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The Brazilian Economy, 1980-1994[1]

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There was a sharp change of course for the Brazilian economy in 1980. Its outstanding growth performance since 1900 became mediocre: GDP per capita increased at the rate of less than 0.1% yearly between 1980 and 1994.[3] This performance would improve only slightly in the decade after 1994. Agriculture maintained its share in GDP around 10% from the mid-1970's to the end of the century while the share of manufacturing industry fell from its peak of 34% in the mid-1970's to 28% in 1990 and remained constant afterwards. A succession of external shocks in an indexed economy in the 1970s ended up causing rising inflation and a deep financial crisis of the Brazilian State whose contribution to domestic savings became negative. The record of the State as an entrepreneur also deteriorated, not only because of the rising number of wrong decisions in the 1970s – *pace* the megalomaniac nuclear programme – but also because public investment was affected by deep cuts in the early 1980's. As the balance of trade increased and the inflow of direct foreign investment was much reduced, Brazil became an exporter of resources and net foreign savings became negative.

Most of the government efforts during the period were centred in achieving the elusive return to price stability and also in overhauling the role of the state. This included attempts to reform inefficient public policies and to improve the quality of public expenditure and also efforts to improve efficiency in the provision of goods and services by government or state-owned enterprises. Towards the end of the 1980s there were initial efforts to reduce high protection. In the 1990s trade liberalization and the

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[2] Professor of Economics, Pontifical Catholic University of Rio de Janeiro. The author wishes to thank Professor Leslie Bethell, the Department of Economics at PUC-Rio, the Centre for Brazilian Studies, University of Oxford, St Antony's College, Oxford, and CNPq-Conselho Nacional de Desenvolvimento Científico e Tecnológico for support.

[3] See at the end of the paper Table 2 which includes the main economic series for the Brazilian economy after 1980

privatization of public-owned assets was deepened and, in 1993-94, there was success in reducing inflation on a sustained basis after many failed attempts since the early 1980s.

1. **Debt crisis and high inflation, 1980-1985**

In 1981-1983 Brazil suffered its worse recession on record, certainly the most severe in the 20th century, as GDP fell 4.9% from its peak in 1980. Massive trade surpluses, the strong recovery of the United States economy in 1984 and the fall in international interest rates made possible a return to current account equilibrium in 1984-1985. There was recovery in the level of economic activity – with GDP growing on average 7% in 1984-85 – but yearly inflation doubled again to reach the 200% yearly mark. During 1985, the first year of civilian government after the 1964 military coup, attempts to control inflation based on contractionary monetary and fiscal policies failed. The stage was set for the adoption of a long succession of failed heterodox stabilization plans between 1986 and 1991 until the Real plan of 1993-1994 successfully reduced yearly inflation to single digit numbers on a sustained basis.

The *fuite en avant* policies, adopted roughly between mid-1979 and mid-1980, attempted to repeat the success achieved by the sharp change of policies in 1967-1968, once again under the inspiration of Antônio Delfim Netto. They resulted in what Mário Simonsen, Minister of Finance 1974-79 and Minister of Planning in 1979, has classified as a "resounding failure". GDP increased 9.1% in 1980, but inflation roughly doubled to around 100% yearly. In an economy where prices were heavily indexed it proved impossible to give credibility to the announcement by the government of declining future inflation targets. Failure led to a long period which extended until 1985 and was marked by unsuccessful policies designed to control domestic demand through restrictive fiscal and, mainly, monetary policies which simply did not work.

Between September 1980 and November 1982, recessive policies were domestically-inspired and recourse to the IMF was discounted as not necessary. There was a clear intention to postpone IMF-supported adjustment as this was considered to be too onerous politically and the effect of such a decision on the outcome of the November 1982 elections was feared. This stance became extremely difficult to hold after the Mexican moratorium in August 1982 given the balance of payments constraints. Indeed, only three days after the elections, the government announced that it was seeking international financial support and opening negotiations with the Fund.

From the end of 1980 to mid-1984 economic policy was mainly defined with an eye on the external constraint. Reserves had fallen US$ 3.3 billion in 1979, then a further US$ 3.5 billion in 1980. The current account deficit reached US$ 12.8 billion in 1980, in spite of a sharp rise in exports. After September 1980, it became clear that foreign capital had been unconvinced by the policy of trying to establish *ex ante* targets for the exchange rate and domestic inflation attempted after September 1979.

The next few years would be marked by a clear official commitment to conventional policies targeting demand to control inflation. There were recurrent declarations of faith in orthodox policies in spite of consistent failure. Policies adopted included: high interest rates, selective control of credit, cuts in government expenditures and wage squeeze through interference with rules of indexation (to correct for inflation) of wages beyond a certain threshold. High interest rates had the additional attraction of compelling economic agents to find finance abroad, something still possible until 1982. With the fall in domestic activity, vent for surplus exports were be induced, as producers had no domestic outlet for their output. Emphasis on expenditure-switching was prevented by difficulties to further devalue the domestic currency in real terms given the recent loss of credibility entailed by the attempt to preannounce yearly devaluation and inflation. It was also thought that the economy faced productive capacity constraints.

Recession begins

Pre-fixation of inflation was jettisoned and a whole range of orthodox restrictions was in introduced after the end of 1980. Wages were contained – but low wages were still to be indexed above inflation – and credit was restricted, but exceptions were established for activities related to exports, energy and agriculture. Restrictions were imposed on the growth of the liquidity. Interest rates were allowed to increase in a vain effort to induce indebtedness abroad. Expenditures by state enterprises were curtailed especially investment. Taxes were increased. Inflation accelerated to 120% on a yearly basis by mid-1981 in spite of all restrictions on demand. It receded only modestly in answer to a favorable harvest.

Alternative interpretations of inflation which underlined the importance of inflationary inertia in a heavily indexed economy started to gain strength. Inflation today was to a large extent a result of inflation yesterday and without interference with nearly full price indexation conventional demand squeeze was doomed to failure. But these ideas took some time to spread and several failed stabilization attempts between 1986 and 1991 to be refined. The adoption of contractionary policies and the wage squeeze led to the sharp fall in the level of activity in 1981-1983, especially sharp in the industrial product which fell more than 16%. Contractionary policies had more success in reversing the trade imbalance which had followed the oil shock. There was a savage deterioration in the terms of trade: after a fall of more than 35% between 1977 – a peak similar to 1973 -- and 1980, they fell a further 15.4% in 1981-1983. In 1983 they were almost 40% lower than the 1970-72 average. A trade deficit of almost US$ 3 billion in 1979 and 1980 was modestly reversed in 1981 and 1982, exports increased rapidly, with a reversal in 1982, but import contraction played a major role in response to foreign exchange devaluation and import controls.

There was more of the same in 1982. Same policies, almost no growth, stable inflation. Agricultural product fell 0.4% after growing almost 9% in 1980-81. This was a bitter blow for the government as the economic strategy was based on enhancing exports, especially of agricultural products, and, at least in principle, on fostering the substitution of oil consumption by other forms of energy. There was substitution of petrol by alcohol. Ex post there was much criticism of the Brazilian policy of stimulus to alcohol consumption but this criticism fails to take into account the extremely high future prices of oil included in the forecast of international organizations such as the World Bank. The current account deficit peaked in 1982 at more than US$ 16 billion, almost 81% of exports, the result of the cumulative effect of high indebtedness and rates of interest – including spread allowing for Brazilian risk – above 20%.

A change more of form than of substance in economic policies was brought about by the Mexican crisis of August 1982. During a transition period there was financial support by the United States Treasury, the Bank for International Settlements and creditor banks. After the elections of November Brazil formally agreed to submit a programme to the IMF. The agreement with private banks included US$ 4.4 billion of new money, refinancing of 1983 amortizations in eight years and unwritten assurances of banks on commercial lines of credit and credit to Brazilian banks. With a time lag negotiations were also concluded with official creditors in the Paris Club. But domestic contractionary policies continued to be very much the same.

Relations between the Brazilian authorities and the IMF had been traditionally quite difficult and nothing happened in the 1980s which contributed to improve this record. Between 1983 and 1985 Brazil signed no less than seven letters of intent as changed conditions had impact on agreed conditionalities.

It was initially agreed with the IMF to establish a target of US$ 6.9 billion for current account deficit with an implied trade surplus of US$ 6 billion. Inflation was to be reduced to 70%. Public sector borrowing requirements and net domestic credit were to be halved. In early 1983 the corrective factor of 1.1 to be applied to half-year readjustments which favoured wages under three minimum wages was abandoned. Average real wages fell 15% in 1983. A revised letter of intent was presented almost immediately as targets had to be adjusted to take into account a significant (30%, domestic currency/foreign currency) devaluation of the exchange rate in February 1983. And other revisions followed.

By far the most important development in the relations with the IMF was the success by Brazil in convincing the Fund to accept a revision of the definition of performance criteria in an economy with high inflation. This was about differences on nominal and real concepts in the definition of a deficit. It was impossible to achieve public sector borrowing requirements targets when so much of the nominal deficit reflected high inflation. A new concept of indebtedness was introduced by deducting from public sector borrowing requirements the component that resulted from monetary and foreign exchange correction of the past debt. This was an effort to segregate the effects of indexation from those of the excess of expenditures in relation to revenues. So the concept of operational deficit entered the stage: it was the primary deficit (expenditures less revenues) plus real interest payments. Nominal deficit would include nominal interest payments. The divergence between nominal and operational deficit increases with the rate of inflation and with the level of public debt.

Recession continued in 1983: GDP fell 2.8% and the industrial product more than 5%. Industrial employment fell 7.5% and there was a reduction in the level of gross capital formation as a share of GDP from 23% in 1982 to 18.9% in 1983. But what was somewhat surprising was that investment fell less than could be anticipated by such a sustained reduction in output in 1980-1994. The reasons for this are complex. The impact of public expenditure cuts hit investment very hard. Rather than concentrating the cuts in the projects with a lower rate of return the government tended to cut over the board so that completion of many projects was postponed. Project rates of return fell significantly. Less productive capacity was created by unit of investment. Prices of capital goods increased significantly as protection favouring domestic products remained very high. Accelerating inflation provided a further stimulus to overinvestment as protection against inflation was sought as had been the case in other episodes of high inflation elsewhere. High inflation also induced a rise in construction costs as contractors sought protection from higher uncertainty concerning their future earnings.

Success in balance of payments adjustment was sustained as all external targets were met. The current account deficit fell to 2.7% GDP. But improvement was more because of import contraction than of export expansion (in relation to targets agreed with IMF). Oil prices fell modestly and the share of domestic production in the apparent consumption increased to 34.7% (from 14% in 1979). Imports fell to 6.8% of GDP. The impossibility of meeting the nominal targets agreed with IMF led a suspension of scheduled disbursements and protracted negotiations on changes in nature of future targets. With inflows of foreign capital half their peak in 1981 (or 1978, for that matter) and shortcomings in the inflow of IMF resources, arrears accumulated as had happened in the 1930s. Uncertainty led to a widening of the wedge between the official and black market exchange rates and the premium exceeded 100% at its peak. Exchange control may have played a role in making Brazil a peculiar case in Latin America as there was limited capital flight if compared with other countries. More importantly, a significant share of foreign debt was indexed to the US dollar and after the late 1970s borrowers in foreign currency were allowed to hedge their foreign exchange risk by making deposits in the central bank. For all relevant purposes the Brazilian overall foreign debt became a responsibility of the Federal government in another chapter in a long history of socialization of losses.

All the good work in the balance of payments side was obscured by the acceleration of inflation from a plateau of 100% to 200% yearly as the impact of exchange rate devaluation worked its way through the indexation system and agricultural prices were under pressure after a second year of reduction in agricultural product.

Net foreign transfer which had peaked at almost 6% of GDP in 1974 and generally hovered around 3% in the 1970s (1977 excepted) fell after 1980 and became negative after 1982. It was negative for the rest of the 1980s with peaks of almost 5% in 1984 and more than 4% in 1988. Balance of payments restrictions to growth were very early in 1980s superseded by fiscal constraints as a severe financial crisis hit the Brazilian public sector. There was further deterioration of public accounts in a process that had started in a limited way after the mid-1970s. Public sector savings shrank from 6-8% of GDP in 1970-1977 to 3-5% in the late 1970s and declined sharply afterwards to became insignificant in 1984 (and negative in 1985). Total savings came to depend almost exclusively on the private sector. A combination of a decline in current revenue as a % of GDP, a rise in current non-interest expenditure and a rise in inflation-corrected interest payments led to public sector borrowing operational (as opposed to nominal) requirements in the 4-5% of GDP range, rather in excess of levels in the mid-1970s. The sharp rise in operational PSBR in 1976-79 had been of a totally different nature as it resulted from very high levels of government investment. Total inflation transfers – including inflation tax on holders of cash and inflation transfers related to non-indexed assets held by the financial sector – reached a post-1964 peak of 6.3% of GDP in 1980 then stabilized at 4-5% compared to the 3-4% typical of 1974-78.

1984 without embellishment

After three years of deep recession, 1984 marked a recovery of the activity level: GDP increased 5.7% with industrial output leading with an expansion of 7%. Favourable growth performance was dominated by exports which increased by 23%, a result of the strength of United States demand. Trade balance increased to reach more than US$ 13 billion as domestic oil production covered almost 50% of apparent consumption. The import-GDP ratio fell further to 6.3%, the current account deficit disappeared and more than US$ 7 billion were added to the reserves.

Attempted *ex post* autobiographical embellishments by Brazilian policy-makers have prompted much self congratulation on the achievements of 1984 and the inheritance left to the new government that took office in March 1985. But these achievements tend to be concentrated on the balance of payments. The yearly inflation rate was stable at more than 200% in spite of a better crop in 1984.

As yearly inflation rose, and then stabilized, at 200% interpretations which stressed the inertial element of Brazilian inflationary process evolved from analytical efforts to policy proposals. Some proposed that in a transitional period two kinds of money should co-exist: old currency and a new indexed money. Prices and wages would be voluntary converted to the new indexed money. Inflation will be eliminated as transition to the new currency became universal. A shock version of stabilization policies based on the inertial diagnosis relied on an abrupt end to indexation rules coupled with a freezing of all prices (including the foreign exchange rate) and wages.

In February 1984 a further waiver was obtained from the FMI and a fifth letter of intent made domestic targets less restrictive. Inflation rate would be halved in relation to 1983. But as inflation remained stable around 200% yearly a sixth letter of intent was required in September to cope with the impact of such failure on domestic targets. In early 1985 the government engaged in the negotiation of a seventh letter of intent with the IMF which would incorporate rescheduling of debt amortization payments, but this was aborted by the failure to meet the conditionalities for the last quarter of 1984.

As oil imports increased to reach a peak of 52.8% of total imports in 1983 – compared to around 30% on average in 1976-78 and 11.5% in 1973 – the share of the Organization of the Petroleum Exporting Countries in imports rose to 40% in 1984 mostly crowding out the European Community. Exports to the EEC also fell while those to the United States rose spectacularly as the United States economy recovered in 1984. The share of exports to OPEP economies doubled to 10% since 1979. Manufactured exports rose from 43.6% in 1979 to 56% in 1984 propped by vent for surplus as the deep recession stimulated producers to find alternative outlets for their output and also by massive GATT-illegal subsidies whose temporary return was allowed by creditor countries unwilling to interfere with the increase in trade surplus required to partly service the foreign debt. These subsidies peaked at 33% per unit value of manufactured exports.

Brazil had faced much pressure during the Tokyo Round of multilateral trade negotiations in the General Agreement on Tariffs and Trade concerning the legality of its extensive use of export subsidies. The new Code of Subsidies made it illegal to subsidize exports by means of direct tax rebates and payments above tax rebates of indirect taxes. The United States applied intense pressure to make sure that Brazil would sign this particular code and agree to discontinue its illegal export subsidies, even if it was to relent later when Brazil needed to substantially increase its trade surplus to service its foreign debt after 1982.

The multilateral trade negotiations in the GATT between 1982 and 1986 were marked by skirmishes between a small group of developing economies, including Brazil and India, and the developed economies with the United States in the forefront. The differences focused on the “new themes” – intellectual property, foreign investment and services – which the developed economies wished included in the agenda and a small group of developing countries which did not.

Back to civilian government

The first civilian government after 1964 took office in March 1985 under dramatic circumstances as Tancredo Neves, the victorious presidential candidate, had become gravely ill and was to die after a long agony. His vice-president, José Sarney, a seasoned old-school politician with long record of cozy links with the military, became the new president. The year of 1985 may be seen as a muddled interregnum. It marked the failure of still another attempt to do away with inflation by gradual means. There was the intention in January 1985, in the last days of the previous government, to negotiate with the IMF an agreement similar to that with Mexico that would include a reschedule of foreign debt. But the way was blocked as Brazil had failed to meet targets on nominal debt and operational deficit. Negotiations with banks were also postponed as an agreement which would result in a reduction of debt service payments (but no debt reduction), following the lines of a Baker Plan, depended on reaching agreement with the IMF. It has been suggested that the IMF tended to become less important for Brazil for two related reasons. The difficulties in the early 1980s had made it clear that direct financial support by the Fund was insufficient to cope with the Brazilian balance of payments disequilibrium. And its seal of quality seemed perhaps less essential to guarantee an agreement with the banks. Interim measures postponed a new explicit agreement debt with the banks from the beginning of 1985 until well into 1986.

The electoral manifesto of Tancredo Neves had included ideas of a *Pacto Social*. But policies actually implemented, while paying lip-service to orthodoxy, were confused, piecemeal and volatile. Initial monetary and fiscal policies under Sarney were restrictive. There were cuts in expenditures and a freeze in the hiring of civil servants. Prices were frozen in April and there was an attempt to extend inflation memory beyond the very short term: monetary and exchange rate correction would be defined by the geometrical average of inflation in the three previous months. There was a compression of costs of inputs until mid-year. The following price decompression together with an agricultural supply shock drove monthly inflation back to 14% in August.

Friction between ministers in favour and against orthodox policies led to the fall of the nominally orthodox Minister of Finance, Dornelles, an appointment of his uncle Tancredo Neves. The way was open to heterodoxy with the appointment of Dilson Funaro, a *Paulista* entrepreneur in the left of the political spectre of interests supporting the new civilian government. There was less preoccupation with the control of monetary base and a fall in real interest rates was allowed to occur. The economy was back to a monthly inflationary memory to define monetary and foreign exchange correction: the avowed limited aim was to stabilize inflation at 10% monthly. The economy was in the way to full indexation but public prices lagged as plans to eliminate the public deficit by a fiscal package at the end of the year were shelved.

With the inflation at this level it was impossible to maintain wage readjustment on a half-year basis. But there was no clear rule on wage indexation, still officially based on half year adjustments as established by legislation back in 1979. Several options on wage policies were considered: quarterly adjustments; monthly adjustments; *scala mobile* with a trigger of 30% (eventually used in the *Cruzado* plan of 1986); monthly pre-set adjustments defined on a quarterly basis (used in the Bresser plan of 1987). Free negotiations of *abonos* and other temporary measures were allowed while new general policies were defined, but could not be taken into account by price control authorities when agreeing with price increases.

There were good external results in this transitional year as the trade surplus, helped by a fall in oil prices and in spite of a contraction of exports of 5.1%, reached US$ 1 billion monthly. The level of reserves increased to US$ 11.6 billion. This allowed Brazil to keep the IMF at arm’s length as there was no demand for further resources. Creditor banks were accommodated with an extension of former agreement. Some recovery of domestic sales compensated for the contraction of exports in relation to 1984: GDP increased 8.1% evenly distributed between industry, agriculture and services. But with the accelerating inflation to reach 16.2% in January 1986, the economy was heading towards a new plateau of 400-500% yearly inflation, double the level that had been inherited from the former government. A shift to a shock strategy against inflation on the lines of that had been adopted in Argentina started to be seriously considered.

2. Failed stabilization attempts, 1986-1990

1981-1985 had been a period of accelerating inflation and average low economic growth in spite the improved growth performance in 1984-85. Economic policies remained very much in the path of orthodoxy after the *fuite en avant* of 1980 had failed. After the transitional year of 1985 there was a series of policy experiments based on the diagnosis that inertial inflation played a major role in explaining chronic high inflation. The Argentinean and Israeli examples served as a permanent reference for Brazilian policy-makers.

The succession of failed stabilization attempts in 1986-1989 combined different blends of fiscal and monetary policies with devices to break price indexation. The main fragility was related to structural obstacles to fiscal adjustment. The government was unable to stop the deterioration of its capacity to generate savings. There was a high volatility of inflation and growth rates. But on average this continued to be a period of high inflation and economic stagnation. As successive heterodox stabilization programmes failed it became increasingly difficult to break inflationary inertia as economic agents tended to learn from previous experiences. With the succession of complex sets of different rules concerning price indexation the scope for judicial disputes involving price indexation was enormously expanded. It would become increasingly difficult for future governments to anticipate their liability in relation to the lagged financial consequences of the periodical release of skeletons in the cupboard involving price indexation by judicial decisions which took a very long time.

Financial problems were compounded by the approval of a flawed Constitution in 1988 which contributed to a further deterioration of the central government financial stance as it decentralized revenues but not responsibility for the corresponding expenditures.

The *Cruzado* plan

The Cruzado plan was the first in a series of attempted stabilization programmes introduced after 1986 which, in contrast with the past, included features that indicated a radical change in the explanation of the causes of inflation. It abandoned the previous emphasis on demand inflation and singled out inflationary inertia as the main explanatory variable for persistent inflation. It was a shock rather than a gradual policy. A new currency was introduced, the *cruzado*, worth 1,000 *cruzeiros*. The last monetary reform had been in 1967 when the 1942 *cruzeiro* lost three zeros. Confusingly, after a short period when the monetary unit was the *cruzeiro novo* there had been a reversal in 1971 to the name *cruzeiro*. One *cruzado* was thus worth 1,000 *cruzeiros* of, say, 1985, and 1,000,000 of the 1942 *cruzeiros*.

The features of the stabilization plan reflected the widely different views of policy-makers involved in its formulation and implementation. These were costs difficult to avoid in the interaction of more technically minded policy-makers or advisers as compared with those more aligned with PMDB – *Partido do Movimento Democrático Brasileiro* – the umbrella-style opposition party that had been victorious in the 1984 with Dilson Funaro, a Brazilian industrialist with a taste for heterodoxy in the Ministry of Finance. The program bore the marks of the difficult political accommodation between these different groups.

Inertial interpretations of the inflationary process in an indexed economy had evolved to two main policy proposals. The one adopted in 1986 in the *cruzado* plan relied on a heterodox shock framework: currency substitution, price freeze, disindexation and neutralization of the distributive effects of disinflation. The major alternative of a gradual transition to a new currency through a period of coexistence of the old and a temporary indexed currency together with other elements would constitute the backbone of the successful Real plan of 1993-1994.

Prices in *cruzeiros* were converted in prices in *cruzados* by taking the average of prices in the past six months. Only electricity prices were adjusted by 20% as they were considered to have lagged in relation to other prices. All prices, including rents and the exchange rate, were frozen. There were attempts to neutralize the redistributive impact of the plan. Wages were to be converted in *cruzados* taking into account their level in the last six months. However, in what critics have singled out as “concessions to populism” there was a 8% further adjustment for the benefit of all wage earners rising to 16% in the case of the legal minimum wage. Yearly wage negotiations (*dissídios*) would adjust wages by 60% of inflation as measured by the cost of living index. A further wage concession was to introduce a mechanism inspired in the Italian *scala mobile* which would trigger an automatic wage adjustment every time inflation reached 20%.

Rules had also to be established for the adjustment of contracts involving future payments. There were two types of contracts. There were contracts where interest rates were determined on an *ex post* basis as an addition of “monetary correction” to “pure” interest rate component. In this case the new rates simply excluded monetary correction. In the other type of contract the interest rate was fixed *ex ante*. An official table of conversion of interest rates was adopted. It was a *tablita* similar to that of the Argentinean shock stabilization that had preceded the *cruzado* plan.

Monetary and fiscal policies were left to the discretion of authorities with the idea that they would be adjusted to the speed of remonetization that was to occur as economic agents showed an increasing willingness to carry cash with the fall in inflation rate. Fiscal policy was considered to have been defined by the fiscal package of December 1985. This did not take into account that inflationary tax would be lost by stabilization and also of the impossibility of raising revenue based, as had been usual in the past, on the taxation of nominal capital gains boosted by high inflation.

The success of the plan until mid-1986 was spectacular with corresponding popular enthusiasm. The illusion that political mobilization could replace markets in price determination got hold of the nation at least temporarily. The monthly inflation rate fell to 0.1% in March and remained little above 1% until July. It was an apparent vindication of those views which stressed the possibility of achieving stability without recession and unemployment.

Increase in purchasing power prompted by the generous wage adjustments in the transition compounded other sources of demand pressure. Economic agents adjusted their precautionary balances to a lower level of inflation and spent more. This led to severe selective demand pressures. There were problems also with the "wrong freezing" of some prices as there was little allowance for the staggered nature of price adjustments in an inflationary economy. Overheating had become clear by mid-June. There were monthly price rises in the 4-5% range for used cars and clothing. By mid-year production of consumer durables had increased by one third in relation to the previous twelve months. Milk had to be subsidized. Beef imports to cope with the combined effect of a higher demand and supply constraints due to bad weather, were late, insufficient and of bad quality.

Increased monetization induced by a higher propensity to hold cash explained a significant expansion of money supply. But its increase went beyond the space created by abrupt disinflation. Real interest rates became negative, prices of real assets shot up, the premium on the official foreign exchange rate more than doubled to reach almost 60% in mid-year, stock exchange prices rose about 50%.

Tax gains related to disinflation – a reversed Tanzi effect – were small and slow. There was a fall in income tax collections and expenditures increased as elections in November approached. It was slowly admitted that the operational deficit would reach 2.5% of GDP, rather than the 0.5% mentioned earlier on, and it became increasingly clear that there was to be either a contraction of demand or an end to the price freeze. Attempts to win the president to the decision of imposing a demand contraction in May failed. The idea that stabilization could be obtained by a costless trick had obvious political appeal.

Failure of the *Cruzado* plan

Small adjustments made in late July – the so-called stop-gap *Cruzadinho* [small *Cruzado*] plan – included a timid fiscal package involving compulsory "loans" on fuel, motor cars purchases, international air tickets and foreign exchange sales for travel expenses, some of which were in theory to be refunded in three years. The government started to attempt to fiddle with the comprehensiveness of the coverage of price indices to avoid triggering the *scala mobile*. Low inflation indices persisted but did not reflect real inflation as "new" products were marketed, side payments failed to be captured by collected prices and scarcity of products started to reduce the size of the sample used to measure inflation. Speculation about foreign exchange devaluation led to a leads and lags situation where exports were postponed and imports stockpiled. The wedge between the official and parallel market rates increased to 90%. Exports fell rapidly (almost 13% on a yearly basis) in spite of a big but short-lived improvement in the terms of trade. A small devaluation in October was followed by the announcement of a return to a policy of small devaluations to avoid a major overvaluation of the *cruzado*.

A stage II of the *Cruzado* plan in the end of the year was announced after a resounding victory for PMDB, the government party. A fiscal package of about 4% of GDP was introduced and public prices -- fuel, electricity, telephone and postal services – increased. Revenues were to finance a rather delirious plan of investments aiming at a rate of growth of 7% yearly. There was much debate on technicalities involving the coverage of price indices and how the *scala mobile* should be applied in an effort to postpone inflationary inertia. Industrial output peaked in September at a yearly rate of growth exceeding 12%. In 1986 as a whole GDP increased by 8% on a year to year basis but the agricultural product fell almost 8% compounding the demand-related inflationary pressures.

The economy was showing clear signs of overheating. Inflation returned at full speed and price indexation was reintroduced to adjust the foreign exchange rate and to define the ex post rate of return on financial instruments. In the beginning of 1987 monthly inflation had reached almost 17%. Attempts to reach a *pacto social* failed, price control was ended and price indexation on a monthly basis reintroduced.

In early 1986 a new agreement with foreign creditors had been signed. For the first time there was no previous agreement with the International Monetary Fund. The agreement with the banks involved a rescheduling of amortization payments due in 1985 and the provision that payments due in 1986 were to be hold as sight deposits in the Brazilian Central Bank until April 1987. Commercial and interbank credit lines were to be maintained at agreed levels. But the *cruzado* plan affected the balance of payments unfavourably by the perverse combination of supply and demand shocks. Negative trade balances started to accumulate in the last quarter of the year. Imports were rationed as the level of reserves fell. Foreign debt interest payments to private banks were suspended in February 1987. The official reasons advanced to justify default were to stop the loss of reserves and to prepare the ground for a new phase of negotiations. When Funaro left in April, monthly inflation was beyond 20% and the foreign debt was in default.

In search of stabilization: 1987-1989

From mid-1987 to March 1990 three further stabilization attempts of varying degrees of ambition were made. They failed much faster than had been the case with the *cruzado* plan: the Bresser plan of mid-1987, the *feijão com arroz* [beans and rice] policy of 1988 and the *Verão* [Summer] plan of 1989. Monthly inflation rate in the last month of the Sarney government was in excess of 80% and the average growth rate of GDP in 1987-1989 had been of only 2.2%. Democracy failed to deliver both low inflation and high growth.

Bresser Pereira, the new Minister of Finance from May 1987, announced modest growth targets and showed some inclination to speak to the IMF in the face of opposition by his own party. There were rumours of a heterodox shock but in fact the Bresser plan of June 1987 was no attempt to completely eliminate inflation. Its limited aims were to end the wage *scala mobile* and to reduce public deficit so as to make possible to sustain lower rates of inflation. In its more general commitments the plan stressed the need of autonomy for the Central Bank in the definition of monetary policy and commitments to unify all Federal government budgets, to improve budgetary practices and not to resort to monetary expansion to cover deficits.

Prices were frozen but not before several public and administered prices were adjusted. Wages and rents were frozen for 3 months but the exchange rate was flexible. The correction of public and administered prices was not allowed to be taken into account in a correction of wages. Contracts with pre-fixed nominal interest rates were discounted using a *tablita*. There was an attempt to extend the price pre-fixation time span horizon to three months. A new wage indexation rule based on the URP (*Unidade de Referência de Preços*) [Unit of reference of prices] was introduced. Each quarter the values for the URP in the next three months were preset, based on the geometrical average of monthly rates in the previous three months. Some have considered the plan's conception as naive as inflationary inertia was only broken by the price freeze and after that inflation was fully transmitted on a quarterly basis.

There were initial intentions to pursue active fiscal and monetary policies and in particular to reduce public deficit from a projected 6.7% of GDP to 3.5%. But initial efforts to increase revenues and reduce expenditures were rather modest covering only about one third of the gap. A *Plano de Coerência Macroeconômica* [Plan of macroeconomic coherence], announced in July was important as the first clearly stated demonstration of concern with fiscal equilibrium since orthodoxy had gained the upper hand in the beginning of 1986. Emphasis was placed on the recovery of government savings which had reached more than 4% of GDP in the mid 1970s and were now negligible. A cut in expenditures, including subsidies, coupled with a raise in public prices, which had been eroded in the long term, plus a progressive tax reform was to increase public savings from zero to 5.3% of GDP in four years. This would make possible an investment ratio of more than 24% of GDP and yearly growth of GDP of 7% after 1989. Putting public accounts in order was to prove elusive for many years ahead. So would high growth on a sustained basis. In the three remaining years of Sarney's term of office gross fixed capital formation hovered around 23-26% of GDP, increasingly affected by high prices of construction and capital goods, while GDP growth averaged only 2.2%.

Inflation fell from 26.1% in June to 3.1% and 6.4% in July and August. Lack of popular support added to dismantlement of price control limited the scope of price freezing. It has been contended that, in contrast with the *Cruzado* plan, the persistence of significant monthly rates inflation is to be explained by the redistributive conflict rather than by demand pressure. Relative prices were again misaligned in the initial price freeze. Already in August some price controls were abandoned and a ceiling of 10% established on selective "emergency" price increases. This ceiling exceeded by very far the pre-set 4.7% adjustment of the URP and the gap created a measure of the plan's failure. Amidst clear signs that fiscal imbalances persisted, monthly inflation almost trebled between September and the end of the year when it reached 14.1%. By the end of the year Bresser Pereira was out of the government. There were intense pressures from wage earners to recover the inflation of 26.1% in July which the Bresser plan had excluded from wage readjustment. To bow to pressure would put monthly inflation back to its pre-Bresser level. The question became emblematic of the "skeletons in the cupboard" syndrome which would result from most pre-1993 heterodox stabilization plans. In the end judicial decisions forced future governments to make the disputed payment.

Exports recovered in the wake of a significant real devaluation of domestic currency and the deficit in the trade balance in the beginning of 1987 was transformed in a surplus after June. The balance of trade in 1987 was in excess of US$ 11 billion. But there were no developments in the foreign debt deadlock as a Brazilian proposal to float new very long-term bonds to securitize the foreign debt was cold shouldered by the creditors. Only palliative measures were adopted. By the end of 1987 there was an interim agreement involving interest payments seeking to avoid the reclassification of Brazilian loans to ‘value impaired’ status in the United States. Moratorium on foreign debt interest was lifted in early 1988 with a payment of US$ 1 billion out of US$ 4.5 billion due in interest payments.

Economic policy during 1988 deliberately avoided the format of a stabilization plan: it was referred to as “rice and beans” policy, a mention to the most popular Brazilian dish as an indication that it was to remain simple and unpretentious. Targets were modest: monthly inflation was to be stabilized at 15% and gradual reduction of deficit estimated at 7-8% of GDP. Reduction in public expenditures included a temporary freeze of public sector wages and made possible relative success in public deficit control which was under 4% of GDP in 1988. Monthly inflation fell under 20% with reassurances that there would be no new heterodox plan. But inflationary pressures returned with agricultural difficulties, very high trade surpluses and conversion of foreign debt into equity. Inflation accelerated again to reach 24% in July and 27% in October.

In 1988 and 1989 there was a significant improvement in export performance which at around US$ 34 billion were more than 30% above their level in 1987 and almost 50% above the level of 1986 which had been badly affected by the *Cruzado* plan. Part of this is explained by some recovery in the terms of trade which increased to a level some 15-20% above their through in 1983 and were to remain roughly there until 1993. But this was still some 30% below the 1970-72 average terms trade.

By the end of June 1988 a preliminary agreement on foreign debt was reached including US$ 5.2 billion of “new money” of which the first tranche of US$ 4 billion would cover interest arrears. The balance was conditional on negotiations with the World Bank on specific projects and remained undisbursed. It also included US$ 14.4 billion referring to the maintenance of commercial and inter-bank credit lines and US$ 1.05 billion of debt conversion to exit bonds with a 30% discount. In the late 1980s the net inflow of resources (inflow net of amortization payments) from multilateral banks such as the World Bank and the Inter-American Development Bank had become negative or negligible. In 1989 the net inflow was US$-166 million for World Bank loans (gross inflow of US$ 903 million) and US$ 32 million for those from the IDB (gross inflow of US$ 280 million). Interest payments remained substantial at US$ 715 and US$ 169 million, respectively.

In the month a new Constitution was promulgated – 5 October, 1988 – inflation was above 27%. The Constitution was a political landmark in the process of return to a democratic political regime. It was also an over reaction to the 1967 constitutional text approved under the military. The balance of power between the central government and the states and *municípios* shifted again in favour of decentralization. The new text transferred Federal revenues to states and municipalities without transferring responsibility for specific services. It increased earmarking of revenues, labour costs and put Federal expenditures under further strain. The structural obstacles to fiscal adjustment were strengthened by the new constitution.

In September 1988 the government failed to convince the IMF to help to reach an agreement with its creditors in an effort to lower the risk of hyperinflation. A social pact to avoid hyperinflation was signed in early November between government, trade unions and employers limiting price and wage adjustments to a ceiling of 26.5% in November and 25% in December. It included a list of interim measures related to price and wage adjustments, inflation measurement, the format of negotiations and a loose government undertaking to present plan to put public finances in order. Actual inflation rates were 26.9% and 28.8%. “Beans and rice” had failed: yearly inflation rate rose from the 400% plateau to 1000% while GDP fell 0.1%.

A new hybrid stabilization plan, the *Plano Verão*, was introduced in early 1989. Its heterodox part included a monetary reform: the *cruzado novo* (equal 1,000 *cruzados* of 1986) was introduced. The repetition of details is monotonous. All indexation was ended or suspended. There was an indeterminate period of price freeze. Wages and rents were converted into *cruzados novos* at the 1988 yearly average. New wage adjustment rules were to be decided in future negotiations. Price increases were to be absorbed immediately in the computation of inflation so as to avoid transmitting old inflation. The exchange rate was devalued 18% (1 *novo cruzado* equalled US$ 1) and was fixed for an indeterminate period. It has been claimed that the technicalities involved in the conversion of contracts including a new *tablita* had a perverse distributive effect in favour of debtors and to the detriment of creditors in the case of contracts with *ex post* price indexation clauses.

The orthodox side of the new plan included an emphasis in demand contraction though a tight monetary policy. Credit to the private sector was restricted and foreign debt conversion into equity suspended. High real interest rates would make rather expensive to speculate in physical stocks or foreign exchange. Fiscal adjustment would rely on rather ambitious targets for reduction of government current expenditures including wages, privatization of public-owned assets, among other radical intentions to control expenditure and increase revenue.

Collapse of the plan would be faster than in the case of its predecessors. The government lacked credibility and, with the more radical extinction of indexation rules, inflation would creep back much faster than in the previous stabilization plans. A measure of the initial lack of credibility and of its deepening was that the US dollar rate premium in the unofficial market rose from 70% in the beginning of the year to 200% in May. This was in spite of record trade surpluses exceeding US$ 20 billion on a 12-month basis in May and of US$ 16 billion in 1989 as a whole. Inflation fell to 3.6% in February but was already 6.1% in March. With no fiscal adjustment to speak of real interest rates were increased significantly. Contrary to what had been anticipated by the government, the plan, rather than being recessive through its deficient implementation, turned out to stimulate an expansion of the economy which would be reflected in the 3.2% growth of GDP in 1989.

Offers by the government to trade unions to compensate for real wage losses during the transitional period were deemed insufficient and a series of strikes marked a growing dissatisfaction with the government. After a general strike in mid-March 1989 the first official price readjustments started and monthly inflation reached 7.3%. In April and May indexation was reintroduced, prices were officially adjusted and a new wage policy with an implied inflation memory of only a month was approved by Congress.

As inflation accelerated and uncertainty increased there was a spike in imports as purchases were anticipated: imports increased from US$ 7.6 billion in the first half of 1989 to US$ 10.7 billion in the second half of the year. Government consumption increased by more than then 2% of GDP between 1989 and 1990 reflecting the generous pay rises for civil servants in the end of the Sarney era. Public prices lagged behind inflation in some cases by almost 50%. The last months of the government were dominated by the fear of hyperinflation. In March 1990 it was beyond 80%.

The Brazilian market remained rather closed in the 1980s. Brazilian share of world exports which was 0.9% in 1979 peaked at 1.4% in 1984 in the middle of the United States import boom and fell back to 1.1% in 1989. Between 1984 and 1989 manufactured exports hovered around 53-56% of total exports but semi-manufactured exports rose significantly from 11.1% to 16.8% of the total. In 1979, two thirds of Brazilian exports had been directed to Europe (EEC and EFTA, 32.9%), the United States (19.3%) and ALADI (14.7%). During the 1980s the shares of ALADI and of the rest of the world were eroded while that of the United States peaked in the mid-1980s at almost 30% and fell to 24.3% in 1989. Europe’s share remained roughly constant around 29-33% throughout the 1980s.

Even with quite a good trade performance it proved impossible to service the foreign debt as agreed in mid-1988. Deterioration of the balance of payments position after the beginning of 1989 with increased profit remittances and repatriation of foreign investment led to suspension of transfer of interest payments on the foreign debt. Deposits were made in domestic currency in accounts in the Brazilian Central Bank. To all purposes any permanent solution of the foreign debt was postponed for 1990 under a new administration. In the 1980s foreign direct investment had typically varied between US$ 1-2.7 billions yearly until 1988, with exception of the very low inflow in 1986. After

1988, as the crisis deepened, the inflow of FDI fell to reach less than US$ 0.1 billion in 1991.

The conjunction of a mediocre growth performance after 1980 with the continuous deterioration of the public sector financial position served as background for a growing willingness to reform the long standing economic strategy based on a strong State presence and significant protection of the domestic market that had prevailed at least since 1945.

Successive stabilization plans in the 1980s failed to deliver stabilization. Inflation proved persistent and accelerated from something around 2-3% a month in the beginning of the 1980s to more than 80% in early 1990. Growth performance was also very bad. GDP increased only 22.2% and manufacturing industry output only 8.3% while population increased 18.8%. Average gross fixed capital formation fell to about 18% in the middle of the decade compared to the 22-24% peaks of the 1970s and only recovered towards the end of the decade. But it was rather less efficient in creating additional productive capacity than in the earlier period because of high prices of capital goods due to protection, high costs of construction, postponement of public projects and the inducement high inflation provided to the purchase of real assets.

Financial deterioration of the State portrayed by the fall in public sector savings from 5.4% of GDP in 1981 to -4.7% of GDP in 1989 was coupled with a reduction in foreign savings from 4.4% of GDP to -0.2% of GDP and acted as a powerful constraint on investment capacity. Internal disequilibria were held responsible for the lack of growth rather than external disequilibrium. This contributed to some soul searching on what was to be the future role of the State and a limited effort to privatize public-owned assets started to take shape.

Financial weakness of the State imposed a less active role in the distribution of subsidies. This affected export subsidies which went beyond indirect tax restitutions which were dismantled after 1983 when they reached a peak of 33% of the value of manufactured exports. The slow dismantlement of the panoply of subsidies was accompanied after 1987 by a shift of traditionally autarchic trade policies and tariff protection was reduced from 57.5% (simple average) in 1987 to 32.4% in 1989. It is true that the initial reduction mainly involved water in the tariff but it had an important demonstration effect as it signalled that further reduction of protection was possible. This was also reflected in a shift of stances in relation to foreign economic policy. Rapprochement with Argentina in 1985 – retrospectively, the main achievement of Sarney's government – and participation in the Cairns coalition, which united many efficient agricultural producers who sought the dismantlement of protection in the developed economies, made easier a transition to a more positive agenda in economic diplomacy matters.

The long negotiations which preceded the launching of the Uruguay Round of multilateral trade negotiations of the General Agreement on Tariffs and Trade (GATT) in Punta del Este in September 1986 were marked by continuous divergences in relation to the inclusion of the new issues – services, intellectual property (TRIPS), investment and trade (TRIMS) and high technology products – and particularly of services. Opposition came from a G-10 coalition of developing countries in which Brazil and India played a prominent role. In Punta del Este the G-10 was defeated as the new themes were included in the negotiation agenda although there was some face saving compromise by placing services in a separate negotiation track. Brazilian policy after Punta del Este increasingly stressed the agricultural *demandeur* aspect in detriment of the purely defensive stance in relation to new themes. Brazil used the GATT's dispute settlement mechanism only sparingly before the 1980's. The incidence of consultations and panels involving Brazil increased significantly in the 1980's and by far the most important dispute concerned Brazilian complaints in relation to bilateral sanctions brandished by the United States based on allegations of Brazilian persistent breach of intellectual property commitments.

Deterioration of the economic scenario in the last year of Sarney's government underlined the shortcomings of policies adopted since the beginning of the 1980s with a mediocre growth performance being accompanied by the acceleration of inflation approaching hyperinflation conditions. Successive governments had shown their incapacity or unwillingness to deter the increased disequilibrium of public accounts. Brazil remained an outcast in the international financial community with the foreign debt question unresolved. Net real resource transfers abroad remained substantial.

The repeated failure of stabilization efforts in 1986-89 had important immediate costs. It entailed a cumulative learning process that helped to ingrain inflation. This contributed to make stabilization shocks progressively less comprehensive, less effective and of shorter life. The private sector became more proficient in anticipating what could be the government moves in future stabilization attempts. Efforts to seek protection from accelerating inflation by anticipating price increases contribute to accelerate inflation. In the longer term stabilization efforts including monetary reforms and complex legislation on the adjustment of contractual provisions created a large scope for judicial questioning of governmental actions that had important delayed fiscal implications after the mid-1980s.

With some help of hindsight it is not difficult to explain why the first direct presidential elections since 1960 gave the victory in 1989 to a rather obscure politician from a peripheral region – the Northeast – who based his campaign on the denunciation of the excesses of State intervention including those for the benefit a small caste of highly paid civil servants. That Collor de Mello, the new president, did not come from the Southeast, nor was linked to any of the main political parties that had taken shape since re-democratization in 1985, would have important future political and economic consequences. Victory came in the second round against Luis Inácio Lula da Silva, a trade union leader who had emerged in the bitter fights of organized labour against the military in the 1970s and early 1980s and a founder of the Partido dos Trabalhadores [Workers Party].

3. Further stabilization attempts, reforms and the Real Plan, 1990-1994

Collor took office amidst widespread expectations that some kind of radical stabilization policy would be implemented. In fact there were two further failed stabilization attempts in 1990 and 1991 – the so-called Collor I and Collor II programmes. An ambitious programme of structural reforms affecting the role of the State – and particularly the privatization of public assets – and envisaging a radical opening up of the economy started to be implemented. After the failure of Collor II, with the president facing increasing political difficulties economic policy became a damage limitation exercise under Marcílio Moreira. As the president's impeachment became unavoidable, a period of turmoil started lasting until May 1993 when Fernando Henrique Cardoso became Minister of Finance. In 1993-1994, the Real stabilization plan was successfully implemented and paved the way for Cardoso's victory – once again against Lula da Silva.

Failed stabilization attempts: Collor I and Collor II, 1990-91

In contrast with preceding heterodox stabilization attempts *Plano Brasil Novo* [New Brazil Plan], best known as plan Collor I, was widely expected to be implemented in the beginning of the new president's term of office given the marked deterioration of the economic position, especially the acceleration of monthly inflation beyond the 80% mark. Its inspiration was the Erhard Plan, adopted in Germany in 1948 to wipe out excessive savings in the hands of economic agents. This made possible to unfreeze prices without fear that savings would put pressure on prices in a situation of supply constraints.

The plan included a price and wage freeze with a commitment to adjust price and wages in such a way as to avoid transmitting the high inflation inherited from the past. Monetary reform involved a simple change in denomination of the currency from *cruzado novo* to *cruzeiro*. About 80% of total financial assets beyond a specific threshold were frozen for eighteen months in the form of deposits in the Central Bank earning "monetary correction" plus 6% a year. These deposits were to be freed over a period of one year. Government payments were exempted from freezing and it was possible to settle debts though the transfer of blocked deposits in the Central Bank.

Another pillar of the plan was to be a fiscal reform which would turn around an operational deficit of 8% of GDP into a surplus of 2% of GDP. While there was not much success in implementing a fiscal reform, the fiscal impact of the plan by, among other things, temporarily reducing interest on public debt was of around 5% of GDP.

In the first month of inflation which was not contaminated by past inflation, the rate was much beyond the less than 1% widely expected by analysts. In May the monthly inflation rate was back to 7.7% signaling defeat. By August it was almost 13% and approaching 20% in January 1991. Problems of all types undermined the plan. In spite of provisions which established a system of indexation preannouncements the government decided to skip its compromise in the first month. In fact operational problems involving the elaboration of a new official price index to be used by the authorities were never solved. The government adopted a threatening stance in relation to the civil service which often did not correspond to its concrete initiatives in the field of reform. This alienated segments of the government machinery which were essential for the implementation of its stabilization plan.

It was not without irony that a government which had strongly stressed its criticism towards public policies based on the discretionary choice of winners – for instance in relation to protectionist policies – should adopt such policies in relation to the release of deposits frozen by the stabilization plan. In the best tradition of rent-seeking policies special interests with political clout managed to extract their assets from clutches of Leviathan. The breach of property rights was selective. Monetary expansion related to exceptions was substantial and likely to have contributed to the plan's failure. Be it because of these ad hoc increases in liquidity or because of deeper reasons affecting the government's ability to have a clear picture about the pace of required remonetization the overall impact on liquidity did contribute to ease the return of inflation. Towards the last quarter of the year the defeat of still another stabilization attempt was there for all to see.

There were widespread criticisms of the plan. Some analysts concentrated on the appalling implementation. Others were more concerned with fundamentals. Some of these insisted that inflation was explained by variations in the means of payment and that the freezing of quasi money was not really relevant as a counter to inflation. Little was known in any case about the “safe” rate of remonetization which would be compatible with low inflation. The government in fact abstained from having an active monetary policy. Some commentators feared that by violating property rights in its move to freeze liquidity the government had unreasonably increased the risk of a run towards holding assets in foreign currency which had been until then been a clear distinction between the experience of Brazil and of other Latin American economies with a similar record of high inflation.

Stabilization measures were accompanied by a comprehensive reform programme. This included a reform of public administration envisaging a significant shrinking of the number of civil servants, a trade policy reform with the aim of opening up the Brazilian protected market, liberalization of foreign exchange policy, structural tax reform so as to sharply reduce exemptions and widespread tax expenditure. There was explicit intention of privatizing much of the rather large Brazilian public sector. The lasting contributions of the Collor government to the much needed structural reforms would prove to be its trade liberalization element and the beginning of a massive, successful and corruption-free privatization programme which was deepened after 1994.

1990 was a bad year for growth: GDP fell by almost 5%, comfortably breaking the previous record in modern Brazilian economic history of a 3.1% contraction in 1981. Agricultural output fell -3.7% reflecting a disastrous performance of crops. Gross fixed capital formation fell from a level above 26% of GDP in 1989 – a reflection of the acceleration of inflation – to 20.7%. The substantial inherited balance of trade was eroded during 1990. It was of US$11 billion as exports fell by almost 10% and imports increased more than 12% in spite of the steep fall in the level of activity as prices were reduced with the beginning of trade liberalization.

A new stabilization plan– called Collor II – was implemented in early 1991. With rather modest hindsight it seems a desperate affair. It has been termed as an attempt to delay apocalypse as the government faced problems to sell its debt without increasing interest rates and the financial position of the state of São Paulo was especially fragile. The government decided to bail out debtors through increased liquidity and try to double its bet. Most of the well known ingredients were there. There was a price freeze, including the exchange rate. There were no rules on price unfreezing: it was left at the government's discretion. Wages were converted by the 12-month average. A new *tablita* was introduced to convert debts based on the assumption that inflation would instantaneously fall to zero. As there was no monetary reform this made conversions – which clearly involved a discretionary reduction of the present value of credits – particularly vulnerable to future legal questioning. In an effort to break inflationary inertia there was an overhaul of indexation rules with old indices being substituted by a new, forward looking, one. There was an attempt to lengthen the maturity of internal debt through taxation. There was even an upbeat program of investments to counter recession.

The favourable effects were extremely short-lived. Monthly inflation was reduced from 20% to around 7% and was held there for three months then started to rise again. Real interest rates fell significantly then increased again. Wage increases helped a timid reduction in the speed of fall in the level of capacity. By May, Zélia Cardoso de Mello, Collor's first Minister of Finance, was on the way out after failing in her two shots against inflation, amidst a wave of press allegations of administrative misconduct and after having established a rather controversial public image. More was going to surface until the end of the following year and the president ended up by being ousted by an impeachment because of his improper conduct.

Interregum and turmoil, 1991-1993

Marcílio Moreira, the new minister, faced an extraordinarily difficult task because of both the unfavourable inheritance left by Cardoso de Mello and of the rapidly deteriorating political climate, with the president increasingly under pressure with accusations of corruption originating from his own family. The new minister interpreted his task as being to hold the fort amidst very bad conditions and concentrate in defusing expectations that the wave of macroeconomic shocks would continue. His tasks ahead were clear: to end the price freeze, to return the frozen Collor I deposits, to adjust misaligned public prices, slowly improve public accounts and keep inflation from getting totally out of control. The foreign debt question was also still not settled.

The government favourably surprised the markets by anticipating the release of the deposits frozen in March 1990. By October most non-public prices were unfrozen. The misalignment of public prices had been significantly cut by the end of the year. A modest foreign exchange devaluation of 14% was undertaken and the exchange rate overvaluation since the beginning of the government was partly corrected. Real interest rates increased steadily from the beginning of the year to reach more than 30% on an yearly basis at the end of the year. Substantial primary government surpluses were maintained: 3% in 1991 and 2.4% in 1992. To show its commitment to trade liberalization the government anticipated the liberalization time schedule of 1992 and 1993.

There was some recovery in the level of economic activity in 1991. After a contraction of almost 5% in 1990 GDP increased 1% in 1991. In 1992 GDP contracted again 0.5%. In spite of this dismal performance gross fixed capital formation fell only to 18-19% of GDP. In 1991 the trade balance surplus remained at the same level of 1990 at around US$ billion. This was increased in 1992 to US$ 15.5 million as export performance improved. During 1992, especially in the first semester, the level of foreign reserves increased significantly: it was of about US$ 9 billion at the end of 1991, doubled in the first semester and remained at the same level until the end of the year. This, besides reflecting the improvement in trade data, resulted from the start of a recovery in inflows of foreign direct investment and transactions related to settlement of arrears of interest payments on the foreign debt.

After the infringement of property rights entailed by the Plan Collor I there was a reduction in the net public debt-GDP ratio from around 50 % where it had hovered since 1985 (peak of 55.8% in 1988) to 33% in 1993. The ratio had increased significantly in the early 1980s to reach the 50% plateau in 1984. This massive increase in the early 1980s resulted from the successive foreign exchange devaluations and from Federal government bail out of the private sector which was heavily indebted in foreign currency when the crisis stroke.

A Brazilian proposal on the foreign debt had been unsuccessfully presented in October 1990. It was based in the conversion of foreign debt into unguaranteed 45-year bonds together with a bridge loan to cover arrear payments. Foreign debt owned by the private sector – only 10% of the total -- would be excluded from the agreement and related financial flows free from government control. A stop gap measure had been introduced in the beginning of 1991 as the government started to pay unilaterally 30% of due interest payments on outstanding debt and freed the big state companies to settle their debts independently. In April 1991 an agreement regulated the payment of arrears: 25% in cash in a few months, with the rest converted into US$ 7.1 billion of new bonds and with some options including fixed interest rates.

By July 1992 an agreement had been reached in principle on a more permanent settlement of the Brazilian foreign debt. After approval by the Senate the Brazilian agreement was presented to creditors and new contracts duly signed in November 1993. Negotiations did not involve the IMF. This may be seen as a settlement corresponding to the period of Brazilian borrowing which started in 1966-67 and ended in 1982 in the same way as the permanent settlement of 1943 had settled the outstanding claims related to Brazilian borrowing between 1824 and 1931.

The Brazilian agreement followed the lines of other Brady agreement entered by debtors since the late 1980s. These agreements involved different combinations of interest payments reduction and principal reduction in a way not essentially dissimilar from what had happened in 1943. Following the Brady structure, principal of the new debt was guaranteed by United States bonds as collaterals and interest payments were backed by a rolling guarantee. The new 30-year discount bonds carried LIBOR plus 13/16% as the rate of interest and involved a reduction of 35% of the original principal. There was some choice for creditors but there were ceilings constraining certain types of conversion offered so not all first options could be accommodated and creditors were redirected to less demanded types of converted bonds. The total issue of new bonds was US$ 43.7 billion. Debt reduction achieved in the Brazilian negotiation was lower than that obtained in several other Latin American Brady negotiations, but Brazil entered into lower guarantee commitments than other debtors. Negotiations on a settlement with official creditors in the Club of Paris were concluded in 1993 and involved US$ 13.5 billion.

Following Collor's impeachment in the end of 1992 its vice-president, Itamar Franco, took office. As a president Franco confirmed all fears about his mercurial temperament from the beginning of his term of office. There were doubts about interest rate policy, price control and public prices, imprudent comments on public debt default, presidential resistance to privatization, a fast rotation of ministers and public venting of disagreement with ministers and other members of his administration. In the light of the incredible dance of chairs in the Ministry of Finance between October 1992 and March 1993, when Brazil had three different ministers in a row, the choice of Fernando Henrique Cardoso may be seen as the surprisingly successful outcome of a random process. Under Cardoso, the Real plan would be successfully implemented and, benefiting with experience acquired in the successive failures since 1986, would reduce yearly inflation to the one digit zone on a sustained basis.

The Real Plan, 1993-1994

Past experience underlined some of the limitations of previous heterodox attempts to cope with inflation in Brazil. Sustainability of initial success in controlling inflation had been repeatedly undermined by the lack of a credible fiscal adjustment stance. The difficulty of assuring that the transition from the high inflation regime to the low inflation regime would not entail distortion of relative prices suggested that a way out of the package which included sudden monetary reform and a price freeze had to be found. Stabilization strategy was designed in the second half of 1993. In July another monetary reform of the cut-the-zeros type was undertaken and *cruzados novos* were transformed into *cruzeiros reais* at the rate of one thousand to one.

The Real Plan was implemented in three stages. There was a fiscal element negotiated with Congress. This was followed by the creation of new unit of account which existed side by side with the “old” currency, the *cruzeiro real.* Finally, a monetary reform substituted the URV by the “new” currency, the *real*. The plan was implemented without the blessing of the International Monetary Fund which remained unconvinced of the possibility of its success. It was a further irony in the troubled history of Brazilian relations with the institution.

From mid-1993 there was some effort, through a *Programa de Ação Imediata* [Program of Immediate Action], to focus on fiscal imbalances. The breakthrough came in the beginning of 1994 with the significant fiscal adjustment introduced by the *Fundo Social de Emergência* [Emergency Social Fund], through a suspension for two years of legislation on earmarked revenues. There was also increased taxation of financial intermediaries. The government acknowledged that a structural fiscal adjustment would have to include an overhaul of the tax system, reform of social security, recognition of liabilities arising from past stabilization plans, definition of limits to the fiscal imbalance of states and municipalities, commitment by all three level of governments on assuring equilibrium of their accounts on the longer term. But all this had to wait for windows of opportunity in the future and would depend on the government’s real commitment to reform. Substantial primary government surpluses were maintained: 2.6% in 1993 and 5.1% in 1992.

The *Unidade Real de Valor* [Real Unit of Value] – URV – was created as bridge between the doomed *cruzeiro real* and the new *real*. Between March and June 1994 the URV and the *cruzeiro real* coexisted as units of account. Wages were converted into URVs taking into account their real value in the last four months as this was the inherited indexation horizon. Many conversions were left to free negotiation between economic agents with the government having more interference in oligopolized prices. The objective was to get relative prices “right” during the transition period and then implement monetary reform. The URV value was corrected daily. Inflation in *cruzeiros reais* was very high – 40-50%

monthly – in the first half of 1994. After July, inflation in *reais* fell below 10% in July and below 1% in December.

Monetary reform in the beginning of July 1994 finally introduced the *real* with the value of one URV and 2,750 *cruzeiros reais*. At the time of its introduction the real was also equal to one United States dollar. Stability was to be guaranteed by a triple "anchor": the exchange rate backed by a substantial foreign reserve position (US$ 40 billion in mid-1994); the commitment to control fiscal deficit through the *Fundo Social de Emergência* arrangement; and a clearly stated intention to limit emissions of new currency.

In spite of Cardoso's substitution as Minister of Finance in March, as he became a presidential candidate, the implementation of the Real plan continued without major problems until the end of 1994. In the second half of 1994 there were signs of a repetition of what had happened following the *Cruzado* Plan as demand for consumer durables overheated, especially in the case of motor cars. The government answered by lowering the tariff on motor car imports. As the consequences of the Mexican crisis of the end of 1994 started to affect Brazil this move was strongly criticized, especially by those against trade liberalization. These criticisms tend to disregard that before December the menace that was being faced by the Real plan was that the level of imports was too low rather than too high. Imports were important to discipline domestic prices and an excessively large trade surplus would put monetary policy under undue strain.

Both 1993 and 1994 were very good years from the point of view of growth. GDP growth rates of 4.9% and 5.8% were the highest since 1986. Gross fixed capital formation rose slightly to reach 20.8% of GDP in 1994. As imports increased in 1993 with trade liberalization and the recovery in the level of economic activity, the trade surplus fell by about US$ 2 billion to US$ 13 billion. In 1994 it was to fall further to US$ 10 billion as growth of imports outpaced that of exports in spite of an improvement in the terms of trade of more than 14%. Recovery in the inflow of foreign direct gained strength in 1993-1994, especially after Cardoso became a minister: US$ 6.2 billion in 1963 and US$ 8.1 billion in 1994.

Privatization and trade liberalization

Of the wide range of reforms mentioned by Collor at the beginning of his government only two were really important before the Real Plan in 1993-1994 and the two terms of office of Fernando Henrique Cardoso between 1995 and 2002. For all his denunciation of the wrongs of government and abuses by the civil service the administrative reform implemented in 1990 was little short of a disaster and its shortcomings contributed to the failure of his stabilization efforts. But both the privatization of public assets and the opening up of the Brazilian economy were major modernizing reforms which gained momentum after 1990.

Government-controlled assets included enterprises in a wide range of activities. There were mining and industrial firms producing industrial and agricultural inputs (iron ore, steel, petrochemicals, fertilizers). Provision of many public services was also state-controlled: telecommunications, electricity services (from generation to distribution). There was an important presence of the state in commercial banking. Oil was a state monopoly from extraction to refining. State monopoly in the provision of most public services meant that regulatory institutions had all been captured by providers of services and privatization of such “natural monopolies” would be more complex than that affecting more competitive sectors. Privatization would require the establishment, almost from scratch, of a more effective regulatory framework.

There had been some timid privatization initiatives in the 1980s. But besides lip service they were generally related to the devolution to the private sector of assets of bankrupt firms which had been taken over by the government. Privatization in the 1990s naturally started with those enterprises in competitive sectors and sales amounting to some US$ 8.6 billion mostly affected steel and petrochemical producers. There was an emblematic importance in such initial efforts as the first important public-owned modern industrial enterprise, the *Companhia Siderúrgica Nacional,* founded by Vargas back in 1940 was successfully privatized. It must be placed on the record that in spite of being undertaken by a government whose record was fundamentally marred by serious findings of improper conduct, the privatization process of such assets was never questioned in spite of the whole complex process involving evaluation, auctions and minotity stakes.

In 1990, the new government decided to overhaul the traditional trade regime based on high protection of the domestic market. Non-tariff barriers were entirely removed, in particular the import prohibitions which accompanied the import licensing system that Brazil had used almost continuously since 1947. Under GATT's article XVIII:B it had been possible to limit imports invoking balance of payments difficulties. A unilateral tariff reduction schedule was announced in early 1991: the average tariff was to be reduced from 32.2% in 1990 to 14.2% in the beginning of 1994. In early 1992 this schedule was anticipated by six months so that by mid-1993 the final target had been reached.

Difficulties emerged in successive GATT meetings until 1993 mainly concerning the so-called new issues – intellectual property, investment and services – and agricultural liberalization with the European Community ending up by convincing the United States to give up its initially radical liberalization programme. In the final agreements in the World Trade Organization agricultural liberalization undertakings were to include modest advances on reduction in support to domestic production, improvement of market access and reduction of export subsidies. The Multi Fibre Arrangement was to be dismantled in ten years. A new agreement on services included a set of basic obligations by all signatories, national undertakings specifying additional liberalization schedules, and a set of annexes dealing with exceptions and specific sectors. Disciplines and dispute settlement related to intellectual property were tightened. The possibility of cross-retaliation involving goods, services and intellectual property was created. Rules on investment policies ruled out policies based on export performance which had been so important in Brazil.

The final phase of the negotiations started in Geneva in 1993 and culminated in Marrakesh. The overall average tariff cut on industrial products was of 32%: 38% in developed economies and 25% in developing economies. All Brazilian tariffs were bound: on industrial products at 35% and on some agricultural products at 55%. Before the Uruguay Round only 23% of Brazilian imports corresponded to bound tariff lines and only 6% of the lines were bound.

The most important development of Brazilian commercial policy in the 1990s was the creation of Mercosul, *Mercado Comum do Sul* [Southern Common Market] established by the Treaty of Assunción on March 1991 to include Argentina, Brazil, Paraguay and Uruguay. This was a development of Brazil's *rapprochement* with Argentina since the mid-1980s. The initial agreement was that there would be a certain number of exceptions to a zero tariff between members of the common market: for Brazil it affected 324 items. By the end of 1994 it was planned that these will have disappeared with some special treatment of the smaller members. This understanding was revised as a regime of final adjustment to the customs union was introduced in early 1995 to cope with an extension of exceptions to free intra-Mercosur trade. As a common market Mercosur had to adopt a unified external tariff. This was not simple as the interests of Brazil, a significant producer of capital goods and informatics products, conflicted with those of other members. While Brazil wished to maintain a high tariff on such products the other members wished to maintain low investment costs.

Negotiations in late 1994 led to the adoption of a common external tariff varying between zero and 20% in steps of two percentage points. But there were three exceptions lists: products included in a basic national list, capital goods and informatics and telecommunications products. Brazil's basic initial list originally included 175 items. Brazil's exceptions for capital goods – some 900 items – would converge (from above) to a CET rate of 14% by 2001. Brazil's exceptions for informatics and telecommunications products – some 200 items – would converge to a CET rate of 16% in 2006. Another important event related to regional trade integration besides Mercosur was that in December 1994 it was agreed in Miami that negotiations should open on a free trade area of the Americas.

In the early 1990s, Brazilian trade with Argentina rose spectacularly, especially Brazilian exports. The share of Argentina in Brazilian exports increased from 2% in 1990 to 9.5% in 1994 and the share of imports in total Brazilian imports from 6.8% to 10.9%. There were no other important changes in the direction of Brazil's foreign trade.

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The period between 1980 and 1994 should be seen as a transitional period following a severe balance of payments and debt crisis in the beginning of the 1980s. This resulted in a deep financial crisis affecting all levels of public finance in Brazil. With high inflation becoming chronic and accelerating there were repeated attempts to stabilize first using orthodox, then more heterodox policies. But the fiscal element was always insufficiently developed and a long sequence of attempts would fail. In sharp contrast with the past the economy grew very little, barely enough to hold a stagnant GDP per capita.

The final years of the transitional period culminated in the Real plan which was successful in taming inflation and in its first two years had raised hopes that the growth path had been rediscovered. The victory of Fernando Henrique Cardoso was a direct result of successful stabilization resulting from the Real plan. The way ahead was to implement a comprehensive program of reforms that would make possible a return to steady and significant economic growth.

Table 2 Brazil, main economic variables, selected years, 1980-2003

	1980	1986	1990	1994	1998	1999	2002	2003
Resident population*, million	121.6	137.7	147.6	156.8	165.7	167.9	174.6	176.9
GDP (1980=100)	100	114.5	117.1	130.7	144.6	145.7	157.0	156.7####
GDP per capita (1980=100)	100	100.8	95.9	100.8	105.5	104.9	108.7	107.1
Gross fixed capital formation as % of GDP	23.6	20.0	20.7	20.7	19.7	18.9	18.3	18.0
GDP deflator (1980=1)	1	244.5	$2.1*10^{6}$	$5.6*10^{10}$	$13.2*10^{10}$	$14*10^{10}$	$17.9*10^{10}$	$20.2*10^{10}$
GDP deflator yearly rate, %	90.4	149.2	2595.6	2240.2	4.8	4.7	10.2	12.8[7]
Real exchange rate**, 1980=100	100	106.3	64.6	49.9	49.5	67.4	73.4	62.2
Exports, US$ billion	20.1	22.3	31.4	43.5	51.2	48.0	60.4	73.1
Imports, US$ billion	23.0	14.0	20.7	33.1	57.7	49.3	47.2	48.3
Current account, US$ billion	-12.8	-5.3	-3.8	-1.7	-33.6	-25.1	-7.7	4.1
Foreign direct investment inflow, US$ billion***	1.5	0.2	0.3	1.9	23.3	27.6	18.8	12.9
Total foreign debt, US$ billion	64.3	111.2	123.4	148.4	241.6	241.5	227.7	235.4
Reserves#, US$ billion	6.9	6.8	10.0	38.8	44.6	36.3	37.8	49.3
Terms of trade (1980=100)	100	89.2	90.8	112.2	129.6	112.5	114.0	112.5
Primary surplus, % GDP	n.a.	1.6	2.7	5.2	0	3.2	3.9	4.4
Total public debt-GDP ratio, %	n.a.	49.0	36.7	30.0	41.7	48.7	55.5	58.7
Prime interest rate## USA, %	15.3	8.3	10.0	7.1	8.3	8.0	4.7	4.1
SELIC interest rate###, %	90.1	71.5	1412	1383	29.5	26.3	19.1	23.4

* Mid-year.

** The higher the more devalued is the Brazilian currency. Domestic currency-US dollar exchange rate. Brazilian and US wholesale prices.

*** Net foreign investment, including reinvestment.

Central Bank international liquidity concept.

Average over days in year.

Yearly nominal interest rates on Federal government paper, after 1990 the SELIC rate.

####Provisional.

Sources: IBGE, Brazilian Central Bank, International Monetary Fund. The evolution of the real minimum wage was nor presented as there many methodological problems involved. See IBGE, *Estatísticas do Século XX*, chapter on earnings and prices.

Bibliographical essay

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Departamento de Economia PUC-Rio
Pontifícia Universidade Católica do Rio de Janeiro
Rua Marques de Sâo Vicente 225 - Rio de Janeiro 22453-900, RJ
Tel.(21) 31141078 Fax (21) 31141084
www.econ.puc-rio.br
flavia@econ.puc-rio.br