAFC that had previously lay dormant. This resulted in its 'New' Institutional View approach to capital flow governance, which was well received across-the-board because it 'finally' provided developing economies with a set of guidelines for when and where capital controls are deemed appropriate. However, as shown, Brazil's recent history is an important case study for judging this framework's potential success. This is because her leaders, without being required to adhere to the Fund's recommendations, nonetheless followed a set of policies wholly consistent with the 'New' View- and ended in calamity. To be

sure, Brazilian authorities, especially at the central bank, repeatedly pursued ‘market-based’ adjustment mechanisms to solve capital flow-induced imbalances rather than use capital controls- *just as the Fund currently recommends*- regardless of whether it involved a depreciation to correct an overvalued currency and current account deficit brought on by FDI (first imbalance), raising interest rates to stem inflation from depreciation (second imbalance), raising rates to reverse capital outflows (third and fifth imbalances), or cutting fiscal expenditure to close budgetary gaps (fourth imbalance). Yet, in every single scenario, the result was counterproductive: the imbalance remained and was enlarged while the economy also had additional obstacles to now overcome. Thus, despite revising its directives in the wake of the GFC, the case of Brazil makes it evident that the Fund’s new policy stance is no more effective than its predecessors since it has shown that it nonetheless remains a recipe for producing and amplifying financial macroeconomic fragility.

At the same time, these events uphold some previously established lessons regarding international financial stability and development. First, they reveal how individual and macroeconomic risks are accumulated by not initially dealing directly with capital flows. Second, they show how such risks can transform stable financial arrangements into unstable ones through the types of endogenous evolutionary processes that Minsky, Kregel, and Frenkel made famous. Third, they demonstrate that attempts to rectify capital flow-induced macroeconomic imbalances primarily through ‘market-based’ adjustment mechanisms can introduce and amplify a whole host of destabilizing forces within a capitalist economy that, once brought into existence, cannot be undone because of path dependence. Hence, contrary to the IMF’s ‘New’ Institutional View, this means that a) capital controls are much more applicable as a first-best, primary, permanent measure for taming financial instability and promoting development than they are as a last recourse and b) market-based solutions to capital-flow induced imbalances are not to be encouraged since they will tend to make matters worse. The sooner the IMF recognizes this, the better off will be its intellectual footing and capabilities for serving the developing world’s needs.

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