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## The Brazilian Experience With Economic Policy Reforms and Prospects for the Future

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*Fernando de Holanda Barbosa*

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# THE BRAZILIAN EXPERIENCE WITH ECONOMIC POLICY REFORMS AND PROSPECTS FOR THE FUTURE

*Fernando de Holanda Barbosa\**

## **I - Introduction**

The Brazilian economy now finds itself in a moment of transition, heading towards a phase that is sure to demand broad economic policy reforms.

Brazil has gone through similar situations in the past, for some facts have appeared recurrently throughout her economic history. The solutions to the different growth crises in Brazil's development did not spring up all of a sudden, from one day to the next, but rather matured and crystallized for a certain time until they formed together a new strategy.

The purpose of this paper is to attempt an analysis of the Brazilian economic policies in the post-war period, and to verify the lessons that such an experience can offer towards a definition of strategic options for economic policy reforms for the solution of the present crisis. There is no concern to document the claims and proposals contained in the text with figures, tables or charts.

## **II - Economic Growth and Recurrent Crisis in Balance of Payment**

The Brazilian economy grew during the period 1945/1980 at an average rate of 7% per year. Despite this high rate, the historical series of the gross domestic product presented cyclical phases with recurrent crises associated with problems of balance of payments, rising public deficit, and accelerated rate of inflation.

During the entire post-war period the structure of Brazilian imports has evolved in such a way that its composition is dominated by capital goods that have no equivalent national product, and by raw materials that prove difficult, at least in the short run, to be substituted by a domestic counterpart.

Any crisis in the balance of payments, whether it be of an outside source (such as a change in relative prices, recession in the developed nations, a rise in the international interest rates, difficulties in obtaining foreign funds), or of a domestic source on account of misguided economic policy, involves a drop in the growth rate in the short run. Brazil's economy has always been subject to foreign restrictions imposed by the balance of payments. In other words, imports of goods and services have to be financed by exports and foreign indebtedness. In the short run, the capacity to import defines the possible growth of the economy. In this context, exchange-rate crises create a process of recession of growth, or recession of the very level of economic activity, as happened in the last decade.

In an economy whose growth is conditioned by foreign restriction of the balance of payments, the rate of growth of the real GDP in a rather schematic and simplified manner (which even supposes an income elasticity of imports equal to the unit) is determined by three factors: i) the export growth rate; ii) the foreign-debt growth rate and iii) the rate at which imports can be substituted by domestic production.

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This simplified scheme serves to illustrate the objectives of the economic policies put into practice over the postwar period by governments with different political, ideological and doctrinaire positions, to face the recurring crises of the balance of payments.

A large number of economic policy measures were introduced to promote the substitution of imports through incentives to domestic production of consumer goods, basic input, capital goods and energy products.

A second set of measures was introduced after the exchange rate crisis of the early sixties to promote exports by diversifying the list so as to make the exports less vulnerable to the fluctuations of the relative prices of some commodities and by encouraging the exports of manufactured and semi-manufactured products.

The third set of economic policy measures was devised to ease the entry of foreign capital, whether in the form of risk capital or loans. The emphasis on capital in the form of loans, from the time of the first oil shock, in combination with the external shocks that occurred in the late 70s and the errors in domestic economic policy that have been made repeatedly since then, led to the present foreign debt crisis.

Using the three components of the growth rate of GDP, one can examine the solution to the present crisis on the supposition that it is desirable to maintain Brazil's historical pattern of economic growth.

The possibility of substituting imports as a lever of economic growth is quite remote, in light of the progress made with such a strategy during the last forty years.

Financing economic growth by means of foreign capital also appears quite a remote alternative for the next few years, since the foreign-debt crisis practically eliminates the possibility of the loan-capital market returning to normal activity. There remains the entry of risk capital, particularly through conversion of part of the debt in direct investment. However, it would be unwise to expect the volume of such resources to be large enough to satisfy the country's growth requirements.

So there remains the alternative of foreign restrictions being attacked and eliminated by an aggressive export-promoting policy. The lessons gathered from Brazil's economic history of the post-war period leads us to believe that this will be the path followed in the next few years in order to overcome the present crisis.

### Foreign Debt

The recurrent crises in balance of payments have always been associated, in one way or another, with problems in managing Brazil's foreign debt.

The present foreign debt crisis has some features that distinguish it from previous crises. Two reasons could be mentioned for this. In the first place, a great deal of the debt was contracted at fluctuating interest rates. Secondly, around 70% of the foreign debt is owed to the international private banks.

The fluctuating interest rates impose a great degree of uncertainty on any projection to be made with regard to the amount of interest to be paid in the future. And to this uncertainty should be added the fact that the international real interest rate seems to have shifted to a new level in its historical trend. This rate was once low (around zero), but has become positive and significant over the last ten years.

The alternative economic policies to administer foreign debt may be analyzed in a quite simple manner by means of the foreign debt/exports ratio. The present crisis undoubtedly is reflected in a high coefficient, showing an excessive degree of foreign indebtedness for the country's payment capacity.

During her history, and despite momentary difficulties with debt services, Brazil has honored her international obligations. This premise seems to be in itself an apt working hypothesis to assess the possible long-term alternatives from which options will eventually be chosen as government economic policy. This premise eliminates from the range of plausible scenarios the alternative of repudiation of foreign debt. Besides, this would cause certain problems that are difficult to predict but could prove an impediment to the country's economic growth. It can therefore be dismissed as a long-term solution to the present foreign-debt crisis. On the other hand, any long-term solution implies a lowering of the debt/exports ratio to reasonable figures.

The first alternative is a partial reduction of the debt through an agreement with the international banks of a scheme involving a reducer applied to the actual value of the debt, along the lines of the agreements recently made by Mexico and Venezuela, and such as the new proposal made by the Collor government in the beginning of the second semester of this year.

The second alternative is based on an exports growth strategy which makes foreign debt cease to be a problem within a few years and allows financial markets to return to normal functioning.

The third alternative is a combination of the other two, with policies oriented toward promoting a sustained increase in exports and coupled with some type of reduction of the nominal value of the debt, such as securitization and conversion of part of the foreign debt into risk capital. This strategy is certainly consistent with the solution of foreign restriction of balance of payments mentioned earlier, which enables the Brazilian economy to maintain its historical rate of sustained growth. This strategy is also compatible with the developmentist ideas that arose in the mid-50s and are still predominant in Brazil's political and economic scenario.

### **III - Inflation, Economic Growth and Public Deficit**

Brazil's economic experience during the post-war period until the middle 80s revealed no evidence that there was any correlation (positive or negative) between economic growth and inflation. This is consistent with the hypothesis that in the long run the Phillips curve for the Brazilian economy was vertical. This assertion amounts to claiming that any rate of inflation was compatible with the economy's historical tendency towards growth. This conclusion was based on different empirical studies and also on the affirmation that there existed periods of accelerated inflation along with a drop in the real production growth rate. There were also periods when inflation accelerated and the economic growth rate rose, just as there were periods of disinflation with a higher growth rate, and still other times when disinflation was accompanied by a fall in the real production growth rate.

The coexistence between inflation and economic growth became more harmonious in the second half of the 60s, with the introduction of monetary correction. This was an attempt to remove the corrosive effects of the inflation that is not expected by economic agents when they decide where to allocate their resources. The monetary correction tool began to be used very widely, covering labor contracts, financial contracts (public debt bonds, financing of real property, savings accounts, time deposits), taxes (including corporate balance sheets to eliminate illusive profits), and exchange rate policy.

Beginning in the mid-70s (after the first oil shock), the mechanisms of monetary correction were regarded as being largely responsible for the inflationary process in Brazil. This view gained many supporters; finally the Cruzado Plan adopted it too, and the

decision was made to eliminate monetary correction from the Brazilian economy, in a frustrated endeavor to extirpate inflation.

By the middle 80s the so called heterodox economists became very influential and well known among Brazilian politicians. As a consequence in the 1986/1991 period the Brazilian economy has been submitted to five heterodox stabilization plans, each of them a complete failure. The only reason for this lack of success rests on the technology developed by the heterodox economists to fight inflation. The heterodox technology combines the following inputs in variable proportions: i) a "cold turkey" treatment through freezing either prices or assets, or both; ii) mandatory change in legal contracts, without the consent of the parties involved; iii) desindexation, iv) transitory fiscal adjustments by using fiscal instruments once and for all; and v) monetary reforms, by changing the standard of value three times. The first lesson one should learn from those experiences is that the heterodox technology did not work out. The second lesson did not require all those plans, because it was very well known before, at least by non-heterodox economists: the only way to fight inflation is to attack the fundamentals. Besides this learning by-doing experience, the heterodox plans did the country a disservice by postponing a structural fiscal adjustment that has to be carried out in order for the Brazilian economy to return to a growth path and a stable rate of inflation.

The positive outcome of the heterodox stabilization plans has been the consensus reached by Brazilian economists, after the Collor Plan experience, in recognizing the fiscal crisis of the public sector as the main problem to be solved in the short run. There is, of course, a lag between the diagnosis made by the economists and the actions to be taken by the politicians. Thus, we can predict that the politicians will follow the economists and in not too long a period of time, reach a consensus concerning the reforms of the public sector.

The historical experience of Brazil's economy, including the recent lessons gathered from the Collor Plan and the other heterodox stabilization plans, reveals that monetary correction, rather than the cause of chronic inflation is one of the effects. From the first half of the 70's up to the middle 80's, monetary correction posed a dilemma for economic policy: fighting inflation versus living with it. The presence of the monetary correction mechanism inhibited the fight against inflation, because of the heavy social cost of disinflation. On the other hand, (for two decades) monetary correction permitted a peaceful coexistence with inflation. Regarding this dilemma, it must be stressed that monetary correction introduced an asymmetry to the historical pattern of inflation, which has reached successively higher levels since the middle of the seventies.

In the early sixties an annual inflation of 100% was interpreted by many analysts as a sure sign that the Apocalypse was near. The existence of the monetary correction mechanisms from then until the end of the military regime led to a situation where no more attention or importance was paid to any cabalistic figure for the rate of inflation.

The steady rise of inflation to ever higher levels (whether caused by demand shocks or supply shocks), ended by shortening the terms for readjusting the nominal values of contracts with a monetary correction clause. The result was that in a given point in time the social cost of disinflation grew negligible; consequently, a stabilization plan could be adopted with a good chance of being successful. The Collor Plan lost this opportunity by basing itself on a radical, erroneous understanding of the Brazilian inflationary process.

The empirical evidence of the last six years no longer supports the hypothesis that the long-run growth rate of the economy's potential output is not affected by the inflation rate. Thus, the idea built up after 1964, that monetary-correction instruments insulated the economy real sector from inflation has not been supported by the facts since 1985. From a

long-run perspective, widespread monetary-correction instruments indeed proved a failure. The lesson one should learn from this experience is that the monetary-correction institution is not a good substitute for a solid monetary-fiscal constitution.

The lessons gathered from the heterodox stabilization plans will definitely have a great influence on the formulation of new stabilization programs. In the near future the roots of the inflationary process will be attacked, instead of just caring about getting rid of the mechanisms that propagate inflation.

This new scenario will not witness the disappearance of the monetary correction instrument; this will still be used for long-term contracts, not only those that concern bonds to finance the government deficit, but also those for financing mortgages and other contracts that by their very nature involve terms of more than a year. This proposition stems from the secular tradition of inflation in Brazil's economy, and from the conviction that a country's historical experience cannot be erased overnight.

### Public Sector Deficit

Until very recently there was no available information to evaluate precisely the consolidated public sector deficit because of the institutional peculiarities of Brazil's economy. Considerable progress has lately been made in this area, although there remains a great deal of controversy on the matter. Nonetheless, it would not be inappropriate to state that during the post-war period the Brazilian government has always spent more than it collected.

Until the mid-60s the public deficit was largely financed by issuing money, which characterizes the so-called inflation tax, which is both indirect and fairly regressive. Since then the issuing of public bonds on the market has become a vital government financing mechanism. In the seventies the low interest rates on the international money market, combined with the growth strategy that was adopted, led to a substantial increase in foreign indebtedness, which later proved to be beyond the country's paying capacity.

Besides the periodical fiscal packages that have become more frequent in recent years, post-war Brazil introduced an important tax reform in the second half of the sixties. This reform was the solution found at that time to solve part of the problem caused by the chronic public deficit of the Brazilian economy, as well as being a modernized improvement of the national tax system.

The situation of Brazil's public finance has been slowly deteriorating since the late 70s, due to the lowering of the tax burden and increasing government spending. The decline of the tax burden can be explained by the following facts: i) increase in the rate of inflation, provoking a reduction in the real collection because of the time-lag between the accrual and the collection of the tax; ii) increase in the share of production exported, with a consequent fall in tax collections due to export exemptions; iii) substantial increase of tax evasion, either as reaction against the increase of tax rates or because of more inefficient inspection; and iv) increase of tax waivers by the State due to the indiscriminate use of tax incentives. On the government-spending side, the following factors contributed to the fiscal crisis; i) increasing indebtedness of the State with the growth of spending on the servicing of foreign and domestic debts; ii) control of the prices of goods and services produced and sold by state companies for the purpose of fighting inflation, and iii) increase of the government's current expenditure.

In October 1988 the National Congress approved a Fiscal Reform within the new Constitution. This fiscal reform transferred resources from the federal government to states and municipalities without the corresponding transfer of duties to the two spheres of government. As a result, the federal government deficit has increased with the new



Constitution, and the states and municipalities have increased their spending. The new national tax system was elaborated without there being the least concern to solve the fiscal crisis presently faced by the Brazilian public sector. In fact, the new system has created some additional problems, and the Brazilian fiscal crisis will have to be solved by means of an increase of the tax burden and this will call for changes in the new Constitution.

Lack of budgetary discipline is a feature of the entire post-war period; it is largely the result of opting for the discretionary type of intervention in the economy. Experience shows that a tax reform will certainly not solve the problem of public finances, just as it failed to do in the past. Bringing the public deficit down permanently to reasonable levels calls for a change in the way that the government intervenes in the economy, where well-defined rules should replace the discretionary action preferred by the Executive branch of the government.

### Domestic Versus Foreign Savings

An underdeveloped country's economic growth can be limited by its importing capacity, by its savings rate, or even by both these variables. As already mentioned, foreign restrictions have always been a feature of Brazil's economy. On the other hand, the rate of investment has never proved to be a significant obstacle to our country's growth.

Throughout almost the entire post-war period Brazil's economy has maintained a high investment rate, which is measured by the ratio between gross fixed capital and gross domestic product. In the seventies this rate gradually rose until the middle of the decade and then began to fall. In the 80s the investment rate measured at 1980 prices, has continued its downward trend.

Keeping the historical annual growth rate at 7% will require an increase in the rate of investment in the coming years. This means that the rate of domestic savings will have to grow, since it is unlikely that the country will receive sufficient foreign savings to finance investments. The solution to the problem, therefore, lies in raising the savings rates of both private and public sectors.

Since the early eighties the government's current-account savings has been negative. Government revenue is incapable of covering current costs (investments not included). Due to the fact that social needs would require increasing government expenditure in the coming years, it would be very difficult to have a decrease in the size of the public sector as measured by government consumption as a proportion of gross domestic product. It is therefore quite plausible that public-sector savings should grow by means of an increase in tax revenue.

On the other hand, increasing the savings rate of the private sector will depend on policies that try to keep the rate of real interest at positive levels that are suitable to stimulate savings.

### Human Capital

In a broader sense, a country's investment rate should include education expenditures, since the accumulation of human capital plays a crucial role in the process of economic growth. In Brazil there are signs that the quality of primary and secondary education has deteriorated over the last twenty-five years. This fact is closely linked to political (with a small p) interference in the state and municipal education systems, which have been used as a tool to elect councilors, mayors, congressmen, senators and governors. There is not the least concern for quality or efficiency. This situation is easy to remedy, but the process is slow and time-consuming. However, the question is not only to

increase the rate of investment in human capital, but also to seek - and even demand - efficiency in what is spent on education.

Although there is no evidence at this point of time, a worthwhile hypothesis would be to test whether or not the state of disarray of the Brazilian education system has already contributed to worsen the rate of growth of the economy during the last decade.

#### **IV - State Intervention in the Economy**

State intervention in Brazil's economy grew gradually throughout the entire post-war period, both in the democratic and totalitarian phases of government. The presence of the State is felt in different ways, such as: i) in the form of entrepreneur, through state-owned companies; ii) as financial intermediary; iii) intervening in the economy's prices system; iv) in income distribution; v) formulating the strategy of economic growth through administrative mechanisms, tax incentives and subsidies for economic activities regarded as priority; and vi) through monetary/fiscal policies to stabilize the economy in the short run.

The State's entrepreneurial role has expanded over the years in response to a whole array of causes. In the case of oil, nationalism (expressed in the slogan "the petrol is ours!") was actually the fundamental factor. In public services such as electricity and telecommunications, the pricing policy adopted invalidated any return on investments in these sectors, and so it was left to the State to absorb them. In the steel making sector the State did play a pioneering role, with the objective of boosting industrial development. In several other cases the federal government was obliged to step in and take over projects already under way but going through financial difficulties. It therefore seems quite apt to conclude that the State's increased participation as entrepreneur sprang not only from ideological option but also from a pragmatic response to problems that appeared in the process of Brazil's economic growth.

The public sector fiscal crisis in the last ten years has contributed to make the Brazilian society more pragmatic towards state intervention in the economy and the recent world events, with privatization occurring in both developed and socialist countries, will have a strong influence in shaping the political outlook of those segments that still hold anti-privatization and nationalistic positions. Based on our past experience and the world events that are still unfolding we can predict that privatization will gain momentum, overcoming its opponents, and eventually will reach sectors that are nowadays state monopoly by the Brazilian Constitution.

In the area of financial intermediation, the federal government plays an important role through the Bank of Brazil, the Federal Savings Bank (and also, until recently, the National Housing Bank), the National Bank for Social and Economic Development, and some regional banks, and almost all state governments have its own bank, acting in different segments of the financial and capital markets. These institutions are active in financing working capital for companies, financing housing projects and urban infrastructure, and administering long-term capital for priority sectors of the economy. Over the last 25 years, compulsory savings funds have been set up by the administration of some of these financial intermediaries, with consequent increase in the amount of resources for the different types of financing.

From 1964 on State intervention in the economy's price system began to expand, and since then the government in some way or another intervenes in determining wages, interests, rents and exchange rate. It also settles the rates for public services such as electric power and telecommunications, oil products, as well as controlling prices of goods and services produced and rendered by private and state-owned companies.

At this point it is interesting to highlight some ideas that lie behind this process of increasing State intervention in the price system. Some economists feel that the inflationary process is caused by the distributive conflict between capital and labor, with the workers seeking real wage increases above the growth rate of labor productivity. These rises are seen as incompatible with the profit margins sought by the employers. When the fractions desired by the two groups are added up, they are greater than the whole. Inflation

is the mechanism that recomposes the logic of the system. According to this diagnosis, the State has the responsibility of administering this distributive conflict by intervening in the price system. Those economists who trace the origins of inflation to this type of distributive conflict also recommend a social pact between workers and employers, possibly with the intervention of the government, as a solution of the conflict.

It should be pointed out that this hypothesis, besides being fragile from the theoretical point of view, has not yet been empirically tested. Also, the prescribed medicine - control of prices and wages -, besides failing to solve the problem of inflation, provokes harmful consequences, disorganizes production and lowers the rate of investment in the economy due to the uncertainty as to how prices will behave in the future. Nevertheless, this distributive conception of the inflationary process enjoys a long tradition in Brazil's economy. It began with the Government Plan for Economic Action during Castello Branco's Administration and reached its apex in the first fifteen months of the Collor government.

One worrisome aspect of Brazil's economic reality is the high concentration of income, both on regional levels (center-south x north-northeast), as well as sectorial (rural x urban) and personal (rich, middle class, poor and miserable). State intervention since the late fifties aimed to lessen regional and sectorial inequalities, but failed to produce the desired results. The failure of this type of intervention has not yet been fully acknowledged. Moreover, powerful interest groups who defend the status quo have prevented radical reformulation from being implemented in regional and sectorial economic development programs. As for personal distribution of income, during the entire post-war period the State has not shown a coherent and articulated policy capable of coming to grips with the problem. The social crisis that is rife at present in Brazil is liable to worsen in the next few years and will unquestionably alter the way the State intervenes by shifting the economic focus to the social.

In the early fifties, and particularly after the Kubitscheck Administration introduced the Targets Plan, the Brazilian government formulated and implemented economic growth strategies by means of different mechanisms. These were of an administrative nature (such as the Executive Group of the Automobile Industry), or had to do with exchange-rate policy (such as Instruction 113 of the Money and Credit Superintendency), fiscal questions, credits, and subsidies (such as export programs, Proalcool, etc). Since the late 50s, economists of different leanings and politicians of different parties have shown a preference for developmentalism as an ideology of economic growth. Although this preference does not have one single characteristic option, it may be claimed that in terms of aims the developmentalists do not accept Brazil's economy to grow at an average rate of less than 7% a year, which corresponds to the average figure during the post-war period (excluding the so-called "lost decade" of the 80's).

The crisis of the early fifties generated a broad debate on the decline that was being felt in the process of import substitution. The 1964-66 period witnessed a reaction to stagnation, with the introduction of wide-sweeping reforms in the Brazilian economy. During the 1967-73 period the tonic was export growth and consumption of durable goods. The years 1974-79 gave priority to substitution of imports of capital goods and basic inputs. An attempt was made in 1980 to reproduce the miracle years of 1967-73. The following two years saw the boat drift aimlessly. In 1983 the economy began to adjust to external conditions, and growth resumed in 1984. From the beginning of the New Republic in 1985, a new phase of turbulence started, with all sorts of experiments being tried but without any well-delineated strategy for economic growth.

Based on historical experience, it is quite likely that Brazil's economy finds itself at a moment of transition. A new growth strategy is now taking shape and will be fully drawn up by the middle of this decade. This strategy will be dictated on the external front by restriction of the balance of payments, and on the domestic front by measures that aim to mitigate the social tensions triggered by concentration of income.

## **V - Rules Versus Discretion**

The State may intervene in the economy by means of rules or by discretion. Economic literature contains a long tradition of discussion of this topic.

An analysis of the historical experience of State intervention in Brazilian economy reveals that our policy-makers have predominantly opted for the discretionary type of intervention, with the institutions adjusting to this particular procedure. In certain situations the rules do exist, but they are simply put aside. The institutional framework of the country, as far as restrictions imposed on decisions of economic policy are concerned, is flexible enough for the existing rules to become dead letter. Here are some examples that illustrate this proposition: a) Determination of the prices of oil products should comply with the legal precept that establishes how these should be calculated. However, different governments, at different times, have used the prices of oil products as instruments to fight inflation, without paying the least attention to the production costs and profit margins of the companies involved in importing, producing, refining and distributing oil products; b) Electric power rates should be calculated so as to give 10% annual remuneration to capital invested in the production, transmission and distribution of electric power. Nonetheless, just as with the prices of oil products, successive governments have used the price of electric power as an instrument to fight inflation; c) Long-term capital financing contracts between the National Bank for Social Development and private firms, as well as the mortgage contracts of the Housing Financing System (both containing a monetary-correction clause), were changed several times under pressure from interested parties who wanted a reduction of the actual value of the debts; d) On several occasions the government altered the price index used to calculate the readjustment of the nominal values of contracts containing a monetary correction clause. In general these changes were made without any technical reason to justify such a decision; e) The abusive, and even unconstitutional, use of law by decree to change the rules of the game halfway through the game; f) The inexistence of well-defined rules in the price-control policy; g) Frequent changes in the rates on income tax withheld, which can be established by an act of the Executive power; h) Frequent alterations in the condition of direct consumer credit for the purchase of durable consumer goods; i) Disobedience of the constitutional precept prohibiting hiring of civil servants without approval by public examination; j) Granting subsidies without due approval by National Congress, an example of the Executive's exaggerated discretionary powers.

This short list is certainly not comprehensive, and could be added to without much effort. The height of discretionary power in the Brazilian economy was during the Collor Plan, when all contracts were changed overnight. This tendency may be inverted from now on, as this form of government action is beginning to be seen as a factor that increases the element of uncertainty in the economy, without any positive counterpart to justify it.

In an atmosphere of such extreme uncertainty, it is observed that all the economic agents involved - workers, consumers and employers - have somehow learned to live with the government's instability by trying to adapt quickly to the new situation. In some cases

the time in which these agents respond to the stimuli of economic policy is surprisingly short.