



Financial Integration in the Americas, Changing Geopolitics and Brazilian Foreign Policy

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Integración financiera en América, cambios geopolíticos y política exterior brasileña
Integração Financeira nas Américas, Mudança Geopolítica e Política Internacional do Brasil

AUTHORS

Finbarr Murphy¹
Kemmy Business
School, University of
Limerick, Ireland
Finbarr.Murphy@
ul.ie

Martin Mullis
Kemmy Business
School, University of
Limerick, Ireland
Martin.Mullins@
ul.ie

1. Corresponding
author: Department of
Accounting & Finance;
Kemmy Business School;
University of Limerick;
Limerick; Ireland

This paper builds on previous work on the relationships that exist between the Brazilian state and financial markets. On this occasion we seek to ascertain whether equity market participants have come to see Brazil as exhibiting the characteristics of a developed nation and as having a position of regional leadership. Financial markets are important in both the exercise of hegemony and in signalling its existence. The data presented examines two periods, 1990–1995 and 2005–2010 and demonstrates that attitudes towards Brazil in the equity markets altered considerably in the intervening period. Using a cointegration analysis we empirically demonstrate the ‘normalisation’ of Brazil and an implicit acceptance of its leadership role.

Este documento parte de un trabajo anterior sobre las relaciones que existen entre el estado brasileño y los mercados financieros. En esta ocasión, trataremos de determinar si los participantes de los mercados de valores han llegado a ver cómo Brasil presenta las características típicas de un país desarrollado y ostenta una posición de liderazgo regional. Los mercados financieros son importantes tanto en el ejercicio de su hegemonía como a la hora de poner de manifiesto su existencia. Los datos presentados examinan dos períodos: 1990–1995 y 2005–2010, y demuestran que las actitudes hacia Brasil en los mercados de valores han variado considerablemente durante el período de intervención. Valiéndonos de un análisis de cointegración, demostraremos empíricamente la “normalización” de Brasil y una aceptación implícita de su papel de liderazgo.

Este documento baseia-se em trabalhos anteriores sobre as relações entre o estado brasileiro e os mercados financeiros. Neste momento procuramos verificar se os intervenientes no mercado de capitais passaram a ver o Brasil como detentor das características de uma nação desenvolvida e como titular de uma posição de liderança regional. Os mercados financeiros são importantes tanto para o exercício da hegemonia como para a sinalização da sua existência. Os dados apresentados analisam dois períodos, 1990–1995 e 2005–2010, e demonstram que as atitudes para com o Brasil nos mercados de capitais se alteraram significativamente no período em apreço. Usando uma análise de cointegração demonstramos empiricamente a “normalização” do Brasil e uma aceitação implícita do seu papel de liderança.

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1. Introduction

This paper builds upon previous work on Brazilian political economy which focused on the interplay between the Brazilian state and global credit markets (*reference removed by editor to maintain anonymity*). On this occasion we extend our analysis to include regional politics and Brazil’s position in the Americas. More specifically, we seek to demonstrate that patterns of trade on equity markets are indicative of important changes in hemispheric politics in the Americas; namely Brazil’s growing integration into global financial markets *and* a perception evident amongst financial traders that the economic fortunes of its Southern Cone neighbours are closely tied to the health of the Brazilian economy. The changes we demonstrate are in some senses paradoxical, we see a greater alignment between the stock markets of New York and Sao Paulo but at the same time we are witnessing a shift in the balance of power between Brazil and the United States. This very alignment between markets is at the heart of changing relationships between Brazil and the US and is pointing to profound changes in hemispheric relations. Our argument is that Brazil is no longer perceived as peripheral by equity markets and is seen as being “inside the tent”. This compliments our previous work on debt markets which demonstrated that a combination of new financial practices and Brazil’s economic orthodoxy has made the country more attractive to a wide variety of investors. Taken together, these two phenomenon mean that a relationship characterized as one of dependence between Brazil and the US has dramatically changed. There is a second, more profound paradox here, more financial globalization can mean a dilution of US power in the Americas and this, in turn, weakens the position of the United States as one of the great drivers of economic globalization.

It has been a long-standing ambition within the Brazilian political elite to establish Brazil as a regional power in South America and to secure Brazilian political leadership in the region. The behavior of financial markets, over the last decade or so, shows that this important and influential community implicitly accept that a new political/economic dispensation is emerging in South America. This new dispensation has two important characteristics; firstly, financial data indicates that Brazil and other Latin American countries have become much more integrated into the global economy. Secondly, within this overarching globalization process, our findings demonstrate that Brazil is gradually being perceived as the predominant power in the region.

In this paper we support our qualitative analysis with empirical results on the last twenty years of stock market returns from the US, Europe and Latin America. Using a cointegration analysis¹, we discern long term trends in the relationship between the performances of the national indices. Our results clearly show that the Brazilian economy, as proxied by the broad-based Bovespa index, is increasingly exhibiting developed world characteristics. These traits are also displayed by other Latin American countries sampled. Extending the cointegration analysis, we also utilized Impulse Response analysis to determine the relative dominance of one index over another. By conducting these tests over different time periods, we can test the changing nature of equity trading patterns across the Americas. Again, we empirically demonstrate the isolation of Latin American economies

1. A cointegration analysis identifies pairs of data that exhibit long term trends. This technique is therefore more powerful than data produced by a linear correlation analysis. We discuss this approach in more detail later in this paper.

KEY WORDS
Financial Integration, Brazil, geopolitics, cointegration

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PALABRAS CLAVE
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to the mid to late 1990s, subsequently in the period from 2005-2010 these countries show empirical evidence of developed world economic characteristics.

Theoretically, we have adopted the notion of hegemony to explain the changing political economy of South America in general and the Southern Cone in particular. There are a number of powerful arguments in favour of this approach. In the first instance, American foreign policy and inter-American or hemispheric relations have been frequently explained in these terms (Augelli & Murphy, 1988; Gill, 1993; Ruggie, 1998). Until relatively recently the United States was seen as the hegemonic power across the Americas. Since the 1990s we have seen the rise of Brazil in the region and the emergence of an overt policy goal of regional leadership on the part of Brazil. Whilst the Brazilian political elite have sought a leadership role it has been very careful to avoid accusations of attempting to dominate the other countries or the region. In debates on the merits on Mercosur, the problem of a preponderance of power residing with Brazil has been consistently to the fore. Brazil for its part has attempted to diffuse this issue by positing itself as merely building a political consensus in the region. The term consensual hegemony has been used in describing this process (Caldas, 1998; Burgess 2008). The notion of hegemony in the field of international relations has its origins in Gramscian political philosophy. In essence, achieving hegemony means convincing others that their interests are similar to those of the hegemonic power. It can be seen then as being less about coercion and more about the normative power of ideas disseminated from the hegemon. The importance attached to the flow of ideas across political space means that a nuanced view of inter-state relations is required. From this perspective it is no longer sufficient to view states as simple atomistic units that are differentiated by their relative power. Instead, societal structure and ideologies play an important role as does civil society. Thus international relations are not simply reducible to States; transnational actors become an important part of the picture.

One such set of actors, the financial markets, is acknowledged as being extraordinarily influential. As a group of actors, they have the ability to shift vast resources from sovereign state to sovereign state and can alter the balance of economic power. They have a degree of prestige and much media is dedicated to their actions and opinions. They are a key constituency for nation-states seeking to achieve political change at a local or international level. In many respects they embody the relationship between objective and subjective realities in that we see their ability to change the economic reality of a region co-existing with phenomena such as confidence and sentiment. To explain *Pax America*, Gill (1993) argues that we need to look at an array of social forces. For decades these social forces tended to cement US power across the Americas. A key element of hegemony is the idea of its 'naturalness'. If social actors come to see a power relationship as natural then it becomes stronger. This is at the heart of our argument; if financial markets come to perceive Brazil as no longer peripheral but increasingly integrated into the global economy this lends credence to the notion that Brazil is no longer perceived as belonging in the *emerging market or developing country* category. The data presented in this paper shows that this is indeed the case. An important and long-standing goal of Brazilian foreign policy has been the attempt to align the interests of Brazil to those of the other countries in the region. Market participants now see this process of alignment as underway. In other words, a key step has been taken in the achievement of consensual hegemony. A second major tenet of their foreign policy has been to resist US domination, or in other words, the satellitisation of South America, and it ap-

pears that financial markets now perceive Brazil as an important economic entity in its own right. Markets then, are seeing South America as a region and not simply as a sub-system within the Americas.

For Hugueneu, regionalism has become a key element of Brazilian foreign policy;

The building of a politically, economically and culturally integrated area in South America, with projections in Latin America, the Caribbean and Africa, is certainly a top priority for Brazilian diplomacy in coming decades (Hugueneu, 2003, p.216).

The goal of regional leadership remains a high priority for Brazil. For well over a decade this has constituted the core of the country's foreign policy. The region encompasses more than the countries of Mercosur and includes Latin America and South America in particular. Brazil has sought to extend its influence more widely across the continent, whilst at the same time seeking to preserve the coherence of the Mercosur group. Regional arrangements in South America will take on a more permanent nature if there is strong solidarity in the region and if participants see the future as closely tied to that of their neighbours. This latter point indicates the importance of the arguments presented in this paper. If financial markets are starting to perceive that many of the nations of the Southern cone are part of one system then in a sense their interests do automatically become aligned.

2. Hegemony and Soft Hegemony

The concept of hegemony was originally developed in the 1920s, it was for Gramsci, a somewhat unorthodox Marxist thinker, an attempt to explain the relative success of the ruling class in convincing workers that their interests were similar. The power of the ruling class could not be explained in terms of pure coercion. At times coercion was used but more important were the waves of ideas emanating from the ruling class that found acceptance in general society. These ideas were not confined to the political sphere and cultural production had a key role in gaining the acquiescence of the working classes. The importance of Gramscian thought is that it allowed the Marxist left to escape the more restrictive aspect of economic determinism and broaden their analysis to include the production of normative ideas. Gramscian thought also allowed for a more nuanced critique of ruling class ideology in that this ideology itself was perceived as having its origins in the work of various generations of thinkers and artists. As a body of thought the dominant ideology was rarely a system, rather an amalgam of ideas laid down over the decades, even centuries.

In the field of international relations (IR), the notion of hegemony is used as an explanatory tool to explain the dominance of the United States after World War 2. Clearly, the US possessed the economic and military might to underwrite its dominant global position but its power was bolstered by the ideas and ideology the country produced. Where its hegemony existed, the US did not have to resort to coercion or violence. Instead the local elites over

time came to share Washington's perspective on political and economic debates. International hegemony then, is achieved through the flow of ideas across state boundaries and the acceptance of these ideas. When these ideas were challenged or rejected the United States had a range of alternative measures it could adopt ranging from a degree of coercion to outright violence. Across the Americas, for great part of the twentieth century, the United States exercised hegemonic power.

For Gramscian IR scholars, hegemonic orders are not just about State-State relationships, the relationship between the State and civil society is a key dynamic (Devetak, 1996). The nature of institutions is seen as crucial to understanding development in international politics. Our focus in previous work was on the financial markets and how, as an institution, they can have a tangible impact on international political economy. Here we are seeking to ascertain whether or not financial markets believe there has been a shift in the political economy of South America. That in itself is very interesting, but such a change would also have a profound effect. If financial market participants start to believe that the interest of Brazil's neighbours and Brazil itself are strongly linked, then *de facto*, they become strongly linked. If sovereign bond spreads rise or equity prices fall in Brazil this will start to feed into the financial system and, in turn, the real economy of those linked countries. This phenomena, driven largely by perception, is labelled contagion.

From its inception, Gramscian theory has never simply been about whether or not working classes accept the ideology of the ruling class. Cultural production across a range of media has been important. In today's world, financial markets and financial data are an important component of newsroom output. The financial markets react to political developments and that reaction itself then becomes news. Therefore for hegemonic power to be accepted it should be reflected in this key institution.

3. The Context of Hemispheric Relations

The bipolarity of the cold war years added a certain urgency to Washington's dealings with Latin America as foreign relations came to be seen through the prism of the ideological battle with the Soviet Union. During this period we see a number of cases of US involvement in the region, frequently in conflict with left wing governments or insurgencies. However, post 1990 we see the US less engaged in Latin America and in the discourse of inter-American relations the idea of security became less pronounced. At the same time the United States' strategic focus increasingly fell on the Middle East as radical Islam and not Marxism came to be seen as the main adversary.

Brazil had long coveted the role of regional leadership and, in terms of this ambition, from the 1990s onward the environment became more positive. As the influence of the US in South America had dissipated somewhat, the other countries in the region looked favourably on regional projects, moreover Brazil's potential as an economic power was becoming

plain to see. Over the course of the 1990s trading and investment patterns in the nations of the Southern Cone became more diversified. Asia became an important export destination, and Europe, the principle source of foreign direct investment. Intraregional trade also became an important consideration. The overall result was that the traditional dependence on the United States was diluted.

During the mid-to late-1990s, we see the beginning of a trend whereby the Washington Consensus began to unravel. Panizza cites the Summit of the Americas in 1994 in providing a definition of the Washington Consensus as the pursuance of prosperity through open markets, hemispheric integration and sustainable development (Panizza, 2009). It is important to note that the Washington Consensus was always an evolving paradigm but it did reflect the liberal free market economics so dominant in the United States. Furthermore, there were serious consequences for any State in Latin America that challenged free market orthodoxy, in other words, the United States would exact a price for policy sets that were perceived as contrary to its interests. By the late 1990s, there was a growing sense of frustration and disappointment with the results of the Washington Consensus and so contemporaneous with the decline of US political influence in South America, we see a growing tendency towards more independent economic thinking across the region. Part of this change saw a move away from notions of a hemispheric free trade area towards a regionalism that embraced the idea of South America. Historically, this was a propitious moment for the Brazilian foreign policy establishment who had long feared that hemispheric free trade would result in the *marginalisation* of the region and would leave little opportunity to develop Brazilian influence in the region. A combination of more open debt markets, favourable commodity prices and political stability meant that Brazil could pursue a more autonomous set of policies and firmly resist hemispheric free trade.

4. Brazilian Foreign Policy

The *Itamaraty* (the Foreign Ministry) has a long history of autonomy within the Brazilian political establishment and those occupying other parts of the political system rarely challenge its policies. The *Itamaraty* had, over the years, secured a high degree of control over policymaking and their influence extended into other parts of government.

Decisions in Brazil regarding international trade are not taken by the trade minister or by the finance minister, as might be expected, but by the Ministry of Foreign Affairs (*Itamaraty*) (Wahrendroft Caldas 1998, p.xxi).

To some extent, the foreign policy establishment was insulated from outside forces. The fragmentation of the political parties in Brazil tended to mitigate against a firm foreign policy emanating from Congress. In comparison with Argentina, the Brazilian elite governed a less democratic country and so was insulated, to some extent, against popular opinion (Escudé & Fontana, 1998, p. 76).

As in the case of both Argentina and Chile, we have a configuration of influences on foreign policy formation in Brazil. The forces at work are similar in all three cases but their relative importance is different in each case. The size and the geopolitical ambition of Brazil tend to colour all parts of the system. Its potential leadership role in the continent shapes Brazil's relations in the region, with the United States and in the wider world.

The *Itamaraty* continues to view the world through a realist prism and so all initiatives such as the FTAA (Free Trade Area of the Americas) have their roots in the power relations of the day.

Brazilian reluctance to join the FTAA is based on a well-founded estimate that particularly with American non-tariff barriers, a regime of free trade will systematically favour the US (Álvaro De Vasconcelos, & Helio Jaguaribe 2000, p. 238).

There is also the question of Brazilian leadership in the region and how this would be damaged by an arrangement that clearly is led by Washington. Hence, on the basis of the long term strategic goals of Brazilian foreign policy, planners in Brazil are bound to resist such an initiative. At stake is Brazilian political leadership in the Southern Cone, its economic development and its autonomy.

Costa Vez argues that under Lula there was no deviation from the central foreign policy themes of previous governments, but nor, he argues, were Lula's policies a mere continuation. Lula affected a change of emphasis, stressing his willingness to take a leadership role in South America, and Mercosur is a test case in this regard (Costa Vez, 2003, p 146-147).

Given its aspirations for regional leadership, Brazil's relations with the US are crucially important. Whilst this aspiration has long been an element of Brazil's foreign policy, there has been less consistency in its relations with the United States. The distinction between strategic goals and tactical considerations is useful in this context. Good relations with Washington is not a strategic goal. Instead positive relations with Washington are seen as a means to achieving economic growth and ultimately development. Following the Second World War, US policy began to run counter to what the Brazilian political establishment perceived to be in their interests. The stress Washington placed on the role of the private sector challenged the economic nationalism and *statism* prevalent in Brazil.

The issue of autonomy is a long-standing concern in Brazil and across the Americas. It relates to the asymmetrical power relations on the hemisphere with a huge preponderance of military and economic power lying with the United States. The issue that arises for the actor in such a system is that autonomy can have a price. If a country in such an environment chooses to follow an independent line they risk antagonizing the United States and this can have far reaching consequences. However, we argue that innovations in the financial markets, Brazilian fiscal orthodoxy and attitudinal changes amongst financial market participants afford Brazil autonomy without the associated costs.

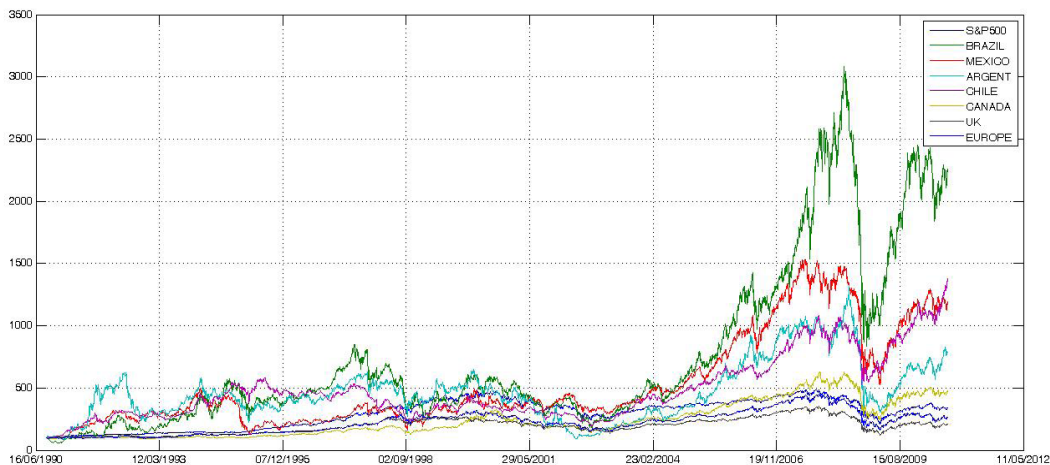
Brazilian ambitions to counter US hegemony also finds expression in its insistence not to see Latin America as one security system but instead to stress the existence of South America as a separate security entity.

5. Empirical Evidence

Cointegration is a statistical property of time series variables. Two or more time series are cointegrated if they each share a common type of stochastic drift: that is, to some degree they share a certain type of behaviour in terms of their long-term fluctuations. Cointegration is a more powerful/nuanced tool than simple linear correlation. Correlation assumes that the distributions of the two variables examined are normal. The greatest limitation of correlation is that it does not tell researchers whether or not the relationship is causal. Since the seminal work of Engle and Granger (1987) cointegration has become the prevalent tool of time series econometrics. Cointegration has emerged as a powerful technique for investigating common trends in time series of financial information, and provides a sound methodology for modelling both long-run and short-run dynamics in a system. We provide empirical evidence of increasing cointegration between global markets. In particular, we demonstrate that Latin American countries are becoming more cointegrated into the global financial system. In other words, we show that the respective conduct of financial markets in Latin America is demonstrating a more integrated behaviour set despite periodic short term deviations. Furthermore, we show that Brazilian financial markets and those of the region are behaving in a more orthodox, developed, manner.

We begin by demonstrating the relative stock market performance in US dollars of certain Latin American countries alongside the US, Canada, the UK and a European basket of shares (see Figure 1 below).

Figure 1: Country Equity Performance. This shows the US\$ MSCI Equity index² of each country. The values are normalized to 100 in 1990. Clearly, Latin American countries have outperformed but not without excessive volatility

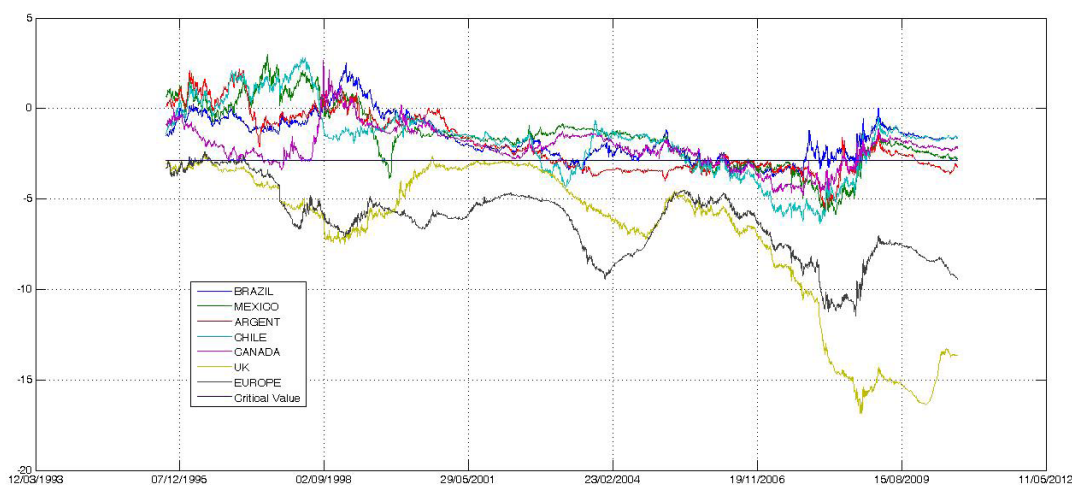


2. The MSCI Global Equity Indices are one of the most widely used benchmarks for cross border equity funds. See www.msicibarra.com

It is difficult to discern any clear trends from the respective stock market performances. A correlation analysis will depend on the timeframe analysed. For example, it is well known that during times of global uncertainty, equity markets are more correlated³. A cointegration analysis will uncover long term trends in the data.

Cointegration exists when a long-run relationship between the data sets can be identified. This identification is based on statistical probability or confidence levels. Figure 2 then shows the increasing cointegration between Latin American countries and the US since 1990. Canada, the UK and Europe have been added for reference. Notwithstanding the disruption of the crisis from 2007, there is a clear trend towards cointegration. This graph shows the increasing effects of financial globalization with developed markets having more advanced integration but with all countries demonstrating a trend towards cointegrated financial markets.

Figure 2: Cointegration. This shows the level each of country's cointegration with the S&P 500 index. From a probabilistic viewpoint, we say that the countries are cointegrated when the graph falls below the critical value



This increased cointegration may be, in part, due to the increased speed and liquidity of modern capital markets. It may also be due to the increased global reach of corporations. Whatever the reason, it is the clear, dispassionate view of the market that Latin American economies (and their associated regulatory/legislative controls) are falling into line with developed country norms.

An impulse response refers to the reaction of any dynamic system in response to some external change. Mathematically, we can model a vector of country's equity index values as a dynamic interdependent system. That is, based on historical data, we can create an at-

3. The reasoning is that during periods of increased uncertainty (or volatility), investors and financial markets as a whole tend to be more sensitive to news and therefore move with a "herd instinct".

rest dynamic financial system. We can then perturb one of the financial indices and observe (at least in a mathematical sense) how the system will react. For our analysis, the impulse response describes the reaction of the system as a function of time. In other words, we examine how the “disturbance” dissipates over time.

For example, Figure 3 below shows how the S&P would react to a one standard deviation (SD) change in its returns over the period 1990 to 1995. Most of the ‘shock’ is dissipated over a period of one day and the system return to normal. Figure 3 also shows that Canada immediately reacts to the US shock but it too returns to equilibrium quickly. There is a notable lack of reaction by Europe, the UK and Latin American countries. We can conclude that as recently as twenty years ago, global financial markets were quite disassociated from each other.

Figure 3: Impulse Response to US perturbation, 1990-1995. Response of countries to a Generalized One SD innovation in the S&P500 over 10 Days. From Sept-1990 to Sept 1995

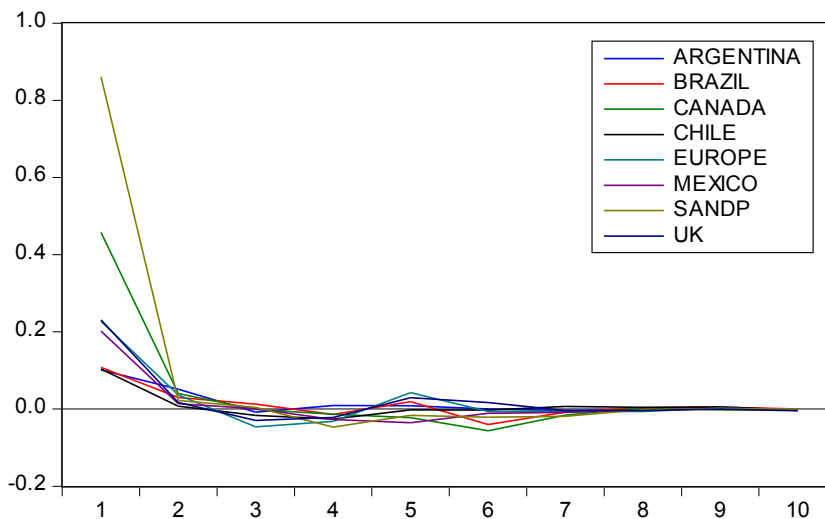
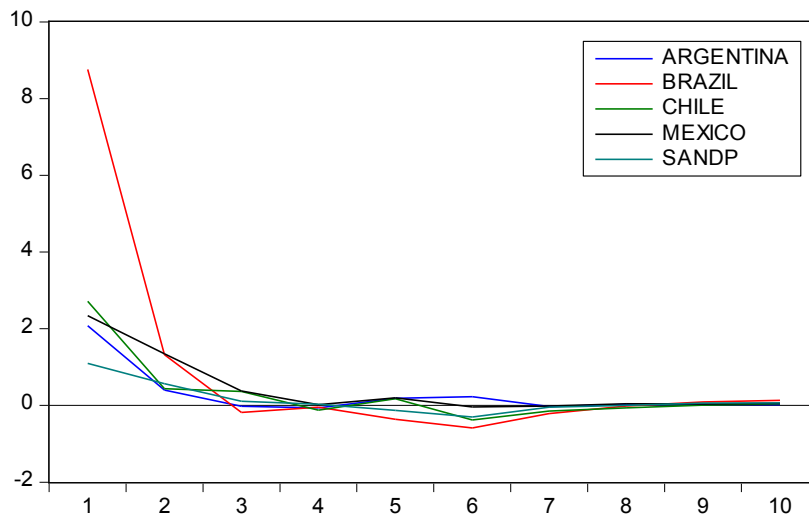


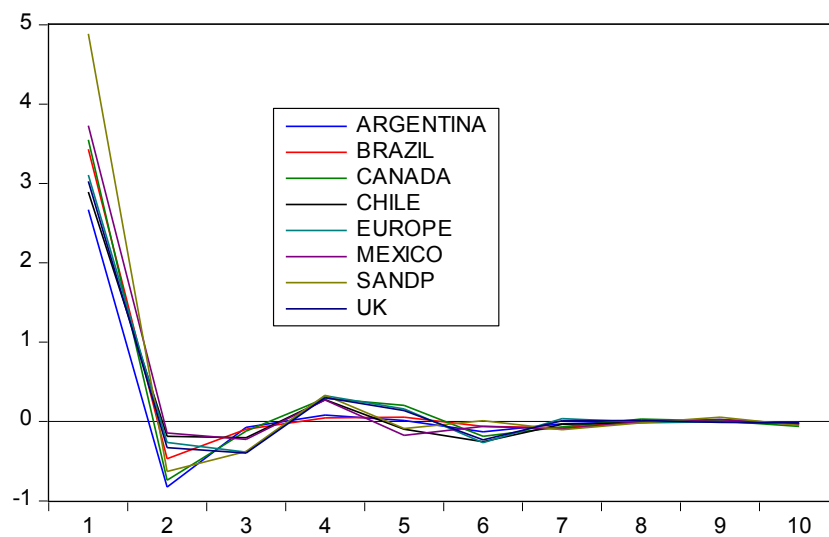
Figure 4 shows how Brazil, Latin American country indices and the S&P 500 would respond to a 1-SD shock to the Brazilian index in the early nineties. Other than Brazil itself, other Latin American countries take little notice and the S&P almost no notice at all.

Figure 4: Impulse Response to Brazil perturbation, 1990-1995. Response of countries to a Generalized One SD innovation in the Brazil equity index over 10 Days. From Sept-1990 to Sept 1995



Now, we conduct the same two analyses for the period 2005 to 2010. Figure 5 shows how countries react to shocks in the S&P500. All countries have an immediate and proportionate reaction and all reactions quickly return to equilibrium after two to three days. This is clear evidence of a global, integrated financial marketplace.

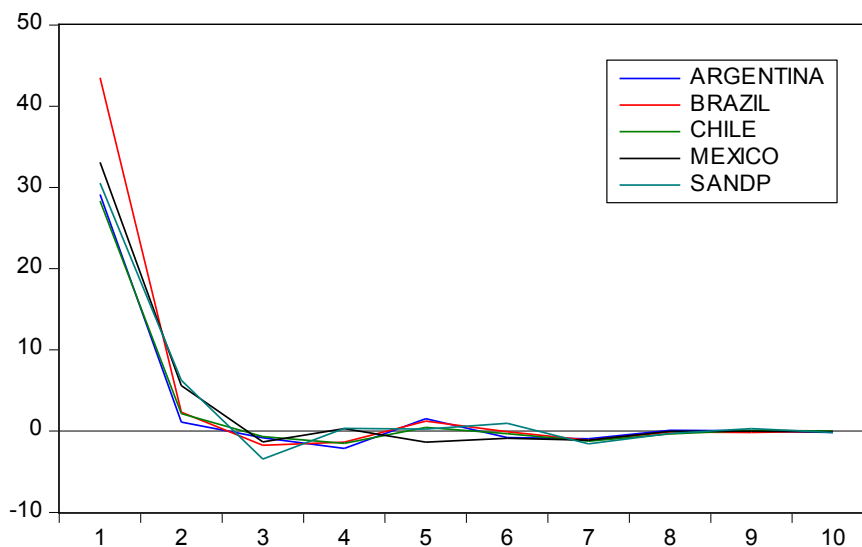
Figure 5: Impulse Response to US perturbation, 2005-2010. Response of countries to a Generalized One S.D. Innovation in the S&P500 over 10 Days. From Sept-2005 to Sept 2010



Similarly, Figure 6 shows that other Latin American countries contemporarily respond to shocks in the Brazilian index. This shows that while Latin American countries are more integrated into the global financial system, there is also a regional dynamic within the system with the Brazilian economy at its centre.

The data presented in figures 5 and 6 demonstrate that a profound change has taken place in the manner in which financial markets interact. Financial globalization has caused reduced idiosyncrasies in bourses located across the Americas. Two trends are very evident; firstly, markets are more *in tune* in the period from 2005-2010 than in the period 1990-1995. Secondly, markets in the Southern Cone are more sensitive to movement in the Sao Paulo exchange in 2005-2010 than in 1990-1995. Thus, we can make the case that financial markets, this powerful institution so vital to hegemonic interests, perceive Brazil as exhibiting developed world characteristics and as being a dominant force in the region. All this closely reflects the long standing ambitions of the Brazilian political elite.

Figure 6: Impulse Response to Brazil perturbation, 2005-2010. Response of countries to a Generalized One S.D. Innovations in Brazil over 10 Days. From Sept-2005 to Sept 2010



6. Conclusions

We have employed a nuanced view of inter-state relations with an emphasis on financial markets as a transnational actor. In previous work, we showed how changes in domestic economic orthodoxy and technical developments in international financial instruments made Brazil more attractive to global investors. In this paper we extend this argument further and argue that these factors coupled with financial globalization have, paradoxically, increased Brazil's hegemony within the region and diluted the dominant position of the US in Latin America. We have shown that financial market behaviour has become aligned with the long standing ambition of the Brazilian elite. Markets, through the objective prism of monetary returns, now perceive Brazil as a developed world economy and as holding a dominant position within South America.

We use objective empirical data from the financial markets to bear out our findings. Taking the broad based equity indices from the sample countries and conducting a cointegration analysis, we demonstrate long term trends towards cointegration within the indices examined. This analysis eliminates short term deviations and conclusively shows the local hegemony of Brazil within an increasingly homogenous global financial marketplace. Our impulse response analysis further highlights the manner in which global markets respond to systematic shocks. This latter theme of financial homogenization through globalization is indicative of a dilution of the financial and political hegemony of the United States in this region.

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