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Successful Reforms

Brazil did not pass through its worst economic crisis without making profound changes. Particularly in 1987, when the magnitude of the crisis began to be acknowledged, substantial fiscal adjustment and deep market-oriented economic reforms were undertaken. Major social, political, and ideological changes were also taking place in the country. The social changes were related to the enormous increase of the middle class and of university-educated people. The political changes were linked to the extraordinary increase of enfranchised citizens and to the consolidation of democracy. The ideological changes were expressed in the crisis of populism and national developmentalism.

Brazil in the mid-1990s is quite different from the Brazil of the late 1970s when this crisis started. Luís Nassif (1995) expressed this modernization or *aggiornamento* very clearly:

> The great Brazilian cultural "aggiornamento" was almost completed. Some principles are already hegemonic: decentralization favoring states and the municipalities, privatization with regulation and without depleting the public patrimony, trade liberalization, the precedence of productivity and competitiveness over protectionism, the view of the state as a regulating and surveying agent, not as an operator.

To the list of ideas embodying this cultural modernization I would add two additional ones: the concern with fiscal discipline; and the realization that wage and salary increases may be inflationary. Budget deficits, which in the recent past have usually been viewed as good because of the expanded aggregate demand, are now approached in an entirely different way. The concept of *trade-off,* which is foreign to the Brazilian culture (there is no corresponding word in Portuguese) has begun to be understood.

These cultural changes, which for many were the outcome of an intellectual transition from the old ideas, corresponded to concrete economic and state reforms: fiscal adjustment; trade liberalization; privatization; and the restructuration of business firms. Yet for two basic reasons, foreigners and even Brazilians had great difficulty acknowledging these changes, particularly the economic reforms. First, high inflation, which remained until the implementation of the Real Plan in July 1994, blinded everybody to the reforms that had been instituted. It was difficult, if not impossible, for people who did not comprehend the logic of high and inertial inflation to understand how fiscal adjustment and economic reforms could be implemented while inflation remained in an incredible two-digits-monthly zone. Second, the Brazil-oriented character of the market-oriented reforms led neoliberal ideologues and business agents who were privately interested in more-radical reforms to say that these reforms were not occurring or that they were not bold enough.

In addition to being market-oriented, the economic reforms were Brazil-oriented because they actively considered the country's national interest as well as macroeconomic fundamentals. They were not confidence-building reforms, designed mainly to build confidence in Washington (the U.S. government and the international institutions) and New York (the financial system). The reforms could also have this goal, but they did not assume that Washington and New York were the depositories of economic rationality or that the national interest of Brazil was equated with that of the developed countries.

The mistake of using a confidence-building strategy was made especially by President Salinas (1988–1994) in Mexico. If one wants to understand the basic reason behind Mexico's financial collapse in December 1994, I suggest it was the militant confidence-building strategy Salinas adopted at the expense of Mexico's national interest and of macroeconomic fundamentals. This confidence-building strategy started in early 1989, when, just six months after the Brady Plan was announced, Mexico signed a debt agreement (the term sheet) in which debt reduction was insignificant. When analysts denounced this fact, observing that the agreement did not serve Mexico's national interest, the answer was immediate: indeed, the discount was small, but the agreement built confidence, and the interest rate paid by Mexico fell.[1] Following the apparent success of the confidence-building strategy, such a strategy became standard in the Salinas administration. Economic growth was not resumed, but Mexico became the model Washington and New York presented to Latin America. The way the privatization of the commercial banks was undertaken and the decision to maintain an overvalued currency—notwithstanding huge current account deficits—were manifestations of a confidence-building strategy that clearly conflicted with macroeconomic fundamentals. The strategy worked for some time, but it finally became clear that it was not Mexico-oriented, that it did not uphold the national interest and macroeconomic fundamentals.

In this chapter I present some of the reforms that were undertaken in Brazil, underlining their Brazil-oriented character—that is, their consistency with the national interest, with strong macroeconomic principles, and with reforming or rebuilding the state. I am not suggesting that these reforms were ideally designed. They have been carried out in difficult, if not abnormal, times, particularly since 1987. The obstacles they faced were huge. They have not been completed by the mid-1990s, but sizable advances have been made.

Particularly in the case of privatization, reforms were undertaken without ignoring the country's national interest. Trade liberalization was bold, but it was carefully planned and pragmatically implemented. Price stabilization was only possible when competent economists ignored the orthodox recommendations coming from Washington or from mainstream economics, which were based on either conventional monetary and fiscal policies that would gradually control inflation or a monetary shock, and which added to the obviously required fiscal adjustment a heterodox strategy aimed at neutralizing inflation's inertia.

Between 1987 and 1994 (see Table 15.1), growth rates were modest, becoming negative in 1988, 1990, and 1992. In this period fiscal surpluses were achieved, but inflation remained at extremely high levels. Only in July 1994 did prices stabilize. In this chapter I discuss the market- and Brazil-oriented reforms that took place during this period, as well as the Real Plan, which successfully stabilized prices after twelve failed previous attempts.

Table 15.1 Budget Deficit, GDP Growth, and Inflation

	Deficit (% GDP)	GDP Growth (%)	Inflation (%)
1987	5.7	3.6	367.1
1988	4.8	–0.1	891.7
1989	6.9	3.3	1,635.8
1990	–1.4	–4.4	1,639.1
1991	0.2	1.1	458.6
1992	1.9	–0.9	1,129.5
1993	0.7	5.0	2,491.0
1994[a]	0.0	5.7	929.3

Sources: Budget deficit, public-sector borrowing requirements in real terms: Central Bank, *Brazil Economic Program*, several issues; GDP growth: IBGE *Anuário Estatístico do Brasil*, several issues; inflation, consumer price index: FIPE/USP.
Note: a. Preliminary data for budget deficit and GDP growth.

There are two types of relevant economic reforms at present: reforms that stabilize the currency and the balance of payments, among which fiscal adjustment is the most relevant; and market-oriented or structural reforms, among which trade liberalization and privatization are paramount. In Brazil both kinds of reforms took place. Fiscal adjustment was started in 1981, just two years after the crisis broke out in 1979; adjustment resumed in 1983, was suspended during the 1985–1986 populist episode, resumed in 1987, dramatically deepened in 1990–1992, and again resumed in 1994 to make the Real Plan viable. Stabilization of the balance of payments was achieved as early as 1983, when the exchange rate was devalued; since that time huge trade surpluses have been presented every year. Only in late 1994, following the Real Plan, the appreciation of that plan, and the warming-up of demand, did this trade surplus become threatened. A considerable restructuration of business enterprises, with around a 30 percent productivity increase in three years, took place in 1990–1992 as a consequence of the recession provoked by President Collor's stabilization attempts and the trade liberalization process.

Trade liberalization was the most far-reaching economic reform Brazil undertook. It was long overdue and should have been initiated in the 1960s when the import substitution strategy proved exhausted, yet twenty years passed before it was seriously considered and implemented.

In 1987, at the Comissão de Política Aduaneira (CPA), its president, José Tavares de Araujo, Jr., a leading neostructuralist economist, initiated studies to liberalize trade. At about the same time, at the Banco Nacional de Desenvolvimento Econômico e Social, another group of state bureaucrats—working in the same direction—proposed that Brazil should change its long-term industrial policies, engaging in a "productive integration program" with the rest of the world. Tavares's project would eliminate all quota and administrative import controls, replacing them with a tariff system. To do that it was necessary, first, to fully revise the tariff system, which had been distorted by several years of misuse. Second, the plan would eliminate all tariff subsidies. Yet in this first stage the level of tariff protection should remain high. Only in a second stage should it be gradually reduced.

As finance minister, I gave full support to Tavares's project and started negotiations with the World Bank for a US$1 billion structural adjustment loan that would be based on trade liberalization. In December 1987, when I left the government, the revision of the tariff system was complete. A few months later it would be implemented. Yet the effective process of trade liberalization took place only after Collor's election. All administrative barriers to imports were eliminated, and a four-year program of tariff reduction was announced. Over the next four years the plan was implemented, transforming Brazil into an extraordinarily open economy. As Table 15.2 reveals, the average protection fell from 32.2 percent in 1990 to 14.0 percent in 1994. Nearly all import quotas and administrative controls were eliminated.

Table 15.2 Import Taxes

	1990	1991	1992	1993	1994
Highest tax	105.0	85.0	65.0	55.0	35.0
Average tax	32.2	25.3	20.8	16.5	14.0

Sources: Ministry of Industry and Commerce; *Revista Exame*, July 1994.

The trade reform followed the national-interest principle. There is an old nationalist interpretation according to which trade liberalization is the outcome of pressure by the developed countries, directly or through the World Bank. This view makes no sense. Conditionality and GATT pressures played no role. Only unilateral retaliations were relevant and only in one case: the radical market reserve for the computer industry. Yet even in this case domestic opposition to protection was the dominant factor leading to its being watered down. Another view suggests that the ideological hegemony of the developed countries played a major role (Nassuno 1995). This is certainly true. Brazilian culture, as a peripheral or developing society, is ideologically enormously influenced by the cultural and economic centers in the North. Thus such influence is part of what explains trade liberalization in Brazil. Yet the decision to open the economy was essentially a domestic one. When I supported Tavares's initial work, or when Collor and Zélia implemented a bold trade liberalization program, we were not trying to build confidence but were acknowledging that the import substitution strategy was long exhausted and that the best and first industrial policy was one that would constrain Brazilian firms—including the multinationals that were supposed to provide protection—to increase their productivity and compete.

It is usual in Latin America to identify trade liberalization with neoliberal reforms and to oppose this reform of industrial policy. Yet when President Collor decided to go ahead with trade liberalization in March 1990, liberalization was viewed as an essential part of an industrial policy. As Fritsch and Franco (1993:28) underlined, the document that introduced trade liberalization in Brazil presented it as the essential ingredient of an industrial policy that would create "stable and transparent rules for industrial competition." Selective incentives, typical of an industrial policy, would be utilized, but the main tool to promote a productivity increase would be trade liberalization. The reform remained a market-oriented reform, but it was also a Brazil-oriented one.

The trade liberalization program was a huge success. Firms had to restructure, dismiss excess personnel, give up some sectors, enter new ones, and become more export-oriented. Between 1990 and 1993 productivity increased around 30 percent. Around four hundred firms won the International Organization for Standardization–9000 certificate. Only a few firms had real problems. Nearly all revealed that they were able to face international competition. The program also proved to be pragmatic. In early 1995, when automobile imports became excessive, the government raised tariffs. The automotive industry is a strategic industry with enormous backward and forward linkages that deserves special treatment.

The privatization program, which had started timidly in the mid-1980s, gained new strength in 1990. Priority was given to competitive industries under state control. The steel industry was the first to be privatized. In 1977, when some small steel mills were being privatized, I asked the leaders of the local industry why they did not demand that large mills be privatized. They told me that this "was impossible." Yet in the early 1990s all of the big mills (Siderúrgica Nacional, Cosipa, Usiminas, Tubarão) were privatized. The privatization of the petrochemical industry is currently under way. Electrical plants will probably be next.

Brazil in 1995 is approaching the time of privatizing monopolies. In this case it is concurrently necessary to establish efficient regulatory systems. When the market is competitive, private enterprises are undoubtedly superior. In the case of natural monopolies, however, regulation becomes a key factor.

The privatization program in Brazil has been implemented cautiously and competently. The results are satisfactory. Between 1991 and 1994 thirty-two state-owned enterprises were privatized, for which the Treasury received $7.9 billion. The two basic motivations behind the program were to achieve more operational efficiency and to solve the fiscal crisis of the state. The first privatizations were subject to some criticism because *moedas podres*—old bonds the Brazilian government was not honoring—were accepted as means of payment in the public auctions. Given the fiscal crisis of the state, these old debts could be consolidated in the long run, and the government would receive cash. More recently, the government has been pressing bidders to offer a larger proportion of cash.

Fiscal adjustment and privatization were other major reforms achieved by Brazil. The budget deficit, which was around 8 percent of GDP in the early 1980s, was brought down to around 4 percent between 1982 and 1984. It rose again in the populist New Republic (1985–1989) and fell dramatically during the Collor administration. After two surpluses, public-sector borrowing requirements in real terms were around 1 to 2 percent of GDP.

In spite of the stern fiscal adjustment, Collor's finance ministers failed to control inflation because their economic teams and, in 1992, the IMF, which approved a stabilization program for Brazil, were unable to recognize the inertial character of Brazilian inflation. In fact, they were victims of a monetarist or mainstream economic bias that made them unable to understand what inertia was and how to fight it. They thought that either a monetary anchor (Collor I and Eris plans, 1990) or a gradualist fiscal and monetary policy (Marcílio Plan, 1991–1992) was sufficient to control Brazil's high and persistent inflation.

A monthly inflation above two digits can be controlled only 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 should be part of a stabilization program. It is impossible to stabilize an economy gradually through fiscal and monetary policies. This kind of conventional policy is suited to control moderate demand inflation. In this case reducing state expenditures, increasing taxes, and increasing the interest rate reduce aggregate demand, thus diminishing real wages and eventually reducing the rate of inflation. Brazilian inflation, however, was neither moderate nor a demand-push one. It was a high, persistent, cost-pushed or inertial inflation. To stabilize high inflation gradually is costly.[2] To stabilize high and inertial inflation gradually is simply not feasible.

In theory, a gradualist approach to control inertia is viable if the rate of inflation is still relatively low. In this case the stabilization plan would consist of the gradual presetting of prices according to guidelines suggested by government. In fact, however, such a strategy would work only if inertial inflation was moderate. When inflation is high, presetting is ineffective because economic agents are reluctant to take risks and to make decisions in terms of the prisoner's dilemma. For the presetting strategy to be successful, economic agents must believe 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 suffer loss. If inertial inflation is low, say 2 percent a month, and a formal presetting has an error rate of 10 percent, the economic agents who followed this guideline—increasing their prices 1.8 percent instead of 2 percent in the first month—will have lost only 0.2 percent. However, if inflation is high, say 20 percent a month, their loss will be much greater—2 percentage points—if the guidelines were not followed by other agents. This is why, when inflation is high, economic agents will not obey government guidelines and will gradually reduce their prices in accordance with the expectation of a declining rate of inflation.

When Latin American economists developed the theory of inertial inflation in the early 1980s and concluded that stabilizing this type of inflation would require adopting heterodox policies, the idea was received with reservation in the First World. Some economists were aware that some inertia existed in inflation but, because they were used to moderate inflation rates, paid little attention to it. Most economists, following the conventional ideas on inflation, completely ignored the problem. Yet in the late 1980s a few First World economists started to recommend a combination of income policies and conventional policies.[3]

M.A. Kiguel and N. Liviatan, in an article with the suggestive title "When Do Heterodox Stabilization Programs Work? Lessons from Experience," presented two scenarios of high inflation in which the heterodox plan is not appropriate: when inflation suddenly becomes high; and when hyperinflation exists. In both cases inertia is irrelevant. They concluded, "The single situation in which the heterodox strategy may be useful, then, is in economies suffering from chronic high inflation" (Kiguel and Liviatan 1992:54). Brazil is the country that best fits this description.

The alternative would have been using a nominal anchor—the exchange rate or the money supply—without neutralizing inertia. All hyperinflations have ended when a fiscal adjustment was combined with the convertibility of the exchange rate at a fixed rate. Yet a necessary condition for this strategy is that the economy be strongly dollarized. At this point all price increases become synchronized, contracts are no longer staggered, and inertia is automatically neutralized, ceasing to be an obstacle to stabilization. This was, for instance, the case in Argentina in 1991. The economy was fully dollarized, so that the adoption of the exchange rate as a nominal anchor automatically stabilized prices. It was never the case in Brazil, whose economy was indexed rather than dollarized. Prices increased in a staggered way—each month, each fortnight—whereas when the economy is dollarized, prices increase every day, if not every hour.

After the Collor administration's four failed attempts to stabilize inflation, the successor Franco administration seemed paralyzed. In less than one year, four finance ministers succeeded each other without being able to formulate and implement a stabilization plan. Finally, in June 1993, when the inflation rate was over 20 percent a month, Fernando Henrique Cardoso assumed the Finance Ministry. New hopes were raised, given the political support he received and the excellent team of economists he put together.

The first positive outcome of the existence of a new and competent economic team was that the strong and irrational reaction against an economic shock vanished. It was clear that the new economic team would soon adopt a shock therapy, which would probably combine orthodox and heterodox economic policies, to stabilize the economy. It was clear that the major component of the high and persistent inflation in Brazil was inertia. The conventional explanation relating inflation to budget deficits, although valid in normal situations, had been recurrently proved wrong in Brazil. The budget deficit had been zero in 1990 and 1991, but inflation remained high. The other conventional wisdom, which attributes inflation to an increase in the money supply, had also been dramatically proved wrong. Even monetarist economists (Pastore 1994) acknowledged the passive or endogenous character of the money supply when inflation is high and inertial.

The proposal that high and inertial inflation should be controlled through a shock (a monetary reform), preceded or followed by a mechanism of neutralizing inertia, was formulated by Brazilian economists in the early 1980s when they developed the theory of inertial inflation.[4] Some of these economists, who had actively participated in the Cruzado Plan in 1986, were back in the government. The Real Plan, which stabilized prices on July 1, 1994, was drawn up by Pérsio Arida, André Lara Resende, Edmar Bacha, and Gustavo Franco. The first three of these economists contributed to the theory of inertial inflation in the early 1980s and were on the team that formulated the Cruzado Plan. When it became clear that this plan's administration was populist and would lead to disaster, they were the first to internally denounce the mistakes that had been made. They resigned from their posts before the complete collapse of the plan. In 1993, back in the government as part of Fernando Henrique's team, they had the opportunity to apply an alternative (to a price freeze) strategy to control inertial inflation—an alternative Arida and Lara Resende had developed back in 1983–1984.

It was clear to the neostructuralist economists who developed the theory that the stabilization of high and inertial inflation should be divided into four phases: (1) preparation, consisting essentially of fiscal adjustment; (2) coordination of expectations through the correction of relative prices to neutralize inertia; (3) a price shock, usually accompanied by a monetary reform and the adoption of a nominal anchor (the exchange rate), thereby dramatically reducing prices; and (4) consolidation through additional fiscal adjustment plus a tight monetary policy.

Phases 2 and 3 could be inverted depending upon the strategy adopted. Previous attempts in Brazil—beginning with the Cruzado Plan—had adopted first the price shock and second the correction of relative prices through conversion tables. Similar strategies were successfully adopted in Israel (1985) and Mexico (1987). In Brazil they failed. Thus in 1994 the decision was made to adopt the second, more complex alternative: first to neutralize inflation through the URV mechanism—a U.S.-dollar-pegged money index, to which all prices were converted in the three months previous to the monetary reform (July 1, 1994) when inflation was practically zero.

The original and extremely ingenious idea in the Real Plan was to have two currencies coexisting at the same time: the old currency, in which inflation would be high; and a new, indexed currency. This dual system would permit economic agents to convert their contracts in a voluntary, market-oriented way from the old currency, in which contracts embodied the expected rate of inflation, to the new currency, which—because it was linked to the dollar—would have no inflation. Then, when monetary reform eliminated the old currency, inflationary pressures, derived from relative price imbalances and from the fact that in inertial inflation prices are changed in a phased, nonsynchronized way, would be absent. Relative prices in the new currency would already be balanced, so that conversion tables (tablitas) aimed at eliminating expected inflation from contracts would not be necessary.

In the early 1990s, when the idea of a new shock was discredited, Lara Resende (1992) came back to his original idea and suggested a further step: that the new currency, convertible to the dollar, would be issued by a Currency Board that would hold the international reserves of the country. Fernando Henrique Cardoso's economic team viewed this alternative as too radical. Preference was given to Arida's simpler proposal. Rather than issuing a second currency, the government would create a daily "price-index currency" reflecting present inflation and attached to the exchange rate. It would not actually be a currency because payments would continue to be made in the old one, the cruzeiro. But as a price-index currency, contracts, including credit sales and wages, could be voluntarily converted to it to avoid the need for a tablita on the day of the monetary reform, when the old currency would be extinguished.

The Real Plan was divided into three phases. In the first phase, between December 1993 and February 1994, fiscal adjustment, based on public expenditure cuts and a tax increase, allowed a balanced budget for 1994. Congress, after some initial opposition, approved the fiscal adjustment, which the economic team defined as a prerequisite for launching the program's second phase.

The second part of the plan, from March to June 1994, consisted of neutralizing inertia by utilizing a currency index, the URV, which measured day-by-day, current inflation. This index was closely attached to the exchange rate variation. It was used to adjust all prices in the economy: wages, public and private prices, rents, long-term contracts, and financial applications. As contracts were converted to URVs, prices in URVs remained stable, whereas prices in cruzeiros changed every day—as happens under hyperinflation and full dollarization. As predicted, the market assured that the conversion of cruzeiros to URVs was made basically (not fully) according to the medium real value of the contracts rather than their nominal peak values.

The third phase of the plan was the shock—the monetary reform—that changed the URV into new currency, replacing the cruzeiro, which was extinguished. The rate of inflation was immediately reduced to near zero. The new currency, which economic agents expected to be pegged to the dollar at a one-to-one relationship, was actually evaluated at around 15 percent. Only then was it pegged to the dollar. Like the Cavallo Plan in Argentina, the major problem the Real Plan faces in 1995 is the real evaluation of the *real*. Eight months after stabilization, residual inflation neared 1 percent a month, but accumulated inflation was around 25 percent.

The Real Plan has not yet been consolidated, but clearly it has been an enormous success—an intellectual success for its authors, who were able to develop a heterodox strategy of controlling price inertia without a freeze; a political success for Fernando Henrique Cardoso, whose election to the presidency was basically the fruit of the plan. The Real Plan was a strictly Brazil-oriented economic reform. It was heterodox because it adopted the URV, but it was also orthodox because it never neglected fiscal adjustment and, since the shock, has been supported by an extremely tight monetary policy.

Market-oriented economic and state reforms, fiscal adjustment, and stabilization did happen in Brazil. The conventional wisdom, dominant in the early 1990s in the developed countries, according to which "Brazil was the laggard of Latin America" was simply false. High inflation blinded everybody. And it was difficult for people who ignore the nature of inertial inflation to understand how such high inflation was possible while economic reforms, including fiscal adjustment, were being undertaken.

These economic and state reforms were Brazil-oriented as well as market-oriented. They were defined and implemented not to please international bureaucrats, government officials, and financial investors in the developed countries but to protect Brazil's national interest and to achieve macroeconomic equilibrium. It is too soon to celebrate victory. Fiscal adjustment will have to produce not only a balanced budget but also positive public savings. Structural economic reform will have to be deepened. Yet, there is no doubt that the crisis was not in vain, that economic reforms were indeed accomplished in Brazil.