Inflation and instability: Brazil's Lost Decade and Cardoso's Response

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In the 1990's Brazil suffered a turbulent period of hyperinflation. In this paper, Isabella Di Paolo provides an intriguing explanation of the policies which led to Brazil's crisis, and an evaluation of how the reforms of President Cardoso helped set Brazil on its current growth path.

1. Introduction

The famous joke goes: "Brazil is, and always will be, the Land of the Future". Long struggling to achieve long-term, sustainable growth - despite its abundant resources and immense potential - Brazil has recently seen considerable improvements in both its economic performance and poverty-reduction strategies. The recent consumer boom, experienced as millions filled middle-class ranks, makes it difficult to imagine that just two decades ago inflation was taking over everyday life.1 It was the centre of all policy concerns, caused hour-long queues in front of supermarkets and crushed innumerable hopes and dreams. Today, a decade-long struggle for macroeconomic stability has rendered the daily reality of twenty years ago completely unimaginable to those who have only known recent prosperity (Leitão, 2011).

After an initial taming of the 'Inflation Monster' via the Plano Real, Brazilian policy-makers have demonstrated continuity in their will to reform, as exemplified by the continued adoption of the Inflation Targeting Mechanism and Law of Fiscal Responsibility introduced at the end of the Cardoso administration. As Brazil begins to display difficulties in continuing down the path of rapid growth, (Financial Times, 2013) it is more important than ever to remember the recent past, and to consider the long way the country has come.

The ups and downs in Brazil's inflationary history can help illustrate the importance of monetary policy for the macroeconomic stability and the long-term prospects of any economy. In Brazil, the long struggle for a stable currency was a painful process, which, with the legacy of the Plano Real, appears to have finally come to an end. Although monetary policy is no magic formula for growth, it has certainly helped construct the solid base on which Brazil was able to take firm steps towards economic and social progress (Leitão, 2011).

This essay will attempt to outline the main characteristics of the inflationary process that hit the Brazilian economy towards the end of the 20th century. In a second part, it will briefly describe the Plano Real, whose long-term effects have vastly been debated. Finally, it will attempt to evaluate if Cardoso's stabilization plan can be considered successful, and emphasise the importance of continuity in economic policy.

Hyperinflation in Brazil: an explanation

In 1989, at the wake of its first democratic presidential elections, Brazil found itself immersed in a profound crisis. High inflation was largely accepted as an inevitable characteristic of the economy: "as old as Brazil itself", it had even financed independence (Leitão, 2011). The young republic faced the difficult task of finding a rapid solution to an immemorial issue: the state-led development project that had begun in the 1930s and culminated with military rule2 had contributed to a soaring public debt and chronic inflation (Brainard &Martinez-Diaz, 2009). By focusing on import-substitution-industrialisation as a way to ensure the country's autonomy, the Brazilian administration had succumbed to a populist approach to economics, 3 which, despite the 'Miracle Growth' years (1968-1974), proved to be unsustainable. In a 2005 report, the World Bank emphasised the need for a stable investment climate in order to engender sustainable growth. In an extensive analysis of the Brazilian case, the growth boom beginning at the end of the 1960s was deemed not miraculous, but simply unsustainable. The closing off to international competition reduced all incentives for domestic, state-sponsored firms: these fell behind in international standards for efficiency and produced lower-quality goods with higher prices. For the military government, the solution was continuing to finance its "development project" through monetary creation. A serious consequence of these import-substitution, protectionist years was not only debt and macroeconomic instability, but also the loss of credibility of the government's commitment to reform (World Development Report, 2005).

This chronically inflationary context - perpetuated by the rigid behaviour of economic agents and the monetary system's "built-in bias towards the expansion of the money supply"4 (Baer, 2005) - was further complicated by external shocks. These included the quintupling of oil prices in 1973-74 and their doubling in 1979; as well as a steep rise of world interest rates in the early 1980s, and the subsequent 1982 debt crisis. As a net oil importer, Brazil attempted to respond to the worsening of it's terms of trade by relying on foreign lending and on printing money to finance government spending (Edwards, 2005). Despite initial success, World Bank economists Nissan and Kiguel (1995) point out that, "Brazil traded short-term gains of growth for a possible long-term stagnation. ... The economy became captive of its own inflation-mitigation technology".

Moreover, after the traumatic 1982 debt crisis, inflation spun rapidly out of control. In 1990 alone, it amounted to 2939% (Sachs & Zini, 1996). This disastrous situation was but the final stage of a "long process of high and increasing rates of inflation, in which a final explosion was all but unavoidable" (Kiguel and Liviatan, 1995, p.369).

The economy had become so accustomed to working under extreme inflationary conditions, that it became particularly difficult to put a sharp end to the process. What ensued was the dramatic stagflation of 1987 – 1993 (Ter-Minassian, 2012). As high and volatile inflation rates damaged economic performance, Brazil's poorest were hit the hardest (Singh et al., 2005). It has, in fact, been said that inflation is the "most regressive tax there is"(Luis Alberto Moreno; 2011, p. 41). In what was already one of the world's most unequal countries, poverty peaked at around 42% in 1994, just as Cardoso was taking office (Clements, 1997).

Cardoso and The Plano Real

The Plano Real was introduced in 1994 by the then Finance Minister - and shortly thereafter President - Fernando Henrique Cardoso, famous sociologist and dependency theorist. A few months after taking office, Cardoso's team led by economist Edmar Bacha, presented a new stabilisation plan that sought to avoid previous weaknesses. Unsuccessful attempts that had rapidly followed one another had greatly undermined the political credibility of the responsible administration. These were, in chronological order: Plano Cruzado (March 1986); Plano Cruzado II (November 1986); Plano Bresser (April 1987); Plano Verão (January 1989) and Plano Collor (March 1990).

Cardoso found it politically wise to distance himself from failed attempts that had relied extensively on the use of price and wage freezes, which had culminated in the largely criticised freeze of savings accounts during the Collor Plan. Such measures had proven to only have temporary effects, as they engendered political pressures from affected business interests, and had led to shortages, black markets and economic distortions. In fact, Brazilian inflation has been analysed as hiding an underlying collective action problem: because of a unique set of financial regulations, influential groups such as bankers and upper-income investors were able to reap economic benefits from rising prices, making it difficult for governments to pursue a coherent policy response (Armijo, 1996).

Cardoso's program therefore represented a novel attempt to break inflationary inertia without using wage and price controls: it involved currency reform, broad stabilization of the exchange rate, and a decisive de-indexation of the economy (Ter-Minassian, 2012).

Most importantly, learning from the failures of his predecessors, Cardoso attempted to address inertial and self-perpetuating aspects of Brazilian inflation, while strengthening fiscal accounts through budgetary austerity.

In the first phase, beginning in January 1994, budgetary controls were enhanced through emergency deficit-cutting measures. Wages, prices, and taxes were then re-dominated in a new unit of account, the URV (Unit of Real Value). Though the URV was a virtual currency, the government encouraged its use on the part of private economic agents - hoping that stable prices would decrease people's inflationary expectations - although transactions continued to occur in Cruzeiros.5 On July 1st, a new currency, the Real, was introduced, and initially pegged to the USD on a nearly one-to-one fixed rate. All URV were to be converted one-for-one into Real prices: one Real equalled 2750 old Cruzeiros Reais, and inflation dropped from the Cruzeiro rate averaging 50.7% per month to around 2% per month (Sachs, 1996).

Moreover, the Plano Real was presented as a comprehensive effort seeking to progressively transform the country's long-term growth prospects. For this purpose it included major structural reforms, many of which were later delayed.6 It mainly featured an increased emphasis on privatisation, on trade liberalisation, and on a reversal of the often inefficient centralising tendencies inherited from colonial rule (Kiguel & Liviatan, 1992). Brazil went from 'isolated giant' pursuing state-led growth, to privatization's 'poster child' in little over a decade.

Moreover, the shifting of responsibilities from federal to state governments, with an emphasis on state autonomy and singularity – particularly relevant in a gigantic country with immense regional disparities – was accompanied by a drive for anti-corruption and pro-transparency measures that culminated in the Fiscal Responsibility Law of 2000 (Ter-Minassian, 2012). Despite the dramatic, though brief, crisis at the turn of the century, what emerged was the image of a 'New Brazil': one that was tackling problems rather than ignoring them, and that had undergone a profound renovation of its political class. This culminated with the 2002 election of a working-class trade union leader Lula who, despite initial concerns, became one of the country's most popular, pragmatic and internationally respected presidents (Edwards, 2010).

The Plano Real: an Evaluation

As can be observed in Figure 1, the Real Plan was initially very successful, with monthly inflation declining from as high as 46.6% in June 1994 to 1.5% two months later (Sáinz & Calcagno, 1999).

	1994	1995	1996	1997	1998	1999
January	42.2	1.4	1.8	1.6	0.9	1.1
February	42.4	1.2	0.8	0.4	0.0	4.4
March	44.8	1.8	0.2	1.2	0.2	2.0
April	42.5	2.3	0.7	0.6	−0.1	0.0
May	41.0	0.4	1.7	0.3	0.2	−0.3
June	46.6	2.6	1.2	0.7	0.3	1.0
July	24.7	2.2	1.1	0.1	−0.4	1.6
August	3.3	1.3	0.0	0.0	−0.2	1.4
September	1.5	−1.1	0.1	0.6	0.0	1.5
October	2.5	0.2	0.2	0.3	0.0	1.9
November	2.5	1.3	0.3	0.8	−0.2	2.5
December	0.6	0.3	0.9	0.7	1.1	1.2

Fig. 1 – Monthly Inflation Rates (1990 – 1999). Source: Edmund Amann, Werner Baer, 2005

As shown in Fig. 2, the sharp decline in inflation experienced from 1995 onwards was accompanied by a sharp decline in poverty rates and a stable, though moderate, resumption of Real GDP growth.7 Economic growth resumed, as stable prices engendered a consumption boom: it was the birth of Brazil's "shopping economy" (Financial Times, 2013).

	1980-1989 average	1990-94 average	1995-98 average	1999-2002 average	2003-08 average	2009	2010	2011
Real GDP growth rate	1.9	1.3	2.5	2.1	4.2	-0.3	7.5	2.7
Real GDP per capita growth rate	0.9	-0.2	0.7	0.4	3.0	-2.0	6.0	n.a.
Consumer price inflation	431.7	1321.3	9.7	8.8	6.1	4.3	5.9	6.5
Unemployment rate	n.a.	7.0	8.1	10.1	9.4	9.1	6.7	6.0
Current account balance (as percent of GDP)	-2.0	0	-2.7	-3.5	0.6	-1.5	-2.2	-2.1
International reserves (e.o.p. ,US$ billions)	9.7	38.8	44.6	37.8	193.8	238.5	288.6	352.1
External debt (e.o.p. , as percent of GDP)	27.8	26.3	26.5	41.8	12.1	12.6	12.3	11.9
Poverty rate	41.2	42.3	34.8	34.9	29.0	22.6	21.4	n.a.
Gini coefficient	0.60	0.60	0.60	0.59	0.57	0.55	0.55	0.54

Fig. 2 – Main Economic and Social Indicators in Brazil (1980 – 2011). Source: Inter-American Development Bank, 2012

The effect of lower inflation on real incomes was notable. Given that the poor and lower-middle class had previously enjoyed limited access to protective mechanisms against the adverse effects of inflation - such as interest-bearing checking accounts and purchases of goods on credit - newly-acquired price stability undoubtedly led to asymmetric gains. With the drop in inflation, low-income groups saw a greater relative increase in their real incomes: some speak of a one-time increase as high as 9% between June 1994 and September 1995. According to a 1997 IMF report, informal sector workers saw their incomes rise by 38.4%, considerably higher than the 18.7% increase experienced by those in the formal sector (Clements, 1997).

Meanwhile, the country appeared to successfully resist contagion from Mexico's Tequila Crisis of 1994. According to Luis Alberto Moreno, president of the Inter-American Development Bank, the macroeconomic adjustment programs of the early 1990s - as well as the rise in commodity prices - are essential in understanding the economic recovery that followed, especially from 2002 onwards (Moreno, 2011).

However, the country proved to still be very vulnerable to external shocks: successive financial turbulences soon put the Real to a test, as a vicious cycle of devaluation, capital flight and debt defaults hit the South American continent (Moreno, 2011).

As previously mentioned, the stability in prices greatly benefitted lower income groups, generating a consumption boom.8 However, their increased indebtedness exposed them to the negative impact of the higher interest rates used by the government to defend its international position (Baer, 2005). The rise in nonperforming loans put a considerable strain on the banking system. Moreover, the pegging of the currency to the USD resulted in overvaluation, encouraged speculation, reduced competitiveness in exports, and generated a bloated trade deficit. With the Asian crisis of 1997 and the Russian crisis in 1998, there was increasing preoccupation about a possible Brazilian collapse.

In response to these fears, in November 1998 the IMF, World Bank and the US government issued a USD 41.5 billion bailout. Once the exchange rate was allowed to float freely, a massive devaluation ensued (Baer, 2005). Despite considerable difficulties, a combination of higher taxes and expenditure cuts resulted in a primary surplus of 3.8%, substantially above the IMF target (Baer, 2005).

The overall balance of the Plan Real years therefore appears to be positive. According to Edwards, "Cardoso… pulled it off. He avoided a new meltdown of the Brazilian economy, stabilized the currency, and prepared the basis for what could be an economic take off" (Edwards, 2010, p.209).

With Lula's election in 2002, continuity in the control of inflation has been one of the main achievements of the Worker's Party administration. In Figure 3, we can observe how the sharp decline in prices achieved in 1994-1995 was followed by continued efforts to control inflation, through the Inflation Targeting Mechanism introduced in July 1999 (Minella et al., 2003).

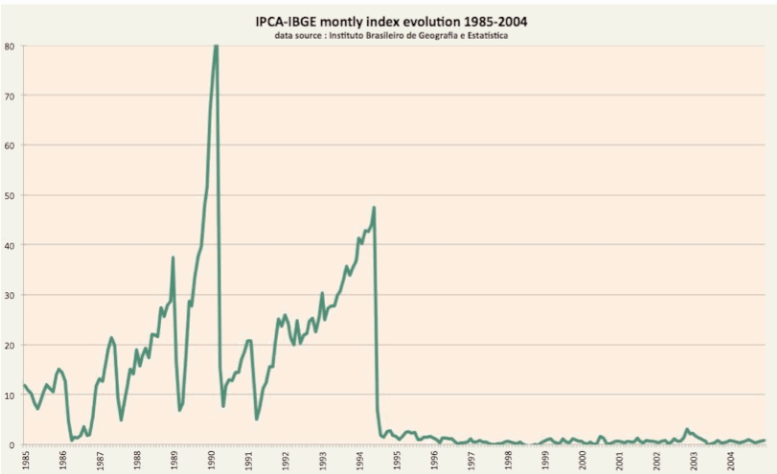

Fig. 3: Consumer Price Index in Brazil (1985-2004). Source: Instituto Brasileiro de Geografia e Estatística.

Lula soon distanced himself from previous positions - having for years been one of the main critics of the Cardoso administration - and demonstrated a rapid understanding of inflation's asymmetrical impact. In an inflationary environment, it becomes difficult for consumer credit to develop, leaving the poor to live on a day-to-day basis in a strictly cash economy. Their small businesses face great difficulties, and they have limited access to housing because of inflating mortgages. It becomes virtually impossible to have any form of long-term vision. Lula's inflation-controlling policy was accompanied by considerable poverty-reduction and hunger-eradication efforts, particularly in the poorest North-Eastern regions.

As we can observe in Fig. 4, the decline in extreme poverty rates has been both impressive and continuous since the early 1990s, reaching an all-time low in 2006.

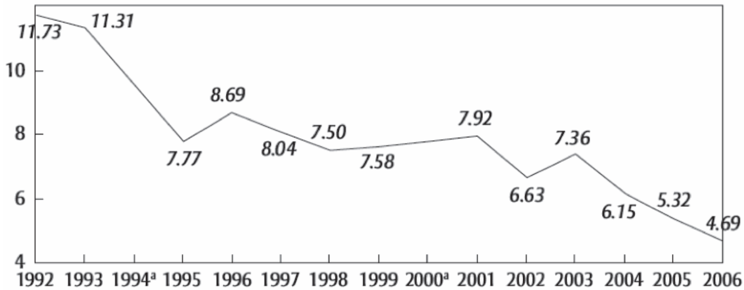

Fig. 4. Evolution of Extreme Poverty in Brazil (1992 – 2006). Source: Brainard, Martinez-Diaz

This was accompanied by a reduction in the country's Gini coefficient from the peak of 0.60 in 1993, to 0.56 in little over a decade (Brainard & Martinez-Diaz, 2009). This level of inequality, however, remains extremely high, especially if compared to the 0.30-0.34 levels observed in Western Europe. Persisting inequality in educational achievement and access to basic services underlies an unequal access to economic opportunities. Considerable challenges remain in terms of designing more effective and well-targeted poverty-reduction strategies addressing structural issues.

Nonetheless, Brazil has undeniably made important steps in the right direction, as was well illustrated by the passage from supermarket-dashes during hyper-inflationary years to the 2003 creation of Bolsa Familia, which allowed an estimated 20 million people's "graduation" from poverty (Brainard & Martinez-Diaz, 2009). This achievement was rendered possible by the economic stability acquired with necessary, albeit painful, stability-seeking reforms inherited from previous governments. If Cardoso's main achievement was currency stabilisation, Lula's was its redistribution (Financial Times, 2013). When greeting the new century, Brazil had finally learned the importance of macroeconomic fundamentals for achieving long-lasting growth (Brainard & Martinez-Diaz, 2009).

Brazil's long struggle against inflation demonstrated that achieving stability is a complex and protracted process, and that there is no such thing as 'easy growth'. It also showed that governments need not to succumb to populism in order to eradicate social injustice, and that poverty-reduction efforts can accompany an austere economic policy.

Sound Monetary Policy as a Prerequisite for Long-term Growth

If in classical analyses, the origins of hyperinflations are usually external, and the policies required to stop them are quite straightforward (Edwards, 2010). In more recent cases, such as the Brazilian one, rapid price increases were but the final stage of a deteriorating process lasting several decades. Pursuing a coherent policy response was rendered even more complex by the costly necessity of demonstrating a credible regime change.

At the outset of the Plano Real, the gradual introduction of a new currency on the part of a recently elected, technocratic government was perceived as a strong commitment to long-lasting reform. This enabled the government, despite some ups and downs, to begin to address the structural changes that had been constraining the economy for decades. Today, macroeconomic stability constitutes the solid base from which Brazil can continue to face complex structural issues. Challenges include increasing productivity, ameliorating infrastructure, encouraging innovation, and reducing the painful legacy of inequality and violence (Moreno, 2011). However, the long-term view recently displayed by political leaders appears to have left Brazil in an unprecedented favourable position to break away from its long history of economic frustrations.

The future is not all bright, however, as signs of an economic slow-down are a worrying reminder of the reforms that have long been postponed. However, twenty years onwards, the 'inflationary monster' has, at least for the moment, been tamed. Meanwhile, Brazil has become a more socially equitable, stable, and democratic economy - something that not all the other 'Brics' can claim.

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