"The Political Construction of the Market Economy in Brazil: Stabilization and Trade Liberalization (1985-95)"

[draft version - please do not quote without author's permission]

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Until 1984, Brazil was a country marked by authoritarianism. The political system was ruled by the military establishment, though elections, parties and the parliament existed. The economy was also closed: protectionism was the rule, both as a mechanism to promote industrialization and as a way to solve escalating balance of payments imbalances. Import Substitution Industrialization (ISI) combined with an inward-oriented growth strategy, which marked the economic model since the 1930s, not only caused balance of payment problems, but was also responsible for the high rates of inflation that have been peculiar to Brazil.

A little more than a decade passed and in 1995 the country was significantly different: the political system was best described as democratic, the economy had been firmly liberalized, and inflation was out of the picture. How can we account for those changes? Can the emergence of democratic politics explain trade liberalization and economic stabilization? What were the main advocates of those policies and how did they finally manage to surmount existing resistances?

This paper addresses those questions. It focuses on the policy initiatives that were successfully implemented - trade liberalization (1990-95) and the Real Plan (1993-now) - , and traces them back in time trying to find its origins and main advocates, as well as previous cases in which they had been tried without success. In so doing, I believe, I can make a stronger case to account for their origins, the political resistances they managed to overturn, and the causes of their success.

The main argument developed here is that the success of economic stabilization and trade liberalization policies was due to the ascendancy of the ideas of a group of scholars from the Department of Economics of the Catholic University of Rio de Janeiro (PUC-Rio) over the economic policies of the administrations of Fernando Collor (1990-92), Itamar Franco (1992-93) and Fernando H. Cardoso (1994-now). Those economists not only have written extensively on those subjects but they have also taken key positions in the economic teams and/or served as advisers to them. A simple comparison between the federal legislation and their academic production reveals how crucial their ideas were in the decision making process of the two policies. So, one of the purposes of this paper is to explain how did those ideas get to the highest positions in government.

This paper has four parts. The first one, introduces the group of economists from PUC-Rio and their main ideas about the two subjects. In the second part I analyze the decision-making process of the two heterodox stabilization plans implemented in Brazil, the Cruzado and the Real. The third part does the same for the trade liberalization policies implemented from 1988 to 1995. Part four is the conclusion.

I. The Group and Its Ideas

The group of economists from PUC-Rio can be easily divided in two thematic sub-groups: one working on stabilization, the other on trade policy. The first group was created in the early 1980s, right after Persio Arida and Andre Lara Resende returned from the US, where they did their Ph.D.'s in the MIT. At PUC-Rio, they joined three other US trained stabilization experts - Chico Lopes (Harvard), Edmar Bacha (Harvard) and Eduardo Modiano (MIT, Sloan Business School) - and a few others interested in tangential issues, like labor economics, public sector economics, and the economics of the external debt.

Those economists developed a new interpretation of the Brazilian inflationary process. After running several investigations on the validity of the Philips Curve to explain the escalation of inflation in Brazil, they came to a rather different conclusion which stressed the importance of institutional mechanisms - indexation clauses - to account for the failure of orthodox stabilization programs implemented in the early 1980s. Their theoretical contribution was called "theory of inertial inflation".
Some of the members of the PUC-Rio stabilization group joined the federal government in the administrations of presidents Sarney, Collor, Itamar Franco, and Fernando H. Cardoso. Arida and Lara Resende were affiliated to the governing party - PMDB - and joined Sarney's economic team in the second half of 1985. Once they were in office, they helped design the government's first stabilization plan, the Cruzado (1986). The Cruzado program was greatly influenced by their ideas, though it comprised a price freeze scheme derived from Chico Lopes' approach - which Arida and Lara Resende strongly rejected. During the implementation of the Cruzado, Arida and Lara Resende developed a close relationship with PMDB Senator Fernando H. Cardoso, the government leader in Congress. Two years later, Cardoso would set up a new party - PSDB - and attract PUC-Rio economists to it.

Eduardo Modiano, who had made important contributions to the development of the "theory of inertial inflation", took part in the first economic team of Fernando Collor. He had been the one that showed the negative impacts of wage indexation mechanisms over the effectiveness of orthodox policies, based on the use of demand-management techniques. Despite that, the Collor Plans I and II cannot be said to follow from the idea of inertial inflation.

President Collor was impeached in December 1992 and Itamar Franco took his position. When Fernando H. Cardoso was appointed Finance Minister by the new President, in March 1993, the PUC-Rio economists returned to the government. At that time, they made their most important contribution to the stabilization process in Brazil, as the main architects and managers of the Real Plan (1993- now), the most successful stabilization plan ever implemented in the country. As a result of the learning process derived from previous failures of stabilization policies, on the one hand, and of the total control over the policy-making process exerted by PUC-Rio economists - especially Arida, Lara Resende, Bacha, W. Fritsch and G. Franco - , on the other, the Real Plan is much more similar to the initial proposition of Arida and Lara Resende (cf. Arida & Lara Resende, 1984) than the Cruzado. Section 2, below, will discuss the policy-making process of the two plans.

The trade policy group was formed in the second half of the 1980s by Winston Fritsch, Marcelo Abreu, and Gustavo Franco. The former two did their Ph.D.'s in the Economics Department, Cambridge University (UK), while the latter did it in Harvard. They worked together in numerous researches and wrote several academic papers in partnership. As the members of the stabilization group, they have also worked for the federal government in different occasions.

Beyond their academic partnership, Fritsch and Franco were also part of the same political network, as affiliated members of the PSDB - where they served as trade and industrial policy advisers to the 1989 Presidential Candidate, Senator Mario Covas, under direct supervision of Senator Fernando H. Cardoso (the head of the PSDB Campaign Committee). Right after Fernando Collor was elected, Fritsch and Franco were invited by their colleague Eduardo Modiano to assist the president-elected's economic team. They were in charge of designing the basic outlines of the trade reforms of the new government. Those reforms were partially launched in Collor's first day in office [MP 158, Finance Minister Decree (Portaria) 56/90]. Despite that, Abreu was the one invited by Collor's Finance Minister to head the Foreign Trade Department [DECEX], and implement Fritsch/Franco's ideas. Abreu did not last for long in DECEX, as he did not accept the Minister's nominees for key positions. Despite that, DECEX implemented trade liberalization in full, following PUC-Rio's economists recommendations.

When Fernando H. Cardoso was appointed Finance Minister of the Itamar Franco administration, in March 1993, he immediately invited Fritsch and Franco to join his economic team. Fritsch was chosen Secretary of Economic Policy, while Franco was his deputy secretary. From those key positions in the bureaucratic structure of the Finance Ministry, they were responsible for the design and implementation of both the Real Plan and the final steps in the trade liberalization process.
- the transformation of MERCOSUR in a customs union and the early adoption of its common external tariff [TEC] which caused substantial tariff cuts -, in order to improve competition and enhance stabilization. Section 3, below, will present the decision-making process of trade liberalization in greater detail.

II. Stabilization Through Heterodoxy: the Cruzado and the Real Plans

Brazil has had a long history of inflation. In fact, it is now clear that inflation was a key component of the inward-oriented ISI model followed from the 1930s on [see Franco, 1999]. A specificity about the endurance of double/triple digit annual inflation rates for such a long time was the institution of a complex system of (backward-looking) indexation, which crossed over the entire economy - from taxes to financial instruments and from wages to prices. But if indexation avoided short-term contractual disturbances caused by inflation, it also created strong difficulties to anti-inflation programs. As early as 1970, Mario H. Simonsen, a distinguished economist, emphasized that the structural/ institutional obstacles to stabilization posed by indexation schemes reduced the effectiveness of orthodox stabilization programs - based on restrictive monetary and fiscal policies [see Simonsen, 1970].

High inflation usually provoked exchange-rate appreciation, which encouraged imports. But the debt crisis, in the early 1980s, forced Brazil to adopt economic policies to generate foreign reserves. With the sudden retreat of foreign capital as a financing alternative, Brazil had to rely basically on foreign trade to increase its foreign reserves. The policy choices made by the Brazilian government in order to achieve large trade surpluses involved constant real devaluation of the domestic currency - a crawling-peg regime. That, in turn, increased the value of the external debt in domestic currency, and also the price of imports which pressed inflation up [see Cardoso & Fishlow, 1988].

The combination of escalating import prices - especially oil - with the indexation of the whole economy drove inflation to its highest levels in history. As correctly put by a respected economic publication: "[w]ithout indexation, a rise in the cost of an imported raw material should mean a once-and-for-all rise in prices. There would be a fall in real incomes, but no lasting change in the inflation rate or unemployment. When wages are indexed, however, the first push from higher costs sets a vicious cycle in motion. First, prices rise; that means higher wages, which means another rise in prices, and so on" [The Economist, 03/30/85, pg. 75]. The association of external shocks (the oil crises and the rise of US interest rates) and maxi-devaluations (30% in 1979 and again in 1983) made annual inflation rates jump from 40%, in 1979, to 100% in 1980, 180% in 1983, 240% in 1985.

Besides, increasing inflation impelled a shortening of the time lags of indexing mechanisms, causing an even faster growth in the money supply. In this context, orthodox stabilization programs were implemented with no success from 1980-85, part of the time (1983-85) under the strict supervision of the IMF. Those policies did not succeed because they did not take into account the need to dismantle the indexation system [see Arida & Lara Resende, 1984].

A simple example can show how indexation made orthodox programs inadequate. Let's imagine that the government launched an orthodox plan that brought inflation down by 2 percent a month for six consecutive months, so that monthly inflation rates after the launching of the plan were: 18%, 16%, 14%, 12%, 10%, and 8%. Due to contractual obligations, in the seventh month wages would be corrected by 107 percent. The problem was that right before the wage adjustment the price structure was compatible with the consumption capacity of the population measured by the money supply figures. The wage increase would, then, undermine the continuity of price reductions, as it would raise aggregate demand.
Motivated by the failure of orthodox stabilization, the stabilization group of PUC-Rio ran a series of econometric studies to evaluate the validity of the Philips Curve to explain Brazilian inflation at the time. From those studies, three of them derived a new theory based on the notion of "inertial inflation", which emphasized the role played by indexation schemes. The so called "theory of inertial inflation" was developed by Andre Lara Resende and Persio Arida [LARIDA], on one side, and Francisco Lopes, on the other. The first two proposed a combination of orthodox policies to control the fundamentals (fiscal and monetary aggregates) with a monetary reform to abolish indexing mechanisms built into contractual relations of all kinds [see Arida & Lara Resende, 1984]. Lopes, on the other side, proposed a price freeze scheme instead of the monetary reform [see Lopes, 1984]. Both perspectives were considered "heterodox", as they appealed to something more than just the control of the money supply and the public deficit.

For heterodox economists, the elimination of the inertial component of inflation required the use of a device to coordinate the expectations of economic agents towards a situation of price stability. This device would essentially establish the entry values of the new (non-indexed) contracts which would substitute those containing indexation clauses. This conversion of on-going contracts could be done either through a monetary reform – the creation of a new currency to substitute the old one, in order to foster a complete transition to a stable environment –, as proposed by LARIDA, or through an incomes policy – with appeal to a freeze in wages and prices or the institution of administrative controls over price increases – as suggested by Lopes (1984), and Bresser & Nakano (1984).

The appeal to such an artifice is what distinguishes heterodox from orthodox stabilization programs. LARIDA’s rejection of a price freeze scheme, as a way to stop inflationary expectations, was already strong in this initial formulation. This is a clear expression of their strong commitment to market mechanisms and voluntary contracting as the main rules governing economic interactions even during stabilization programs. In their view,

“under a high rate of inflation, relative prices are extremely volatile. (...) A legal/authoritative frozen of nominal prices would inevitably freeze inadequate relative prices. If the price freeze was only for a very short period of time it wouldn’t eliminate the inflationary legacy of the past; if it were too long, the inconsistencies in relative prices as well as any shocks over supply or demand would result in ration schemes. The very end of the price freeze would, most likely, put strong pressures to reestablish the previous relative balances, with potential inflationary consequences. (...) The freeze also generates a higher demand for currency that, if not met by an expansion of the monetary base, promotes inflation.” [Arida & Lara Resende, 1984:16-17].

In sum, during periods of high or chronic inflation, relative prices are constantly changing as price increases are not perfectly synchronized. For that reason, the relative price of a product tended to deteriorate immediately after it had been raised. So, in LARIDA’s opinion, price freezes would almost certainly crystallize imbalances among relative prices. The likely result would be that those agents/individuals negatively affected by the freeze would be tempted to increase their prices right after price controls were relaxed. In other words, economic agents would not share the expectation of price stability, if they thought the price of the products they sell had been unfairly converted to the new currency. The distributive equilibrium would be broken by the price freeze, and inflation would then tend to show up right after the relaxation of administrative controls.

Following their commitment to a conservative administration of the fundamentals, LARIDA pointed to the need for tight control of the public deficit prior to the implementation of the monetary reform, as the reform alone would only affect the inertial component of inflation. Given the control
of the public deficit (adjusted to inflation) and the clear identification of the inertial character of inflation, they presented a proposal of monetary reform:

“the government should introduce a new cruzeiro (NC) whose value would increase in line with prices expressed in the old cruzeiro. The government would immediately conduct its own transactions in NC’s; common folks could turn in their old money for NC’s at a rate of exchange fixed by the government.

“Suppose the initial rate of exchange was 10 cruzeiros to the NC. If prices (in old money) went up by 10% in the following month, the government would adjust its rate of exchange, and swap one NC for 11 cruzeiros. So the NC’s purchase power would be unchanged: inflation in NC terms would be zero by definition. All would quickly see the advantage of getting their wages and paying their bills in NC’s” [The Economist, 1985:75, emphasis added].

Therefore, the core idea of the monetary reform: the creation of a new currency followed by the voluntary conversion of all on-going contracts into it, without violating the setting of prices by the market. Contracts in the new currency would not be allowed to carry indexation provisions. Government would fix an exchange rate to conversions of contracts into the new currency based on the full discount of inflation. That would create a strong incentive for voluntary conversions because it would work as if the new currency had been itself indexed [cf. Lara Resende, 1984a; Arida & Lara Resende 1984a]. And contracts – wages, prices, capital investments, loans, debts, etc. – converted into the new currency would contain expectations of price stability for two reasons: first, converted contracts would set new entry values (making supply and demand compatible), and second, indexing clauses would not exist anymore.

During a transitional period the two currencies would exist at the same time. As long as the conversion of on-going contracts into the new currency preserved the same distributive equilibrium verified in the previous (inflationary) equilibrium, there would be no sources of tension between contracting parties, and consequently no resistance to the end of inflation. If there were no other sources of inflationary pressure – and again, they believe that the public deficit is the main cause of inflation because it stimulates money printing – this reform would be enough to curb inflation. If the fundamentals were not under control, the inflation remaining after the reform would be of a conventional (excess demand) kind, which would call for the use of demand management techniques – restrictive (orthodox) monetary and fiscal policies.

The monetary reform would, in practice, avoid the problems involved in the price freeze because economic agents would voluntarily convert their contracts (prices included) to the new currency. This voluntary conversion would only happen if the new currency proved to be a better index than the ones they had been using before. Part of the stimulus would derive from the fact that the new currency would have a daily rate of appreciation in relation to the old one – attractive to all contracts which did not have a daily indexation.

The monetary reform would, thus, work as the printing of indexed money, i.e. money protected from inflation. In this regard, it would mean the radical indexation of the whole economy, but this time an indexation by the same index. After the majority of economic actors were using the same index (a process that they thought would take up to two months), and when price increases were entirely synchronized, the index itself would become the new currency – i.e. one unit of the new currency would be quoted in one unit of the index.

Now I turn to the analysis of the two stabilization programs designed and implemented by PUC-Rio economists, the Cruzado and the Real.
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The Cruzado Plan (1986)

Policy and Political Networks.

The government decision to launch a heterodox plan was greatly influenced by the fact that Argentina had already started a similar program which seemed to work. The Argentine economists responsible for the Austral Plan (1985) had been visiting scholars in the Department of Economics at PUC-Rio, and their program was seen as a variation of the LARIDA proposal.

Arida and Lara Resende's rise to the top positions in the decision-making structure of the Brazilian government must be credited to the political networks they were linked both as a result of their overall academic recognition and because of their affiliation to the PMDB - the strongest party in Sarney's coalition. Furthermore, the fact that they had been generally recognized as major critics of the recessive stabilization policies of the early 1980s as well as proponents of non-recessive stabilization policies put them in a central position among PMDB economists. In the past, they had maintained close professional, academic and personal relations with two important members of the Sarney administration, Joao Sayad (Planning Minister) and Fernao Bracher (Governor of the Central Bank). Also an academic economist, Sayad pushed very strongly for the nomination of Lara Resende and Arida for key positions in the economic team as he saw LARIDA's stabilization program as the perfect solution to combine growth and inflation-control.6

There are three important political issues to be clarified concerning the nature of the Sarney government. First, with the election of Tancredo Neves for President, the task of choosing the economic team was subject, more than in the previous regime, to political arrangements. The PMDB, the leading party in Congress, had acquired a definitive influence over economic decisions. The choice of João Sayad, represented a clear willingness of the President to woo the support of the PMDB from São Paulo, represented by Ulysses Guimarães, Fernando H. Cardoso, and Governor Franco Montoro.

Second, as the government was the result of an alliance between the PMDB and the PFL, and as Tancredo decided to start the government with a conservative financial policy to gain international confidence, he appointed Francisco Dornelles as his Finance Minister.7 Dornelles had already been the Director of the Federal Tax Department [Receita Federal] and was at that moment a representative in Congress for the PFL. Except for freezing the price of services provided by the state companies, Dornelles' stabilization policy in the first half of 1985 was clearly orthodox. But since Tancredo (who was also Dornelles' uncle) never got to assume the Presidency (he got sick on the day of the inauguration and died a month later), Dornelles lacked the necessary political backing to maintain a tight control of fiscal and monetary policies. His sharp divergences with the developmentalist vision of Sayad, and of Sarney himself, were significant enough to make his position in the government very difficult. He finally resigned in August, when President Sarney backed Planning Minister Sayad's new Target Plan, which implied a substantial increase in public spending in social programs when Dornelles was proposing a 10% across-the-board cut in government spending.

With the resignation of Dornelles, Sarney chose Dilson Funaro, a São Paulo industrialist, for the Finance Ministry.8 Funaro had close links to the PMDB of São Paulo, representing a real turn in the government’s economic policies. Funaro brought with him two famous economists from UNICAMP-State University of São Paulo at Campinas, both of whom had important PMDB credentials – João M. Cardoso de Mello and Luiz G. Belluzzo. They were also key decision-makers involved in the Cruzado Plan, though they were not experts in issues of monetary and stabilization policies. They also did not know in detail the nature of the LARIDA.

Finally, the changes in the Finance Ministry with the coming of Funaro were obviously reflected in the nominations for the Central Bank – BACEN. From the most conservative board in years under Dornelles (headed by Antonio Carlos Lemgruber), the BACEN became a central place in the elaboration of the heterodox program, especially after October 1985. Fernão Bracher was
appointed Governor by Funaro. As he was close to the heterodox group, he invited Lara Resende and Arida to join the new Board. Arida changed from SEPLAN to BACEN at the end of the year. Lara Resende was appointed Director of Public Debt and Open market, in charge of the setting of interest rates, and Luis C. Mendonça de Barros – another banker – Director of Capital Markets. It can, thus, be said that after Dornelles’ resignation, the focus of political resistance to the nomination of heterodox economists to the Board of the BACEN had been eliminated.

Bracher was also responsible for making the heterogeneous economic team to work in unison under the guidance of Lara Resende and Arida in the design of the basic set of measures, as his authority as Governor of the Central Bank implied compliance from potential recalcitrant subordinates. In October, while Arida continued officially under Sayad at SEPLAN, the core group of SEPLAN, BACEN, and the Finance Ministry began a series of meetings to design a monetary reform. Chico Lopes was, then, incorporated as an informal adviser until it became clear that the government would launch the program. At this point, only those holding government positions took part in the discussions.

The single most important feature of the political process behind the design and implementation of the Cruzado Plan was that the two experts who had first designed the technology of monetary reform – Lara Resende and Arida – were in subordinate positions in the decision-making apparatus of the government. As far as it was only a matter of design, their capacity to control the process was almost absolute, as the technology they had created was not fully known by any of their fellows in government. Lara Resende and Arida were the only ones with government credentials that knew, for instance, how to write the law, how to carry out the monetary reform, how to set the mechanism to convert the contracts, and a series of technical details which were not at the disposal of the other decision-makers – whether politicians or technocrats.

But this technical control exerted by the policy-experts declined as the design of the package of measures advanced, and became known by those holding political posts. As soon as the final set of measures was completed, the political centrality of the experts came to an end. As they only held technocratic posts they had no authority to change decisions coming from their hierarchic superiors, or by top politicians, even when those decisions were totally inimical to the basic logic of the program they had designed [the concession of wage bonus for the entire mass of wage-earners is one example].

Therefore, both their superiors in the bureaucratic structure (ministers, and top politicians) and the other technocratic advisers with political connections – the case of Belluzzo and João Manoel, the two main economic advisers of the Finance Minister – were capable of changing the policy measures proposed by Lara Resende and Arida. This is even more important when we consider that none of the other members of government, even economists, had understood the basic logic of the heterodox program as Lara Resende and Arida had formulated it.

In sum, it was only after the definition of the basic set of measures by the two experts, that all the other members of the government – not only those part of the economic team, and of the political coalition in Congress – had a chance to alter the content of the package. At this point the capacity of the designers to keep intact the basic logic of the program was sensibly reduced. The logic of compromising among different economic and political principles, assumed center stage. Conflicts arose and were solved through bargaining.

Disputes inside the economic team itself marked both the desicion-making and the implementation processes of the Cruzado. The issues along which these disputes developed are discussed below.

**Heterodox Measures.**

Basic characteristics of the program:

- a new currency, the Cruzado, replaced the Cruzeiro on February 28, 1986. One Cruzado was worth one-thousand Cruzeiros;
• prices were frozen, by fiat, for an indeterminate time. The exchange-rate was also fixed. These two actions were taken based on the idea that the zero-inflation target would be immediately achieved and sustained through time;

• wage conversion: in the conversion of on-going wage contracts into Cruzados (the new currency) entry values were equal to the average purchasing power in the previous six months plus a 8 percent increase in general and a 15 percent increase for the minimum wage. Annually, wages were to be adjusted to at least 60% of the rate of inflation accumulated since the previous adjustment. The other 40% would be directly bargained between workers and employers;

• trigger mechanism: an indexation clause determining that every time accumulated monthly inflation rates reached 20 percent or more, all wages would be automatically adjusted to the full accumulated rate of inflation;\(^{12}\)

• demand deposits, Cruzeiro bills, and shares in public financial funds were converted into Cruzados right away. A Tablita scheme – a daily devaluation mechanism based on the discount of indexed values implicit in forward-looking contracts – was established to the conversion of cruzeiro-denominated liabilities with future maturities. Liabilities explicitly indexed were not made subject to the Tablita;

• indexation: new contracts could only be (officially) indexed if they were to last more than one year. In this case, the index would be the OTN-Obrigações do Tesouro Nacional, which substituted the ORTN as the index to public prices. The OTN was to be frozen for 12 months, when it would be adjusted to inflation. The indexation of contracts effective less than one year was prohibited;

Though both Arida and Lara Resende were theoretically against the idea of a price freeze, especially due to its long-term effects on the economy, they accepted its inclusion in the Plan as a short-term instrument. As I have already made clear, they were convinced of the importance of the price system to determine an efficient allocation of resources among the different sectors of the economy, but chose the price freeze for three reasons. First, there were constitutional problems involved in the idea of creating a transitional period during which both the new and the old currencies would be valid. Can a country have two different currencies? It was only in 1992, after the failure of four non-orthodox stabilization shocks, that Arida designed a way of avoiding such a debate through a very inventive idea: the new currency could be only virtual, i.e. it did not need to circulate in the economy as a medium of exchange – this was the logic applied in the Real Plan.

Second, a short-term price freeze (between 30 and 90 days) would help controlling speculative attacks against the Plan resulting from potential skepticism (a it-will-not-work-so-let-me-rise-my-prices type of behavior). Finally, it would be an important factor to bring the necessary support of the public opinion, especially because there was great suspicion about the way organized labor would react to the formulae of wage conversion [cf. Solnick, 1987:90-1; 160-1].

Another important aspect of the decision to launch a price freeze is that Chico Lopes, the most important supporter of the shock therapy and an informal member of the economic team that designed the Cruzado, had already been convinced of the adequacy of the monetary reform (gradual) strategy instead of the price freeze. The option for the price freeze was not accepted by any of the experts in monetary and stabilization policies involved in the Cruzado.

Beyond the price freeze, still other changes in the original formulation were introduced both to convince other segments of the government to adopt the new policy option, and to create cooperation from social groups. Two of those changes had a clear distributive impact: wage bonuses [abono], and the creation of the “wage-trigger” [gatilho] mechanism. The neutrality criterion to be
applied in the conversion of on-going contracts was, then, definitively compromised. These two measures were obviously inimical to the basic logic of the plan, but they were thought to be necessary to gain the support of Labor Minister, Almir Pazzianotto (PMDB), and to promote the acquiescence of trade union leaders. In the specific case of the wage bonuses, it was not even accepted by the two experts who designed the package – as one of them told this author, the bonuses were decided in the night before the announcement of the program, after both Lara Resende and Arida had already left the rest of the team to get some sleep.

Despite the opposition of the economic team, during its implementation the Plan was wrongly associated with the price freeze. The public support that derived from the sudden drop of inflation was politically important for the government but it made politicians (especially President Sarney) reluctant to abolish the price freeze. It was clear for all of those (economists) involved in the implementation that the price freeze could not last for long, because even “natural” reasons – e.g., the effect of a dry season reducing the supply of vegetables, or of an increase in the international price of an imported product – would require some change in relative prices. As a consequence of a long price freeze, imbalances in relative prices would certainly generate supply problems and the development of black market schemes.

On the other hand, the combination of price freeze, wage increases, and politically fixed low interest rates had suddenly created an “excess demand” – i.e. a level of aggregate demand incompatible (even in the short-run) with the supply capacity of the domestic economy. This was still further aggravated by the need to promote huge surpluses in the balance of trade account. The rise of demand was identified in April, less than sixty days after the inauguration of the Plan. At that point, May 1986, part of the economic team – especially Lara Resende and Arida – knew that a higher level of aggregate demand tended to have a negative impact over the balance of payments, as fewer products would be available for export. In addition, the mix of limitations in supply and the ceiling on interest rates, meant that some imports would be necessary just to match the rising domestic demand, further debilitating the external accounts.

After launching the monetary reform and the consequent conversion of on-going contracts to new entry values supposedly compatible with the current level of supply of goods in the economy, the inertial component of inflation was stopped. Thereafter, macroeconomic decisions were to be based just on the use of conventional demand management techniques. At that moment, though, there was not a clear recognition of the expansionary nature of sharp and sudden desinflation programs. The issue of launching tough controls on aggregate demand was, in consequence, unpredictable for most of those who believed heterodoxy to mean the absence of any restrictions over consumption – among those, Finance Minister Dilson Funaro, and Planing Minister J. Sayad.

As an industrialist, Funaro had a very particular perception of the ideal economic order, which rejected some of the counter-intuitive solutions required by the heterodox alternative. The fact that he had not understood the basic logic of the program exacerbated the conflicts with the team. In Arida’s view, Funaro had a bias typical of the business community. He came from a world in which high interest rates and trade liberalization were seen as necessarily harmful, a world in which rising aggregate demand is an absolute good. This includes an implicit belief that higher consumption standards endogenously generate an increase in investment, so that an increase in supply will always follow. Nevertheless, for Arida, a mature analysis holds that ‘the pace through which the economy adds supply capacity will never be adequate to offset the excess demand’. When it is clear that there is an excess demand, it is necessary to cut it, raising interest rates in the short run. For sure, some investment will also be cut as a by-product of higher interest rates, but interest rates have to be raised anyway. It is counter-intuitive, in Arida’s own words. In the case of Funaro, despite his civic engagement his intuition led him in the wrong direction.
**Conventional Measures during implementation.** To avoid those negative consequences of the excessive demand, Lara Resende and Arida advocated a long-term fiscal adjustment, to be preceded by a tightening of monetary policy – i.e. a substantial increase in real interest rates in order to cut the aggregate demand.

The Finance Ministry was internally divided in relation to the issue of increasing the interest-rates. Funaro, the Minister, was against it, as well as one of his two major advisers – João Manoel Cardoso de Melo. The other economic adviser to the Minister, Luiz Gonzaga Belluzzo had a very similar position to Lara Resende and Arida’s, pushing for higher interest rates. In respect to another issue – that there had to be a general cut in the level of government spending --, this group of economists from MFaz. and BACEN totally agreed. However, due to legal provisions, budget cuts were under the responsability of the Planning Ministry (SEPLAN). In this sense, the Finance Ministry gave support to an important principle of the original formulation of the Plan: that the public deficit had to be zero. But, SEPLAN resisted to budget cuts. The Finance Ministry also preferred increases in indirect taxes – e.g. on production and consumption of particular goods – rather than on the direct ones, like the income tax.

In general, the adjustments published in July (the “Cruzadinho”) followed the lines of the MFaz.’s understanding, although the price freeze was maintained by a decision of the President himself. In order to cut down the “excessive demand” it introduced compulsory savings mechanism via the creation of temporary taxes over the selling price of automobiles and gasoline, which were to be refunded to consumers after three years. In addition, the ‘Cruzadinho’ instituted new taxes on purchases of foreign currencies to international trips and on purchases of international air tickets. Interest rates were slightly increased, due to an individual decision of Lara Resende, against Funaro’s will. Despite its intention to use some instruments to reduce the aggregate demand, this package was complemented by the launching of the ‘Plano de Metas’ – a document written by the SEPLAN establishing an explicit intention to promote a 7 percent a year growth rate through increases in public spending.

**Table 1:** Corrective Measures to the Cruzado Plan, Discussed in May of 1986 by the Economic Team, and the ‘Cruzadinho’ Package of July:

<table>
<thead>
<tr>
<th></th>
<th>Monetary Policy (increase in interest rates plus cut in private credit)</th>
<th>Fiscal Adjustment (cut of public spending)</th>
<th>Price Freeze during formulation process (after May (Carajás’ meeting))</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MFAZ.</strong></td>
<td>partially in favor</td>
<td>proponent</td>
<td>in favor</td>
</tr>
<tr>
<td><strong>BACEN</strong></td>
<td>Proponent</td>
<td>proponent</td>
<td>theoretically against, but agreed as a second-best alternative</td>
</tr>
<tr>
<td><strong>SEPLAN</strong></td>
<td>Against</td>
<td>against</td>
<td>in favor</td>
</tr>
<tr>
<td><strong>PRESIDENCY</strong></td>
<td>Against</td>
<td>in favor</td>
<td>against</td>
</tr>
<tr>
<td><strong>“Cruzadinho”</strong> (July/86)</td>
<td>Small increase in interest rates, due to Lara Resende’s personal decision</td>
<td>NO (some indirect taxes were raised or created, just to reduce consumption of particular goods)</td>
<td>-- continued for an indeterminate time</td>
</tr>
</tbody>
</table>

* Despite the fact that Arida was not at the Central Bank but at SEPLAN as an adviser to Sayad, during the whole decision-making and implementation processes his positions were totally in accordance with those of the BACEN group, especially Lara Resende’s.

At that moment, the Planning Minister, João Sayad, pushed the decision for lower interest rates not only to promote private investments, but also to reduce the negative effects of the interest rates on the internal debt. He also resisted cuts in public spending because of the general impact it would have on the economy, reducing incentives for private investments. As an alternative to both
higher interest-rates and cuts in public spending, Sayad proposed a reduction of subsidies and cuts in the transfers of revenue from the Federal government to states, as well as an increase in direct taxes (income taxes, especially). The SEPLAN’s conception was essentially one of promoting economic growth without short- or mid-term preoccupation with the supply capacity. The increasing demand was seen by Sayad as a transitional “bubble” of consumption, which was to automatically decrease in a very near future.\(^{21}\)

The President and his closest group were indeed resisting measures that could cause harm to the popular support of the plan, what was clearly reflected in their aversion to cutting demand. Low interest rates, increases in public spending and the maintenance of price controls were thus fiercely favored.\(^{22}\)

If it is true that inflation rates continued to show a very low standard through out the year until October, a series of inflationary pressures developed under the price freeze. First of all, the very simple fact that more people were willing to spend a greater amount of money in consumption creates a disposition for sellers to raise their prices. Second, as some sectors approached a situation of full capacity, bottlenecks tended to develop. Third, the supply of both raw materials and intermediate goods became scarce as the result of both seasonal events and high demand. Fourth, the economic package adopted in July – the ‘Cruzadinho’ – increased some production costs and, at the same time, signaled that the price freeze was not applied to all products. Finally, there were some sectors in which the price freeze was never effective – like clothing, second-hand autos, hardware, among others. In those sectors, either the final cost of the product involved the payment of illegal and hidden surcharges [ágio] or small changes in the layout of the product were made in order to by-pass the regulations [cf. Modiano, 1987].

Inflation resumed even during the period of price freeze. As a consequence, black marketeering mechanisms developed, the nominal exchange-rate appreciated and the monthly accumulation of rising inflation rates made the onset of the trigger mechanism a real possibility.

From October on, the negative impact of the price freeze on the trade balance became clear. A sharp drop in the trade surplus reflected the combination of higher prices in the domestic market – due to surcharges and to the rising level of aggregate demand – with the growing speculation over the possibility of a maxi-devaluation of the Cruzado against the dollar.\(^{23}\) As export revenues were transferred to exporters in Cruzados, using the official exchange-rate, the possibility of a sharp devaluation naturally motivated a delay in export contracts. The weak external position made urgent the design of tough corrective measures, but the proximity of the congressional elections created a political constraint upon the economic team. A new package, the Cruzado 2, was launched in November, two weeks after a remarkable victory of the governing coalition.

The Cruzado 2 Plan consisted, basically, of: (i) a sharp increase in indirect taxes over the purchase of some specific goods (new automobiles 80%, cigarettes 120%, and alcoholic beverages 100%); (ii) the prices of some products provided or controlled by the government were also increased, even though they were supposed to remain frozen (gasoline 60%, energy and telephone 35%, and postal services 80%); (iii) reestablishment of a mini-devaluation system for the set of the nominal exchange-rate, based on the full discount of daily rates of inflation; and, (iv) re-indexation of all financial contracts to the Letras do Banco Central-LBC, which reflected the market expectation of future interest rates.

Table 2, below, summarizes the basic divergences among the three technical areas over the setting of those measures. This time the President did not interfered in the decision, but urged his Ministers to present a consensual package. The consensus was not accomplished, as the opinions of the two ministers were opposed in almost all issues. The positions advocated by the Finance Ministry prevailed in most of the decisions as Funaro had a stronger influence over President Sarney – increase in indirect taxes, and control both over the level of interest rates and of direct taxes. The SEPLAN managed to avoid budget cuts as they would in fact depend on its willing to implement
them. Finally, the BACEN, where both Lara Resende and Arida were located, did not have any of its proposals approved (high interest rates, budget cuts, and no tax increases). The Cruzado 2 was, then, exactly the opposite of what the “fathers” of the Cruzado wanted.

**Table 2: Cruzado 2, inter-bureaucratic conflict over the policy instruments and final set of corrective measures**

<table>
<thead>
<tr>
<th></th>
<th>increase real interest rates</th>
<th>increase direct taxes</th>
<th>increase indirect taxes</th>
<th>cut in public spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>MFaz.</td>
<td>vetoed</td>
<td>against</td>
<td>proposed</td>
<td>favored</td>
</tr>
<tr>
<td>SEPLAN</td>
<td>favored</td>
<td>proposed</td>
<td>against</td>
<td>vetoed</td>
</tr>
<tr>
<td>BACEN</td>
<td>proposed</td>
<td>against</td>
<td>against</td>
<td>proposed</td>
</tr>
<tr>
<td>Cruzado 2</td>
<td>NO</td>
<td>NO</td>
<td>YES</td>
<td>NO</td>
</tr>
</tbody>
</table>

Note: “veto” means that the agency has the power to impede the choice of the policy instrument.

As the Cruzado 2 was perceived to be highly inflationary, future interest rates were predicted to increase substantially, creating an extra protection for current financial contracts.

From November to December, inflation more than doubled, from 3.3 to 7.3 percent. Once the trigger was first applied, inflation became even higher and inevitable, although most of the prices were still frozen. Violations of the price freeze were made very likely as now essential elements of the cost structure of firms were substantially augmented. The money supply assumed its highest level at this moment, further increasing pressures for price rises. In January, 1987, the inflation rate surpassed that of one year before, which had motivated the launching of the Cruzado. The prices of the great majority of products were officially liberalized in February, creating expectations of a 20 percent rate for the inflation, which did not materialized due to an explosion of real interest rates. The actual inflation for February was 13.9 percent. Finally, the general indexation of the economy followed the end of the price freeze.

In sum, there are four aspects that were decisive in driving the decisions taken during the design and the implementation processes of the Cruzado Plan away from its essence as formulated by LARIDA. First, increasing popular support for the new president (mixed with regime support) was considered essential by the President himself and his political group. Sarney needed to consolidate his position as President after a year of uncertainty due to the death of Tancredo.

Second, old developmentalist ideas – very similar to what Dornbusch & Edwards (1990) called “economic populism” – were strongly represented in both the Planning and the Finance ministries. These ideas were an important factor behind the reversal of Sarney’s economic policy, back in August of 1985, when he decided to replace his Finance Minister Dornelles, with Funaro. The focus on growth was evident in the social programs, which involved proposals for both the increase in public spending and for distributive policies to parallel the stabilization effort.24

Third, a genuine concern about the actual impact of the plan on wages emerged inside the government, especially in the Ministry of Labor, and pushed the plan towards a more distributive approach. This latter concern is in part explained by the very fact that the PMDB had centered its previous electoral campaigns on the issue of wage shrinkage [arrocho salarial], and also by a clear concern over the need to generate popular support in the initial phases of the plan.

Finally, and most importantly, except for the two experts who had formulated the first draft of the package – Lara Resende and Arida –, and maybe Belluzzo at the Finance Ministry, none of the other decision-makers who influenced the design and the corrective measures of the Cruzado Plan had a clear understanding of its nature. In addition, those who did understand the plan did not hold the highest bureaucratic positions.

On February 20, 1987, Brazil decided to decree a moratorium on the external debt. At that moment, none of the experts who designed the initial package and demanded reforms during its implementation remained in government: Lara Resende resigned in December, Persio Arida and
The two ministers and their advisers still continued for sometime: Sayad left in March, while Funaro, João Manoel and Belluzzo stayed until April.

**The Real Plan**

The Real is by far the most successful and consistent stabilization plan implemented in Brazil since the beginning of the economic crisis, eighteen years ago. It is a heterodox plan but, beyond that, it is almost an exact implementation of the initial ideas formulated by LARIDA, ten years before, and sketched in the opening parts of this article. Lara Resende and Arida also played the central roles in the economic team that formulated and implemented the package, as top decision-makers in the Finance Ministry.

Fernando H. Cardoso was the Finance Minister from June 1993 until April 1994, when he left the government to run for President. He was replaced by Rubens Ricúpero, a diplomat, who was chosen to provide the economic team with the necessary political support. Ricúpero resigned in August 1994, after a statement about the electoral consequences of the success of the Real program on Cardoso’s candidacy was made public through national television. Yet under Itamar, Lara Resende was the Chief Negotiator of the external debt, at MFaz., Arida was President of BNDES – a federal development bank –, Pedro Malan was the Governor of the Central Bank, and Chico Lopes and Gustavo Franco were members of the Board Directors of the BACEN. Edmar Bacha held an advisory position at the MFaz.. These were only formal positions and did not reflect a rigid hierarchical distinction. At the end of the design phase, in November 1993, Lara Resende left the government and became partner in a financial institution. After Fernando H. Cardoso took the Presidency, Malan became Finance Minister, Arida Governor of the Central Bank, and both Lopes and Franco remained as members of the Board of the BACEN. Bacha went to the BNDES, as President. Arida left the Central Bank in the end of 1995, when he was replaced by G. Loyola, a BACEN career-technocrat. After Loyola decided to leave the Central Bank, in 1998, G. Franco replaced him. Lopes remains at the Board of Directors.

In effect, all of those involved in the Real enterprise were part of an extremely homogeneous team engaged in designing the stabilization program. Among them the monetary reform approach of Lara Resende and Arida was totally hegemonic. In fact, a distinctive feature of the political process behind the design and implementation of the Real is that there had been no intra- or inter-bureaucratic conflict since Fernando H. Cardoso took office in 1993 – other Ministries were excluded from the decision-making process, and even President Itamar Franco did not interfere in any of the decisions proposed and taken by the economic team. The internal debates among the economists was rather intense, but the technical controllability of the process approached the ideal standard.

Since the failure of the Cruzado, the core group of economists from PUC-RIO – Lara Resende, Arida, Bacha, and Malan – had decided not to join any other government to which the stabilization of the economy was not seen to be its main political project. In this regard, they perceived the assurance of an extended horizon for the economic team to work as an essential condition for the success of any stabilization attempt. They believed that the credibility of the stabilization policies depended directly on the ability of the government to persuade economic agents about their durability. Thus, they demanded full competence to make and implement technical decisions without the need to accept any sort of political veto or demand contrary to the basic logic of the program. In practice, the team would have to take over and hold the most important positions in government, but would still depend on the confidence of the top politicians above them.

The political circumstances behind the nomination of Fernando H. Cardoso to the Finance Ministry, in the first half of 1993, created such a set of conditions. First, Fernando H. Cardoso was Itamar’s fourth Finance Minister in less than one year. This implied a continuation of significant
political uncertainties originated after the impeachment of President Collor. Macroeconomic variables, in turn, directly reflected such vacillations—for instance, positive interest rates were less capable of reducing the acceleration of inflation. Second, as a prerequisite for accepting President Itamar’s nomination, Fernando H. Cardoso demanded and was granted total autonomy and responsibility over the economic decisions of the government. Third, as a respected Senator from a moderate party Fernando H. Cardoso’s nomination also implied a stronger basis of congressional support for the government.

Therefore, Fernando H. Cardoso was free to choose his economic team, and set the basic macroeconomic objectives. The group of heterodox economists from PUC-RIO deserved Fernando H. Cardoso’s total confidence for three basic reasons: first, because they had already worked together during the Cruzado—Cardoso as a Senator from the non-developmentalist-wing of the PMDB had been a natural ally of Lara Resende and Arida, as well as Bresser; second, because these economists had already joined the PSDB, Fernando H. Cardoso’s party, before he had become Minister; third, as Fernando h. Cardoso himself, the core group from PUC-RIO was composed of distinguished scholars, and this surely counted to reinforce Fernando H. Cardoso’s confidence. As one of the members of this group explicitly told the author, “it was not simply a team of economists from the same political party of the Minister. It was a group with personal ties to the Minister himself (…) based on mutual confidence and personal loyalty”.

Beyond prior relationships with the economic team and in contrast to ministers Funaro and Sayad, Fernando H. Cardoso was also totally immersed in the technical debates around each one of the measures. In accordance to what was told by key members of the economic team, Fernando H. Cardoso had total knowledge about the need to cut public expenditures and implement a fundamental fiscal reform along with the first measures, the exchange-rate policy, the requirements for a tight control of aggregate demand via positive interest-rates after the monetary reform, the wage policy, etc.

Therefore, it was a distinctive feature of the political process behind the Real that the politician responsible to make the ultimate decisions and to negotiate them in Congress—and also with the (populist) President—knew exactly what the package consisted of before it had been launched. That proved essential in order to filter the political demands and surpass political resistances that originated both inside and outside Congress during the negotiation of the package.

Among the key members of the economic team, Professor Edmar Bacha was chosen as a negotiator to discuss with political parties, state governors, and individual congressmen marginal changes in the basic set of measures. There were no changes in the strategy of monetary reform nor in the monetary and exchange-rate policies as a result of those negotiations. However, the fiscal component of the program—the Fundo Social de Emergência (FSE)—turned out to be weaker than initially proposed, as some interests were able to reduce their short-term costs in the stabilization package through political pressure.

Compared to the Cruzado, the Real depended much more on congressional approval, due to two changes introduced by the Constitution of 1988: first, the fact that it abolished the instrument of decree-laws, through which the Sarney administration ruled above Congress; second, it increased the fiscal burdens on the Federal Executive, which had to be removed through constitutional reforms in order to achieve a situation of budget equilibrium. Beginning in October 1988, the Executive had at its disposal a legislative instrument called Medidas Provisórias, through which most of the economic measures affecting current laws were made.

The Constitution, in itself, was also an obstacle to the balance of the federal budget. It established capital transfers from the federal government to states and municipalities without a similar transfer of policy responsibilities. Furthermore, it created a series of fixed expenditures
In order to change the Constitution, to avert the inflationary consequences of quasi-inevitable budget deficits, the government had to maintain a congressional alliance of 3/5 of the members of the Senate and of the House, a proportion that revealed to be impossible given the controversial character of this kind of legislation, as well as its short-term social and political costs – especially in an electoral year. The tenuous political support is even more important if we consider that the Itamar Franco administration was supported in Congress by a fluid plurality of center-right wing parties. Thus, the 3/5 majority needed to be built issue-by-issue.

Other political variables are also important. First, the Plan was implemented in an electoral year, suggested by experts as a particularly adverse timing [cf. Przeworski, 1992]. Second, as both the President and Congress were to be elected at the same time, the so called “honeymoon period” – during which a new President is supposed to be allowed to rule with the acquiescence of the opposition in Congress – could also be expected to be less favorable than other periods, as the opposition would also feel a renewed legitimacy. Despite those unfavorable political conditions, the Plan was an astonishing success.

Conventional Measures. The Plan was divided in four parts. First, the team worked in a set of measures – referred to as the Immediate Actions Program \textit{[Programa de Ação Imediata-PAI]} – directed towards the balancing of the 1993 budget deficit. Back in the first half of 1993, this phase involved the following: cuts in public spending; increasing the efficiency of tax collection mechanisms; resumption of payments from states and municipalities concerning their debt with the federal government; the control of public banks’ resource allocations; the recuperation of the financial health of federal banks; and the improvement and expansion of the privatization program. The short-term results were substantial: a US$ 500 million (15%) increase in monthly tax revenues, due mainly to fighting tax withholdings (fraud); a US$ 6 billion cut in expenditures previously included in the federal budget; and, the resumption of states and municipalities payments to the federal government. The most important indicator of success was that inflation-adjusted public deficit of zero, or close to zero, in the end of 1993. As previously reinforced in this article, this was an essential requirement for the launching of a stabilization package based on the LARIDA proposal.

The second phase was, in essence, another set of emergency measures, now intended to balance the 1994 federal budget, which had been sent to Congress in August of 1993. The measures were decided by the economic team in December of that year and then submitted to Congress by President Itamar Franco. Those measures did not address the structural causes of fiscal imbalances in Brazil, which, for the most part, required constitutional change [see the third part of the Plan above].

The initial proposal for the 1994 federal budget included an estimated deficit of US$ 22.2 billion [4.9% of the GDP (US$ 456 billion in 1994)] to be financed through inflationary resources. This was viewed as a burden on the domestic financial market, since the deficit would require further increases in domestic interest rates. Deciding to adopt a heterodox stabilization plan, the government opted to cut the inflation-adjusted deficit, for which it took fundamental measures: a general cut in the voluntary capital transfers from the Federal government to states and municipalities; imposition of rigid limits on the creation of government bonds; creation of tighter controls to the use of Treasury funds, especially for personnel and investment spending; and general cut in public spending, including personnel and welfare benefits.

Despite all these efforts to balance the budget, the estimated fiscal deficit for 1994 was still high, US$ 9.3 billion [2% of GDP]. The government then opted for the creation of the so called “Fundo Social de Emergência-FSE”, another set of emergency adjustment measures to finance the remaining deficit. The FSE, initially designed to last for only two years (but still in place in 1998),
implied the congressional approval of a constitutional amendment allowing the President to bring the inflation-adjusted public deficit to zero.\textsuperscript{31} The single most important instrument was granting the President authority to confiscate 20\% of the revenues of all federal taxes, which meant that the participation of states and municipalities in the distribution of the revenues produced by those taxes [known as gastos vinculados] would be reduced in the same amount.\textsuperscript{32} The revenues transferred to the federal government by the FSE would finance 20\% of the total non-financial expenditures of the government in 1994, and it proved essential to eliminate the budget deficit.

As the FSE was extended through 1996 and 1997, the Federal government is still circumstantially released from the constitutional obligations to share those tax revenues with states and municipalities while a definitive fiscal reform is not approved by Congress, eliminating what is known to be the constitutional obstacle to fiscal balance.

The third phase of the Real would be a series of constitutional reforms destined to increase the general efficiency of the economy, and that of the government. Reforms would extend over an enormous range of constitutional matters: pension system [previdência], civil service [administrativa], economic modernization (privatization, foreign capital, monopolies, public concessions), tax system [tributária], budget, and fiscal federalism. This phase was never fully implemented due in part to the intricate Executive-Legislative relations, but also to the very controversial nature of the issues involved. As a result, the government opted for the re-edition of the FSE, leaving the structural causes of fiscal imbalance still unattended.

**Heterodox Measures.** Finally, the monetary reform was presented in February 1994, after Congress had approved the FSE.\textsuperscript{33} It is in this part of the Plan that the importance of LARIDA’s initial formulations become more evident.\textsuperscript{34} This phase was intended to eliminate the inertial component of inflation, identified in the system of indexation of contracts through which the whole economy was bound to past rates of inflation. In addition to the “fundamental” causes of inflation – the public deficit and the money supply –, the “memory” of the indexation system was the most important obstacle to the reduction of inflation.

Despite the improvements in the control of the public deficit, the inflation rate kept a rising path in the first half of 1994. From January to June, the IPC-FIPE (one of the more accurate inflation indexes) grew by 10\% – 40,3\% in January, 50,75\% in June. As explained by the government itself, the rise of inflation after the reduction of the fiscal imbalances were due to

“… several factors, including inflationary inertia, which was further reinforced by the generalized indexing introduced by the URV [after March], uncertainties regarding the second and third stages of the Stabilization Plan and the pressures brought to bear on the monetary base by the excess supply of foreign exchange (coupled with the consequent growth in the public debt, used to sterilize this growth)” [BACEN, 1995:08].\textsuperscript{35}

Different from the Cruzado, the Real assumed that de-indexation would follow the control of inflation, instead of preceding it. The de-indexation of the economy would not be part of a shock therapy (e.g. a price freeze) which was already known to harm existing contracts. De-indexation would rather result from the voluntary agreement of all economic actors to the use of the same index – the Unidade Real de Valor-URV. This change in the perception of the economic team was due, in great part, to the idea that, in order to alter the inflationary expectations of private actor, the government could not start by eliminating their primary source of protection against inflation.\textsuperscript{36} Private actors would be convinced that the new system was better off in itself, and voluntarily move into it. In this regard, the Real Plan did not involve any price freeze. As an alternative, the program created an inventive process for the gradual conversion of all contracts from one currency into the other during a transitional period which lasted for three months. The whole process was based on creating economic expectations, among private actors, consistent with the stabilization of prices.
The Real, then, would involve the adoption of a new currency that would represent a single source of indexation for the whole economy. The government, through the Central Bank, would fix a daily rate of discount to the conversion of the old currency into the new one (the URV), reflecting the actual rate of inflation (like a currency devaluation). The government decided to link the rate of devaluation of the old currency to an independent measure of inflation, in order to give more credibility to the Plan, and in so doing promote the voluntary conversion of contracts to the new currency. This conversion mechanism was indeed very similar to the one that regulated the conversion of the domestic currency into the American dollar, known by Brazilians since the 1960’s [mini-desvalorizações cambiais].

The value of one URV was initially set as US$ 1.00 in the free market. As the current inflation rate was used thereafter to devalue the old currency [Cruzeiro Real] both in terms of the URV and in relation to the American Dollar, a fixed parity between the new currency and the Dollar was kept throughout the period. When the Real finally substituted the URV – in a one-to-one basis – its parity with the Dollar was also assured.

When this process was completed, i.e. when the whole economy was indexed by the same index (the URV), the index itself would become the new currency – one URV worth one Real. The URV was, then, a “virtual” currency, which avoided all the difficulties associated with the use of two currencies at the same time. In other words, the URV served only as an unit of account, as it has never been printed, it has served neither as a store of value nor as a medium of exchange. The belief of the economic team was that, when the expectations that contracts (wages, prices, financial investments, etc.) converted into URV were definitely protected against inflation, the Real could safely substitute the URV. The mini-devaluation system through which the value of one URV was protected against inflation in Cruzeiros Reais, would assure that inflation was kept in Cruzeiros Reais – the old currency. In this regard, the inflation-rate in URV’s would always zero, by definition.

The gradual approach that guided the Real is also noticeable in the way different kinds of contracts were regulated. Three basic kinds of contracts were defined (wages/welfare; non-financial; and financial contracts):

(i) wages remained indexed to past inflation rates throughout the phase of emergency fiscal adjustments described earlier. Then, in the beginning of the transitional period (March 1st, 1994), all wages and welfare benefits were authoritatively converted into URV’s through its average values in the four previous months (November 1993-February 1994). Despite that, wages were allowed to increase as a result of direct bargains between employers and employees, intended to guarantee that labor groups would benefit proportionately to their different mobilization capacities. After their conversion, wages would be protected from daily inflation, promoting the acquiescence of trade unions. Finally, a transitory wage policy assured that wages would be corrected to the inflation in the first year of the Real, and then it would be established a system of direct bargaining.

a) even after June 1994, when contracts started being written in Reals, they were admitted to include indexation clauses. These clauses were to be bargained between the parties, but could only apply after an interval of 12 months;

b) wage indexation was not suppressed until June 1995 [MP 1053].

(ii) up to the end of the transitional period, all non-financial contracts in the economy (rents, private schools, health plans, leasing, etc.) were required to be converted into the URV, by way of free agreements among the parties. Prices, for example, were allowed to increase during the transitional period, since the agreement with consumers was through the market. The government would only require that, contracts, once converted into URV terms, did not
include any indexation clause or price adjustment mechanism to apply in an interval shorter than one year;

(iii) financial contracts (savings accounts as well as all kinds of financial transactions), were only to be converted after the Real substituted the Cruzeiro Real, and not in the transitional period. This decision was taken to reduce the propensity of savers to withdraw their money and engage in (excessive) consumption. Indexation clauses to financial contracts were never abolished.

There was a clear advantage to all other contracts than wages, though there was not an immediate loss to the latter. Prices would be free to convert into Reals until the last minute of the transitional period, the only constraint would be the amount of money at the disposal of consumers. The potential threat to workers caused a political reaction inside the government apparatus. President Itamar Franco himself demanded the creation of protective instruments to avoid any negative social consequences. Price control mechanisms were then created against the will of the economic team, who in turn never applied them.41

When the law of Monetary Reform was first announced, in February 27, 1994, the transition period was set up to last for up to one year.42 It would be over when the first Real bills were printed. In latter decisions, the government defined that the first printing of Reals, and consequently the end of the transition period, would be announced 35 days in advance.43 On May 27th, less than two months after this later decision, Congress finally approved the MP 482, transformed in the Law 8.880. This Law defined that Real bills would be printed on July 1st, 1994.

At this point, it also established a monetary anchor to the program – a ceiling to the printing of Reals. That threshold was never violated, as the amount fixed was indeed very large. Nevertheless, fixing a ceiling for the printing of new money attempted to signal to economic agents that there would not be an inflationary printing, both to foster their trust in government and to limit their propensity to increase their prices disproportionately.

The whole process of monetary reform was, then, previously announced and negotiated through Congress, pointing to its main objective: to avoid hurting existing contracts. On the other hand, the fact that the transition period was much shorter than first publicized (4 months instead of one year) is a sign that the inducements, set by the government, to promote the voluntary conversion of private contracts into the new currency were indeed effective.

The role of the government in changing the expectations of private actors was to assure that the “fundamental” causes of inflation were being kept under control, i.e. that there would be no fiscal deficit and that, as a consequence, there would be no expansion of the money supply. The real value of the new currency would be assured, and this would give credibility to the Plan. As a way to create this credibility, all public tariffs and prices of public services, as well as most of the taxes, were immediately converted to URV. As the government did not intend to create fiscal imbalances, the convertibility of its sources of revenue to the URV pointed out to its strong inclination to keep the new currency protected from inflation.

This inclination to protect the new currency was also to be assured via the free convertibility of Reals into American dollars, through a flexible exchange-rate market. By the law that implemented the monetary reform, the printing of new money (of Reals) was made subject to the actual level of international reserves.44 The high level of foreign reserves in the Central Bank, coupled with the entrance of foreign financial capital attracted by the higher level of domestic interest rates, created a consistent tendency towards the appreciation of the Real.45 The appreciation, at the same time, made it easier for the government to guarantee the conversion of Reals into Dollars, and strengthened the incentives for private actors to act in accordance with the stabilization.
The appreciation of the Real created natural incentives to the increase of imports. On the other hand, the existence of a reliable level of international reserves made it possible for the government to allow an increase in imports of goods in sectors characterized by low levels of domestic competition (oligopolies and monopolies).\textsuperscript{46} Due to the substantial increase in imports that followed the launching of the Real program, domestic prices fell especially in those sectors that could be reduced by market pressure alone, partially releasing the government from the burden of implementing price controls.

The success of the plan was immediate, both in economic and electoral terms. Inflation rates started to decline consistently after July, dropping from 5.5% (July) to 1.55% (Sept.), 2.55% (Oct.), 2.47% (Nov.), and 0.57% by the end of 1994. Public surpluses were verified both in the inflation-adjusted (operational) and in the primary concepts – respectively, 4% and 0.4%, in 1994.\textsuperscript{47} Interest rates were kept high and the credit policy was much tighter, in order to adjust supply and demand. The rise in imports, as already noted earlier, also played a key role in his regard.

In the political arena, the Presidential elections of 1994 were easily won by Fernando H. Cardoso, and the level of public support for the tough economic measures is still high in 1998. This year, despite the negative social consequences of the low levels of economic growth caused by very high interest rates, Cardoso was re-elected.

III. Trade Liberalization (1985-95)

The Brazilian economy has changed dramatically in the decade started in 1985. The level of state intervention was drastically reduced, through the processes of trade liberalization and privatization of state enterprises that were launched in the early 1990’s. As a result, the level of efficiency of the economy grew substantially while the public deficit was put under more severe control.\textsuperscript{48}

Protectionism began to fall in 1990, when a presidential decree (Medida Provisoria 158/90) abolished the entire set of non-tariff (administrative) barriers (NTB) applied to imports. Until that time, NTBs were the fundamental type of protection used by Brazil's government to foster industrialization, since the 1930s [see Fritsch & Franco, 1993]. NTBs were so central as a mechanism to obstruct specific imports that the products allowed to enter the country paid very low import duties, if any. For instance, in 1987 though the average nominal tariff for the entire economy was 51%, the average effective tariff - the one paid by products actually imported - was 7% [see GATT, 1993]. Furthermore, almost 80% of the products actually imported paid no import duties at all, due to "special import regimes" (part of the industrial policies) lifted in an ad hoc basis. In that regard, the system of protection used in Brazil was inefficient in at least two ways: it did not serve as an effective instrument to protect "strategic sectors", because it was generalized for almost all sectors and products; and it did not function as a source of revenue for the state, as just a few imports actually paid duties.

The recent process of trade liberalization started in 1987-88. At that time, the Tariff Policy Council (CPA), of the Finance Ministry, designed and implemented a tariff reform intended to promote the technological development of the industrial structure. The tariff reform aimed at: reducing the general level of administrative protection (but not to abolish NTBs); removing redundant tariff rates; and adding to the tariff all import fees, in order to increase the efficiency of the tax system. It accomplished successfully the last two of those tasks, though it was not able to eliminate many of the existing forty-two "special regimes". As a result, the level of redundancy of the tariff structure was reduced from 41.2% (1987) to 17.8% (1989) while the average tariff fell to 38% from 51% [see Kume, 1994]. Although the tariff structure was considerably rationalized the reform
did not imply in an increase in the level of competition in the domestic market because imports did not grow due to the persistent use of NTBs.

NTBs were a key policy instrument of the New Industrial Policy (NPI) which was formulated and launched at that same time of the tariff reform. But while CPA perceived gradual trade liberalization as a potential mechanism to promote technological modernization, the group of economists and technocrats responsible for the design of the NPI saw liberalization as a threat to domestic producers. The removal of NTBs was, in that regard, resisted by the NPI group which was able to push the government position to their side.

Because of the debate that developed around the idea of trade liberalization and technological promotion, in 1989 two groups of economists made different proposals for government action. On one side, a group of technocrats of the BNDES [Banco de Desenvolvimento Economico e Social] a government developing bank led by Julio Mourao and Luiz Paulo Velloso Lucas. On the other side, a group of academic economists affiliated to the PSDB, led by Winston Fritsch and Gustavo Franco, from PUC-Rio. The first group proposed a policy of "competitive integration to the world economy" (IC), which consisted of a combination of a set of horizontal (cross-sectors) measures - among which trade liberalization was the most important - with the promotion of strategic sectors through government incentives [see Lucas, 1989 and 1992; Mourao, 1994; BNDES 1987, 1988]. The PUC-Rio/PSDB group, on the contrary, supported a "radical reform" of the economic model, with the elimination of NTBs and the gradual reduction of tariffs. Broadly speaking, this latter group posed one single role for the government in order to foster technological modernization of domestic industry: increase competition in the domestic market by eliminating all entry barriers (protection) created by the government itself [see Grupo do PSDB, 1989a, 1989b, 1989c, 1990a, 1990b, 1990c].

The election of Fernando Collor de Mello, in 1989, brought to power the idea of state reform including structural economic reforms. Collor's economic team worked hard to launch a large number of structural reforms in the very first day of the government (March 15, 1990). Among the economists who joined his economic team was Eduardo Modiano, one of the members of the stabilization group at PUC-Rio. Modiano invited Fritsch to outline a set of reforms of the trade structure and, later, to write important policy initiatives: a presidential decree launching the reform followed by an "explanation of purpose" [Exposicao de Motivos]. Fritsch, Franco and Guimaraes were the ones that wrote those two documents [see Fritsch et alli, 1990].

So, in his first day in office, Collor promoted a radical change in the current structure of protection as he eliminated the entire set of "special import regimes" [MP 158/90] influenced by PUC-Rio economists Fritsch and Franco. At the same time, the government abolished the list of products whose imports were prohibited, known as CACEX's [Foreign Trade Council] "Anexo C" [Portaria MEFP 58/90], and abolished duties on imports of capital goods not produced locally, in order to speed up productivity growth. Finally, the government announced a plan to reduce tariffs in the next four years [Exposicao de Motivos 48/90]. Table 3, below, summarizes the tariff structure set to 1994.

**Table 3: Brazil, Nominal Tariff Structure (1987-94)**

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<td>Min/max rates</td>
<td>0-105</td>
<td>0.85</td>
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<tr>
<td>Average</td>
<td>51</td>
<td>41</td>
<td>35</td>
<td>32.2</td>
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<td>mean-deviation</td>
<td>26</td>
<td>27</td>
<td>20</td>
<td>19.6</td>
<td>17.4</td>
<td>14.2</td>
<td>10.7</td>
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After those initial actions, Collor Finance Minister, Zélia C. de Mello, invited most of the members of the BNDES group to occupy key positions in the economic team. Fritsch and Franco, as
well as all the other PUC-Rio economists but Modiano, remained out of the government and the PSDB chose to remain in the opposition. Joao Maia - an informal member of the BNDES group - was chosen National Secretary of Economic Affairs and brought with him Lucas and Mourao to the Dept. of Industry (DIC). The Dept. of Trade (DECEX) and especially the Trade and Tariffs Division (CTT) under it were occupied by non-BNDES technocrats, which shared the core ideas of the PUC-Rio group.

As a result of that distribution of key positions in the economic team, CTT designed the timetable for tariff liberalization as initially set by Fritsch and Franco in the Exposicao de Motivos 48. At the same time, the BNDES group launched a series of industrial policy initiatives to promote strategic sectors which were very similar to the ones proposed by President Sarney, in the NPI [see Pio, 2000]. However, those policies were never implemented because Congress rejected them.

Even though the legitimacy of the Collor administration was strongly affected by its failure to control inflation, the trade liberalization timetable was implemented even faster than initially proposed. The fact that the government did not need congressional approval to implement trade liberalization was certainly decisive. So, during the impeachment process (May/September 1992), the Finance Minister Marcilio M. Moreira, decided to accelerate in six months the execution of the last two rounds of tariff reduction, scheduled for January 1993 and January 1994. Consequently, in July 1993 the last phase of that process was implemented.

Together with the timetable presented on Table 3, above, the Collor administration also initiated talks with three of the other southern cone countries - Argentina, Uruguay, and Paraguay - to build a sub-regional common market structure, known as MERCOSUR. The original treaty - *Tratado de Assunción* - was signed in 1991, still under Collor, and established January of 1995 as a tentative date to start the economic integration process. Nevertheless, it was unclear about the nature of the integration to take place: whether it would start as a "free trade area", a "customs union", or a "common market". 50

The first step taken by the four MERCOSUR countries was the elimination of all existing administrative barriers applying on imports from member-countries. Then, they negotiated a timetable for the gradual elimination of intra-MERCOSUR tariff barriers, to last from June 1991 until December 1994, when there would not remain any import duties charged on imports of MERCOSUR products.

Those agreements set a compromise among the four countries to create a free trade area. However, during Itamar administration (1993-94), when Brazil implemented the Real Plan, Brazilian diplomacy pushed the other MERCOSUR partners further into the establishment of a customs union. This action resulted directly from Winston Fritsch's view of the importance of external competition to promote price stability in the domestic market. The transformation of MERCOSUR in a customs union offered the possibility of making import competition the permanent rule of the game as the creation of a customs union required the four countries to adopt a single external tariff. 51 In the second half of 1994, when the Real Plan was put in place, Brazil anticipated the adoption of the TEC for a large number of industries, in order to foster price stabilization.

For Brazil, MERCOSUR was the final step in the process of trade liberalization for two reasons. First, the TEC implied a reduction in the maximum possible tariff, to 20% down from 40%. Second, MERCOSUR substantially reduced the level of sovereignty the government had to change the rate of protection, as it is now part of an international treaty. Although there still exists the possibility of excluding specific industries from the TEC, actions such as this cause strong reactions from the other members.
IV. Concluding Remarks: market-oriented ideas, stabilization and trade liberalization in Brazil

The previous sections described the decision-making process of stabilization and trade liberalization policies in Brazil, from 1985 to 1995. Those policies, together with privatization, constitute the most important steps to the construction of a market economy in Brazil, starting from a very protected and poorly competitive economic structure typical of the inward-oriented ISI policies which dominated the economic agenda of the country for more than fifty years.

The focus of this paper was on the formulation process of stabilization and trade liberalization policies. I tried to explain the final policy content through the ideas of relevant actors that influenced the policy-making process. I could in fact identify a particular group of economists whose ideas exerted strong influence over the content of both trade liberalization and stabilization policies. Those economists were Economics Professors at the Catholic University of Rio de Janeiro, PUC-Rio. Their ideas were tested and adjusted along the Sarney, Collor, Itamar Franco and Fernando H. Cardoso administrations, to whose economic teams they served in different positions. The chart below summarizes the process through which their ideas about economic policies ended up framing those policies.

My hunch is that ideas about economic policies (independent variable) influence policy content (dependent var.) through the political system - mainly political parties and professional as well as personal networks. To explain how a particular set of ideas end up influencing policy decisions I argue that the appointment of individuals as members of an economic team represent a choice of a particular set of ideas over others. The nomination of the members of the economic policy staff is, in turn, greatly influenced by political parties, influential politicians, and by the President and his inner circle of advisers. This is true even in situations where politicians do not know in detail what the ideas favored by their nominees are. Ideas can also be borrowed directly from the academia, without the intervention of political agents, given that members of the economic team frequently are part of non-governmental networks, both professional and personal. A final, though less important way to convey ideas to the economic policies is by the action of opposition parties, which are sometimes able to alter or force the economic team to adapt policy content (e.g. through Congress).

The content of the two policies studied here were decisively influenced by the ideas of PUC-Rio economists. That influence can be perceived in two ways. First, before they occupied key positions in the economic teams, those economists had already written extensively about the economic policies that had been followed by previous administrations. In these works they discussed the reasons for the failure of the policies and proposed the use of alternative strategies. Second, the content of economic policies during the time they were in office followed closely the ideas expressed in their previous works.

The two main political channels through which ideas were transformed into economic policies were political parties and personal ties to key political figures in the government apparatus. Let's first consider the case of stabilization programs. The two case studies advanced here - the Cruzado and the Real plans - derived from the very same core ideas, which were first stated by PUC-Rio economists Persio Arida and Andre Lara Resende, in 1984. In both cases, those economists joined the economic team because they were part of important political networks. In the Cruzado Plan, they were affiliated to the PMDB - the governing party. In the PMDB, they developed close ties with Joao Sayad, the Planning Minister. In the Real, they were affiliated to the PSDB - the party of the Finance Minister, Fernando H. Cardoso - and had already developed a strong relationship with Cardoso himself.
How can one explain that the Real Plan was much more similar to the ideas of Arida and Lara Resende than the Cruzado? There are two key factors to consider. First, as Planning Minister, Sayad was not the main responsible for the setting of stabilization policies in the Sarney administration. Therefore, Arida and Lara Resende took subordinate positions in the economic team. As a result, they lacked the autonomy to set up the basic instruments of the plan. The need to accommodate political pressures originating in the Ministry of Labor led to the adoption of policy instruments that were totally inconsistent with their theoretical as well as empirical understanding of the inflation process. Second, neither Sayad nor Funaro (the Finance Minister responsible for the anti-inflation strategy in 1986) accepted entirely the policy choices proposed by Arida and Lara Resende. This lack of support from the economic authorities also contributed immensely to the inconsistencies built into the Cruzado Plan.

In the case of the Real, Arida and Lara Resende's prior knowledge of the political game provided them with more room to push for their own policy preferences. First, they conditioned their move into government to the occupation of central positions in the economic team. That gave them control over the decision-making process, and over decisions motivated by particularistic interests which could hurt the coherence of the economic program. In this regard, they were able to force the higher ranks of the economic bureaucracy to reduce the scope of political bargaining as far as policy content was concerned. Second, the Finance Minister Fernando H. Cardoso, the main responsible for the design of the stabilization program in 1993, exerted strong political support for their ideas against pressures arising from political parties in Congress as well as from other branches of the government - including President Itamar Franco himself.

The decision-making pattern of trade liberalization developed in a similar fashion. In fact, affiliation to the governing party and personal links to key cadres of the party were crucial in this case as well. The transformation into economic policies of trade policy ideas elaborated by PUC-Rio economists Winston Fritsch and Gustavo Franco greatly depended upon their belonging to the PSDB. As trade policy advisers to the 1989 Presidential Candidate of PSDB Senator Mario Covas, Fritsch and Franco exposed their proposal to increase productivity and promote technological development in the Brazilian economy through the dismantling of ISI institutions and policies. Personal links to Eduardo Modiano, another PUC-Rio economist and a key figure in the economic team of President Fernando Collor, account for the fact that they were the ones chosen to write both the decree that abolished non-tariff barriers to trade [Medida Provisoria 158], and the first draft of the tariff reduction program which was implemented from 1990 until 1993. PSDB politicians, particularly Senator Fernando H. Cardoso - who headed Covas' Campaign Committee - allowed Fritsch and Franco to assist the new economic team.

Once Fernando H. Cardoso became Finance Minister, in 1993, Fritsch and Franco were appointed to the economic team. Together with other PUC-Rio economists - Arida, Lara Resende, and Bacha - they helped to design and implement the Real Plan as well as the transformation of MERCOSUR from a free-trade area in a customs union. That latter step implied a further reduction in trade barriers, and represented the final stage in the process of trade liberalization in Brazil.
Chart: Ideas and economic policies

IDEAS

Political Networks

POLICY CONTENT

- ECONOMISTS
- GOVERNING POLITICAL PARTY
- INFLUENTIAL POLITICIANS
- OPPOSITION PARTY
- ECONOMIC TEAM
- ECONOMIC POLICIES

Affiliation to a Political Party or tie to a politician
Mutual influence
Nomination to a Government Job
Policy influence
Flow of ideas
BIBLIOGRAFIA


"The Political Construction of the Market Economy in Brazil"


SOLNIK, Alex (ed.). (1987), *Os pais do cruzado contam por que não deu certo*. São Paulo, L&PM.

Notes

1 Arida was a especial adviser to the Planning Minister - Joao Sayad - while Lara Resende served as Open Market Director of the Central Bank.
2 There are at least two different types of indexation, depending on the period of reference used by the parts in a contract. Indexation clauses can be either forward looking – if the mechanism is a tentative anticipation of the rate of inflation that will occur during the contract – or backward looking, if the contract takes some reference of the past as a parameter for the adjustments set to take place during the time of the contract. The indexation clauses of this latter kind are often based on the rate of price increase in a period of time of equal length that preceded the signing of the contract.
3 This point is especially important to a clear understanding of the reasons why price freezes cannot be accompanied by a strong devaluation, or by an increase in the prices of services provided by the government (like electricity, telephones, water, etc.), or by any kind of “artificial” increase in the inputs of economic agents (like wages, for instance). Those agents affected by an increase in the price of their inputs immediately before or after the freeze will be reluctant to accept these losses as definite.
5 It is important to note that, in 1984, there was not a daily basis for indexation in Brazil. Such an index was only created some years later, as a natural response of the market to increasing inflation. The theory, thus, was ahead of its time.
6 Sayad's own political connections derived from both his personal links to the Governor of Sao Paulo State, whose son had been his colleague at Yale University, as well as to his affiliation to the PMDB. Sayad served as Finance Secretary of Sao Paulo from 1983-85, when he developed close ties with the developmentalist (pro-economic growth) wing of the party. So it was Sao Paulo Governor Franco Montoro who suggested his name to occupy the Planning Ministry after Tancredo Neves had been chosen President. After Sayad was appointed, he immediately invited Lara Resende to assist him in the Planning Minister. Lara Resende declined as he had a clear preference to work in the Central Bank. Persio Arida, Sayad’s next pick, promptly took the job. He then became Sayad’s closest economic adviser.
7 In the making of the new economic team, elected President Tancredo Neves, deliberately refused to assign Lara Resende or Arida to any of the key positions available. Though they were important economists in the opposition front, their names were associated with the idea of a heterodox stabilization policy, known to be overtly opposed by the IMF. As Tancredo wanted to push for a more orthodox approach to gain international confidence, he did not accept Sayad’s initial recommendation of Lara Resende to govern the Central Bank [see Sardemberg (1987); and Solnik (1987)]. Lara Resende and Lopes were also vetoed by Dornelles to join the Board of Directors of the Central Bank, when their names were proposed by Fernão Bracher – a potential candidate to govern the Central Bank before the inauguration of Tancredo. Mário Henrique Simonsen also proposed Lara Resende to the Board.
8 Funaro was, then, president of the BNDES – the main federal development bank. He had already served as both Planning and Finance Secretary in a government by ARENA (Abreu Sodré, in São Paulo State), in the early 1970’s. Despite that, in the early 1980’s he had played an important role, as a leading representative from São Paulo’s business community, in the movement to restore democracy (“Diretas-Já”).
9 The economic team of the Cruzado was, thus, formed by: Lara Resende (BACEN), P. Arida (SEPLAN), Luis G. Belluzzo (MFAz.), João Manoel Cardoso de Mello (MFAz.), L.C. Mendonça de Barros (BACEN), Francisco Lopes (informal adviser to the group), plus J. Sayad (Minister of SEPLAN), D. Funaro (Finance Minister), F. Bracher (Governor of BACEN), E. Bacha (FIBGE), A. Calabi (SEPLAN).
10 Arida, interview.
“… when we developed the theory of inercial inflation, heterodox shocks, indexed currency, all that had involved years of work. When the government decided to adopt those ideas, it adopted them from day to night. It did not evidence a maturation, neither in theory nor in practice – the government launched a program without knowing exactly what it was all about. (…) [but] after the plan is introduced it needs to be implemented. It is necessary to understand its essence. In my view, for instance, the idea of distributing income along with an stabilization plan is absurd! But that is because I had thought about it for years! (…) I had built [mathematical] models, debated specific issues, etc. (…) a recent comer to the field might say: ‘why not [include distributive mechanisms in the plan]?’” [Arida, in Solnik, 1987:78-79].

This last view – based on the compatibility of stabilization and income distribution -- was, for Arida, representative of João Manoel and Belluzzo’s approach:

“[for them] the Brazilian inflation is the result of a process of distributive conflict, and would only be reduced if there is a decline in the level of conflict, i.e. through a better distribution of income. I would say exactly the opposite: that inflation infact is a distributive conflict, but that I can reproduce the samedistributive status quo in a situation of low inflation; if I try to mix the two things [stabilization and redistribution] I will neither improve the level of income distribution nor reduce inflation. (…) But they shared the same view of the PMDB” [Arida, interview with Solnik, 1987:71].

12 The first time this mechanism was used was in December, 1986, right after the government launched the so called Cruzado 2 – an emergency package involving an increase in indirect taxes and of some public prices. This first use was also marked by an alteration in the legislation: the trigger was activated but the wage adjustments were to be limited to 20 percent, and not to the full rate accumulated. The rest would count as a residue contributing towards the next 20 percent.

“[the idea of a] wage bonus and of the institution of a wage trigger came out of the discussions with [PMDB Labor] Minister Pazzianotto. The trigger was not an element of our program [the LARIDA]. João Manuel was the one that suggested it, arguing that if we adopted it we would be embracing a long time demand from the PMDB and the labor movement … All of those concessions we made emerged from the fear that the general public would not support the program in its beginning. That explains the 8 percent [real] increase for all wages and the [15 percent] rise in the minimum-wage. (…) The Plan, in its original outline, in our understanding, would be based on the neutrality criterion. Wages would be converted by their average value and then the wage policy would enforce annual free-bargaining; therefore, there would be no wage freeze but annual free negotiations [between employers and employees]; (…) the trigger mechanism was an all-or-nothing choice. Either the Plan would be effective enough to keep inflation in the first year under the 20 percent threshold, or the trigger would fire a dynamite, due to the [negative] effect of a 20 percent rise of all wages at the same time” [Lara Resende, interview to Solnik, 1987:155-157, emphasis added].

13 Persio Arida, interview with the author.

14 “The decision over the increase in the minimum wage was a political decision. If you increase the minimum wage without raising the other wages, you create a huge distortion. A 15 percent increase in the minimum wage does not have to be followed by a similar increase for the rest. So it was decided to assign an 8 percent increase in general. But that was excessive anyway. (…) The argument is simple: wages represent 40 or 50 percent of the GNP. If there is an average 10 percent bonus to wages, wages will increase by 5 percent of the domestic income. The domestic income is about US$250 billions. Total wages represent US$125 billions, 10 percent of which equals US$ 12.5 billions. Suppose workers spend 80 percent of their wages on consumption: this equals a US$ 10 billions increase in the purchasing power of the population, from night to day. This creates further difficulties, for sure” [Arida, interview with Solnik, 1987:88-89].

“[We noted that the Cruzado] produced some transfers. First in the nature of wealth, from indexed bonds to commodities. Beyond that, the public withdraw their savings in reaction to the sharp drop of nominal interest rates, causing a substantial increase in the money supply. The ‘monetization’ of the economy was indeed very fast, driving the economic team to worry with the increase in aggregate demand. This process was noticed in April, or May” [Luis G. Belluzzo, interview with Solnik, 1987:96].

“Price stability compel people to hold a higher volume of currency in their pockets, and ‘monetization’ was, indeed, very fast [after the launching of the Cruzado]. Specially in the beginning, we should have raised the level of interest rates. That was the conviction of both Persio [Arida] and André [Lara Resende]. We did not set properly the interest rates” [Belluzzo, interview to Solnik, 1987:100].
“… the economy was passing through a very fast overheating process, since the second semester of 1985. The rhythm was not sustainable. (…) The task of macroeconomic policy is to foster a sustainable economic growth. (…) We [Lara Resende and Arida] tried to set a correct interest rate, to tight the monetary policy – reducing the level of credit, restricting, for instance, the credit to buy automobiles (…). There were resistances coming from the Finance Minister and, specially, from the Planing Minister [SEPLAN]. (…) There was a strong concern [among the top members of the Sarney administration] to look different from the previous [authoritarian] regime, which appeared as a regime inclined towards the use of recessive policies. In this regard, they attempted to distinguish the new regime as one in favor of economic growth. That was a mistake. In my opinion, we had to be the team favoring a sustainable growth rate, not one favoring growth at any cost” [Lara Resende, interview to Solnik, 1987:158].

“…It is impossible to keep such a high level of trade surplus with the economy growing for a long time. (…) We accepted the assumption that we had to maintain huge trade surpluses, what in itself create problems for any kind of stabilization policy. To open up the economy was not an alternative as we could not increase imports. [But] a big economy as Brazil’s could not be kept so closed, as there was no competition in the domestic market. Competition had to come from the outside. However, the restrictions over the balance of payments made it impossible for us to increase the level of imports. Consequently, any increase in the domestic level of consumption reflected [negatively] in the trade account. There is indeed this restriction: Brazil has to generate [trade] surpluses” [Belluzzo, interview with Solnik, 1987:102, emphasis added].

“Back in May I had already said: ‘We have a price freeze that cannot last, the economy is overheated, there will be automatic pressures for rationing, and we are heading for a balance of payments crisis. The trade account will deteriorate immediately’. That was not because the exchange rate was frozen, but solely due to the absorption effect, that is, because of the increase in consumption. So that was producing a balance of payments crisis” [Lara Resende, interview to Solnik, 1987:166]. The long term solution for both Arida and Lara Resende was, then, a fiscal adjustment. In the short-run, interest rates had to be used to reduce aggregate demand.

Persio Arida, interview. The best illustration of Funaro’s understandings is the issue of setting of a ceiling on the level of interest rates. To cut the excess demand, Funaro did not agree with Lara Resende and Arida’s push for higher interest rates. In response, he opted to ask the people to save money instead of spending it.

“I made innumerable pleas on national TV for people to keep their money in savings account. This was because of two factors: the gain was positive [over inflation], and a transfer of money out of consumption into saving accounts would avoid that explosion of consumption.

(…) Saving accounts, after one year, offered a 6 percent real gain over inflation, but Brazilians did not believe in the policy. They thought nominal interest rates were too low. But we knew it would be impossible to raise interest rates as it would break the Housing Fund System. Beyond that, 6 percent a year represents a high standard of interests anywhere in the world!. This transfer of money from the saving accounts into consumption created a series of difficulties [for the control of inflation]. But to say that a nation cannot have high wages does not follow from this circumstance: if, last year [1986], the population had earned higher wages but, instead of turning it into consumption, had saved a part of it, we would not have experienced such difficulties. Therefore, to say that the Brazilian society is not ready to experience higher wage standards would be a very irresponsible assumption” [Funaro, interview with Solnik, 1987:141 and 148].

On the other side of the dispute, Arida reacted like this:

“…What is the adequate level of interest rates? (…) it is that one necessary to convince the public to keep their savings out of consumption. It can be either 10, 50, or 30 [%]. If the population is withdrawing the money from their saving accounts, it is because the actual level of interest rates is low. It is not worth debating it. (…) Reality is what matters. (…) excess demand is fixed with higher interest-rates and cuts in public spending. (…) The Central Bank adopted this policy in November [of 1986]. I was pushing for it since April” [Solnik, 1987:131-3]
among the economic team. (…) I would say that the Central Bank was indeed very concerned about the overheating, asking for a tightening of the monetary policy and for a fiscal adjustment. (…) the group of the Finance Ministry, specially Belluzzo (…), but also João Manoel in some way, had also the feeling that a fiscal adjustment was necessary. The Finance Ministry, in general, resisted the rise of interest rates – specially João Manoel as Belluzzo has always had opinions closer to ours” [Lara Resende, interview to Solnik, 1987:164-5].


20 The program supposed that the inflation adjusted public deficit [déficit operacional do setor público] was kept closer to zero. That implied a path of tight control of public expenditures, but “the behavior of the government after the launching of the Cruzado was one of increasing public expenditures” [Arida, interview with Solnik, 1987:83]. “Sayad had always been an enthusiast of the monetary reform. Of course his view of the reform was not similar to the way I saw it. My opinion was that the monetary reform was to be followed by a strong contraction of public expenditures, in general. Sayad did not agree. Until the end of the Cruzado he disagreed” [Arida, interview to Solnik, 1987:84].

21 “The Planning Ministry resisted to do the fiscal adjustments. The whole team of the SEPLAN resisted: there is not an excessive demand, that is not the case … it is only temporary, it is just a consumption bubble and it is going to blow up” [Lara Resende, interview with Solnik, 1987:164-5].

22 “The President did not accept the end of the price freeze back in April, and again at the Carajás meeting with the economic team [in May]. He also resisted accepting the corrective measures that should have been adopted as soon as June” [Belluzzo, interview with Solnik, 1987:97].

23 At that moment, the price of the dollar in the black market was 90 percent higher than the nominal exchange-rate fixed by the government. This level of surcharge was at least three times higher than before the launching of the Cruzado.

24 See, in this regard, the document launched by the SEPLAN in July, of 1986, during the demand upsurge crisis. The document was called “Plano de Metas” [Traget Plan], in which there is a clear proposition of resuming the path of rapid growth – by 7% a year [“Aspectos macroeconômicos do Plano de Metas”, in Revista de Economia Política, vol. 6, n. 4, 1986].

25 At the time Fernando H. Cardoso was nominated Finance Minister, he was serving as Foreign Minister.

26 There is a good example to show how those personal connections might be relevant to understand the confidence between the political chief and the technocratic team. Back in the early 1970’s, Fernando H. Cardoso wrote a letter of recommendation for Arida when he decided to apply for a Ph.D. program at Cambridge University (UK). Arida was referred to Cardoso by Celso Furtado, maybe the most important Brazilian economist from the left [Persio Arida, interview with this author]. The episode of the Cruzado only reinforced those connections.

27 Persio Arida, André Lara Resende, and Alkimar Moura, interviews with the author.

28 Persio Arida, interview.

29 A Medida Provisória (MP) is a legislative resource reserved to the Federal Executive in Brazil, through which the government can take immediate actions without the approval of Congress. MP’s become laws for 30 days, during which time Congress is supposed to debate and vote on the measure. Even if Congress does not reject it, it lacks efficacy after a month. Congress can approve, amend or reject a MP. When approved or amended by Congress, a MP returns to the President, who can veto all the changes made by the Legislature. If that happens, the process continues with the presidential vetoes being voted by Congress. If the presidential vetoes are broken by a majority of congressmen, the Executive cannot overrule.

30 See especially articles 157-161, of the Brazilian Constitution.

31 Cf. Congresso Nacional, Emenda Constitucional de Revisão # 1, 1994. Congress approved the Fundo Social de Emergência after a long debate. In the end, marginal changes were introduced by Congressmen to reduce the burden shared by states and municipalities, but the main characteristics of the FSE were preserved.
The FSE implied more than the confiscation of 20% of Federal taxes by the federal governments. Beyond that, it also implied the transfer from states and municipalities to the federal government of a proportion of their shares in earnings resulting from particular taxes, like: land property [ITR], income [IR], financial transactions [IOF], social contributions [PIS/PASEP/Confins], production [IPI], etc.. These shares were defined by the constitution.

Cf. Exposição de Motivos da Criação da URV, # 047, February 27th, 1994. This was the official presentation of the “logic” behind the Monetary Reform, and essentially followed the ideas already made public in December 7th, 1993 (cf. “Exposição de Motivos # 395”, that accompanied the Fundo Social de Emergência). Before the Real Plan got approved by Congress on May 27th, Law 8.880, President Itamar Franco had to send three Medidas Provisórias (MP) containing the stabilization plan: # 434 (February 27th), # 457 (March 27th), and # 482 (April 28th).

As already emphasized before, the fiscal balance was also an imperative of the LARIDA proposal.

Here, the government considers the attack on the public deficit as the first phase of the stabilization plan, followed by the creation of the URV (second), and the monetary reform, i.e. the actual change of currency (third). It does not refers to the constitutional amendments, as they were not stabilizing measures, but more structural adjustments. I prefer to separate the combat of the public deficit in two different phases, the Programa de Ação Immediata-PAL, and the measures designed to balance the 1994 federal budget. I also make two further qualifications: I include the constitutional reforms as part of the Real, and the creation of the URV in the process of monetary reform. That is why I talk of four phases, while the government stresses only three.

In this regard, cf. § 111, “Exposição de Motivos # 395”, December 7, 1993. Here, the Finance Minister assumes that “It is not viable to eliminate the indexation prior to the stabilization of prices. To eliminate indexation without the conditions to assure that prices will not increase implies the elimination of the only protection that the economy has to confront inflation. In so doing there would be a risk of disorganizing the economic activity fundamentally and definitively”.

The government defined that the “official” inflation would vary between the smallest and the biggest rates of three different inflation indexes, as measured by statistical institutes independent from the government. The three indexes were: the IPC-Índice de Preços ao Consumidor [Consumer Price Index] (by the Universidade de São Paulo), the IPCA-Índice Nacional de Preços ao Consumidor Ampla [Wide National Consumer Price Index] (by IBGE), and the IGPM-Índice Geral de Preços do Mercado [Market General Price Index] (by Fundação Getúlio Vargas. Of those, only the IBGE-Instituto Brasileiro de Geografia e Estatística was an agency of the federal government, the other two were independent organizations.

It is important to note that this process of currency change, though complex, was not unusual to ordinary Brazilians, but for the first time in the recent economic history of the country it was announced before its ultimate adoption. In this sense, for the first time it was not made through shock.

MP # 434 is the first legislation concerning the monetary reform. Immediately after it was promulgated by the Executive it was applied to wages, on March 1st. This MP sets up the forth phase of the Real Plan.

MP # 457 (March 29th) established that the government had to announce the first printing of Reais at least 35 days in advance, as it would put an end in the transitional process. MP # 482 fixed that the first printing would occur on July 1st.

The Anti-Truste Law (Anti-Collusion Law) [Lei 8884] is one of these instruments. See, in this regard, Oliveira, 1996:60-63.

Cf. MP 434 (February 27th). This Medida Provisória was replaced after 30 days by MP 457. After 30 days, MP 457 was replaced by MP 482 (April 28th). Each of those subsequent re-editions involved marginal changes, the most important of which are referred in this article. Law 8.880 is the final result of Congressional debate and approval of MP 482. The President then vetoed some of the changes introduced by congressmen, and those vetoes were maintained by Congress.


“The Real will be a currency rigidly fixed in terms of the international reserves and the assets of the Federal government. (…) The initial print of Reals, (…) as well as all the other ones that follow, will depend on the simultaneous consignment of a corresponding amount of foreign reserves and shares owned by state enterprises with high liquidity in the international markets. The reserves consigned to back up the printing of Reals will remain blocked, in low-risk investments. In order to release any amount of the blocked reserves, there will have to be an immediate elimination of an equivalent amount of Reals. That will create an institutional order able to guarantee, at any time, the consistence, the convertibility, and the stability of the value of the domestic currency” [“explanation of purpose for the launching of the URV”, signed by President Itamar Franco, § 71-72].

At that moment, Brazil was already back into a situation of strong inflows of foreign capital (attracted by the higher level of domestic interest), what created a natural tendency for a fall in the value of the dollar against the domestic currency.

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It is essential to consider here that the Brazilian external situation was a completely different one, after 1992. After that year, Brazil could consider increasing imports due to the reversal of the situation in the capital account. As imports only started increasing after 1993 with the end of the recession (1990-2), the levels of reserves increased consistently. Between 1992 and 1994, the capital account showed net surpluses of US$ 25.3 billion, US$ 10.1 billion (1993), and US$ 14.2 billion (1994). In 1991, the capital account had shown a deficit of US$ 4.5 billion.


See, for example, Moreira (1999a; 1999b) for an attempt to evaluate the productivity gains in the Brazilian economy.

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A Free Trade Area (FTA) is a regional agreement that establishes that countries cannot restrict imports from other member-countries, either through tariff or non-tariff barriers. A Customs Union (CU) is a FTA that also has a common external tariff. A common market is a CU that also has free mobility of capital and labor among the members.

This was a difficult step in negotiations, as the levels of protection of the four economies differed enormously. Brazil's was the most protected economy of them all. So, in order to overcome the other countries' resistances to the creation of a customs union - that, in practice, would imply an increase of import tariffs for manufactured goods - the Brazilian government agreed to the creation of a "list of exceptions" - products that, for five years, would not observe the Tarifa Externa Comum (TEC) [common external tariff] of MERCOSUR.