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Chapter Author: Eliana Cardoso, Albert Fishlow

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approach to mounting internal and external disequilibrium that would make demand restraint unnecessary. That was sweet music to the ears of a president elected because of his pledge to wider popular political participation, who was persuaded that prosperity was a necessary condition to its success. Unfortunately, as the next chapter shows, the realization was much different than the expectation.

3 Adjustment in the 1980s: From International Monetarism to the *Plano Cruzado*

As our discussion has shown, Brazilian adjustment policies, even before the second oil shock, were in need of a midterm correction. Simonsen's orthodox approach was rejected barely after its announcement and before it could be implemented. Delfim's more optimistic heterodoxy was much more congenial. But it too proved inadequate, both because of its own limitations and the deteriorating international economic environment. Brazil by 1981 was in the midst of a harsh austerity program designed to compensate for its mounting external disequilibrium. It could hope to succeed only if external credit were restored. The Mexican debt crisis in August 1982 dashed that hope and soon sent Brazil scurrying to the International Monetary Fund for assistance.

The experience with the IMF was tumultuous and marked by repeated letters of intent and waivers for nonfulfilled targets. Improved external performance came partially at the expense of domestic inflation and investment objectives. Still, with the large increase in exports of manufactures in 1984, the economy began to show signs of recovery and resumed growth. The new civilian government that took office in 1985 soon defined itself as committed to expansion rather than macroeconomic restraint. Ample reserves made it possible to delay any long-term agreement with private creditors and to allow the extended program with the Fund to lapse.

Accelerating growth in 1985 was accompanied by accelerating inflation that threatened the transition to sustained growth and provoked popular discontent and political dissatisfaction. The *Plano Cruzado*, in February 1986, was the heterodox response. In the mold of similar programs previously launched in Argentina and Israel, it identified inertial inflation as the source of inflationary rates that had already exceeded annual rates of 300 percent. It was a bold, and temporarily successful, way to devise a recession-free domestic adjustment to match that of the external accounts.

But it is necessary to begin the story of adjustment in the 1980s, that would eventually lead to the Cruzado Plan, with Delfim's earlier heterodox experiment.

3.1 Supply-side International Monetarism

Delfim's program to reduce inflation while abetting growth had four components. In sectoral terms, first priority would go to agriculture and energy. The former bore much of the weight, and hopes, of the policy. It was felt that rapid growth of agriculture would do the following: end the relative food price shocks that had been so troublesome in recent years; provide the exports to assure continued service of the debt; permit energy substitution through the alcohol program; and facilitate more equal income distribution. There was also then, more than ever, a self-evident need to give equal importance to increased supplies of energy, whether from domestic production of crude or oil substitutes. Both sectors, agriculture and energy, were thus assured all the subsidized credit they needed or wanted.

Macroeconomic policy was based on a theory of cost-push inflation, but was not always consistent with it. On the one hand, Delfim set out to undo the previous high real interest rates through strict controls in September 1979 that brought nominal rates sharply down. Yet at the same time, many administered prices were freed during the fall. In November a new wage law provided for more frequent semiannual inflation adjustments as well as relative gains for lower wage workers. While these actions accelerated inflationary pressures, the price increases were blamed upon the previous administration. On the positive side, the fiscal deficit was somewhat reduced and a potential labor conflict averted. The price increases set up what was hoped would be a substantial deceleration beginning in 1980 that could be claimed as a policy success.

On the external side, Delfim decreed a maxi-devaluation of 30 percent in December, the first large devaluation in more than ten years of experience with the crawling peg. Export subsidies and prior deposits on imports were removed as redundant after the realignment of prices. In addition, alert to the deterioration in the balance of payments, Delfim actively took new measures to encourage private foreign borrowing to rebuild reserves.

The final element was the true novelty in the program. Delfim preannounced the rates of both monetary correction and devaluation that would prevail during 1980, the former at 45 percent, the latter at 40 percent. Credit was to be limited accordingly. This move was intended to change inflationary expectations; if only everyone believed that inflation would be 45 percent in 1980, then it could be. Heavy doses of controls reinforced the message.

The Delfim strategy, as it thus took form, was a mixture of three approaches: the standard IMF formula of devaluation to stimulate exports and import substitutes; Southern Cone international monetarism, predicated on a close relation between changes in domestic and international prices; and traditional Brazilian interventionism to induce desired supply response through subsidies. The program created confusion in the international financial community. At first, when the thrust was toward freeing markets in the Christmas package of December 1979, foreign bankers applauded; as disequilibrium became rampant in 1980, they rebelled. The bankers had the final word. Their refusal to roll over the debt without a more conventional stabilization package led to a new approach in November 1980.

The results of Delfim's heterodox approach had by that time fallen far short of its objectives. Although economic growth in 1980 exceeded 7 percent, it was fueled by consumer demand. The ratio of investment to GDP declined. Financial assets, now yielding much less than the inflation rate, were abandoned in favor of the speculative acquisition of consumer durables and real estate. Meanwhile, inflation soared and crossed the three-digit threshold for the first time in Brazilian history. And the current account deficit in 1980, under the impact of additional increases in the oil price, attained a record $12.4 billion and required massive finance. The net debt stood at almost $60 billion, three times the level of exports, compared to a 1977 debt/export ratio of little more than two.

Delfim's policy failed in 1979/80 for four reasons. First, it did not confront the excess demand under which the economy was laboring. The public sector deficit in 1980, excluding monetary correction, is variously estimated as between 5 and 7 percent of GDP. Although possibly smaller than the 1979 level, the deficit remained high and could not be voluntarily funded in the controlled financial markets of 1980; instead it had to be monetized. Unlike the "miracle" years, domestic supply was not elastic enough to satisfy demand. Capacity was nearly fully utilized, especially in the rapidly growing sectors.

A second factor was the wage law of November 1979 that conceded semiannual rather than annual inflation adjustments. Increasing labor unrest in 1979, as accelerating inflation eroded real wages, had put pressure on the government to devise a new scheme. Delfim, in a bid to secure order, accepted not only more frequent adjustment but also a law that favored the lowest paid. The adjustment of their wages was to be greater than the inflation index. These two concessions, in theory, would have led to large increases in real wages. Many have therefore singled out the law as a principal determinant of the doubled inflation rate.

The independent effect of the law is not so readily established. The World Bank mission to Brazil in 1982 concluded: "A simple examination of trends in total and per unit labor costs in industry from November 1979 to May 1982 suggests that the formula was not a major contributing factor to inflation" (World Bank 1984, 108). Among the reasons are high turnover at the bottom of the wage hierarchy, the lag in the new official consumer price index, the INPC, (to which the wages were linked) behind general inflation, and the more generous settlements and readjustments that already prevailed in the private sector. But what the law did do, because wage correction was based exclusively on past trends, was to make impossible significant deceleration in inflation without a large real wage increase. The much lower inflation target of 45 percent for 1980 was thus doomed from the start.

The third reason for the failure of Delfim's strategy was the absence of competitive imports to discipline domestic prices, as international monetarist theory required. Brazil was in the midst of a balance of payments crisis in 1980, despite rapidly rising exports, as a result of higher oil prices and increased interest rates. Imports remained controlled, as they had been for several years. It was an inopportune moment to experiment with this new approach, as Argentina and Chile were also to discover.

Finally, this was not the moment to reverse inflationary expectations. Rising import costs, fears of oil shortages, and a demonstrable commitment to expansionary policies all negated the rhetoric of pre-fixed monetary correction and exchange rage devaluation. Rather, as the disparity between reality and the government forecast widened, the only uncertainty was when the policy would change. Expectations, and attendant financial speculation and holding back of exports, focused on the timing of devaluation and not the announced inflation target for the year.

Delfim has been rightly critized for the errors of this aberrant policy. Bolivar Lamounier and Alkimar Moura (1986, 173–74) are especially harsh:

> The monumental failure of that heterodox experiment of economic policy can, in part, be explained by the attempt to implement a strategy of economic growth without consideration for the accentuated deterioration in the conditions of the international economy in 1979 and 1980. . . .It cannot be said, however, that there had been a generalized inability, among the government technocrats, to interpret the unequivocal signals of economic difficulty arising from the international economy. The predominant attitude was to try to exorcize such ghosts with the optimistic rhetoric inherited from the years of the Brazilian miracle.

3.2 The Second Oil Shock

Exorcising ghosts was not enough in the face of the new strong external shocks Brazil experienced after 1979. Table 3.1 presents the balance of payments effects of the second oil shock, the interest rate shock, and the attendant international recession. These show how Brazil was overwhelmed by the adverse turn of the external environment. More than half of the $4 billion deterioration in the current account in 1979 is explained by rising oil prices and higher interest rates. A still larger part of the $1.5 billion increase in net interest payments, $1.2 billion, is accounted for by the interest due on the change in accumulated debt (and smaller receipts on reduced reserves) during the year.

Table 3.1 The Balance of Payments and the Second Oil Shock (in billions of U.S. dollars)

	1978	1979	1980	1981	1982
Trade balance	−1.0	−2.8	−2.8	1.2	0.8
Net interest	−2.7	−4.2	−6.3	−9.2	−11.4
Current account	−6.0	−10.0	−12.4	−11.0	−16.3
External effects resulting from:[a]					
Higher oil price		−1.8	−5.7	−7.1	−6.1
Reduced export volume		−0.6	−1.4	−2.4	
Higher interest rate		−0.3	−1.1	−2.5	−5.9
Actual net debt[b]	36.2	46.4	57.7	68.0	83.5
Policy-adjusted net debt assuming:[c]					
Export increase		45.6	55.8	64.5	78.3
Import limits		44.8	54.0	64.9	82.5
Slower growth		45.8	55.7	65.9	81.46

[a]External effects calculated assuming that: oil price was fixed at 1978 nominal value; effect of reduced export volume was as in table 2.1, using deviation from 1974–78 average growth of 3.1 percent; and interest rate effect was based on constant 1978 average real interest rate (with respect to U.S. GNP deflator).

[b]Net debt inclusive of short-term debt, from Paulo Nogueira Batista (1985).

[c]*Export increase:* export response to 10 percent real devaluation. *Import limits:* real imports held constant at 1978 levels. *Slower growth:* Unitary elasticity effect on imports of product growth at 3 percent.

Conversely, an array of feasible alternative policy efforts would have provided only modest offsets to the balance of payments deterioration in 1979. Neither export promotion, strict import limits, nor slowed growth taken individually would have been equal to the effect of higher oil prices. It would have taken all together to begin to match the adverse turn in the international environment and the inertial effect of rising debt.

In 1980 even higher oil prices and interest rates made matters considerably worse. The actual worsening of the balance of payments was smaller than would have been anticipated owing to the 58 percent increase in the value of exports since 1978. So substantial was the gain in earnings that in the absence of the rise in oil prices, Brazil would have enjoyed a healthy trade surplus in 1980. But oil prices did rise and there was little room for maneuver.

Delfim inherited the problem of inadequate adjustment; it was not simply of his own making. Starting from its much higher debt in 1978 and the continuing large volume of oil imports, Brazil had much less flexibility in dealing with the second oil shock than the first. That said, however, there was a strong argument for conserving what few degrees of freedom remained. A more cautious policy would have marginally improved balance of payments performance, prevented spreads—and hence interest costs—from rising, and retained domestic credibility. A more conservative policy would have also avoided exchange rate appreciation that would later have to be undone. The beneficial effects of the December 1979 devaluation were more than wiped out by inadequate correction that failed to keep pace with domestic inflation.

3.3 Pre-IMF Orthodox Stabilization

Expectations did turn out to be rational. The virtually universal disbelief in the adequacy of the initial heterodox policy was confirmed by its abandonment in November and December of 1980 under increasing pressure from foreign creditors. Unlike some of his fellow policymakers in the Southern Cone, who believed both in their policies and that sustaining them even when they were not working was the only way to make them work, Delfim was more pragmatic. Yet it is a measure of the gap between ongoing political liberalization and the technocratic monopoly on economic policy formulation that he yielded to external influence rather than domestic critics.

More orthodox policies of restraint became the order of the day. Capital expenditures of state enterprises were a principal target, both to reduce the budget deficit and to limit imports. Total loans to the private sector were limited to no more than a 50 percent increase over their December 1980 nominal value. Controls were removed from all loan rates, except for credit to agriculture and to exports. Monetary expansion was severely limited, provoking a liquidity shortage. Real interest rates rose from large negative to positive levels. Firms cut back on production and tried to work down their bloated, and increasingly expensive, inventories. Private investment declined. These deflationary impulses produced a decline in gross output of 1.6 percent between 1980 and 1981 and an even larger drop in industrial production. Urban unemployment became overt. Brazil had entered a period of falling income that was to prove more severe than the setback of the Great Depression.

The strategy followed in 1981 was to conform to the shortage of foreign exchange by reducing absorption. Devaluation was ruled out by the failed attempt of late 1979 and the prevailing belief in limited opportunities for export in the midst of a world recession.

The immediate gains from the new policy were relatively modest. Inflation decelerated from 121 percent in 1980 to 94 percent in 1981. The trade balance moved into modest surplus. The primary effect of the recession was to unloose a new flow of capital from commercial banks, placing Brazil further in debt. Instead of conceding the need for more fundamental changes and then implementing such changes, Delfim's primary stabilization objective was to retain international creditworthiness and avert a liquidity crisis.

In other words, it was a poor recession, just as the preceding period had been a false prosperity. To avoid going to the IMF, Brazil undertook an even more severe short-term stabilization to persuade international creditors of its sincerity. But in so doing, Brazil lacked a program of real adjustment or coherent strategy for coping with its expanding, and increasingly short-term and interbank, debt.

The balance of payments problem thus remained. The real exchange rate, after an acceleration of the mini-devaluations in the second half of 1981, was not quite back to where it had been in early 1979. Now, with the dollar—to which the cruzeiro was linked—appreciating, more aggressive policies to improve the trade balance were necessary. Export growth, aided by restoration of subsidies to manufactured products, was respectable in 1981 but not spectacular. Almost as much of the trade improvement was achieved by more rigorous import controls. During 1982, exchange rate devaluation again fell behind Brazilian relative inflation, causing resumed appreciation.

On the internal side, the tight monetary policy and fiscal restraint were not sustained. The deficit of the consolidated federal public sector actually rose, and in 1982 it reached 8.5 percent of GDP (see chap. 5). While controls over the money supply were apparently effective, with large real declines in liquidity as measured by narrow M1 and M2 aggregates, internal debt was used instead to finance the deficit. In 1981 and 1982, the augmented series of money and quasi money (M4) exceeded inflation. Progressively greater reliance on internal debt, which was to increase from 15 to 30 percent of GDP between 1980 and 1984, was a very dangerous course. (See figure 3.1 for the recent evolution of the debt of the public sector.) Since interest rates were much higher than the growth of revenues, today's finance was converted into tomorrow's larger deficit. In general, a potentially destabilizing situation results, in which explosive growth of the debt can crowd out real capital formation and lead to ever higher interest rates. In Brazilian circumstances, it also meant fewer degrees of freedom with respect to policy as government bonds had to be guaranteed against changes in the exchange rate and not only against domestic inflation.

The hope was that a short, albeit severe, recession would permit Brazil to resume its access to external finance and economic growth. The crucial November election loomed in 1982, and government hopes for controlling the selection of the next president, turned on a respectable showing. That objective helps to explain why, despite the gathering clouds in financial

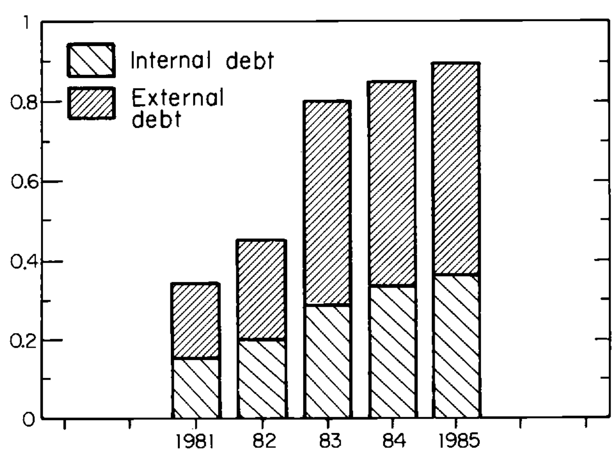

Fig. 3.1 Public sector debt (year-end, as a share of GDP)

markets in early 1982, domestic restraint eased and industrial decline was moderated. The political motivation was reinforced by the recalcitrance of inflation; it stopped falling in 1982, making the tradeoff with excess capacity much more unfavorable than in the previous year.

The government was later to blame the decline in exports in 1982 on spreading international recession, the increase in net interest payments on the high international interest rates, and the closure of financial markets on the Malvinas/Falklands war and the Mexican default. As was shown in table 3.1, Brazil by 1982 was indeed laboring under very adverse external conditions. But the recession of 1981–82 was also poorly managed.

3.4 Going to the Fund

Brazil waited too long to approach the Fund formally, only going after the election although contacts had been established earlier. Already by March 1982, the net reserves of the Central Bank were negative. Until virtually the very end, however, the technocrats insisted that they were capable and that Brazil was different from its profligate neighbors. Indeed, before going to the IMF, Brazil put together in October its own spartan plan for presentation to the private banks, a plan calling for minimal finance and exuding confidence: "It is precisely this blending of short- and long-term adjustment which will create the preconditions for the Brazilian economy to find a path of relatively more stable economic growth with smaller imbalances and being threatened neither by growing inflationary pressures nor by the unforecastability of external factors" (Conselho Monetario Nacional 1982, 10).

And it was precisely this blending that had been absent in the previous three years. Policy had been very much oriented toward short-term goals and was frequently altered. Ad hocery was rampant. Solutions were designed for immediate problems, but frequently introduced new distortions that later would inhibit effective policy. The government failed to clear out the baggage of credit subsidies and tax incentives inherited from the past and establish meaningful priorities. Domestic political support was irrelevant. The judge and jury were the external creditors. Planning and finance ministers undertook well-orchestrated forays to the exterior to assure and reassure that overly optimistic targets were securely within reach. Meanwhile, domestic credibility dissipated. Delfim remained in office because there was not even enough governmental capability to define an alternative strategy.

When agreement was reached in December 1982 with the international banks to reschedule principal and provide new finance, Delfim announced that a letter of intent was being presented to the IMF. The Fund board approved it with special speed to reassure the financial community that the debt crisis was under control. The Fund program incorporated the limited relief that had been previously asked of the private banks. Table 3.2 provides details of the quantitative internal and external performance criteria Brazil was obligated to fulfill in return.

Table 3.2 **IMF Agreements: Quantitative Performance Criteria**

		Predicted Values							
		January 1983 (letter #1)	February 1983 (letter #2)	September 1983 (letter #3)	November 1983 (letter #4)	March 1984 (letter #5)	November 1984 (letter #6)	December 1984 (letter #7)	Actual Values
Borrowing Requirement of the Public Sector (billions of cruzeiros)									
1983	March	1,200	2,800						3,578
	June	3,200	5,000						8,334
	September	5,000	6,600	14,900					13,263
	December	7,000	8,800	19,350	24,600				23,891
1984	March				11,750	11,750			9,686*
	June					23,750			23,648*
	September					35,500	44,500		45,466*
	December						67,800		84,371
1985	March							35,500	48,536
	June							70,000	121,125
Operational Deficit (billions of cruzeiros)**									
1983	December				3,600				3,629
1984	March				1,300	1,300			−638*
	June					300			−1,692*
	September					600	1,100		587*
	December						−2,100		6,169
1985	March							5,300	
	June							−13,000	6,696
	September								20,051
Monetary Authorities' Net Domestic Assets (billions of cruzeiros)									
1983	March	4,050	6,150						7,415
	June	4,650	6,950						9,895
	September	5,150	7,550	5,600					5,417
	December	5,800	8,300	3,540	3,540				6,685

1984	March				3,300	5,350			4,365
	June					4,550			3,105
	September					2,800	1,600		223
	December						−50		−2,064
1985	March							−5,000	−6,659
	June							−7,750	−14,257
Changes in Net International Reserves, relative to December of the previous year (US$ billion)									
1983	March	−1.5							−1.6
	June	−1.5							−1.8
	September	−0.7		−3.1					−2.8
	December	0.0		0.0					−3.3
1984	March				0.1	1.7			2.7
	June					2.7			4.2
	September					3.7	5.1		5.8
	December					4.3	5.7		7.0
1985	March		(no targets)						
Increase in Net External Indebtedness (US$ billion)									
1983	March	2.2	3.0						1.3
	June	3.0	4.5						2.5
	September	4.0	5.3	5.5					2.7
	December	6.0	6.0	9.0					3.5
1984	March				2.5	3.9			3.1
	June					6.8			5.1
	September					9.1	8.6		7.0
	December						10.8		8.4
1985	March							0.8	
	June							1.7	
	September								−0.007

Source: Banco Central do Brasil, *Brasil: Programa Economico*, various issues.

*As estimated by the Central Bank in early 1985.

**Operational deficit is equal to the BRPS minus payments of monetary correction on government bonds.

Central to the initial letter of intent and its modifications was a targeted \$6 billion trade surplus in 1983. Exchange rate devaluation of one percentage point per month in excess of inflation was deemed adequate. External debt was to increase modestly. Limited public sector borrowing and drastic restraint on net domestic credit (to the extent of a decline by one-half in its estimated previous year value) were the operative elements on the domestic side. Government expenditures were to be reduced to conform to the reduction in borrowing requirements. By the end of the year, an inflation rate of 78 percent was to be attained as a result of such policies.

Barely had the first letter been issued than it was necessary to modify the Public Sector Borrowing Requirement (PSBR) and domestic credit limits. The February devaluation of 30 percent following a wave of speculation in the black market made the earlier nominal values meaningless. Larger credit allocation was allowed for export promotion and import substitution to help achieve the external goals. Monetary correction of government indexed bonds to match the devaluation of exchange rate altered borrowing requirements.

The next series of letters of intent was provoked by the continuing acceleration of inflation. Only three months after formal approval of the stabilization program, the IMF suspended the scheduled \$2 billion disbursement because the government failed to reduce its nominal deficits. This was no surprise, since any shortfall in attaining the inflation target translated into far different nominal results for equivalent real magnitudes. Two major supply shocks—the 30 percent February devaluation and the upward trend of agricultural prices—combined with indexation to prevent contractionary monetary policies from reducing inflation. In fact, inflation reached the 200 percent level during 1983.

Two modifications were introduced. One reduced the extent of wage indexation. The IMF insisted upon limiting inflation adjustment of wages to 80 percent of any rise in the new consumer price index, despite the tendency of the INPC index already to understate true inflation. Thus there was explicit recognition of the force of inertial inflation. After considerable reluctance and the imposition of executive pressure, the Congress acceded. The other change was also a response to recalcitrant inflation. After prolonged discussion, a new measure of the deficit, the "operational deficit," was introduced. In this concept, the payment of monetary correction on the public debt was subtracted from the global PSBR (see chap. 5, app. 2, for more detail). The allowance for the effects of passive response to inflation provided a better measure of feasible fiscal restraint.

These changes did not obviate the need for more new letters of intent. After the four in 1983, there were an additional three in 1984. They arose, as can be seen from table 3.2, largely as a result of the violation of targeted nominal public sector borrowing requirements. Domestic inflation remained immune to reduction in 1984, despite controls over increases in net domestic assets and favorable performance of the operational deficit. External objectives were overfulfilled, on the whole. After the sharp decline in output in 1983, steeper than that of 1981, there was even a modest recovery in 1984 to which rapid growth in industrial exports contributed.

3.5 Evaluating the IMF Program

The Fund program of 1983–84 provoked increasing criticism within Brazil for being an inadequate response to its difficulties. Much of the opposition was directed to the continuation of onerous external interest payments. In magnitude these payments came to rival the entire import bill. Or to put it another way, debt service, even with rescheduled principal, came to about half of export earnings.

Creditors were reluctant to concede a multiyear rescheduling along the lines of the Mexican agreement. That would have postponed a larger part of the principal that was coming due in the future, as well as reduced spreads. The longer that the agreement was delayed, the less sense it started to make, as it became clear that the soon-to-be successor government was likely to be led by the opposition. The Fund itself was always unhappy with Brazil's performance and lack of compliance with policy targets. The series of revised letters of intent from Brazil offset the favorable impact of its excellent trade performance.

The case of Brazil epitomized the limits of the IMF approach. Despite favorable management of the trade account, internal stabilization and a sound basis for renewed economic growth did not follow. Rather than decelerating, inflation more than doubled. Meanwhile, high real interest rates (figure 3.2), the counterpart of tighter money and large government sales of debt, discouraged private investment. Together with controls over

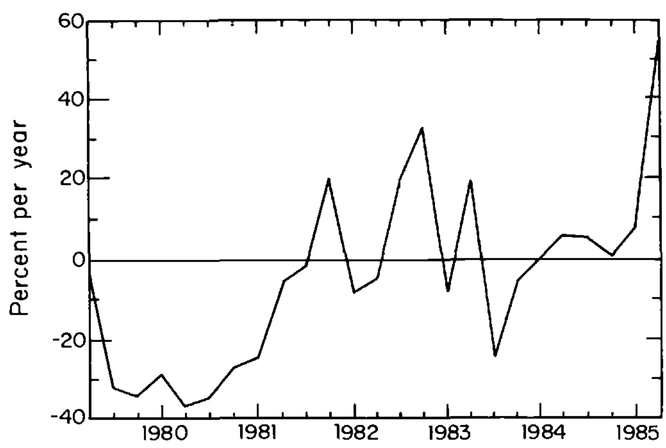

Fig. 3.2 Real interest rate nets of taxes (CDB: 30 days, average monthly yield, by quarter)

public investment, this led to a decline in the ratio of gross capital formation to only 16 percent in 1984, just about its lowest level of the postwar period. Since the inception of the program, the public sector deficit was continuously pressured by the rapid growth of internal and external interest payments.

Figure 3.3 shows that the share in GDP of the current account net of factor payments has turned positive since 1983. To critics of the IMF stabilization approach, the stark asymmetry of the results obtained on the balance of payments and domestic stability came as no great surprise. Contrary to the IMF's implicit monetarist model, the Brazilian experience confirms a very different interpretation. Improving the external accounts has become an important source of internal disequilibrium.

The very policies required to permit large trade surpluses and payment of external interest add to inflation and subtract from investment. Thus aggressive devaluation of exchange rates reflects itself sooner or later, and mostly sooner, in domestic inflation because of the ubiquity of indexing. In addition, the public sector must attract ever larger resources from the private sector in order to service the now largely public external debt. When it does so on a voluntary basis, interest rates are high and become a source of higher costs that are passed along to prices. In addition, government deficits, whether financed by money or internal debt, then maintain nominal demand and sustain the inflation. The state is too weak to raise taxes and accomplish the large transfer needed in a noninflationary way.

The extensive resources that have been transferred externally, amounting to some 5 percent of gross product in 1983 and 1984 and reducing national

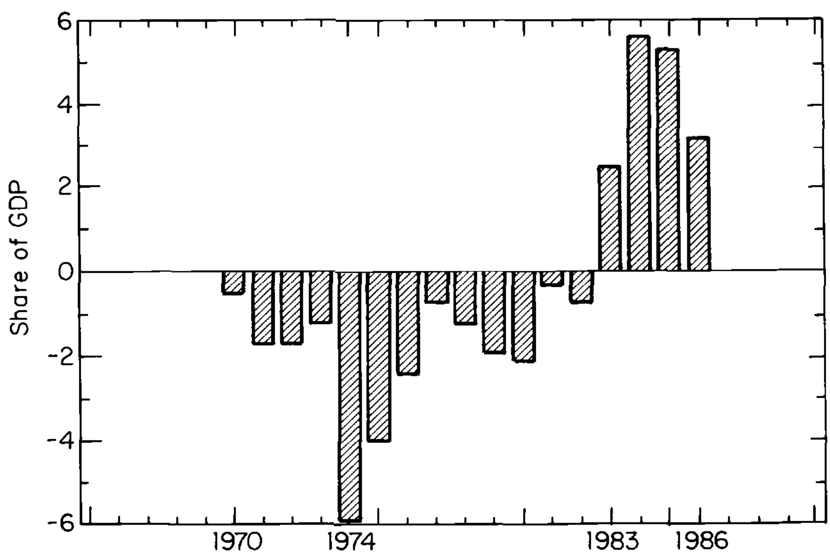

Fig. 3.3 Nonfactor current account in Brazil, 1970–86

income proportionally, have come primarily at the expense of investment. Consumption outlays have resisted further compression. Even with the changes in the wage-indexing arrangements required by the IMF, there were limits to further declines in standards of living. Saving has not been responsive despite the continuation of high real interest rates; bank certificates of deposit net of taxes were highly positive in 1984.

These economic circumstances, despite attempts to show that Brazilian performance was better than elsewhere in Latin America, and despite a modest recovery led by manufactured exports in 1984, contributed to the Figueiredo government's loss of political control. The rules of succession, which had been thought to assure not only continued dominance of the government party but also one more military president to guide transition, proved unable to withstand the clear lack of popular acquiescence. Tancredo Neves was selected by the electoral college in January 1985. With his untimely death before he assumed office, the New Republic's leadership fell to José Sarney.

3.6 After 1985

During much of 1985 and 1986 the debt issue and the problem of the balance of payments took a back seat to domestic economic policies in the new government. Economic recovery quickened, but was accompanied by accelerating inflation. Brazil's trade balance remained positive and adequate to service its interest payments up to mid-1986. Falling oil prices and interest rates, and sharply increased terms of trade in 1986, added up to significantly improved external conditions. From a high of 62 percent in 1982, the ratio of interest payments to exports fell to 44 percent in 1985 and 45 percent in 1986. The absence of additional capital flows meant real reductions in the level of the debt after the end of 1984.

In these circumstances it is not surprising to see the recent external crisis blamed exclusively on poor domestic policy and the failure of the Cruzado Plan. Roberto Campos, a former planning minister in the first post-1964 government and now a senator from the opposition party, prominently did so in the national and international press. He was joined by Luís Inácio da Silva, better known as Lula, the leader of the Labor party on the other side of the political spectrum. Both have been joined by countless external observers who emphasize that there is no guarantee that exaggerated real domestic targets will not confront balance of payments constraints. Wishing to grow at high rates, and even needing such growth for laudable political ends, does not make it come true.

The large debt burden of Brazil, however, was an important contributing factor to the failure of domestic policy that was a proximate cause of the precipitate decline in the trade surplus and the inability to continue normal interest payments. Three interactions are worth emphasizing: the lack of new capital flows to finance larger imports, the effect of the drain of external interest payments on domestic capital formation, and the immediate vulnerability of the balance of payments to even temporary shocks.

First, it was unrealistic to expect Brazilian imports to remain at low levels despite accelerating growth and to project large continuing surpluses. Import elasticity is especially high when increased investment becomes necessary after a first phase of using up excess capacity. A popular view in Brazil was that import substitution had proceeded so far and so successfully that requirements were permanently reduced, and that made the debt, and the required surpluses, less central to domestic strategy than it ought to have been. Especially in the context of the Cruzado Plan, capital inflows would have been of considerable assistance in permitting import liberalization and thus a market check to inflation, rather than relying on price controls alone.

In the second instance, the large resource transfer, amounting to more than $30 billion in three years, made it difficult to sustain domestic capital accumulation. Consumption could not be compressed to make the transfer; indeed, pent-up demand further reduced domestic saving, thereby aggravating the domestic imbalance. In addition, transfers of that magnitude—amounting to some 4 or 5 percent of product—complicated fiscal policy. The public sector was the principal remitter; it had to compete for the surplus of the private sector. A bias toward government deficits was a consequent, and ultimately disastrous, result.

Thirdly, the fact of a large foreign debt gave little scope for error. Even a few months of diminished international performance were sufficient to erode reserves and provoke strong policy reactions. Those measures in November 1986 were badly received and contributed to the lack of credibility and a generalized sense of deterioration that quickly became self-fulfilling as the year ended and 1987 began. There was little time to regroup or to formulate new approaches. A moratorium on interest payments became inevitable.

A large debt creates its own special problems for the formulation and implementation of policy, as the United States too is beginning to appreciate. This is not to exculpate Brazil's responsibility in not sustaining its export growth. While everyone was busy citing Brazil as an example of successful adjustment, Brazilian export volume, after an increase of about 20 percent in 1984, grew by less than 2 percent in 1985 and declined by 8 percent in 1986. Irregular export performance has plagued Brazil even when its exchange rate policies have avoided extreme overvaluation. But that is precisely why the debt problem is so serious and so damaging to Brazilian developmental prospects. Ignoring the difficulty by projecting high compound rates of export growth is only more wishful thinking.

Any serious analysis of the sad denouement of late 1986 and early 1987 is thus incomplete without reference to the larger story of the risky, and ultimately mismanaged, Brazilian adjustment policy via external debt since the early 1970s.