

## The Difficulties of the Cruzado and the Austral Plans

Six months after the Cruzado Plan was implemented on 28 February 1986, its success in solving the specific problem for which it was created—the elimination of inertial inflation—is undeniable. Inflation, which was around 350 percent a year, fell to a figure of somewhere between 15 and 20 percent. However, strong inflationary pressures threatening the continuity of the success of the plan persist. Conversely, fourteen months after its implementation (on 16 June 1985) the Austral Plan has failed to eliminate inflation, while Israel's second heterodox stabilization plan, thirteen months after its D Day in July 1985 has succeeded in eliminating inertial inflation.

After fluctuating at around 4.5 percent a month between March and June 1986, Argentine inflation reached 6.8 percent in July and 8.8 percent in August. The annualized inflation for June, July, and August reached 118 percent, and that of August, 175 percent. The situation for the Cruzado Plan is more favorable for the moment, but if urgent measures are not taken to reestablish the micro- and macroeconomic balance of the plan, the freeze by itself will certainly not be capable of preventing the resurgence of inflation. In Israel, the success of the reform is more solid. About half of the price controls have been removed and the monthly rate of inflation is below 1.5 percent. The public deficit has been severely reduced while the level of production and employment has been kept stable.

Given those inflation rates, the freeze in Argentina has definitely been broken. Inflation is in full acceleration, which will only end when the new readjustments of prices and wages are relatively able to neutralize the most recent price increases. At this point, the inertial component of inflation would then become dominant again and, as has already happened in Israel, a new shock could be attempted.

There are those who mistakenly attribute the failure of the Austral Plan to the relative lifting of the price freeze that took place in April. This partial price liberalization, however, was already a consequence of inflationary pressures that had not been resolved. In a capitalist economy, it is impossible to maintain a price freeze for a long time. Either the government eliminates the main inflationary pressures and then proceeds with a planned lifting of the freeze, or else it does not manage to eliminate the accelerating factors of inflation and thus is forced to liberate prices because of the irresistible pressures from imbalances in the market. It was the latter alternative that prevailed in Argentina.

It is important, therefore, to know what these imbalances were and what the origin of these inflationary pressures was. Theoretically, we can have two kinds of imbalances: the macroeconomic ones that are represented by an excess of aggregate demand and the microeconomic ones that are explicit in the imbalances of relative prices.

Everything indicates that the Argentines were not dealing with a macroeconomic imbalance or, more specifically, with excess demand. Even though the public deficit had not been completely eliminated, it was significantly reduced. However, the economy definitely remained in recession until the beginning of 1986. In the first quarter of 1986, the growth of the GNP was only 0.4 percent, as compared to the same period in the previous year. Recently, a clear process of expansion has taken place, registering growth of 5.7 percent in the second quarter, but the levels of unemployment and idle capacity are still very high.

The imbalances that were not resolved, therefore, could only have been microeconomic. The economic authorities were unable to resolve the distortions in relative prices that existed on 16 June 1985, when the shock was applied. When the pressures from the sectors that suffered losses became unbearable, the floodgates began to open. The heating up of demand that took place at this point probably helped this process along—the freeze began to break. As a result, the pressures from workers for wage readjustments and exporters for exchange devaluations became stronger and stronger. When there was no other alternative except to give in to the pressures from wages and the exchange rate, the freeze lost its force and inflation entered into a straightforward process of acceleration, which probably has not yet ended.

The same thing does not necessarily have to happen in Brazil. The present situation of the Brazilian economy is much more favorable than that of Argentina's. Production is expanding. Although it is investing with moderation, industry is incorporating technical progress at an accelerated pace. The trade superavit is still very high. The Brazilian financial system is much better organized and developed than Argentina's. Its industry is more modern and competitive, and the fiscal system is much more developed. Last, the state bureaucratic apparatus is much better equipped. For all of these reasons, the Brazilian government has more effective means for carrying out its economic policy and controlling its economy. Perhaps it is for these reasons that inflation, in the first six months of the Cruzado Plan, was considerably lower than the corresponding inflation of the Austral Plan: 6.4 percent from March to August 1986 in Brazil as opposed to 20.1 percent from July to December 1985 in Argentina.

However, there is no question that the Brazilian economy is faced with serious macroeconomic and microeconomic imbalances. At first, the economic expansion, which reduced fixed unitary costs, and the reduction of the interest rates helped to neutralize the imbalances in relative prices, which the government itself did not feel able to solve. Next, however, an extraordinary increase in consumption changed the economic expansion into a serious macroeconomic distortion, which the compulsory loan and raising of the internal interest rate are not capable of resolving.

There is no question that the Cruzado Plan finds itself in a dangerous situation now. Part of the support that it initially received does not exist anymore. Consumers are irritated and disappointed with the lack of merchandise, with waiting lines and overpricing. Even though they are earning good profits, businessmen feel that their control over their own activities is threatened. Those who are the most conservative or who have lost the most say that the economy is being nationalized, that Brazil is being turned into a police state, and they place themselves more and more against the freeze.

In this situation, the mere insistence of the government in maintaining the freeze does not resolve the problem. It is essential to maintain the freeze for now, but it is also essential to reestablish the microeconomic balance of relative prices and the macroeconomic balance of aggregate supply and demand.

The Brazilian economy as a whole, which should not be confused with the Cruzado Plan, continues to show an extremely favorable performance. Between March and June of 1986, industrial production grew 12.4 percent and wholesale sales were up 29.9 percent in relation to the same period in the previous year. The unemployment level fell from 5.6 percent in June 1985 to 3.8 percent in June 1986. Real wages increased 14.6 percent from one year to the next. The foreign commercial superavit accumulated in this year continued at around \$13 billion, although an increase in imports and a fall in the prices of some primary export products are beginning to threaten this favorable result and make us remember that the external debt is still a serious unsolved problem.

Actually, this excellent performance of the real sector of the economy is the first problem of the Cruzado Plan. The extraordinary increase in consumption, widely overtaking the increase in production, implies shortages of supplies, waiting lines, and inflationary pressure translated into an increase of profit margins through either overpricing or the elimination of financial discounts on term sales. Contrary to what is generally stated, there is still idle capacity in the economy, but this does not prevent the inflationary pressures that come from the appearance of bottlenecks, especially in the supply of raw materials and meat. The new expansive cycle of the Brazilian economy, which began in 1984, has reached a peak in 1986—which the Cruzado Plan had favored.

The question of demand should be put into proper terms. Demand has not reached an excessively high level, but rather has had an excessively rapid recovery. According to the survey of the Getúlio Vargas Foundation of July 1986, the average degree of capacity utilization reached 82 percent, less than the record levels of 1972 and 1973—89 and 90 percent respectively. Industrial production only recovered to the average level of 1980. It is true that some sectors had already reached almost full capacity, such as nonferrous metals, cellulose, textiles, plastic containers, etc. It is also true that the level of demand became excessive in those sectors in which the flow of goods and services depends on stocks (which were greatly depressed after almost four years of recession), as in the case of beef herds. But the biggest problems are occurring in the sectors that still have some idle capacity, but which are faced with a scarcity of raw materials and thus are unable to expand production. This happens basically because demand has grown explosively and, in many segments, it is not possible to simply double production every two or three months, as has been happening with the demand for certain consumer goods. That is why the

Getúlio Vargas Foundation survey shows that the consumer goods sector is utilizing only 72 percent of its capacity and that 45 percent of the corporations have had difficulty in expanding production because of a scarcity of raw materials.

The situation will probably get worse in the last quarter of the year, as industry traditionally operates at levels 10 to 15 percent higher in this period than the average for the rest of the year in order to meet the end-of-year demand. Demand should also continue to expand in order to restore stocks, which are at a very low level. Faced with this situation, the government's hesitation in taking urgent fiscal policy measures to decelerate the growth of demand is hard to understand. Given a diagnosis that the problem is not an excessive and generalized level of demand in relation to productive capacity, but rather an excessive rhythm of expansion, a fiscal policy should contain this growth without the need to reduce the level of employment.

The second problem is the new outbreak of pressure from the trade unions for higher wages, which is added to the pressure from the market itself, especially for specialized labor. The explosion in the demand for labor and the higher demands of the trade unions has led to real increases in wages, which are considerably higher than the increase in productivity. These wage increases will not be translated into a reduction of profits only if they result in increased prices instead.

The Cruzado Plan's third problem is the microeconomic imbalance of relative prices, or prices which have been "ahead" or "behind" since the day of the shock. The shortage of merchandise in the stores is not due only to excess demand, but also to the fact that the producers, especially those who can substitute products, stopped making a series of goods whose prices were behind on 28 February. Almost half of the products with set prices (all prices have been frozen, and about 500 products had their prices set in order to make the control easier), for example, are disappearing from the retail stores because their producers stopped making them, substituting for them whenever possible with new products. When the producer manages to substitute for the controlled goods, he solves his problem by provoking a small amount of inflationary acceleration; when he cannot do this, it appears immediately as a focus of repressed inflationary pressure.

The problem of the retail companies, on the other hand, is far from being solved. The financial discount they were supposed to receive from their suppliers in order to compensate for the end of inflation (since these suppliers had built an average monthly inflation of 14.6 percent into their term sales) should be 12.6 percent a month, but, in practice, ended up being an average of 5 percent. Those suppliers that gave greater discounts are now taking advantage of the excess demand, without formally

disregarding the freeze, to reduce or eliminate the discounts, leaving the retailers in a difficult situation in spite of the increase in sales.

On the other hand, the corporations whose prices were ahead on 28 February and those that gave an insufficient financial discount to their customers saw their profit margins increase substantially. The increase in margins, together with the increase in sales, has led to an incredible increase in profits. The auditing companies have calculated that, in the first half of 1986, the profits of the industrial corporations would be, in real terms, approximately double the profits for the same period of 1985. This increase in profits allowed the corporations to concede significant real wage increases to their workers, which, in turn, stimulated consumption even more and therefore accentuated the imbalance between aggregate supply and demand.

These inflationary pressures built into the macroeconomic imbalance between aggregate supply and demand, the pressures from wages, and the unresolved distortions in relative prices will accelerate inflation as soon as the price freeze is lifted.

On the other hand, given an operational public deficit of between 4 and 5 percent of the GNP, while the economy is operating at close to full capacity, the public finances are still unbalanced, thus creating a fourth focus of inflationary acceleration. In 1986, this deficit is being partially financed by the monetization of the economy. The same level of deficit is predicted for 1987, during which the contribution of the compulsory loan should be less than 1.5 percent of the GNP. Assuming that bonds will be issued, corresponding to another 1.5 percent of the GNP, there is still between a 1 and 2 percent deficit that will either be financed by new international loans and/or by an increase in taxes.

Faced with these inflationary pressures, the government has taken some steps, such as the compulsory loan on the purchase of gasoline, cars, trips abroad, and raising interest rates. Its basic strategy, however, is too simple. It consists of trying to maintain the price freeze at all costs, even by using the police. For some members of the government, "the Cruzado Plan is the freeze," which therefore should be maintained indefinitely.

The Cruzado Plan is not the freeze, and the freeze should not be maintained indefinitely; it is a shock that was applied to the economy to try to eliminate inertial inflation. However, it cannot show a lack of respect for the law of value that rules the functioning of the market. The freeze succeeds in eliminating the factors that maintain inflation; it does not eliminate the accelerating factors of inflation that operate in the market: excess demand, uncontrolled increases in wages, and imbalances in relative prices. In order to control these accelerating factors, additional measures of economic policy are needed. These factors can only be

temporarily repressed until the imbalances in the market are solved or until the moment that these pressures become irresistible and the freeze is broken.

The second alternative is the one that prevailed in Argentina. Although the Austral Plan was not faced with the problem of excess demand, it was neither able to contain wages nor resolve the problems of relative prices.

It is still too early to predict what the level of inflation will be in Brazil when the price freeze is lifted. The government will try to put this moment off as long as possible while it tries to correct the macroeconomic imbalance between aggregate supply and demand and the microeconomic imbalance of the relative prices. Meanwhile, if it does not show more energy in solving the problem of excess demand and in correcting the lagging prices, the Brazilian economy will be faced with a new inflationary acceleration in 1987. As for the lagging prices, it will have to make a choice between a little more inflation now or uncontrolled inflation in the near future. And, as for the macroeconomic imbalance, it will have to increase taxes and cut public spending. If these micro- and macroeconomic imbalances are not corrected rapidly the pressures from the market will be so strong that the freeze will break up, and, after a transitional period of acceleration of inflation, a high level of inertial inflation will be necessary. In this case the only reasonable alternative will be a second heterodox shock followed by a more firm conduction of aggregate demand and of relative prices.

*September 1986*