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THE LEGACY OF THE REAL PLAN AND AN ALTERNATIVE AGENDA FOR THE BRAZILIAN ECONOMY [*]

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The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes

John Maynard Keynes

INTRODUCTION

Coming, as it did, after many frustrated attempts at stabilization policies in Brazil during the 1980s and 1990s[1], the Real Plan (effective, according to this paper's authors, from July 1994 to January 1999) is thought to be the most successful plan for economic stabilization Brazil has implemented recently, in relation to the economy's prime objective of reducing and controlling inflation. Inflation figures bear witness to the

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[1] The Cruzado Plan in 1986, the Bresser Plan in 1987, the Verão Plan in 1989, and the Collor Plan in 1990, are some examples of these frustrations.

Real Plan's success. In June 1994, one month before the introduction of the real as legal tender, the annual inflation rate was around 5 150%, whereas by December 2001, the annual inflation rate had fallen dramatically to approximately 10 percent.

Although the incontrovertible success of the Real Plan is evidenced in price stabilization, the Plan as a whole has actually been a failure when viewed in the light of Brazil's poor economic performance throughout the *real* period (understood by this paper's authors as beginning with the introduction of the real in July 1994, and continuing to the present day). From 1994 to 2001, the average growth rate in the GDP was only 2.8% per year, very similar to the average growth rate in Brazil's GDP during the 1980s, a "lost decade" according to Brazilian economists, when the growth rate was 2.9% per year.[2]

This paper has two objectives. Firstly, it aims to analyze the Real Plan's legacy. On the one hand, inflation was eliminated in Brazil. On the other, the Brazilian economy became highly vulnerable due to heavy dependence upon foreign finance, and because of the financial fragility of the domestic debt. In this regard, the paper shows that the Brazilian stabilization policy, during the real period, has caused an increase in fiscal imbalances and balance of payments deficits; and that these disequilibria have resulted in constraints that will continue to affect the recovery of Brazil's economic growth, in the medium and long term.

Secondly, taking Post Keynesian theory into consideration, the paper presents an Economic Agenda aimed at controlling inflation and promoting sustainable economic growth in Brazil.

The paper comprises four sections, section 1 reviews the Real Plan's logic and theoretical framework. Section 2 describes how the monetary authorities have managed economic policy during the real period; and the impact of that policy on real variables, before and after the September 1998 to January 1999 Brazilian currency crisis. In addition, section 2 also includes an interpretation of the other Brazilian currency crises occurring during the period 1997-1999. Section 3 analyzes whether there have been any significant changes in the macroeconomic constraints on Brazil's

[2] These average growth rates in the GDP were calculated according to table 1.

economy, following the exchange rate devaluation in January 1999. Section 4 presents some policy recommendations aimed at restoring macroeconomic balances, a factor which is vital if inflation is to be kept under control, and if at the same time there is to be sustainable, long-term economic growth and social development in Brazil.

1. THE LOGIC AND THEORETICAL FRAMEWORK OF THE REAL PLAN

1.1. Stabilization Plan with Exchange Rate Anchor, and Liberalization of Trade and Capital Accounts in the Balance of Payments: some general facts[3]

Generally speaking, experience with stabilization programmes, based on some kind of exchange rate anchor with liberalization of the balance of payments trade and capital accounts, shows that the immediate initial effect of such plans is an abrupt drop in the rate of inflation, accompanied by marked appreciation of the exchange rate.[4] The local currency appreciates as a result of differential evolution by domestic and foreign prices in a context where the nominal rate of exchange remains stable, thus causing the balance of payments current account to contract substantially, due principally to an increase in the value of imports. Normally, the resulting deficit is accompanied by a large capital account surplus, which not only finances the current account, but also increases the volume of the country's international reserves. This increase in the reserves is the result of a surge of foreign capital flowing into the country, attracted by the stabilization plan's initial success, generally combined with liberal structural reforms.

Higher domestic interest rate, an added attraction to external financing, are normally used to reinforce these factors still further. Indeed, defence of the exchange rate requires that monetary policy be devoted mainly to

[3] This Section is partly based on Paula and Alves Jr (2000, Section 1).

[4] Among other problems, dependence on foreign capital flows causes the real exchange rate to appreciate, non-tradables to expand at the cost of tradables, and trade deficits to increase, all of which can leave a country's economy increasingly vulnerable to external factors. For more on this, see Gavin *et all* (1995), and Corbo and Hernández (1996).

maintaining that exchange rate. The introduction of tight monetary policies and greater freedom for foreign investors create an interest rate differential large enough to attract arbitrage capital inflows. The increasing influx of foreign capital, however, can lead to a still greater real appreciation of the exchange rate, leading to a further increase in imports and also to a downturn in exports.

On the other hand, the need to maintain high interest rates in order to continue attracting foreign capital, plus efforts to sterilize the inflow of foreign capital (also requiring high interest rates), both lead to increasing public internal debt and to a deteriorating fiscal balance. In fact, sterilization of inflows is a potentially expensive strategy for the Government, because the interest rate on domestic bonds being sold by the Central Bank, is higher than the interest rate on foreign bonds the Central Bank is buying. Thus sterilization can create significant fiscal costs in the financing of these high levels of reserve holdings, depending on the scale of the operation and on the size of the interest differential *vis-à-vis* external rates in reserve centres (Cardoso and Goldfajn, 1998:165).

In this context, a larger and growing current account deficit will only be sustainable if equivalent levels of long-term external funding continue to remain available, in association with productive investment capable of generating a future flow of exchange revenues sufficient to pay off outstanding debt. The precise nature of capital inflow is fundamentally very important, since one of the great perils of stabilization plans with exchange rate anchors is precisely that any reversal in the flow of foreign capital can lead to a balance of payments disequilibrium of such magnitude, that it becomes unfeasible for the Government to maintain the existing exchange rate. Expectations of an exchange rate devaluation are thereby generated among international investors, leading in turn to shrinkage in the inflows of foreign capital and, consequently, to a fall in the levels of reserves, leaving the Government with no option but to effect a substantial devaluation in the nominal exchange rate. This in turn may have a prejudicial effect on domestic prices and on the behaviour of non-resident investors, thus further jeopardizing the stabilization effort.

In other words, a balance of payments disequilibrium results from the fact that, in a world of globally mobile financial and productive capital investments, domestic stabilization policies can be inherently destabilizing. This is because, under these conditions, the initially successful application of an internal stabilization policy may generate an endogenous process of deteriorating economic conditions (a growing public deficit, a growing deficit in the balance of payments current account, dependence on foreign capital, etc.), which may leave a country vulnerable to speculative attacks on its currency, and thus subject to currency crises (Kregel, 1999).

1.2. The Real Plan: Conception and Phases

The Real Plan was developed by a group of academics from the *Pontifical Catholic University of Rio de Janeiro* (PUC). Among others, the group featured: André Lara Rezende, Francisco Lopes and Pérsio Arida. (This same group had previously designed the heterodox shocks in the 1980s[5]). The Real Plan was implemented by Fernando Henrique Cardoso, (formerly Minister of Finance in the Itamar Franco Government, and later President of Brazil).

The Real Plan diagnosed that Brazil's inflation rate was related to the public deficit and the general indexation of the economy's nominal contracts. In light of this diagnosis, the Real Plan aimed to create a new framework for economic management, in order to change *i*) the contents of the fiscal policy, and *ii*) the monetary regime. Economic stabilization was therefore developed in three phases. First, the Government was to adjust the short-term fiscal deficit; second, the monetary authorities were to introduce a price index to stabilize relative prices; and third, a

[5] According to this group, the Brazilian inflation rate was basically related to the general indexation of nominal contracts in the economy. This idea, known as "inertial inflation", argues that if there is not a price shock in the economy —such as demand expansion or supply cost— current inflation is determined *only* by past inflation. In this context, the strategy to reduce the inflation rate involved price- and wage-freezing, deindexation of the economy and/or monetary reform. The Cruzado Plan, Bresser Plan, and later also the Real Plan, operated along lines consistent with this strategy. For more on this, see for example, Resende (1985) and Lopes (1985).

monetary reform was to be implemented —the real was to become legal tender.

According to the Real Plan's formulators, the disequilibria in the fiscal budget were a consequence of what became known as "the reverse Olivera-Tanzi effect" (Bacha, 1994).[6] The basic argument was that there was a "hidden" public deficit in Brazil, because taxes were protected against inflation by indexing; whereas Government expenditure was established in nominal terms. Thus inflation was causing a reduction in Government spending in real terms; and the "hidden" public deficit would have been revealed once inflation began to fall, had the Government not taken adequate steps. For this reason, it was necessary to make an *ex ante* fiscal adjustment in order to control the inflation rate.

At the same time, the monetary reform managed to prevent some more drastic measures against high inflation, such as price freezing or the confiscation of financial assets. In this connection, the main features of the monetary reform introduced by the Real Plan were: "a stabilization plan announced in advance, without price freezing, confiscation of financial assets or recession, and followed by a flexible exchange rate and monetary policy" (Bacha, 1997:11).

The short-term fiscal adjustment, created at the end of 1993 by the Federal Government, and later approved by the National Congress, was called the *Fundo Social de Emergência*. This Fund imposed fiscal measures to reduce public spending at all levels of Government, and, at the same time, created a tax on financial transactions in order to increase fiscal revenue. The Fund also allowed the Federal Government free use of 20% of predetermined items in the fiscal budget, during the fiscal years of 1994 and 1995. As a result, in June 1994, one month before the institution of monetary reform (introduction of the real as legal tender), the primary fiscal surplus was equivalent to 2.6% of the GDP, and the nominal public deficit the overall result of the operational and primary fiscal exercise in the Union, States and Municipalities, plus any surplus from State-owned industries —was reduced to 1% of the GDP.

[6] This effect came to be known as "the Bacha effect".

The second step of the Real Plan, taken in March 1994, was the introduction of the *Unidade Real de Valor* (URV) as the new standard of monetary value, whilst the *cruzeiro real* (CZR) was to continue being used as legal tender. The URV, an average index of some representative inflation indexes in Brazil: IPC/FIPE, IPCA/IBGE and IGP-M/FGV, was designed to be a unit of account linked to the US dollar, aimed at stimulating the economic system to find a sustainable price standard, and also at recovering the notion of a stable unit of account in the economy. The URV was created so that, at a later date when the new currency was introduced into the Brazilian economy, it would be possible to remove the indexation process from all nominal contracts in the economy. The idea was to introduce a daily index linked to the US dollar, so that even though the Brazilian economy was not in fact dollarized conditions similar to dollarization could be simulated in the economy, for example in a hyperinflation context.

Under this transitory monetary system, it was obligatory to convert wages, residential rents, school fees and public fees to URVs, whilst other prices would convert freely. It is worth emphasizing that this step in the Real Plan was successful because in contrast to what had happened during other Brazilian economic stabilization plans, the URV was introduced in a context in which market mechanisms were fully respected. Nevertheless, the success of this phase was only partial, because the URV soon lost some of its effectiveness when many goods prices in different sectors were unbalanced by the introduction of the new legal tender at the beginning of July 1994.[7] Yet, as wages were converted according to their average value and then indexed to the URV, workers' claims for income losses, such as had accompanied previous stabilization programmes in Brazil were efficiently neutralized (Sicsú, 1996).

The last step of the Real Plan, taken in July 1994, converted the URV into legal tender. In other words, a monetary reform was introduced, using the real (the URV) to replace the *cruzeiro real* as the medium of exchange, the unit of account, the standard of deferred payment and the

[7] For this reason, the success of the second step of the Real Plan considered the main reason for the Plan's success tends (in the view of this paper's authors) to be overestimated by analysts.

store of value. This new legal tender, the real, was thus created on 1st July 1994, and the initial value of the real was set as equivalent to the last registered value of the URV (CZR$ 2 750.00).

The Government also established two nominal anchors: a monetary anchor and an exchange rate anchor. As regards the monetary anchor, the monetary authorities established some expansion targets in the money supply, specifically in order to control high-powered money. As regards the exchange rate anchor, the Central Bank of Brazil was to control the maximum price of the exchange rate —one real could not be superior to one US dollar— whilst the foreign exchange market would establish the buying price.[8] Thus, the exchange rate anchor would be used to reduce and control the inflation rate, whilst the strategy of the monetary anchor would be used to reduce the "impetus" of aggregate demand.

To sum up, the Real Plan was created on the same basis as stabilization programmes with a nominal anchor similar to those applied all over Latin America since the late 1980s using a fixed or semi-fixed exchange rate in combination with a more open trade policy as the price anchor.

It is worth mentioning that many of the criticisms levelled at the stabilization programme implemented in Brazil in 1994, are related to the consequences of the pattern of financing for current account deficits, and to the consequences of financial commitments assumed in the recent past. In particular, the argument continues, keeping interest rates high from when the Real Plan came into operation, had attracted short-term foreign capital in volumes many times greater than the needs required by the balance of payments, thus raising the level of reserves and leading to a real appreciation of the exchange rate. This had two effects. Firstly, as trade arrangements were also being liberalized at the same time, the exchange rate appreciation resulted in significant balance of trade deficits, due to increasing imports. Secondly, this capital inflow entailed foreign exchange commitments concentrated largely in the short term,

[8] According to Bacha (1997:181), in terms of the "asymmetrical exchange band", the Central Bank undertook to intervene in the exchange rate to prevent any devaluation of the real against the dollar beyond its 1:1 parity, but would leave the market free to appreciate the real against the dollar.

which sparked off an incessant pursuit of funds to refinance the commitments. The effects of this liberal economic policy arrangement were claimed to have aggravated Brazil's external financial fragility, by making Brazil yet more dependent on the need to obtain foreign financing in order to sustain its current account deficits.[9]

2. WAS THIS THE PRECURSOR OF A DEVALUATION PROCESS?

2.1. The Evolution of the Real Plan: some macroeconomic imbalances

As is commonly known, the Real Plan was successful in bringing inflation down fast, due to the combination of deindexation, exchange rate appreciation, and a huge reduction in import taxes.[10] As a result, demand was expanded in the short term.[11] Table 1 shows the performance of the inflation rate and GDP growth rates before and after the Real Plan. Six months before the Real Plan, the average inflation rate had been running at 43% per month. From July 1994 to December 2001, however, the accumulated inflation rate was 175%, giving an average inflation rate of a more acceptable 1.1% per month. In regard to the GDP, between 1990 and 1993 the average growth rate had only been 1.3% per year. At the beginning of the Real Plan, however in 1994 and 1995 the average growth rate of the GDP rose to roughly 5% per year.

[9] For more on this, see the next Section.

[10] In August 1994, the Brazilian Government reduced tariffs on the imports of more than 4,000 products, to a maximum of 20 percent.

[11] Demand was expanded for three reasons. First, in the context of a rapid decline in inflation, money supply increased sharply. Second, decline in inflation abruptly reduces the nominal interest rate. Third, low-income wages experienced an immediate real increase, as inflationary tax was reduced substantially after the introduction of the new legal tender, the real.

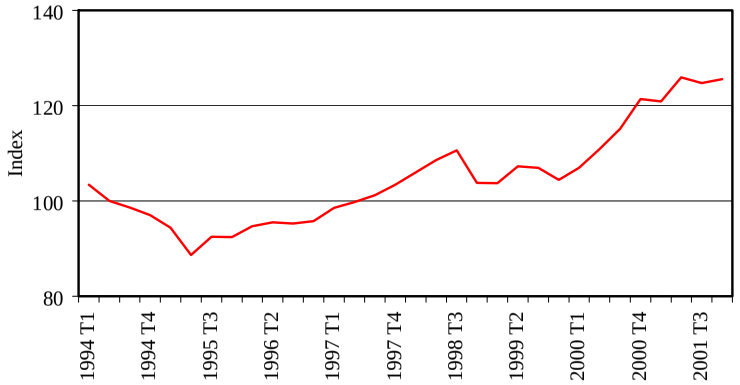
TABLE 1.
Some Macroeconomic Indicators
US$ Billion

Period	IGP-DI/FGV[1]	GDP Growth Rate	Exports (X)	Imports (M)	X – M
1990	1 476.7	(4.3)	31.4	20.7	10.7
1991	480.2	1.0	31.6	21.0	10.6
1992	1 157.8	(0.5)	35.8	20.5	15.3
1993	2 708.2	4.9	38.6	25.2	13.4
1994	1 093.9[2]	5.8	43.5	33.1	10.4[3]
1995	14.8	4.2	46.5	49,8	(3.3)
1996	9.3	2.7	47.7	53.3	(5.6)
1997	7.5	3.6	53.0	59.8	(6.8)
1998	1.7	(0.1)	51.1	57.7	(6.6)
1999	19.9	0.8	48.0	49.2	(1.2)
2000	9.8	4.2	55.1	55.8	(0.7)
2001	10.4	1.5[4]	58.2	55.6	2.6

Source: Fundação Getúlio Vargas (IGP-DI) and the Central Bank of Brazil.
Note: [1]Inflation rate.
[2]From January to June 1994, the 6-month accumulated inflation rate was 763%, whereas in the second half of 1994 the inflation rate dropped to 38 percent.
[3]Between January and June 1994, the surplus was, approximately, USD 6.9 billion, whereas in the second half of 1994 the trade balance surplus fell to USD 3.5 billion.
[4]Preliminary estimate.

The combination of bringing inflation down and provoking expansion in demand at least in the short term forced the Government to slow the economy down. This they did by controlling domestic credit and increasing the real interest rate. It is important to say that the Brazilian Government was afraid that a "consumer bubble" as had occurred with a former stabilization plan (the Cruzado Plan) might develop again. The consequence of the high real interest rate and capital account liberalization, was short-term capital inflows. Thus, the exchange rate quickly became overvalued. Figure 1 shows the evolution of the exchange rate for the real, during the real period.

FIGURE 1.
Real-USD Exchange Rate,
following Introduction of the Real
(1994-T2 =100)



Source: NAPE/CPGE/UFRGS.
Note: T2 means second quarter.

The expansion of demand and the overvalued exchange rate created immediate difficulties for Brazil's external sector: the trade balance declined and the balance of payments current account deficit increased in nominal terms.[12] Trade balance figures for the period January to June 1994, show a surplus of approximately USD 6.9 billion, which fell during the second half of 1994 to USD 3.5 billion; a drop of almost 51%. Table 1 also presents the evolution of the trade balance, before and after the real period. As can be seen in table 1, the trade balance deterioration during the period post real, is incontrovertible. Between 1990 and 1994, the trade balance had accumulated a surplus of around USD 64 billion; whereas the period 1995-2001 registered a trade balance deficit of around USD 21.6 billion.

[12] It is important to emphasize that the critical situation of the current account deficit occurred during the Russian crisis of 1998. At that time, the deficit was almost 4.5% of the GDP.

Despite this drastic reversal in the trade balance, the monetary authorities were optimistic about the sustainability of Brazil's balance of payments.[13] Indeed, before the 1998-1999 currency crisis, the Brazilian Government took the view that the noticeable growth in imports was a consequence of industrial production restructuring, ongoing in Brazil in the recent past in response to globalization, stabilization and privatization (Barros and Goldenstein, 1997) and that the resulting productivity gains would in due course contribute to generating trade surpluses which would be sufficient to restore stability to the balance of payments. In addition, it was argued that short-term debt was being supplanted by long-term debt and foreign direct investment, basically because the privatization programme was attracting substantial inflows of capital, bringing the restructuring strategy into line with financial time-frames. Moreover, in the high level of foreign reserves, the Government considered it had a "safety-net" to use in case of speculative attack against the domestic currency.

At that time, some critics of the exchange rate regime, the former Minister of Finance, Antonio Delfim Netto, the former President of the Central Bank of Brazil, Affonso Celso Pastore, the leftist economist and former Federal Deputy, Maria da Conceição Tavares,[14] among others, were arguing that exchange rate appreciation would create an insoluble problem for the Real Plan, because the current account deficits would not be sustainable in the medium and long term. However, Brazilian monetary authorities replied that exchange rate appreciation was the "natural" outcome of low inflation and financial liberalization. The monetary authorities also supported the idea that the current account deficits could be financed by "foreign saving", citing the increasing predominance of foreign investments.[15] In table 2, the figures for the current account during the real

[13] In the Government's view, the imbalance in the balance of payments would become problematic only if the ratio between the current account and the GDP rose to more than 3% (Franco, 1998).

[14] For more on this, see Delfim Netto (1999), Pastore and Pinotti (1999), and Tavares (1997).

[15] At the beginning of the Real Plan the current account deficit was financed by "foreign saving". This did not occur in 1997 and 1998. As is shown in table 2, in 1997 and 1998, the overall current account deficit was around USD 64.5 billion; whilst capital

period, show that the exchange rate regime critics seem to have been right as regards this debate.

Table 2 shows that, from 1994 to 1995, the current account deficit increased 959%; and that it continued to increase until 1998. This untenable trend in its foreign accounts put Brazil at risk of a currency crisis, given its high degree of external financial fragility, which left it susceptible to short-term changes in the international situation.[16]

TABLE 2.
Balance of Payments (BP) 1994-2001
USD Billion

Period	Trade Balance	Current Account	Capital Inflows	Net Investment	Overall BP
1994	10.4	(1.7)	14.3	7.3	12.9
1995	(3.3)	(18.0)	29.3	4.7	13.5
1996	(5.6)	(23.1)	33.9	15.5	9.0
1997	(6.8)	(30.9)	25.9	20.7	(7.8)
1998	(6.6)	(33.6)	16.3	20.5	(17.3)
1999	(1.2)	(24.4)	13.5	30.1	(10.7)
2000	(0.7)	(24.7)	22.3	29.6	(2.6)
2001	2.6	(23.1)	26.8	22.6	3.3

Source: The Central Bank of Brazil.

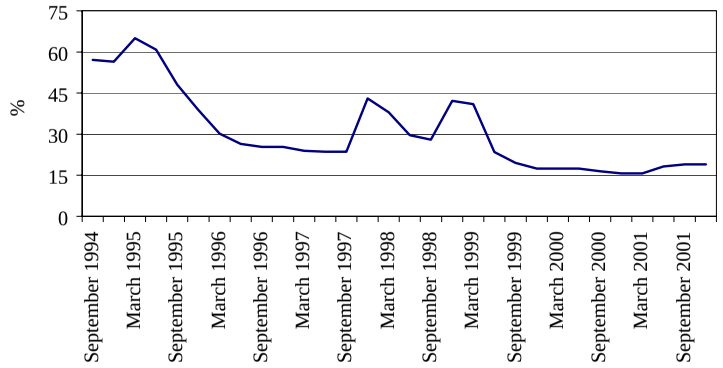
The Mexican crisis in 1994-1995, indicated that sooner or later the consequence of exchange rate appreciation would be a currency crisis in Brazil. As a result of the "Tequila" effect, foreign investment declined, thereby reducing Brazil's foreign reserves. At that time, critics of the Real Plan claimed that devaluation of the exchange rate was the appropriate solution for restoring equilibrium to the balance of payments. However, the monetary authorities worried that exchange rate devaluation might cause

inflows for the same period only amounted to around USD 46.6 billion. In other words, the capital inflows only financed 72.2% of the current account deficit during that period.

[16] For more on this, see Section 2.2.

inflationary shock and as a consequence bring back the indexation process. The monetary authorities therefore decided against devaluation, and instead, introduced a crawling peg system to operate the exchange rate flexibly.[17] At the same time, interest rates were gradually raised to nearly 65%. The authorities also moved tariffs upwards in some specific sectors,[18] and increased the nominal interest rate, in an attempt to entice international capital, especially portfolio capital, back to Brazil. Figure 2 shows the evolution of the nominal interest rate post real.

FIGURE 2.
Annual Nominal Interest Rate, 1994-2001*



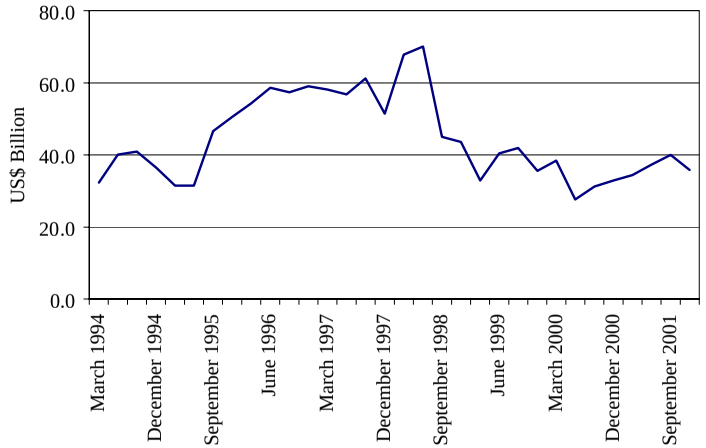
Source: NAPE/CPGE/UFRGS.
* [1]From July 1994 to September 1996, and from June 1999 to December 1999, the nominal interest rate was Over/Selic. From December 1996 to March 1999 the nominal interest rate was TBAN.

The result of this orthodox monetary policy was a recovery in the foreign reserves by the end of 1995, as shown in figure 3. In December 1995,

[17] This system was abandoned in January 1999, when a flexible exchange rate regime was adopted. This was then followed by the institution of an inflation-targeting regime.
[18] At the beginning of the Real Plan, tariff reductions were used as a weapon against domestic price-makers (entrepreneurs who effectively determine prices because of their power of monopoly).

foreign reserves had risen to around USD 50 billion, up from around USD 31 billion in June 1995; an increase of 61.2 percent.

FIGURE 3.
*Net Foreign Reserves**
USD Billion



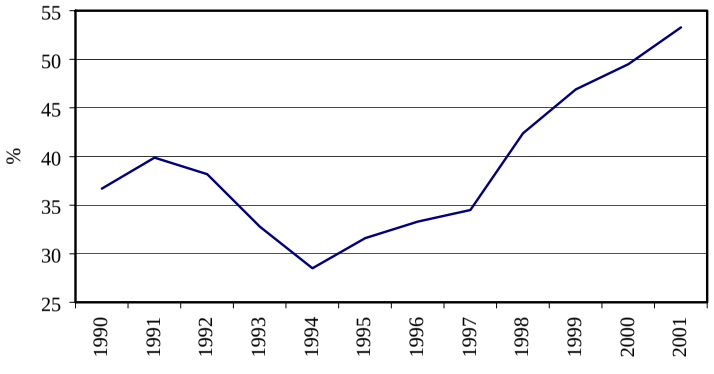
Source: The Central Bank of Brazil.
* Operational concept, including disposable assets.

These measures were effective in preventing a speculative attack on the real and as a consequence no Brazilian currency crisis occurred. However, a consequence that did occur, was a slow-down in the growth rate. The average growth rate of the GDP in 1995 and 1996 dropped to 3.4%, as can be seen from the figures in table 1.

Furthermore, the increase in the nominal interest rate produced a marked fiscal imbalance and growth in net public debt. Figure 4 illustrates the ratio between net public debt and the GDP, which increased 86% during the period 1994-2001. The policy of a high nominal interest rate also caused difficulties for businesses, in terms of financial fragilities, and as a result the financial system suffered a serious crisis, due to a rapid increase in the number of bad loans. At that time, to

prevent a crisis in the financial system, product of the system's fragility, the monetary authorities decided to help this sector by launching the PROER.[19]

FIGURE 4.
Net Public Debt/GDP



Source: The Central Bank of Brazil.

Up to the end of 1996, the two basic pillars of the Real Plan: an overvalued exchange rate and high interest rates, were aggravating macroeconomic instability. The trade balance and the current account deficit were worsening, public debt was increasing and economic activity was slowing down. As a result, uncertainty regarding the Real Plan's future began to enter the expectations of economic agents. Nevertheless, the elasticity of the foreign reserves gave the monetary authorities especially Gustavo Franco (1998), Director of Foreign Affairs and later President of the Central Bank of Brazil the confidence to argue that although *the world was in a bad situation, the Brazilian economy was in good shape*.

[19] PROER aimed at stimulating and restructuring the National Financial System. It was launched to avoid the contagion crisis caused by the micro-economic vulnerability of three of the biggest private domestic banks, namely: Bamerindus, Econômico and Nacional.

However, the real was unable to fend off a speculative attack consequent on the East Asian crisis in the second half of 1997, thus demonstrating the external vulnerability of Brazil's economy at the time. The speculative attack resulted in capital flows moving out of the country, thereby reducing foreign reserves. Figure 3 shows that, between June and December of 1997, Brazil's foreign reserves fell by almost 10 percent.

The reaction of the Government was swift and once again conservative. The nominal interest rate was raised, as shown in figure 2; TBAN the economy's basic interest rate rose from 24.5% per year in October 1997, to 46.5% per year in November of the same year; and current Government expenditure was cut. These orthodox measures, taken to prevent a Brazilian currency crisis,[20] inspired some "confidence" in the economic agents, as evidenced by a reduction in capital outflows during the first semester of 1998. The Brazilian economy managed to regain some semblance of "normality", witnessed by the fact that foreign reserves rose to USD 70 billion by the end of July 1998 (up from USD 40 billion at the beginning of the Real Plan in July 1994).

However, in the third quarter of 1998, the speculative attack on the real, a mix of a contagion crisis arising out of the Russian crisis, plus perception on the part of market operators that Brazil was experiencing serious macroeconomic imbalances clearly, demonstrated that foreign reserves were no protection at all against attempted speculative attacks on the Brazilian currency.

Given that 1998 was politically important to the Government because of the Presidential Elections, despite pressures to devalue the real, the monetary authorities insisted instead on adopting a further short-term orthodox economic policy. Once again, public expenditure was cut, taxes

[20] A currency crisis was prevented only by swift action on the part of the Government. Part of the voluminous international reserves were sold off (falling from USD 61.2 billion in September 1997, to USD 51.4 billion in December 1997); annual interest rates were raised sky-high (from 21% to 44%); and the supply of hedge-financing was increased by selling exchange-adjusted government securities, so as to revert the speculative process under way at the time. In addition, the Brazilian Government announced a strong fiscal policy package and measures to attract capital inflows.

were increased and the Central Bank of Brazil raised the nominal interest rate sky-high.[21] This time, however, as opposed to what had happened following the Mexican and East Asian crises, their orthodox policy did not inspire confidence in the Real Plan. Indeed, disappointment with slippage in the fiscal adjustment during 1998, plus a growing public debt, contributed to the general feeling that Brazil still remained vulnerable. This sentiment developed because of the Government's inability to improve economic fundamentals, particularly the public sector deficit. The Brazilian Government had promised strong fiscal adjustment, but had not fulfilled this promise.

After Russia's devaluation in mid-August 1998, the crisis in Russia soon led to pressures on emerging markets, and this particularly affected Brazil's external capital account. With macroeconomic imbalances and uncertainties about the Real Plan's future, capital started flowing out of the country and foreign reserves fell rapidly. Between September and December 1998, foreign reserves plummeted by 38%, as can be seen in figure 3. The solution decided on at that time, was to seek an agreement with the International Monetary Fund (IMF) financial support to the tune of around USD 40 billion. Brazil, however, had to compromise in terms of *i*) adopting fiscal and monetary austerity policies, and *ii*) accepting financial and trade liberalization.

Despite the IMF rescue package, the Real Plan did not regain the confidence of the financial markets, and as a result Brazil was unable to defend its currency. Repeated financial crises both Asian and Russian in a very short period of time, plus the international recession of 1997-1998, also contributed to a deterioration of the Brazilian economy. Thus, in January 1999, after continuing losses in foreign reserves, Fernando Henrique Cardoso's Government was finally forced to admit that the real was overvalued, and the exchange rate regime was changed; the "fixed" exchange rate regime (the main pillar of the Real Plan) was supplanted by a floating exchange rate.

The change in the exchange rate regime caused yet more problems for Brazil's economy. First, as usually occurs after a fixed nominal price is

[21] As shown in figure 2, the annual nominal interest rate was increased from 29.7% in June 1998, to 42.2% in December 1998.

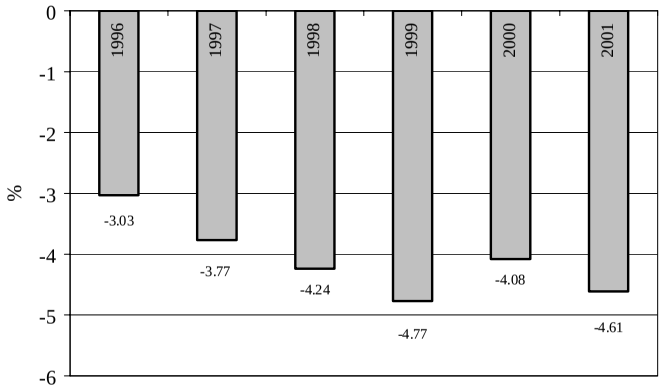
maintained for a long period, the devaluation of the exchange rate ran into an overshooting process: the exchange rate of around R$ 1.2 per dollar at the beginning of January, jumped to R$ 2.1 by March. The consequence of this exchange rate shock was increased inflation, which jumped from 1.7% in 1998 to 19.9% in 1999, as shown in table 1. Secondly, the devaluation forced the Government to abandon its agreement with the IMF.[22]

Given that short-term scenario at the beginning of 1999, a degree of scepticism started creeping into expectations regarding the Brazilian economy. Economists, entrepreneurs and politicians all expected *i*) explosive inflation, possibly reaching rates prevailing before the Real Plan, and *ii*) a dramatic recession with consequent increasing unemployment. In other words, the scenario severely affected the expectations of the economic agents, demonstrating how easily confidence in economic stabilization can be destroyed.

However, a few months after this economic turbulence brought about by the devaluation, surprisingly, Brazil's economy seemed to rally once more and began to show signs of recovery. In the second half of 1999 and during 2000, the figures improved impressively: in 1999 and 2000 the GDP increased 0.8% and 4.2%, respectively. In 2000, there was positive growth in all components of demand. Inflation rose by a mere cumulative 6%, probably due to the high degree of deindexation of the Brazilian economy at the time; the trade balance and the current account deficits decreased; and the medium- and long-term inflows of portfolio capital and basically international direct investments rose. Given Brazil's economic performance in 1999 and especially 2000, President Cardoso began calling Brazil's critics "*neo-bobos*" (*neo-fools*, a play on *neo-liberals*). The monetary authorities were now able to argue that because of its macroeconomic fundamentals and insertion into international financial and productive circuits Brazil's economy was entering a new prosperity cycle that would be characterized by low inflation and an average growth rate of GDP of around 5% per year.

[22] Of course, months later, the agreement with the IMF would be renegotiated on different terms.

FIGURE 5.
Current Account/GDP



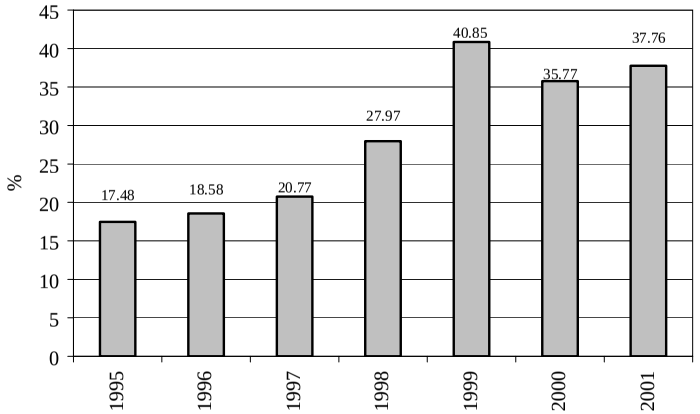
Source: Monthly Bulletin of the Central Bank of Brazil.

However, in 2001, owing to a number of international shocks such as the slow-down and recession in the US economy (particularly after the terrorist attack in New York on 11th September), stagnation in Japan's economy, and the Turkish and Argentine crises the Brazilian economy again began to flounder. Economic growth fell to 1.5%,[23] down from 4.2% in 2000, and inflation was running at 10.4%. On the other hand, although the balance of payments current account had fallen from USD 33.6 billion in 1998 to USD 23.1 billion in 2001 (table 2), the ratio of the balance of payments current account to the GDP remained over 4% (figure 5). The behaviour of this ratio is partly explained by the fact that the GDP in dollars had shrunk after the 1999 devaluation of the real. Thus Brazil still remained vulnerable to the mood on international financial markets, because of its continuing need for external capital to finance its current account deficit. Furthermore, the high level of external debt up from 20.8% in 1997 to 37.7% in 2001 (figure 6) represented a heavy constraint on Brazil's macroeconomic policy, given that a floating exchange rate

[23] Preliminary estimate.

regime under these circumstances is not able to eliminate exchange rate risk. This was yet another reason for Brazil's external vulnerability.

FIGURE 6.
External Debt/GDP



Source: The Central Bank of Brazil.

2.2 The 1997-1999 Brazilian Currency Crises: an interpretation[24]

The speculative attacks on the real that occurred in October 1997 and during the second semester of 1998, seem to have stemmed from a mix of a "contagion crisis" arising out of the effects on Brazil of the East Asian and Russian crises and an outbreak of speculative activity triggered by market operators who perceived evident macroeconomic imbalances in Brazil. The contagion effect manifested as a fall in the price of bonds issued by Brazil (and all emerging countries) and traded on international financial markets; and also as losses suffered by global players in their applications on the East Asian and Russian stock markets. The result was that investors on the Brazilian market began to sell their positions in reals to cover their losses on other markets.

[24] This Section is partially based on Alves Jr *et all* (2001).

The Russian moratorium not only caused substantial losses to major Western financial institutions, but it also led to their selling assets on other emerging markets in order to raise funds to cover their losses, thereby creating an outflow of capital from those markets. This affected Brazil in particular, because the markets for Brazilian equities and Brady bonds are amongst the largest and most liquid of all emerging markets, and play sizeable roles in global arbitrage strategies. Furthermore, the perception on the international financial market was that the Brazilian economy somewhat resembled the Russian economy: a large and growing public sector deficit; an exchange rate-based stabilization policy; real appreciation of the currency; rising foreign deficits, sustained by large short-term capital inflows based on interest rate differentials; and vulnerability to commodity price declines.

In terms of doubtful economic fundamentals, this unsustainable trend in its foreign accounts put Brazil at risk of a currency crisis, because of the economy's high degree of external financial fragility. As Paula and Alves Jr (2000) stressed, there is clear evidence that the degree of Brazil's external financial fragility increased during the Real Plan, (principally in 1996 and 1997), and basically because exchange liabilities actual and potential were not covered by current revenues or sources of longer-term financing, thus leaving Brazil systematically dependent on external refinancing.

Brazil's economic authorities seemed to be neglecting the effects of a possible change in the international situation, putting across the idea that the real was a bulwark. The central idea was that the large trade deficits being experienced were the result of restructuring industrial production in Brazil, and that this restructuring promised sufficient medium-term productivity gains to offset exchange appreciation. The exchange risks of this strategy would be minimized by the fact that the deficit was claimed to be soundly financed with growing participation by long-term foreign capital. In addition, the high level of foreign reserves was considered a "safety-net" against any attempted speculative attack on the Brazilian currency, the real.

Nonetheless, events in Brazil demonstrated that in view of increasing current account deficits long-term financing for such deficits was

insufficient to preclude external vulnerability. Brazil was thus obliged to resort to external refinancing, which served only to increase the already voluminous stocks of bonds and credits with short maturities, thereby leaving the Brazilian economy yet more vulnerable to shifts in the short-term expectations of foreign investors. *The Brazilian currency crisis was thus directly associated with the dissolution of the context of normality that had prevailed since the beginning of the Real Plan, and with agents' deteriorating expectations in relation to this context, as a result of a loss of confidence in the Government's ability to maintain this regime and in the sustainability of the balance of payments.*[25] The IMF-led financial assistance package, designed as a "preventive" measure, did not succeed in persuading the financial markets that Brazil was in fact able to defend its currency. This was not only because of the IMF's onerous, complex conditions; but also because the image of the IMF itself had been tarnished by the failure of its intervention in East Asia. The fact of repeated financial crises East Asian and Russian in a very short period of time, plus the international recession of 1997-1998, also contributed to a deterioration of the Brazilian economy.

[25] In the case of Brazil during the Real Plan, normality as regards external affairs was closely associated with a strong belief among resident and non-resident agents in the stability and maintenance of the exchange rate regime (the "crawling exchange rate band"), in the Government's ability to maintain this regime, and also in the sustainability of the balance of payments. This belief created a macroeconomic context in which a sort of "convention of stability" prevailed, so that economic agents demonstrated confidence in the macroeconomic sustainability of the price stabilization policies. By contrast, the currency crisis was associated with the dissolution of this context of normality, and with deteriorating expectations among agents because they lost confidence in the Government's ability to maintain this regime or sustain the balance of payments.

3. HAVE MACROECONOMIC IMBALANCES REGISTERED ANY CHANGE SINCE THE DEVALUATION OF THE REAL? THE BRAZILIAN ECONOMY 1999-2001[26]

As already mentioned, the period following the implementation of the Real Plan was marked by an impressive reduction in inflation, despite the major devaluation of January 1999. However, the evolution of the GDP after two years of economic growth (1994-1995), as a result of the initial effects of the exchange rate anchor based stabilization plan disappointed previous expectations of sustainable economic growth consequent on price stabilization. Indeed, the movement of the GDP has followed a "stop-go" pattern (table 1).

The Brazilian economy has in fact suffered the impact of a succession of crises (Mexico 1995, Asian countries 1997, Russia 1998, Brazil's own crisis in late 1998 and early 1999, and, more recently, Argentina since end-2001), all because of the perception of high external vulnerability. This perception has been created by the need to finance high balance of payments current account deficits; the semi-stagnation of the economy; the adoption by the Central Bank of very high short-term interest rates; and the consequent increase in public debt. All these factors have contributed to defining a very unstable macroeconomic context.

Macroeconomic constraints in Brazil are mainly a heritage from the period when the exchange rate anchor was being operated in a context of trade and current account liberalization. That situation created high external fragility in the economy, with some serious resulting macroeconomic imbalances (high foreign debt, fast growth of internal public debt, and so on). The state of expectations in the private sector had deteriorated due to the impact of various external shocks, plus weak performance of the Brazilian economy, and very high interest rates. Despite the change in June 1999 from an exchange rate anchor to a floating exchange rate regime with an inflation-targeting regime, there has been no significant improvement in the economy's macroeconomic

[26] This paper's authors consider that the Real Plan effectively ended in January 1999, with the shift from an exchange rate anchor to a floating exchange rate regime followed by the adoption of an inflation-targeting regime.

variables. It could be expected that the adoption of a floating exchange rate regime would have made it possible to reduce the rate of interest more quickly. However, after the sharp increase in the overnight rate to sky-high levels (reaching more than 40% per year) dating from the effects of the Asian crisis until the devaluation of the real in January 1999 even though the rate of interest did in fact decline somewhat, it then rose again during 2001 (figure 2), because of the turbulence on international markets (effects of 11th September 2001, Argentina's crisis, and so on).

Very high interest rates are the result of high country-risk (due to high external vulnerability and the risk of fiscal insolvency), the adoption of inflation-targeting[27] in a context of various macroeconomic constraints, and the high level of internal debt with low average maturity. However, monetary policy management has been very conservative in Brazil in recent years. At any sign of macroeconomic instability, Brazil's Central Bank has immediately raised the interest rate. For this reason, interest rates have tended to absorb all the macroeconomic imbalances. Bresser-Pereira and Nakano (2002) suggest that the causality between interest rate and country-risk might even be the inverse. In other words, given that the short-term interest rate has been at a very high level, foreign creditors might have deduced from this that the country-risk was high. According to Bresser-Pereira and Nakano, the interest rate in Brazil is high, because it is designed to carry out multiple functions: to keep inflation on target; to limit exchange rate devaluation; to attract foreign capital; to rollover public debt; and to reduce the trade deficit through control of internal demand.[28]

The high interest rates have caused two effects: *i*) constraints on economic growth, because of expensive credit (loan rates), and because of negative expectations on the part of entrepreneurs; *ii*) increasing

[27] Under the inflation-targeting regime, the Central Bank of Brazil operates monetary policy only to keep inflation low and under control, whilst levels of output and unemployment are determined on the supply side of the economy. In other words, the inflation-targeting regime supposes that there is a separation between the real side and the monetary side of the economy, the well-known "classical dichotomy".

[28] For more on this, see also Toledo (2002) and Oreiro (2002).

public debt, mainly formed by indexed bonds or short-term pre-fixed bonds. Indeed, the strong demand for hedges against exchange rate devaluation and interest rate changes, during turbulent periods, has influenced Brazil's internal public debt, because in order to rollover public debt the Brazilian Government has been compelled to offer securities buyers these hedges, which charge a high-risk premium. As a result, since the end of 1998, more than 50% of Federal domestic securities have been indexed to the overnight rate, while more than 20% have been indexed to foreign exchange, as can be seen in table 3. In addition, the ratio of net public debt to GDP rose from 34.5% in December 1997, to 53.3% in December 2001 (figure 4).[29]

TABLE 3.

Federal Domestic Securities, Percentage Share of Index Numbers

End-of-period	Foreign exchange	Reference rate*	Inflation	Overnight rate	Preset	Long-term interest rate	Other	Total
Dec 1996	9.4	7.9	1.8	18.6	61.0	1.4	-	100
Dec 1997	15.4	8.0	0.3	34.8	40.9	0.6	-	100
Dec 1998	21.0	5.4	0.4	69.1	3.5	0.2	0.5	100
Dec 1999	24.2	3.0	2.4	61.1	9.2	0.1	-	100
Dec 2000	22.3	4.7	5.9	52.2	14.8	0.0	0.0	100
Jun 2001	26.8	5.0	7.1	50.2	10.8	0.0	0.0	100
Dec 2001	28.6	3.8	7.0	52.8	7.8	0.0	0.0	100

Source: Monthly Bulletin of the Central Bank of Brazil.
(*) Average rate of time deposits.

As a result, the behaviour of domestic public debt in Brazil has proved extremely vulnerable to any interest or exchange rate changes. A decline in public debt depends on the reduction of its financial burden through a fall in the interest rate or appreciation of the exchange rate, and/or through an increase in the primary fiscal surplus. Thus, the Brazilian

[29] For a comprehensive analysis of the recent behaviour of public debt in Brazil, see Sobreira (2002).

Government has been forced to generate a high primary fiscal surplus (around 3.5% of the GDP), which poses obstacles to the enforcement of any anti-cyclical fiscal policy. This fiscal effort, however, is partly neutralized by increases in the interest rate or exchange rate. This creates something of a dilemma. Given the structure of the public debt, a fall in the interest rate at the same time as a reduction in the financial cost of that part of the debt tied to the overnight rate, can have a negative impact on that part of the debt tied to the dollar, because of resulting exchange rate depreciation.

This situation poses the question: Does the Brazilian economy really have, as the monetary authorities have argued that it does have, the macroeconomic fundamentals consistent with keeping inflation under control and simultaneously promoting economic growth and social development in the medium and long term?

4. HOW CAN EFFECTIVE DEMAND BE EXPANDED IN CONDITIONS OF MACROECONOMIC INCONSISTENCY?

As mentioned above, from 1994 to1999 and in common with other Latin American countries, Brazil implemented a stabilization policy based on trade and capital account liberalization, currency overvaluation and high domestic interest rates. This policy made the Brazilian economy highly vulnerable because of dependence upon foreign finance and the financial fragility of the domestic debt. As a consequence, the Government was faced with problems such as speculative attacks and currency instabilities. Equally worrying was that from 1994 to 2001the average growth rate in the GDP had been very low, and unemployment had risen alarmingly. Added to this, as already mentioned, there was no significant improvement in the macroeconomic variables of Brazil's economy in 1999-2001, in other words, after the adoption of a floating exchange rate regime plus an inflation-targeting regime. (The nominal anchor of the domestic prices had been changed from a fixed exchange rate to an inflation-targeting regime.) Brazil's recent experience shows that in countries with a high level of external debt, excessive dependence on external finance can cause periods of intense exchange rate instability, and this can jeopardize

efforts to attain any announced inflation target. This situation can also cause low economic growth, because monetary authorities tend to increase interest rates during periods of financial instability.

Returning to the query posed above, namely: Is the Brazilian economy entering a new prosperity cycle, in which case does the current macroeconomic inconsistency perhaps not matter? And if Brazil is not entering a new prosperity cycle, what needs to happen to allow Brazil to enter on a self-sustainable economic growth path that would be compatible with equilibrium in the balance of payments and low inflation?.

As regards external imbalance, despite the fact that the balance of payments has improved over the past two years, the Brazilian economy is still vulnerable to external forces. This is due to the following reasons: *i*) considering that, at the end of the 1990s, the current account deficit plus amortizations was running at around USD 50 billion per year and assuming the past is a guide for the future over the next few years, the Brazilian economy will need a substantial volume of "foreign saving" to equilibrate the balance of payments;[30] *ii*) the mega trade surplus expected by economic authorities following devaluation of the exchange rate, may not be attainable in the long run, because of the high income-elasticity of imports in Brazil, in other words, during periods of economic growth, mega trade surpluses cannot be achieved;[31] *iii*) the greater degree of trade openness in the 1990s, made the Brazilian economy heavily dependent on import inputs and as a consequence any expansion of industrial production would force imports up; *iv*) the international investment entering Brazil in recent years, is basically related to non-tradable goods,[32] and therefore the deficit service balance in the future will increase, because of outflows of royalties, profits, dividends, etc.; and *v*) the consequences of the US recession, the fragility of the *euro*, the

[30] At this point, in a world of slowing growth rates due to economic problems in Japan, the US economy and Argentina it is unrealistic to expect that capital inflows (both risk and portfolio) will maintain their past trend.

[31] In 2002, a trade surplus was achieved due to a combination of excessive exchange rate devaluation and low GDP growth.

[32] For more on this, see Laplane *et all* (2000).

deflation and recession in Japan and more recently the devaluation of the Argentine peso, will all pose additional obstacles for Brazilian exports.

As regards fiscal sector imbalance, even if the Government decides to implement another short-term fiscal policy such as squeezing current expenditure and increasing taxes the current interest rate (the real value [index by price] of the exchange rate) will compromise public sector equilibrium, given that as is commonly known the main cause of fiscal deficit is the financial component due to increasing costs in rolling over the public debt.

In this context a balance payments deficit and fiscal imbalance Brazil's economy is actually facing severe obstacles to any possibility of returning to a growth rate path.

Although the complexity of Brazil's economy reduces the margin for a short-term economic policy, we think that the adoption of an Economic Agenda, which we may call *Post Keynesian Economic Growth Targeting*, would stand a good chance of stimulating economic growth of the GDP plus social development, without compromising monetary stabilization.[33]

Many years ago, Keynes emphasized the importance of government intervention aimed at removing constraints on full employment, and reducing inequalities in wealth and income distribution. To address this objective, the government should, according to Keynes, operate a fiscal policy to expand effective demand; ensure that monetary policy makes a significant impact on the level of economic activity; co-ordinate the financial markets; develop an industrial policy; etc.[34] Such policies can promote a stable environment in which the private sector would be encouraged to reduce speculation and liquidity preference, and as a result to invest.

Bearing this in mind, Brazil's economic policy must be focussed on reversing the short-term macroeconomic constraints, both fiscal and external. Therefore, the question now is: How can the monetary authorities

[33] Ferrari-Filho (1999), among others, explores this point.

[34] For a Post Keynesian theoretical approach to a possible Economic Agenda, see Arestis and Sawyer (1998), Cardim de Cravalho (1992: Chapter 12), and Davidson and Davidson (1996).

reduce short-term interest rates; a crucial pre-condition to economic recovery, whilst at the same time reaching a balance of payments' equilibrium?

The conclusion is that an external balance aimed at reducing dependence on foreign capital, should be the priority of the economic policy. We believe the external deficit (or imbalance) could be reversed if the following measures were adopted:

- The Central Bank of Brazil should manage the exchange rate every time speculators want to manipulate the market. In other words, the exchange rate regime must be similar to a dirty floating system. However, this mechanism is limited, as countries with high external debt very often tend also to have unstable exchange rate markets. For this reason, the monetary authority has to be able to provide an anti-speculative mechanism to regulate movements of capital.
- The Government should implement fiscal and financial policies aimed at stimulating exports. For example, the BNDES could increase its role in financing exports and the Government should also decrease domestic taxes levied on exports, thereby making exports more competitive.
- The Government and the private sector should operate an industrial policy aimed *a*) at inserting the Brazilian economy in the international scenario in a context where Brazil can incorporate the technological and structural revolutions occurring in the world; and *b*) at attracting international investments that would add aggregate value to exports; in other words, international investments that produce tradable goods.[35] Industrial policy should be used both to increase and change the composition of Brazil's exports, in order to incorporate other products with high levels of aggregate value.
- Considering that current World Trade Organization agreements prescribe special treatment for developing countries,[36] the Brazilian

[35] In the area of industrial policy, by means of fiscal incentives to micro, small and medium businesses, it would be important to create some mechanisms in order to legalize the informal sector. In this way, the creation of those mechanisms could also be related to international trade.

[36] See www.wto.org.

> Government should revise its trade policy, reducing tariffs on the importing of capital goods, and increasing tariffs on the importing of durable goods.

In other words, given that any exchange rate devaluation would face issues related to inflation pressures, an increase in the trade balance surplus is needed in order to reduce the necessity of foreign capitals. Such an increase is a vital pre-condition if Brazil is to overcome its external vulnerability. It would require a more active trade policy and a policy of industrial restructuring, in order to promote exports and a process of import substitution that would reduce the aggregate value of imports. To this end, the Brazilian Government should selectively use tariffs on imports and non-tariff mechanisms such as subsidized credit that could stimulate import substitution by domestic production in some sectors. Indeed, the production of a trade balance surplus in the balance of payments is essential to make it possible for the Government to reduce interest rates, a measure which in turn would be compatible with greater economic growth.

It would also be necessary for the Brazilian Government to implement some kind of preventive capital controls on the balance of payments capital account, using a modern and efficient system of regulating capital inflow and outflow.[37] Capital controls should be used to allow the adoption of a more autonomous monetary policy, as they can be a useful mechanism to break the arbitrage between the price of assets (including the exchange rate) that make the interest rate exogenous, (*i.e.* that the rate of interest is effectively determined *abroad*). Capital controls can also reduce exchange rate instability through the selection of the capital flows that the country wants to absorb, using mainly market-based controls such as an unremunerated reserve requirement.[38]

Aiming at equilibrium in the public sector is of paramount importance. In this regard, fiscal austerity in the Union, States and Municipalities; fighting

[37] For more on this, see Batista Jr (2002).
[38] For a comprehensive analysis of capital controls, see Neely (1999).

fiscal evasion; operating a tax reform;[39] implementing Social Security reform; and operating a privatization programme,[40] are all relevant measures, but they are not enough. Creating conditions for reducing interest rates is also essential if a fiscal balance is to be reached, given that part of the public debt is indexed to the overnight rate, as mentioned above. Furthermore, if the public sector is to be balanced, the maturity of the public debt must be extended. In our opinion current taxes on financial transactions could be operated as a valuable weapon in encouraging extension of public debt maturity. In other words, taxes on short-term financial applications could be increased, whilst taxes on long-term financial applications could be decreased. The effect of such a tax policy on capital gains, and on confidence in the economy on the part of economic agents, would be a reduction of interest rates brought on by changes in the liquidity preference of these economic agents.

Two points are very important if wealth is to be created and income redistributed. On the one hand, keeping inflation under control is vital, and this could be achieved by an income policies to regulate wages and prices. Furthermore, as inflation to date in Brazil has arisen essentially on the supply side (costs inflation), given that the Brazilian economy has been stagnant in recent years, it is essential to manage permanently all sources of price rises. For this purpose, the use of regulation stock of specific products, and the revision of determined contracts and practices in those sectors with prices linked directly to the exchange rate (*oil*) and to the

[39] The project for tax reform still awaiting a vote in the National Congress, might be an interesting proposal for tax reform.

[40] It is necessary to emphasize that the privatization programme is an efficient mechanism for eliminating the economic and social idiosyncrasies of the State. However, reducing the stock of public debt by using revenues from a privatization programme, will not solve the public deficit, because the annual revenues from privatization are less than the nominal interest rate that the Government has to pay for postponing its debt. Besides, the Brazilian experience has shown that privatization is quite peculiar in that, first, the State monopoly is developing into a private monopoly since privatization; and second, BNDES is financing the privatization process. For the authors of this paper, privatization is not an ideological issue. However, a clear definition is required as to what to privatize, how to privatize, and what to do with the revenues from such privatization.

inflation rate (utilities in general), would be required. These policies would prevent the frequent use of the interest rate to deal with inflation pressure regardless of the cause of that inflation. In addition, fiscal policies such as progressive income taxes and capital levies, guaranteed minimum income[41] and social expenditure to improve the standard of living of poorer people are required to promote personal income redistribution. In other words, Government intervention is vital in the redistribution of income.

The above are the economic policy recommendations we would suggest for inclusion on an Economic Agenda for Brazil. In conclusion, economic stabilization cannot neglect fiscal, monetary, exchange rate and trade policies as instruments for stabilizing prices and expanding effective demand. Instead of an inflation-targeting regime, what Brazil really needs is economic growth targeting.

[41] For instance, Brazilian Senator Eduardo Suplicy drew up a proposal to eradicate poverty in Brazil. See Suplicy (1994).

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