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## BRAZIL: THE STRUGGLE FOR MODERNISATION

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### THE FAILURE TO STABILISE

*On one hand, elites learn from past mistakes to design better programs. On the other, individuals - as economic agents and political actors - learn from past failures to expect that new reforms will also fail. If this is true, then we should expect that more comprehensive and consistent programs will be offered each time to a more sceptical population. (Przeworski)*

The Brazilian economy faces stagnation. In 1993 *per capita* income is 10 percent below the 1980 level. The investment rate fell from 25 percent in the mid-1970s to 14.5 percent of GDP in 1992. There is a consensus among economists that the direct cause behind this fact is a high rate of inflation that spurs high real rates of interest and necessarily reduces the investment rate. Inflation, on the other hand, has a deep and indirect cause, i.e. the fiscal crisis of the state, that originated in the foreign indebtedness of the 1970s and the economic populism of the 1980s, and a direct cause, i.e. the inertial or indexed character of the Brazilian inflation. Notwithstanding the consensus, and despite the numerous orthodox and heterodox attempts to stabilise the Brazilian economy, inflation remains at high levels. In 1992 it averaged 23 per cent a month.

Why is Brazil unable to stabilise its economy? Is it because fiscal adjustment is practically unfeasible, requiring to be complemented by a reduction of the public debt? Is it because the stabilisation programmes were inefficient, a result of technical incompetence? Is it because of a lack of political will in society? Each of these three questions corresponds to a hypothesis or theory concerning the cause of the lack of stabilisation. These theories say that high, inertial inflation, independently of the level of demand, will not be overcome because: (1) the public debt is excessive and its maturity too short, indicating the loss of credit of the state, i.e., a major fiscal crisis; (2) the economic teams and the IMF (when the programme was IMF monitored) lack competence in dealing with the problem and adopt inefficient stabilisation programmes that imply unnecessarily high costs or are just ineffective; and (3) the economic team that is responsible for the reform does not have the necessary political support from society.

I would call the first the 'extreme crisis hypothesis'; the second, the 'economic inefficiency hypothesis'; and the third, the 'political hypothesis'. These three theories, however, are complementary rather than exclusive. When a country reaches extreme levels of inflation, as was the case of Brazil, this means that the state is bankrupted, that its credit-worthiness is

very low, that its public debt is plagued by short term maturity and/or by arrears, that it is not any longer able to back its national currency. In other words, it means that the extreme crisis hypothesis is part of the explanation, and that reduction or consolidation of the public debt is required. When a country fails repeatedly to stabilise, this is an indication that the economic policies that are being adopted are not adapted to the problem they are supposed to solve, that they are too costly, or just ineffective. This is an indication that the economic inefficiency explanation is also relevant. Finally, when fiscal adjustment is never fully reached, this means that political support for stabilisation is lacking, that society shows a lack of resolve in relation to inflation. In other words, this shows that the political hypothesis is also meaningful.

In recent years, the last explanation became popular. The number of conferences, papers and books dealing with the political aspects of economic reforms increased extraordinarily. This is certainly true, but does not contain the whole truth. The inefficiency hypothesis was always popular among economists, but the more common assumption in recent days is that economists and the multilateral institutions, based on the 'Washington consensus', know what should be done; what is lacking is political support.<sup>1</sup> I believe that this approach is mistaken, as was demonstrated by the failure of the orthodox stabilisation programmes in Brazil. Finally, the extreme crisis explanation, that is obviously not popular among creditors, be they foreign or internal, is also correct, but is far from explaining everything.

Since the present Brazilian crisis began in 1979, and inflation accelerated from an average of 40 percent a year in the 1970s to 100 percent a year in 1979-1981, the country has experienced twelve stabilisation plans. Some were emergency plans, others were well prepared. Some were 'heterodox', using price freezes, but most adopted 'orthodox' strategies.<sup>2</sup> Some adopted the shock strategy, and others tried gradualism.<sup>3</sup> In some cases, even though inflation had not been subdued, the economic picture improved, while in others the crisis only worsened. In some cases the final outcome was just costs, in others, costs and benefits. Today (February 1993), after the failure of the Marçílio Plan, no real stabilisation plan is being implemented, although the Itamar Franco administration is supposed to be preparing a stabilisation programme.

The Marçílio Plan was the twelfth stabilisation programme since 1979. It began in April 1991; after January 1992 it had the official support of the IMF. Its objective was to lower inflation gradually from around 24 percent a month to two percent in December 1992. After analysing it and taking a

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brief look at the previous plans, I will discuss the three hypotheses. Finally I will present my view on how to stabilise the Brazilian economy, and I will conclude using the three hypotheses to explain why such a strategy is not adopted.

### THE INEFFICIENCY HYPOTHESIS WHEN INFLATION IS INERTIAL

The inefficiency hypothesis to explain the failure to stabilise may be illustrated by the Marcílio Plan, developed by Minister Marcílio Marques Moreira, in the Collor Government, between May 1991 and September 1992, when President Collor was impeached for corruption. The Marcílio Plan was a gradual and fully orthodox plan, IMF sponsored, that ignored the inertial character of inflation, raised real interest rates to around 40 percent a year during 1992, maintained the economy in permanent recession and perversely increased the budget deficit (from a surplus in 1990 and 1991, it returned to a deficit in 1992), although some fiscal discipline was maintained. The resurgence of the deficit was due to the high interest paid by the state on its internal public debt.<sup>4</sup>

In the first months of 1992 the Collor administration lost its second great opportunity to achieve stabilisation.<sup>5</sup> The budget deficit was still under control, as a consequence of the fiscal adjustment measures adopted mostly in 1990; relative prices, including public prices and the exchange rate, were balanced; inflation was high but stable and the government had recovered political support, particularly the support of the elites, due to a combination of favourable factors: inflation had stopped accelerating since November, President Collor had changed his Ministry, choosing a group of competent and highly respected intellectuals and politicians,<sup>6</sup> financial markets were tranquil, the support of the international community and the multilateral institutions was strong given the market oriented reforms initiated in 1990, and international reserves were increasing. In that moment a combination of a nominal anchor, Argentina style, with a temporary freeze and a social agreement, would probably have strengthened the fiscal adjustment process and achieved stabilisation. Keeping, instead, to the gradualist strategy, which besides being inefficient is ineffective against inertial inflation, a genuine opportunity to stabilise was lost.

Under the Marcílio Plan, inflation accelerated until November 1991 when it reached 25 percent. From this month until April 1992 the inflation rate fell moderately, coming close to 20 percent. Between May and August it stabilised around 22 percent. In October, when Marcílio left the ministry, inflation was back to 25 percent a month. Yet, in the first months of 1992, when for the first time since 1987 inflation had stopped accelerating and had even fallen a little, this orthodox plan raised hopes among economists and policymakers unable to understand the inertial character of the Brazilian inflation.

The main reason that inflation has accelerated systematically after each stabilisation plan is the need economic agents face

to restore the balance in relative prices that the plan in some way disrupted. But it was also a problem of lack of confidence. The resurgence of inflation and the awareness of the fiscal crisis of the state - ie., of the lack of public credit - drives economic agents to lose confidence in the currency, to anticipate that inflation will accelerate and to protect themselves accordingly. Thus, when inflation stopped accelerating in November 1991, this could be an indication that the fiscal crisis had been partially overcome, that public faith had been partially restored. The reduction by half of the internal public debt in 1990 was a partial explanation for that fact.

Yet, besides the confidence factor, inflation and its inertial character is a real problem, directly related to distributive conflict over relative shares. The acceleration of inflation after each freeze during the Collor administration (there was a price freeze in March 1990 and another in January 1991) cannot have a conventional explanation - excess demand - since the Brazilian economy remained in recession. It also cannot be explained by the increase in the money supply due to budget deficit, since the Brazilian economy presented an operational (real) budget surplus in 1990 and 1991, and a Treasury (cash) surplus between March 1990 (when the Collor administration began) and November 1992. It can always be explained by strict or tautological monetarism, that, utilising the exchange ratio,  $Mv = Yp$ , relates inflation,  $p$ , directly to an increase in the money supply,  $M$ , given a constant velocity of money,  $v$ , and a constant GDP in the short run,  $Y$ . In fact, the monetary base increased with inflation, but it is well established today by the neo-structuralist and Keynesian schools that the money supply is endogenous or passive when inflation is high and inertial.<sup>7</sup> The exchange equation is definitional, not establishing a causal relation. If  $v$  and  $Y$  are assumed constant, then either  $M$  could cause an increase in  $p$ , as the monetarists contend, or  $p$  - that increases for inertial reasons - could cause an increase in  $M$ .

The neo-structuralist theory of inertial inflation presents a more sensible explanation. The maintenance of inflation at a high level is based on the dynamic of relative prices, that are successively balanced and unbalanced, while a distributive conflict unfolds among the economic agents.<sup>8</sup> The acceleration of inflation is due to the attempt to change in real terms the relative prices balance, while inertia derives from the acceptance that relative prices are in real terms balanced in the medium term, but in the short term are unbalanced due to the phased character of price increases.

According to this view, the acceleration of inflation that took place in 1991, after Collor Plan II, was due to the need to recover the balance of relative prices lost with the freeze. Inflation accelerated because (1) the last freeze, with its 'tarifaço' (sizeable correction of public prices), had aggravated the imbalance of relative prices, acting as the motor for the resumption of inertial inflation to its pre-freeze levels; (2) because the post-freeze 'inflationary residue'<sup>9</sup> above five percent left it clear that there was no other alternative for

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economic agents after the plan except to engage again in the inertial game of indexing their prices, correcting them in a phased way so as to guarantee their income share; (3) because, in this distributive conflict, economic agents, based on their previous experience with inflationary acceleration, add an incremental value to past inflation in order to protect themselves against the probable increase of inflation; (4) because by acting this way, they transform their expectations into a self-confirming prophecy; and lastly, (5) because they know that, as the state is bankrupt, it is in no position to guarantee the stability of the currency, and will end up sanctioning inflation as it increases the monetary base.

This last characteristic defines the scenario of 'indexed hyperinflation' or of 'repressed hyperinflation', or what André Lara Resende (1988) called the 'hyperinflationary process'. Actually, since the failure of the Cruzado Plan, the Brazilian economy has been in an intermediary state between inertial or autonomous inflation and hyperinflation. The indexation mechanisms, related to past inflation, continue to operate, but extremely volatile expectations, generally pointing to an acceleration of inflation, are added to them, as a result of the fiscal crisis and the consequent loss of confidence in government. Economic agents anticipate the acceleration of inflation and behave as such.

Beginning in November 1991, however, inflation stopped accelerating. Why? I see two reasons for this, one of a real nature, the other, expectational. First of all, although Collor Plan I failed, it had one positive aspect: in 1990 around 50 percent of the internal Treasury debt was cancelled. Almost US \$28 billion were written off. As a result, the fiscal crisis was objectively reduced. Secondly, Minister Marcílio finally was able to impose his calm, trustworthy style. At the end of October 1991, there was a speculative attack against the cruzeiro. The premium on the parallel market, that had been around zero, rose to 50 per cent in three days. At this point, the Central Bank, which had always sold gold on the parallel market when this had happened, took a risky but correct decision: it decided to leave the market alone. To the surprise of the Brazilian financial markets, this strategy worked. The speculative attack failed. The premium on the parallel market quickly fell back to zero. After this, economic agents changed expectations. They recognised that they no longer had the power they had in 1989 to carry out speculative attacks on the cruzeiro.

A third reason why inflation ceased to accelerate was the recession caused by the extremely high interest rates. Inertial inflation is autonomous from demand. This means that a strong recession has little effect on lowering the level of inflation. It can, however, keep inflation from continuing to accelerate. This must have happened in November 1991.

The partial recovery of public confidence and the recession interrupted the acceleration of inflation. Yet it did not break the inflationary inertia. It did not eliminate the indexed nature of the economy. Economic agents in Brazil are too used to

correct their prices in accordance with past inflation. Thus, it is incorrect to suppose that, given the volatility of expectations, the 'reversal of expectations' would gradually do away with inflation.

Monetarists, particularly the followers of rational expectations, confuse expectations with decision.<sup>10</sup> They imagine that all expectations are self-fulfilling, as they are automatically transformed into economic decisions. But there is an important step between expectation and decision. For the neo-structuralist theory of inflation, economic agents, concerned with protecting themselves in the generalised distributive conflict that characterises high inflation, are very cautious in changing their decisions. They can change their expectations, admit that inflation may go down, but, as these are volatile and not trustworthy, they do not change their decisions. Averse to risk, concerned with protecting themselves knowing that the economy involves a real process of income distribution,<sup>11</sup> economic agents conservatively maintain their decision to raise prices. As this kind of rational behaviour will be adopted by the great majority of economic agents, a reversal of expectations will not become reality.

In the case of Brazil, a reversal of expectations was able to reduce the hyperinflationary component of Brazilian inflation, but was unable to break down its inertial character. Inflation stopped accelerating at the end of 1991, but did not go down, although expectations - strongly influenced by the dominant ideological character of monetarist views - were that it would. Distributive conflict, the protection of income shares, the prevalence of decisions over expectations, the tendency economic agents in the real sector have to base their price decisions on past experience (only in the financial sector are expectations dominant in defining price decisions<sup>12</sup>), the fact that inflation is essentially a real process with monetary consequences rather than just a monetary phenomenon, checked the expected reduction of the inflation rate. What was left was just an inefficient and ineffective economic policy.

### THE STABILISATION PLANS

As in the case of the Marcílio Plan, most if not all stabilisation plans were inefficient in Brazil. All purely orthodox plans, such as the two IMF-sponsored stabilisation programmes (the Delfim Plan III, 1983, and the Marcílio Plan, 1992), the Rice and Beans Plan (1988), the Eris Plan (1990), were inefficient because they did not take into consideration inertial inflation and tried to stabilise gradually. All populist plans, such as the Delfim Plan I (1979) and the Cruzado Plan (1986), were inefficient. They were an outcome of the lack of political support for the necessary fiscal adjustment. Some were just flawed, such as the Delfim Plan II (1981), the Dornelles Plan (1985), the Summer Plan (1989). The stabilisation programme for which I was responsible, which came to be called the Bresser Plan (1987), was an emergency plan left uncompleted when I left the Finance Ministry seven and a half months after taking office for lack

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of political support for the fiscal adjustment plan I formally proposed to the President.<sup>13</sup>

The idea that a stabilisation programme with a new freeze, coupled with the use of the exchange rate as a nominal anchor, could efficiently control inflation, when the five previous freezes were not successful, is naturally received sceptically in Brazil today. Yet four other plans were orthodox and also failed. Let us then take a quick look at the twelve stabilisation programmes that the Brazilian economy has experienced since the present long-term crisis started in 1979.<sup>14</sup> Why did they fail? Because they were heterodox, or because they were orthodox? Because they were shock plans, or because they were gradualist? Which of the three hypotheses presented earlier were preponderant in each plan?

(a) Delfim Plan I (1979), a populist right-wing programme that was concurrently developmentalist and monetarist. It was based on the pre-fixation of the exchange rate that, at the time, was the key feature of the Chicago school. The exchange rate guide-line would change expectations and lead economic agents obediently to correct theirs accordingly. However, inflation went from 50 to 100 percent a year, and the foreign debt grew from \$40 to \$60 billion in two years.

(b) Delfim Plan II (1981), a classical orthodox programme, accompanied by a strong recession. GDP fell 3 percent in 1981 and inflation remained at 100 percent until the end of 1982.

(c) Delfim Plan III (1983), an orthodox programme monitored by the IMF and again marked by recession. Given the inertial nature of inflation - ignored by this plan as by the two previous ones - and the maxi-devaluation in February 1983, inflation doubled to 200 percent, or 10 percent a month; the trade balance, however, since then has presented large surpluses.

(d) Dornelles Plan (April-July, 1985), a partially heterodox plan based on the freeze of public prices and some private oligopolistic sectors, corresponding to about 40 percent of the GDP, combined with a strictly monetarist policy at the level of the Central Bank. Inflation fell from 12 to 7 percent a month for three months, then returned, as was to be expected, to the previous level when the frozen prices were finally liberated or corrected according to inflation.

(e) Cruzado Plan (March-December, 1986), a heterodox programme, based on a price freeze. It was well formulated and enjoyed enormous popular support, but became lost in populism and in excess demand. Inflation went from 14 percent to almost zero due to the freeze. When, in December, it became impossible to maintain the price freeze, inflation exploded.

(f) Bresser Plan (June-December, 1987), a heterodox emergency plan. It did not include either de-indexation or monetary reform. The exchange rate was not frozen. It was based on a provisory, short-term price freeze, and an incomplete fiscal adjustment. Relative prices were deeply unbalanced, including the exchange rate. As was to be expected, inflation started to increase again slowly. The programme plan should have been completed with a gradual correction of public prices (which was done) and a fiscal reform at the end of the year, that would serve to prepare for a definitive price freeze at the beginning of 1988. Because of a lack of political support, the plan was not completed. I left the Ministry in December of that year.

(g) Rice and Beans Plan (1988), an orthodox plan, based mainly on an attempt at fiscal adjustment, and on the celebration in August 1988 of a conventional ('new money') agreement on the external debt, when discussions on a reduction of the debt were already well advanced. Besides being inefficient as a stabilisation plan, political support for fiscal adjustment was non-existent. Actually, it ended up being a muddling through strategy, given the unwillingness of President Sarney to provide a stern fiscal adjustment. Inflation, at 14 percent in December 1987, went up incrementally, reaching 30 percent a month by the end of the year.

(h) Summer Plan (January-June, 1989), a heterodox programme, because it was based on a freeze, on de-indexation and on monetary reform, and also a monetarist plan, because it was supported by an extraordinarily high real interest rate (16 percent a month in the first month). At the moment it was decided, President Sarney was ending his government, with very low popularity ratings. The decision to adopt an extremely high real interest rate speeded up its failure, since it indicated that the

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government was bankrupt. It began to explode in June and led to hyperinflation in December.

(i) Collor Plan I (March-April, 1990), a heterodox *and* orthodox programme, combining the retention of monetary assets with a rapid freeze, and a strong fiscal adjustment. It succeeded in lowering inflation from 82 percent in March to 3 percent in April. After that, inflation was supposed to be controlled by a mixture of fiscal and monetary policy and incomes policy. The formal abandonment of incomes policy in May 15, when the planned gradual pre-fixation of wages was suspended, marked the end of an incomplete plan.

(j) Eris Plan (May-December, 1990), the second phase of Collor Plan I that is entitled to be considered a new plan. It was the most strictly monetarist and orthodox strategy ever adopted in Brazil. The fiscal adjustment effort, to which President Collor continued to give full support, was complemented with the definition and pursuit of a monetary target: nine percent increase of high powered money in the second semester of 1990. The plan was not officially adopted by the IMF, but received full support from Washington, as I can personally testify. In a paper with Nakano (1990), written in May-June 1990, we predicted its failure. This plan evidenced once again the endogenous character of the money supply when inflation is high and inertial. Notwithstanding an enormous recession, inflation increased gradually, rising from six percent in May to 20 percent in December.

(k) Collor Plan II (January-April 1991), a heterodox emergency plan, combined with a big increase in public prices (a 'tarifaço'). A fully inefficient programme, inflation increased again immediately afterwards, reaching almost seven percent in April and ten percent in June.

(l) Marcílio Plan (May 1991-October 1992). An inefficient orthodox stabilisation plan, with IMF support.

### THE EXTREME CRISIS HYPOTHESIS

The reason why these plans failed was partly inefficiency; however it was not only the incapacity of governments to devise a comprehensive stabilisation programme, based on

past experience, free from the previous mistakes, able to predict the reactions or defences that economic agents will develop to the stabilisation policies. The extreme crisis and the political hypothesis are also relevant.

The explanation based on an excessive public debt is powerful. There is no doubt that a high foreign and internal debt makes stabilisation efforts self-defeating.<sup>15</sup> It is not a coincidence that most of the highly indebted countries failed to stabilise, so long as a reasonable solution to it (e.g. the Brady Plan) was not found. When countries face an acute fiscal crisis and hyperinflation, it is not by chance that they almost invariably recur to some sort of internal debt cancellation.

Yet public debt reduction, be it foreign or internal debt, is a stabilisation strategy that has clear limits. The foreign debt reduction does not depend only on the debtor countries. Arrears are always an alternative, but a costly one. There are some classical cases of unilateral cancellation of part of the foreign debt. This was the case of the United States in the last century, of Germany in the 1930s and again in 1953. It was the case of Britain after World War II. To a certain extent, it was the case of Costa Rica before the Brady Plan legitimated it. However, usually countries do not have the external power and the internal unity to execute such a move.

Brazil did not have the power unilaterally to reduce the foreign debt. This fact initially helped to explain Brazil's failure to stabilise. Yet, while substantial sectors of the economy hoped for a foreign debt reduction, this possibility represented a hindrance to the required internal adjustment. Now that the debt is being negotiated according to the Brady Plan, the hope of transferring a larger share of the fiscal adjustment costs to the foreign creditors has disappeared. The foreign debt reduction promises to be small; unsatisfactory, but it is all that is politically possible to obtain. The burden sharing process is over. Given that the foreign debt is a public debt, since 1992 Brazilians know, or are supposed to know, the adjustment costs they have to face.

The partial cancellation of the internal debt is a much more common fact. But it is also risky, and provokes strong political reactions. It may only be adopted when the crisis is very acute. Even in this case, it demands courage. And, if it does not succeed in stabilising the economy, the debt may easily be rebuilt. This was the case of Brazil. Collor Plan I cancelled about half of the internal Treasury debt. This fact significantly improved the fiscal condition, but as the fiscal crisis was not overcome, nor stabilisation achieved, the internal debt began again to increase, particularly after November 1991, when the interest rates were sharply increased. It is not by chance that today in Brazil the possibility of a long-term consolidation of the internal debt - a milder form of debt cancellation - is again being discussed.

After the internal debt cancellation that Collor Plan I adopted (almost 10 percent of GDP), stabilisation became easier. That

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is one of the reasons - besides the political support the Collor administration enjoyed at certain moments - why in early 1990 and early 1992 two concrete opportunities to stabilise the Brazilian economy came forth. The fact that they were lost, when political support was present and the fiscal crisis was subdued, is an indication that they lacked technical competence, that they were inefficient.

### THE POLITICAL HYPOTHESIS

Finally, we have the political hypothesis to explain the delay in stabilising Brazilian inflation. Behind the political theory there are two complementary phenomena - economic populism and the tolerance of inflation - that disclose the lack of political support economic teams face for the hard fiscal adjustment measures that any stabilisation programme requires.

Political support for economic reforms depends on the perception by society of the need for reforms and on the net costs of transition. Reforms are not always perceived as needed. When the inflation rate is still at a 'reasonable' level, certain societies, such as the Brazilian, that are not sensitive to inflation, are ready to live with it. Other reforms, such as trade liberalisation, may take a long time to be viewed as necessary because they confront hidden interests.

Once the need for reform is perceived, it is necessary to consider the net transitional costs. They represent the difference between the costs involved in the reform in terms of higher taxes, unemployment, business enterprises restructuring, and the costs of postponing reforms, of muddling through the crisis.<sup>16</sup>

Net transitional costs tend initially to be high, since the costs of not adjusting or reforming, of living with the inflation, balance of payment problems, protectionism and inefficient prices, are still small, and the costs of adjusting the economy, of stabilising, getting prices right, proceeding with market oriented reforms, are high. As reforms are delayed, the costs of muddling through the crisis increase and eventually become higher than the costs of adjusting the economy. At this moment the nonadjustment cost curve will cross the transitional costs curve. At the limit, the increasing distortions will lead to an acute fiscal crisis and hyperinflation. At this moment, society will have no doubts that the costs of muddling through are much higher than the transitional costs, that net transitional costs are highly negative, that it is time to adjust.

Yet it may take a long time before the country reaches hyperinflation. On the other hand, the net transitional costs may already be negative and society may be resistant to reforms. This collectively irrational behaviour may have several explanations. First, society may not have perceived this fact. The previous growth strategy may have been so successful that it is difficult to admit that it became distorted

and disruptive. Second, total net transitional costs may be negative, but some groups within the economy may still be gaining from the crisis.<sup>17</sup> If we draw the two sets of curves for each significant group, class or economic sector in society, we would probably find that for some the costs of muddling through the crisis crosses very soon the transitional costs curve, while for others this intersection takes longer to take place, if it ever happens, since they are profiting from inflation. These group will resist adjustment, they will deny political support for stabilisation as much as they can.

Reforms may also be delayed or fail for lack of the institutions that facilitate the negotiations leading to the required decisions. If the associations of workers and businessmen are not representative, if the political parties are weak and disorganised, if the state is disrupted by a severe fiscal crisis and does not have ministries that are able to intermeditate the negotiations and enforce the agreements, it will be much more difficult to reform successfully.

All the twelve stabilisation programmes faced difficulties in this area. Yet it must be emphasised that the three stabilisation plans of the authoritarian regime (Delfim Plans I, II and III) did not fail for lack of political power. On the other hand, the Sarney administration (the Cruzado Plan), and the Collor administration (the Collor Plan I, the Eris Plan and the Marcílio Plan between January and April 1992) enjoyed reasonable political support. Yet the Cruzado Plan and the Delfim Plan I failed for an essentially political reason. They were populist stabilisation plans. In particular, the Cruzado Plan had enormous political support. But it was a perverse support, since it derived from the populist aspects of the plan. The Cruzado Plan did not fail for lack of political support, but for excess of it. The Collor Plan I, the Eris Plan and the Marcílio Plan were not populist plans. Nevertheless, they did not fail for lack of political support. The Brazilian and the foreign elites strongly supported them. They failed for their inefficient or mistaken character.

### ORTHODOX-HETERODOX COMBINATION

Any monthly inflation above two digits can only be controlled by a radical attack. If this inflation has a strong inertial component resulting from the informal indexation of the economy, some kind of coordination of expectations - in principle a very quick freeze coupled with a nominal anchor - should be part of a stabilisation programme. It is impossible to stabilise an economy with these characteristics gradually, through fiscal and monetary policies. This kind of conventional policy is suited to control demand inflation of a moderate character. In this case, the reduction of state expenditures, the increase in taxes and the increase in the interest rate reduce aggregate demand, diminish real wages and eventually reduce the rate of inflation. The Brazilian inflation, however, is not moderate nor demand-push. It is high and cost-push. More than that: it is a combination of

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inertia with hyperinflation. To stabilise a high inflation gradually is costly.<sup>18</sup> To stabilise a high and inertial inflation gradually is just not feasible.

The stabilisation of high and inertial inflation is a process that could be divided into three phases:

(i) Preparation, consisting of (a) fiscal adjustment that eliminates the public deficit and avoids inflationary financing; (b) correction of public prices and the exchange rate, to avoid a *tarifaço* and a maxi-devaluation on the day of the shock; and (c) a social agreement on wages.

(ii) Guarantee of independence for the Central Bank. The price freeze interrupts in a synchronised way the price-wage-exchange rate spiral that characterises inertial inflation, by establishing a single level of equilibrium for the key nominal values of the economy (prices, wages, exchange rate, nominal interest rates, contracts).

(iii) Consolidation, supported (a) by an austere fiscal policy; (b) by a very tight monetary policy, only allowing the emission of money to buy international reserves; and (c) by the implementation of trade liberalisation reform in order to check internal oligopolies.<sup>19</sup>

The need for an incomes policy - specifically a temporary freeze - to control inertial inflation was initially acknowledged by the Brazilian economists.<sup>20</sup> The alternative would be a nominal anchor: the exchange rate. All hyperinflation ends when fiscal adjustment is combined with the convertibility of the exchange rate at a fixed rate. Yet this strategy requires that the economy be already strongly dollarised. It is particularly necessary that the *numéraire* be the dollar (or any other hard currency), so that all prices are changed daily according to the exchange rate. If this is the case - it was certainly the case for Argentina in 1991 - the use of the exchange rate as a nominal anchor will automatically stabilise all prices. If this is not the case, if inflation did not become so high as to entail dollarisation, the alternative will be a combination of a temporary freeze with a nominal anchor, provided that the fiscal adjustment was or is being assured. This was done successfully in Israel in 1985 and in Mexico in 1987. It is the efficient stabilisation policy for Brazil.

But would it not be possible to have a gradualist incomes policy, instead of a shock? In principle this would be possible. It would consist of the gradual pre-fixation of prices, according to guidelines that the government would suggest. As a matter of fact, however, a strategy like that would only work if inflation were inertial but moderate. When inflation is high, pre-fixation is ineffective because economic agents are

averse to risk and take decisions in terms of the prisoner's dilemma. For the pre-fixation strategy to be successful, economic agents must believe that inflation is falling and will continue to fall, and must be ready to correct their prices accordingly. But if inflation does not behave according to predictions, the economic agents who believed in the prediction will take a loss. If inflation is low, say two percent a month, and if an informal pre-fixation of ten percent points a month is made, the economic agent who follows this guideline, increasing his prices 1.8 percent instead of 2 percent in the first month, will lose only 0.2 percent if inflation continues at the previous level. However, if inflation is high, say 20 percent a month, his loss will be much greater - two percent. This is the reason why, when inflation is high, economic agents will not obey the government guide-lines and gradually reduce their prices in accordance with the expectation of a declining inflation.

When Latin American economists developed the theory of inertial inflation, in the early 1980s, and concluded that the stabilisation of this type of inflation would require the adoption of heterodox policies, the idea was received with reserve in the First World. They knew that some inertia existed in inflation, but, used to moderate inflation rates, did not give much attention to it. More recently a growing number of First World economists have been recommending a combination of income policies with conventional policies. See, for example, Dornbusch and Fischer (1986), Kiguel and Liviatan (1988) and Bruno (1989, 1991). In an introduction to an excellent book that he edited with Fischer, Helpman and Liviatan with the title of *Lessons of Economic Stabilisation and Its Aftermath*, Bruno states:

Given inflationary inertia, the orthodox cure is necessary but not sufficient. The correction of fundamentals does not by itself remove inflationary inertia, as the most recent Mexican example has shown. Supplementary direct intervention in the nominal process, such as a temporary freeze of wages, prices and the exchange rate, can substantially reduce the initial cost of disinflation (1991, p. 2).

It is not possible to be clearer. In a recent article with the suggestive title of 'When do heterodox stabilisation programs work: lessons from experience', Kiguel and Liviatan present two scenarios of high inflation in which the heterodox plan is not appropriate: when inflation suddenly becomes high, and when there is hyperinflation. In both cases, inertia is irrelevant. They conclude: 'The single situation in which the heterodox strategy may be useful, then, is in economies suffering from chronic high inflation' (1992, p. 54). Brazil is the country that best fits this description.

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### INEFFICIENCY COMBINED WITH LACK OF POLITICAL SUPPORT

Today an overwhelming majority of economists that are versed in inflation theory and stabilisation policy, and have some knowledge of the Brazilian inflation, agree that the solution for it is a combination of fiscal adjustment with a shock. The gradual alternative is excluded, they may diverge on the nature of the shock (whether it be a price freeze, a nominal anchor, a combination of both, or the co-existence of the old and the new dollar-denominated currency, the latter backed by a Currency Board<sup>21</sup>).

In a visit to Washington D.C., in November 1992, I had a long conversation with Steri Beza, Director of the Occidental Hemisphere Division at IMF, and my friend Alexandre Kafka, Director for Brazil at the IMF. I criticised the IMF for having sponsored the Marcílio Plan. In the conclusion of the conversation, Beza said approximately the following: 'Well, you know that IMF decisions have a political component. We consider what the government of the country wants, we consider our Board's views, and we take a decision. But if one asked the staff of the Fund about how to stabilise the Brazilian economy, I would say that between two-thirds and three-fourths of them would agree with you on the need for shock therapy.'

If this is so, if there is such broad agreement on the inviability of gradualism, why did the Brazilian government adopt the Eris Plan and the Marcílio Plan? Just because the economic team did not know the theory of inertial inflation? Just because they had radical orthodox views on economic theory? This was certainly not the case for the Eris Plan. And I would say that it was also not the case for the Marcílio Plan. Orthodoxy was rather a rhetoric than a firm belief.

Why, then, were these inefficient stabilisation programmes adopted? Because five price freezes failed before? This is part of the answer, but the orthodox stabilisation programmes failed as well. Actually, the reason is not theoretical, but political and economic. A shock therapy is being shunned in Brazil, particularly in the last two years, because businessmen feel extremely threatened. Among the five previous freezes, I would say that only the one for which I was responsible represented a change from less to more safety or tranquillity; the crisis just before the Bresser Plan was so acute that the plan represented more stability. I admit that this is a personal and possibly biased view. The others only caused more insecurity. The Cruzado Plan failure was outrageous. The Summer Plan and the Collor Plan II failed from the start, only causing indignation. The Collor Plan I was extremely threatening, less for the price freeze, much more for the monetary reform that embodied a 75 percent freeze of existing financial assets and the cancellation of almost 30 billion dollars of the public debt. After the last two freezes the losses business enterprises suffered were enormous. These losses were heavily related to the recession, that provoked a 10 percent reduction in *per capita* income between 1990 and

1992, but this was not understood by businessmen.

This fear, this sense of insecurity, that is widespread in Brazilian society, was used by opportunist intellectuals and politicians to join voices with businessmen against any type of shock. An informal censorship was established. 'Shock' became a bad word. The economists that dared to speak about shocks were and are being informally repressed. The policymakers that were able to assure society that no shock, no freeze, no nominal anchor, would be adopted, were praised. Their prestige increased, although inflation remained high.

In this way, the adoption of inefficient stabilisation policies turned into a consequence of lack of political support. It should not be so. Net transitional costs of stabilisation are already negative, and this fact was already partially perceived by society. The strong fiscal adjustment that took place in 1990 and 1991 was no accident. The support for fiscal adjustment is today larger than a few years ago. The disposition of workers to participate in a social agreement improved substantially in the last five years. Yet, contrary to what Przeworski predicted, elites were not 'able to learn from past mistakes' and 'develop more comprehensive and consistent programs' for a more sceptical population (1991, p. 179).<sup>22</sup> However rational and desirable, this is proving to be false in Brazil. The fear of a new shock is enormous, leading to inefficient stabilisation programmes. Inefficiency and lack of political support join forces. And, as the real interest rate remains high, the fiscal crisis reappears. The three hypotheses to explain the failure of Brazil to stabilise - the inefficiency, the political and the extreme crisis hypothesis - come together.

### NOTES

1. It should be noted that John Williamson (1993), who coined the expression 'Washington consensus', is very clear that, besides political support, successful economic reforms require a competent and stable economic team and a comprehensive economic programme.
2. In this paper a 'heterodox' stabilisation policy is one that acts directly over prices, wages or the exchange rate, while an 'orthodox' one will act indirectly over prices, through fiscal and monetary policy that affects demand and/or changes expectations. According to this definition, incomes policy is a heterodox policy.
3. A shock may be heterodox (a price freeze combined with a social agreement) or based on a nominal anchor (usually the exchange rate, that will be fixed and made convertible). The alternative to shock therapy is gradualism, that may be orthodox (based on fiscal and monetary policy, or based on guide-lines), or heterodox (also based on guide-lines and incomes policy).
4. Given the high interest rates, only the state, the state-



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owned enterprises and a few bankrupted firms are actually highly indebted in Brazil today.

5. The first opportunity was lost in the inauguration of the new administration, in March 1990, when Collor Plan I was implemented and failed to stabilise the economy.

6. Examples are Hélio Jaguaribe for the Secretary of Science and Technology, Celso Lafer for Foreign Affairs, Adib Jatene for the Ministry of Health, Elieser Batista for Special Economic Development Projects Secretary, besides José Goldemberg, Minister of Education, in government from March 1990, and Marcílio Marques Moreira, in government from April 1991.

7. As a matter of fact, even with low or moderate inflation the money supply is relatively endogenous. See Rangel (1963), Kaldor (1970).

8. The explanation for the acceleration of previous inflations can be found in Bresser Pereira and Nakano (1991).

9. For the concept of 'post-plan inflationary residue', see Bresser Pereira and Nakano (1991), where we defined it in operational terms as the inflation two months after a price freeze.

10. For more on this, see Tokeshi (1991). In this work, he looks for the 'microfoundations' of inertial inflation.

11. The distinction between expectations and decisions may be illustrated by the views of a rich Brazilian rice merchant, who once full-bloodedly said to me: 'money is a serious matter, one should not play with it'. 'Money' to him means profit. To 'play with profit' is to take decisions according to volatile, unreliable expectations.

12. I owe this distinction between price decisions in the real and in the financial sector to Fernando Holanda Barbosa.

13. On my personal experience in the Finance Ministry, see Bresser Pereira (1988) and (1993).

14. In a previous paper, on which this one is partially based (Bresser Pereira, 1992b), I referred to 11 instead of 12 plans. The reason is that I decided to recognise the second phase of Collor Plan I as a distinct stabilisation plan: the Eris Plan, after the name of the Central Bank governor Ibrahim Eris.

15. I developed this idea in Bresser Pereira (1989).

16. I developed the concept of net transitional costs in Bresser Pereira (1992a). For a further development of the concept, see Abud (1992).

17. This last case was analysed and formalised by Przeworski (1991) and Alesina and Drazen (1991).

18. The best-known experience of an orthodox, gradual stabilisation of a high inflation is the case of Chile (1973-1979). The social costs, however, were extremely high, only possible under a fierce dictatorship like that of General Pinochet. Also, in Chile, although inflation was high, it did not become inertial or have an informal indexation.

19. A definition of similar phases was formulated by Yoshiaki Nakano (1990).

20. See Bresser Pereira and Nakano (1984) and Francisco Lafaiete Lopes (1984). Both papers proposed a freeze. Assuming the same theory of inertial inflation, Arida and Resende (1984) proposed the adoption of two currencies, one dollar indexed.

21. This proposal was made by Lara Resende (1992).

22. Przeworski's complete quotation is in the epigraph of this paper.

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