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## Brazil

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Economic reforms will succeed or not depending on their efficiency and on the political support they elicit. In recent years, the second factor has been emphasized by economists, political scientists, and policymakers, but it should not be forgotten that many reforms fail simply because they impose unnecessarily high transition costs and are thus politically infeasible. In certain cases, even inefficient reforms eventually succeed because the government—usually an authoritarian one—is able to go ahead with them despite their costs.<sup>1</sup> That was clearly the case in Chile, particularly in the 1970s. But under usual circumstances, inefficient reforms that are not part of a comprehensive and sensible economic program will fail, even if the government initially enjoys strong political support, because the transitional costs involved or its sheer economic inconsistency will cause it to lose that support.

In his background paper for this conference, Williamson proposes some hypotheses to explain how successful reformers have been able to mobilize and maintain political support for their reforms. His list can in fact be reduced to two main factors: political support for reforms depends on the perception of a crisis, and their success depends on the efficiency and quality of the economic program, which in turn requires a competent economic team and a statesman at the top. To these could be

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1. Inefficient reforms are those whose costs are disproportionate to their outcomes. Besides being inefficient, a reform may also be ineffective, that is, unable to achieve its objectives whatever the cost. Here I am speaking only of inefficient reforms.

added two other factors: the sensitiveness of the society in question to economic disarray and sheer fortune. The positive impact of the crisis will depend on the society's responsiveness to economic distortions. A society like Germany that is extremely sensitive to inflation will easily support anti-inflationary measures without waiting for a real crisis. On the other hand, some political events, such as the emergence of a statesman, and some economic ones, such as a sudden improvement in the terms of trade, are blessings that only chance can explain. In this extended context, Williamson's "honeymoon hypothesis" is a special case, and the presence of a fragmented opposition is only a positive factor if it results in a strong government. But we know that in democracies strong governments—that is, legitimate governments, which can count on support from the society at large—are usually accompanied by strong opposition parties.

I have been working with a model for explaining the success of economic reforms that is close to Williamson's. The basic idea of the model is, first, to gauge the seriousness of the crisis and the sensitiveness of society to it, and second, to compare the costs of muddling through the crisis with the transitional costs of reforming, to determine the net transitional costs. It is quite a different matter to discuss successful reforms in normal times, when economic distortions are just emerging, than to discuss them in abnormal times, when the economy is approaching hyperinflation.

Political support for economic reforms depends on the society's perception of the need for reform and of the net costs of transition. Reforms are not always perceived as necessary. When the inflation rate is still at a modest level, certain societies, such as the Brazilian, that are not sensitive to inflation, are content to live with it. Other reforms, such as trade liberalization, may take a long time to become viewed as necessary because they threaten certain special interests.

Once the need for reform has been perceived, it is necessary to consider the net transitional costs. These are calculated as the short-run difference between the costs of reform, in terms of higher taxes, unemployment, and restructuring of business enterprises, on the one hand, and the costs of postponing reforms or muddling through the crisis, on the other. Net transitional costs tend initially to be positive and high, since the costs of not reforming—of living with inflation, balance of payments problems, protectionism, the inefficient use of resources, and so on—are still small, while the costs of reform—of stabilizing, getting prices right, and orienting enterprises and consumers toward the market—are high. As reforms are delayed, however, the costs of muddling through the crisis increase and eventually become greater than the costs of adjusting. The "costs of not reforming" curve eventually crosses the transitional costs curve, making them negative. In the extreme case the distortions lead to an acute fiscal crisis and hyperinfla-

tion. Net transitional costs will be highly negative. When this happens, society ceases to doubt that the costs of muddling through are much greater than the transitional costs.<sup>2</sup>

Yet it may take a long time before a country gets to hyperinflation. Before it does, what can induce a society to support necessary economic reforms? Even when the net transitional costs are already negative, society may remain resistant to reforms. This collectively irrational behavior may have several explanations. First, society may not have perceived that the balance has shifted. The previous growth strategy may have been so successful in the short run that it is difficult to admit that it has now failed. Second, some powerful groups within the economy may still be gaining from the status quo even though the economy as a whole is losing.<sup>3</sup> If we were to draw the two sets of curves for each group, we would probably find that for some groups the curve representing the costs of muddling through the crisis crosses the transitional costs curve early on, while for others this intersection occurs much later, if ever.

Reforms may also be delayed for lack of institutions able to facilitate the negotiations between these groups on how to adjust the economy and guarantee their implementation. If labor unions do not really represent workers, if business associations do not really represent business owners, if political parties are weak and disorganized, or if the government is disrupted by a severe fiscal crisis, it will be much more difficult to implement reforms successfully.

Finally, even when the crisis is serious and society perceives the need for reforms, they may still be delayed for lack of political leadership or for lack of a competent team of economists capable of defining a comprehensive and efficient program for the transformation of the economy. At this difficult moment, fortunate societies will have political leaders with the vision and the courage to challenge vested interests, conservatism, and fear of change—which are usually disguised as common sense or conventional wisdom—and take the radical and risky economic reforms that the situation requires.<sup>4</sup> If these leaders are served by competent economic teams, capable of understanding the

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2. For a more complete analysis of the efficiency of economic reforms and their net transitional costs, see Bresser Pereira (1993). For a more detailed analysis of the net transitional costs see the commentary of Jairo Abud (1992).

3. This last case was analyzed and formalized by Przeworski (1991) and by Alesina and Drazen (1991).

4. In Portugal, for example, President Mário Soares twice lost elections (in 1977 and 1984) because he implemented unpopular economic reforms; in the second episode he was voted out even though adjustment had already been achieved. Socialist President Felipe González of Spain broke with his party's populist views and was able to promote reforms without betraying his leftist beliefs. President Miguel de la Madrid of Mexico embarked on fiscal adjustment and structural market-oriented economic reforms in 1985, at a time when most of Latin America remained prisoner to old national-developmental views.

particular dynamics of their country's abnormal times and of defining comprehensive, bold, market-oriented reforms, the chances of success are greatly enhanced.

The last observation suggests that it is important to distinguish economic reforms in normal from those in abnormal times. States have grown too big all over the world since the 1930s; their economies have become distorted and have fallen into crisis and now are in need of reform. But just as the crisis of the state varies in intensity from case to case, so the depth of the required reforms also varies. The present crisis of the economy—which is essentially a crisis of the state—broke in the 1970s. Most of the developed countries and some developing ones, particularly in Asia, faced the crisis early on, when the net transitional costs were still positive and avoided a deeper crisis. Others, particularly in Latin America and Eastern Europe, refused to incur short-term transitional costs, postponed adjustment and got trapped in huge foreign debts and still greater domestic distortions. These countries faced a deep crisis of the state, defined by a fiscal crisis—the state had lost its creditworthiness—and a crisis of the mode of state intervention—the state-led development strategies that had been so successful had become distorted and inefficient. A major crisis defines abnormal times. If normal times allow conventional economic policies to succeed, abnormal times will require heroic and sweeping ones. The objective is the same: to stabilize, to get prices right, and to implement market-oriented reforms. But the strategies will be different.

I will discuss here the economic reforms I tried to implement in Brazil in 1987. I was finance minister of Brazil for less than eight months, from 29 April to 20 December. Thus, I did not have much time to implement reforms. Yet if I were asked what was the basic reason why I did not succeed, I would not say it was lack of time, but rather faltering political support from the president and from Brazilian society. That lack of support turned into outright opposition on the part of some interest groups. It was this lack of support for the fiscal adjustment to which I and my team were committed that led me to resign in spite of the president's attempt to insist that I stay.

Five years later, after several more attempts to stabilize and reform the Brazilian economy, the country remains in deep crisis. This suggests that the forces opposing reform were and remain very powerful and that political support for reforms was faltering as the society continued to show a low sensitivity to inflation and economic disarray, and failed to perceive that the net transitional costs were turning negative. It is also an indication that Brazil lacked either the political leadership or a competent and stable economic team capable of formulating and implementing a comprehensive and efficient reform program. On several occasions Brazil failed to stabilize the economy for this last reason. The 1986 Cruzado Plan and most of the first phase of the administration of Fer-

nando Collor de Mello (March 1990 to May 1992)<sup>5</sup> are examples of inefficient economic reforms undertaken when the political conditions were favorable for serious reform.

In the first section of this paper, I will describe the economic and ideological environment that prevailed when I took office. In the second I will present the "Bresser Plan," the heterodox part of the stabilization program implemented during my tenure, and in the third the "macro-economic control plan," which was the orthodox part of the program, besides containing my first diagnosis of the fiscal crisis as the basic cause of the Brazilian crisis. In the fourth section, I will discuss how my administration tried to manage Brazil's foreign debt and how that problem related to macroeconomic adjustment. In the fifth section, I attempt to describe the planned second phase of the stabilization program, which was to include a new heterodox shock, preconditioned upon the conclusion of the foreign debt negotiations, a redefinition of Brazil's external commitments and their fiscal aspects, and a strong fiscal adjustment, including expenditure reduction and tax reform. In the concluding section, I will evaluate the reasons for my decision to resign and thus abort this second phase of the stabilization program; in this section I will use as reference the reasoning I have briefly developed in this introduction.

## A Populist Environment

I took office as finance minister at a crucial moment in the economic and political history of Brazil. The Cruzado Plan, a well-conceived but poorly implemented heterodox stabilization plan, which came to be known as the last populist episode in Brazil (Sachs 1988), had just broken down. Inflation was exploding, sales and real wages were falling vertiginously, firms were going bankrupt, and international reserves were vanishing. Yet behind the acute short-term crisis was a much more serious one, which Brazilian society eventually started to acknowledge by 1987.

This deeper crisis was both political and economic. The political crisis was defined by the collapse of the 1977 democratic-populist pact, which marked the transition to democracy in Brazil from 1977 to 1987. This collapse was a direct consequence of the failure of the Cruzado Plan. The structural economic crisis was essentially a crisis of the state. To the popular acknowledgment of the severity of this crisis I, while finance

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5. The political crisis that led to the impeachment of President Collor in December 1992 began in May of that year. Already by that time two opportunities had been lost: the first at the inauguration of the new administration and the second during the first four months of 1992, when the economic and political conditions for a decisive stabilization plan were present.

minister, gave a significant push. My warning to the nation that Brazil was facing not just a short-term crisis but a structural one was perhaps my most important contribution to the country during my short time as finance minister.

As long as Brazilian society remained unaware of the crisis, the democratic-populist coalition that commanded the transition to democracy tended to make the political environment adverse to economic reforms. The transition to democracy started in 1974, when the party that opposed military rule won the senatorial elections, and particularly in 1977, when President Ernesto Geisel's authoritarian "April package" aroused indignation throughout the society. Beginning in that year the business elites in Brazil, which had up to then supported the military regime, deserted the old alliance and entered into a new one with the democratic forces that had been defeated in 1964. This is the historical fact that explains the emergence of a democratization process in Brazil. But it also explains why, when the transition was complete and José Sarney took office as president in March 1985, a populist coalition found itself in power.

National-developmental views on how to run the economy, which had been successful from the 1930s to the 1950s, entered into a crisis in the 1960s. The 1964 military coup was in large part a consequence of this crisis. Once in power, however, and particularly in the 1970s, the military regime was able to postpone adjustment and artificially resume populist policies, based on foreign finance. Only in 1981 did the authoritarian government embark on an adjustment program, and then in a hesitant and incompetent way. From then until the end of 1984, the authoritarian regime tried to stabilize the economy with the adoption of orthodox policies—including an IMF program in 1983—but without success.

The new democratic government that took over in 1985 was based on a broad coalition between the entrepreneurs, who had definitively broken with the military, and the middle- and working-class pro-democracy groups, which had opposed authoritarianism from the beginning. The democratic-populist coalition's critique of the military regime included opposition to the "orthodox economic policies" that characterized the 1981-84 period. All evil was attributed to the IMF's orthodox policies and to technocratic rule. The implicit idea was to return to the good old days of the 1950s—to accelerate development together with some degree of income redistribution and moderate inflation, as had prevailed in the Vargas-Kubitschek years (1930-59). In other words, the climate was ripe for a new populist experience, with the difference that the country now faced a fiscal crisis. Moderate populism, of which the national-developmentalism of those years was a form, may work well when the initial fiscal situation of the country is sound and when there is a sector of the economy from which income can be transferred without major

distortions.<sup>6</sup> But neither condition prevailed in 1985. The inevitable result was “populism with empty hands” (Faucher 1991). If populism in general is not workable in the long run, populism without some fat to burn is not viable even in the short run.

The first two years of the “New Republic,” ending with the Cruzado Plan, were populist years. Populism had returned in full force, using democracy as a disguise. The right wing, which had been basically developmentalist and populist during most of the military regime, converted to economic austerity in the early 1980s, when the pressure from the international banks became unbearable. Given its basic commitment to free-market ideology, it was relatively easy for those on the right to switch to a rhetoric of fiscal discipline and support for structural reforms aimed at reducing the size of the state. They remained, however, tied to protectionism and to a web of subsidies that favored certain industries and regions. For those on the left and the center-left, such as myself and my team, this change was more difficult, because it also had an ideological aspect. My party, the PMDB (Partido do Movimento Democrático Brasileiro), was the core of the democratic opposition and was strongly populist.

My own change to nonpopulist views—which did not extend to embracing an orthodox economic approach—had taken place in the early 1980s, while I was studying and teaching inflation and stabilization theory and fiscal adjustment theory at the Getúlio Vargas Foundation. Drawing on the neostructuralist theory of inertial inflation, to whose development I and my associate Yoshiaki Nakano had contributed,<sup>7</sup> I remained strongly critical of the gradualist and conventional strategies advocated by the IMF to fight the type of inflation prevailing in Brazil, which was driven by a high level of indexation throughout the economy. I also remained critical of the way the creditor countries and the multilateral financial institutions were managing the debt crisis for the benefit of the creditor banks. But it was clear to me that fiscal discipline and market-oriented reforms aimed at increasing the market’s role in coordinating the economy and reducing the role of the state were essential to any rational economic policy in Brazil. This conviction would cost me a great deal when I was later nominated finance minister.

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6. During this period, agricultural export goods, particularly coffee, benefited from high international prices. That made it possible to transfer income from the old primary-exports oligarchy to the new industrialists and the urban workers. This was the basis of the “populist pact.” When prices, particularly coffee prices, fell in the last part of the 1950s, the populist pact became unworkable.

7. At that time we published together a collection of essays on inertial inflation, titled *Inflação e Recessão*. Inertial inflation (i.e., high inflation autonomous from demand) is a type of inflation that lies between moderate inflation and hyperinflation. It is defined by its level and its highly indexed character (the indexation may be formal or informal). It is also possible to speak of an “inertial component” in all three types of inflation.

When my predecessor and friend Dilson Funaro fell in disgrace after the failure of the Cruzado Plan and the cold reception abroad and internally to the foreign debt moratorium of February 1987, President Sarney had to choose another finance minister. Besides being a well-known economist in the government party, I had experience as chairman of the State Bank of São Paulo and as chief of staff of Governor of São Paulo André Franco Montoro. The condition PMDB had imposed on the president was that the new minister should come from within the party. Sarney did not know me. I was not a person of his confidence. But after a troubled process, I was finally invited to head the finance ministry.

The crisis that followed in the wake of the Cruzado Plan was serious and acute. A lot of people were therefore surprised that I accepted the job. In the days following the announcement, two friends—Celso Furtado, then culture minister, and Olavo Setubal, a banker and former foreign minister—told me separately that Brazil had not faced such a grave crisis since the 1930s at least. Yet I was prepared for the job and knew I would be able to assemble a good economic team. What I did not foresee was the resistance that I would face once in the job, from the left and the right, from the populists and the orthodoxists, and from the clientists (or “physiologists” as we call them in Brazil), the corporatists, and the rent seekers.

### **A Heterodox Program**

On the morning of 29 April, as I was preparing my acceptance speech, I received the visit of the departing country division chief for Brazil at the World Bank, Roberto Gonzalez Cofiño. This was my first interview as finance minister. I was not known in Washington. Thus, he was agreeably surprised when I told him that Brazil needed an urgent fiscal adjustment and the elimination of all subsidies so as to permit the recovery of the state’s savings capacity, positive internal real interest rates, a new stabilization program combining orthodox and heterodox policies, the regularization of the foreign debt through a realistic agreement with the commercial banks, and an export-led development strategy. These goals, plus trade liberalization and privatization, which I included in my program a little later, guided my actions in the finance ministry.<sup>8</sup> These ideas were the source of continual conflict with my party, the political staff of the president, and the Brazilian business community, to whom I made it clear that fiscal adjustment involved not only reducing state expenditures but increasing taxes as well. My decision to leave the government seven months later derived from the lack of political support for a tax reform that increased taxes and made them more progressive

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8. Privatization was not my direct concern, since it was not the province of the finance ministry, but I strongly supported it.



and for a program of public expenditure reduction that involved the elimination of several departments and sections of the state apparatus.

When I assumed the ministry, it was clear to me that the transfer of real resources due to the debt crisis was a major cause of Brazil's high rates of inflation. The debt crisis also made net foreign saving negative and, through the heavy burden of interest payments, reduced public saving. The consequence was a dramatic reduction in the rate of growth of the Brazilian economy in the 1980s. A solution had to be found to this central question. It was also clear that Brazil could not prolong its moratorium on debt service indefinitely, and that an agreement with the commercial banks and with the Fund was urgent. But I wanted a debt agreement that, while implying internal sacrifices, proved to be at least consistent with price stability and the resumption of growth. The scheme offered by then-US Secretary of the Treasury James A. Baker III (the so-called Baker Plan), with its menu approach and the pledge of additional financing (which never materialized), seemed to me insufficient, but at that moment I did not see any alternative. Schemes of debt reduction or debt relief were not on the Brazilian agenda at that time simply because no one imagined Brazil's creditors would accept them.

In the next three months I would learn a lot about the debt crisis. As a consequence I was eventually able to propose the securitization of the debt (with the creation of a debt facility to manage it) and a relative delinkage between the IMF and the commercial banks in the debt negotiations. These two proposals initially were branded as a "nonstarter" by Secretary Baker but later became the cornerstones of the plan proposed by Baker's successor Nicholas F. Brady: the Brady Plan.<sup>9</sup>

My main concern in office was macroeconomic stabilization. I needed to put together a program immediately: a short-run stabilization plan, to stop the inflation that was exploding in the wake of the Cruzado Plan's failure,<sup>10</sup> and a medium-run stabilization plan, based on a sound assessment of the Brazilian crisis and laying out the basic policies that would orient my future actions. At the same time, it was essential to introduce institutional reforms in the state apparatus in order to make fiscal and monetary policy more effective.

The short-run stabilization program, which came to be called the Bresser Plan, consisted of an emergency price freeze coupled with institutional reforms and some fiscal adjustment measures.<sup>11</sup> The objective was to reduce temporarily inflation and to regain a minimum degree of

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9. A history of the Brazilian debt negotiations was published in the work of mine cited above (Bresser Pereira 1992), an English version of which will be published as part of The World Bank History Project, sponsored by the Brookings Institution.

10. Inflation rose from around 2 percent in the month of November 1986 to 26 percent in June 1987.

11. For a comparison of the Bresser Plan with the Cruzado Plan see Bresser Pereira (1988).

control over the economy, so as to permit, in the second phase, a definitive stabilization program. This heterodox shock was consistent with my neostructuralist views on inertial inflation. As it was an emergency policy, the freeze was intended to be very short. We did not deindex the economy, nor did we undertake a monetary reform or attempt to use the exchange rate as a nominal anchor. The objective of these measures was not really to stabilize the economy, but rather to stop the explosion of the inflationary process. My forecast was that within six months inflation would still be around 10 percent a month because of the insufficient fiscal adjustment and the imbalance in relative prices at the time of the freeze. Thus, a second and definitive plan would be required some months later.<sup>12</sup>

Inertial inflation is an asynchronous process of phased price increases through which firms and workers try to protect themselves from prevailing inflation by indexing their prices. In this process, which lacks a basic coordinating mechanism, relative prices are constantly shifting between balance and imbalance. Conventional monetary and fiscal policy, although a necessary condition for the success of the stabilization program, are ineffective by themselves to control this type of inflation. The only way to put an end to it is to combine orthodox fiscal and monetary policies with a heterodox direct intervention on prices so as to establish a mechanism for coordinating expectations (Lara Resende 1991). As inflation accelerates and price changes become more frequent, there is less asynchrony and thus a tendency for relative prices to stay close to balance. When the economy reaches a state of hyperinflation, price decisions become practically synchronous, and it is enough to impose and sustain a nominal anchor, usually the exchange rate. This, coupled with a stern fiscal policy and a tight monetary policy will stop the inflation. But until inflation reaches this level—that is, as long as inflation is merely inertial—only a price freeze, as was adopted in Israel in 1985 and Mexico in 1987, will work. Even a price freeze, however, will not be successful if relative prices are extremely unbalanced, or if prices charged by state-owned enterprises and/or the exchange rate have been artificially kept behind inflation. An abrupt price correction at the moment of the freeze (a *tarifação* and a maxi-devaluation) will not be a solution because economic agents will feel injured and will try to recover their losses (or supposed losses) at the first opportunity once prices are again free. If inertial inflation is a continuous process of balancing and unbalancing relative prices, a reasonable price equilibrium (it can never be perfect) at the moment of the freeze is essential.

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12. Obviously I did not transmit this prediction to the press. Instead I shared it only with the two economists who directly collaborated with me in the definition of the plan, Yoshiaki Nakano and Francisco Lopes.

On the other hand, to impose a heterodox shock without adopting strong fiscal measures is useless. In June 1987, relative prices were very unbalanced, and I had neither the time nor the authority to adopt a full-fledged fiscal adjustment. Thus, my plan called for two short price freezes. The first, of an emergency character, was implemented immediately, and the second was to follow six or seven months later, after public prices and the exchange rate had been corrected and a fiscal adjustment program had been enforced. The first freeze would be provisional, the second definitive.

The Bresser Plan went into effect in June and was successful in normalizing the economy: in achieving a minimum of macroeconomic balance, in halting the precipitous decline of real wages coupled with the skyrocketing rate of inflation, in coping with the record number of bankruptcies of small and medium-sized enterprises that had borrowed and invested during the euphoria following the initial success of the Cruzado Plan, in stabilizing the interest rate, and in recovering a minimum level of government control over the economy. The fiscal and institutional measures that were introduced along with the plan made it possible to recover some control over the budget deficit, which had gone out of control during the Cruzado Plan and in the first months of 1987.<sup>13</sup> But, as expected, the plan was not able to solve the fiscal crisis or to neutralize completely the inertial component of inflation. The rate of inflation, after falling from 26 percent per month in June to around 3 percent in August, increased in the next several months at a slightly faster rate than expected. In December it reached 14 percent instead of the expected 10 percent.<sup>14</sup> The resurgence of inflation even as aggregate demand remained shaky was essentially due to economic agents attempting to reestablish relative price balance as soon as prices were liberated. It also indicated the state's lack of creditworthiness—the essential characteristic of all real fiscal crises—which expressed itself in the overnight maturity of treasury bills and the lack of confidence in the currency.

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13. The first projection of the operational public deficit for 1987 was 7.2 percent. This projection was almost exclusively based on already realized or definitively committed expenditures. We officially planned to reduce it to 3.5 percent, but we knew that this would be practically impossible. The final figure for 1987—the result of our strict control over new expenditures, which created a lot of dissatisfaction, particularly among the other ministers—was 5.2 percent.

14. The 6 percent “inflationary residuum” after the freeze showed that relative prices had been highly unbalanced at the moment the stabilization plan was implemented. I knew that, besides an effective fiscal adjustment, the other condition for a successful heterodox program was to have relative prices reasonably balanced at the time of the imposition of the freeze. That is why I expected a 10 percent rate of inflation in December.

## An Orthodox Program

The Bresser Plan was the heterodox part of the stabilization program. The medium-run stabilization plan—the macroeconomic control plan—was the orthodox part. It was prepared by my staff between May and early July. The plan, which drew on a macroeconomic model of the Brazilian economy, sought to define the parameters for the negotiation of the foreign debt, establishing Brazil's capacity to pay. My guidelines to the excellent staff of economists<sup>15</sup> who drew up the plan were quite clear and had been advanced in a paper that I had presented to a seminar at Cambridge University on 5 April, 24 days before taking office (Bresser Pereira 1987). The diagnosis should emphasize the fiscal crisis of the state: that the budget deficit was high; that public saving, which had been highly positive in the 1970s, was turning negative, forcing public investments to be financed through the budget deficit; that the public foreign debt was very high, demanding extensive financing; and that the internal public debt was increasing at a dangerous rate.

I wanted the macroeconomic control plan to look as much as possible like a letter of intent to the IMF. These letters, usually drafted by the staff of the Fund and signed by the local authorities, define certain strategic targets (the nominal and the operational budget deficit, domestic net credit growth, variations in the basic monetary aggregates, etc.). I planned to sign an actual letter of intent with the IMF, but first I had to prepare Brazilian society for the idea because at the outset actually signing an agreement with the Fund was out of the question politically. The previous conflict with the Fund, due to its one-sided position on the debt crisis and the failure of the IMF-sponsored stabilization program of 1983, was aggravated by the populist views that dominated Brazil after the transition to democracy was completed in 1985. But I knew that a stabilization plan could not diverge substantially from the basic recommendation of the Fund in the fiscal arena. The only possible divergence, which I believed would be a minor and merely formal one, would be on the need for a heterodox shock. As a prudent international bureaucracy, the IMF does not propose shocks, but it accepts them quite easily. I remember very well my first meeting with Thomas Reichmann, the IMF's chief economist for Brazil, in May 1987. I had already decided to impose a price freeze, but I did not tell Reichmann that; nevertheless, in our conversation he came close to proposing a move in that direction.<sup>16</sup>

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15. Among others, the macroeconomic control plan benefited from the participation of Yoshiaki Nakano (head), Fernando Maida Dall'Acqua (coordinator), Adroaldo Moura da Silva and Enio Kadota (developers of the macroeconomic simulation model), Gustavo Maia Gomes, João do Carmo, and Sílvia Rodrigues Alves.

16. Later Reichmann told Yoshiaki Nakano that he was convinced that a price freeze was necessary at that moment.

I needed a program that would orient my later actions and those of my team, and that could be understood by both Washington and New York—by the multilateral institutions and the American government, and by the commercial banks, since I planned to visit both groups as soon as the plan was announced. On this same trip I would start the negotiations on the foreign debt. Thus, I also needed a plan that would define Brazil's ability to pay. For that purpose, my staff, using the macroeconomic model already mentioned, was given two basic financial parameters: Brazil would receive finance for 60 percent of the interest coming due on its commercial bank debt, while paying the banks the remaining 40 percent;<sup>17</sup> on debt to the multilateral institutions and the Paris Club Brazil would maintain an even cash flow: interest plus amortization would equal new disbursements. For the multilateral and official loans the even-cash-flow assumption seemed fair, given the interest of the creditor governments in solving the crisis.

I also proposed a growth parameter: future real GDP growth would be assumed to be 5 percent per year. The model had its own additional parameters, including a saving function (including public saving), a function for the tax burden, a consumption function, an investment function, and parameters for the internal and the foreign debt, the level of international reserves, and so forth, which to a certain extent could also be considered as variables.

After running the model, my staff came to the conclusion that the two debt parameters and the growth objective were feasible but implied the need for an increase in total saving. In order to increase public saving, a substantial increase in taxation and a reduction in state expenditures were necessary so as to reduce the operational public deficit to 3.5 percent of GDP in 1987, 2 percent in 1988, and zero in 1989. In this way public saving, which had been sharply reduced in the early 1980s, would be restored. The alternative would be to try to increase private saving by reducing wages and consumption. Yet there was no assurance that reducing wages would increase private saving. On the other hand, by increasing public saving, which had fallen from higher levels in the past, rather than private saving, which had not, the burden on workers and consumers would be smaller. But they would have to carry some additional burden, since even a progressive tax reform would not leave the lower middle class untouched.

The model showed that a 5 percent growth of GDP would require an increase in public saving of 5 percent of GDP. I was not happy with this result: the target was too tight. The sharing of burdens between Brazil and its foreign creditors did not seem fair. The creditors were, after all,

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17. Although the banks did not like to speak in terms of "refinancing of interest" but instead of "new money," they showed some disposition to finance between one-third and one-half of the interest coming due. I was asking for just a little more.

as guilty as we for the debt crisis, and the only thing they were offering to do was to refinance part of the debt. But, again, at that moment I was not considering any other alternatives. In order to recover foreign confidence and domestic business confidence, the essential thing was to suspend the moratorium and regularize Brazil's foreign payments. Thus, I decided to publish the plan with those constraints, to submit it to the president and the National Development Council—and to take it to the United States.

### The Foreign Debt

In mid-July 1987, two and a half months after taking office, I finally traveled to Washington with my macroeconomic control plan. My second appointment, after a courtesy visit to the Inter-American Development Bank, was with Senator Bill Bradley (D-NJ). On the way to his office, Marclio Marques Moreira, the Brazilian ambassador in Washington, told me that both houses of Congress had already approved resolutions asking the administration to provide some form of "debt relief" to heavily indebted Third World countries. I was very surprised and asked Marclio to repeat what he had just said, since I, like practically all Brazilians, had never heard the term. Marclio repeated the words and informed me that this was already a familiar issue in the creditor countries. This was for me a revelation, and one that I immediately connected with the talks about securitization of the debt that I had had with some bankers and economists during the previous two months in Brazil. I became convinced that something should be done in this direction. The climate in the creditor countries, it seemed, was favorable to new ideas.

Once back in Brazil, I started to prepare my proposal, helped by Fernão Bracher, the chief Brazilian negotiator, by Yoshiaki Nakano, my closest fellow economist, and by many others. I also asked for technical help from two international investment banks—First Boston Inc. and S. G. Warburg—particularly on the securitization deal.<sup>18</sup>

Local resistance to the unconventional proposal I was preparing soon emerged. To begin with, I faced some difficulty in convincing my own staff. They liked the idea but thought it dangerous because it could elicit a strong negative reaction from Brazil's creditors. Indeed it did. I remember very well Edwin Yeo, the secret representative of Paul Volcker for Latin America, on his second visit, telling me that "after Funaro decided on the moratorium, Washington concluded that he could not remain the finance minister of Brazil." The internal debate ended when I said, somewhat dramatically, that I was in the finance ministry to face and solve these problems, even at the risk of losing my job. I was ready to compromise, but only on minor things, not on the essentials.

18. The two banks produced a joint memorandum regarding the "Partial Securitization of Bank Debt," dated 16 November 1987.

Much more serious was the resistance of the staff surrounding the president. A very able diplomat, Rubens Ricúpero, was Sarney's international adviser. He obtained the support of Ambassador Moreira and Jorge Murad, the conservative son-in-law of the president. Together they developed the argument that, domestically, Sarney already faced an economic and a political crisis and therefore should not risk an international crisis as well. Therefore Brazil should make a conventional proposal to the banks.<sup>19</sup> I argued that the risk was not as great as they thought, since there was an increasing conviction in the creditor countries that the Baker Plan had failed to solve the debt crisis. Besides, some risk is part of the game when the national interest is involved. After a difficult debate, part of which took place during Sarney's visit to Mexico in August, the president accepted my reasoning.<sup>20</sup>

The strongest resistance, however, would come from the commercial banks and the US Treasury. Toward the end of August I received a call from Secretary Baker. He had been informed that I was preparing a debt proposal and asked me to visit him. An invitation from the US secretary of the treasury to a Latin American finance minister is tantamount to an order. I said I would visit him on 8 September.

My visit to Baker was initially a disaster but eventually a breakthrough. The first part of the meeting was a private talk. Baker rejected the obligatory partial securitization of the debt that I had intended to include in my proposal. In exchange, he accepted the idea of voluntary securitization and delinkage of the IMF and the commercial banks in the debt negotiations. However, pressed by his staff, which during the formal meeting that followed the private one expressed its opposition, Baker issued one hour later an aggressive note to the press, saying that the Brazilian proposal was "a nonstarter" and ignoring the concession he had just made privately. Yet two weeks later, when the IMF-World Bank annual meeting began in Washington, the "nonstarter" turned into a "starter." Securitization was now the word of the day. Eighteen months later the Brady Plan would incorporate both Brazilian proposals: securitization and delinkage.

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19. Brazil signed a conventional agreement with the commercial banks eight months after I left the ministry, in August 1988. It was a failure. One year later Brazil was again in arrears.

20. An interesting episode during this visit was my talk with Carlos Salinas de Gortari, then the planning minister of Mexico. My old friend Gustavo Petricioli, then Mexico's finance minister, took me to see Salinas and Pedro Aspe Armella. My comments during the meeting concerned exclusively the advantages of a heterodox shock to control the Mexican inflation. Salinas, who was already being talked about as a future president, listened very attentively but made no comments. Four months later the Mexican inflation would end with the conclusion of a social pact and a heterodox shock, which complemented the fiscal adjustment and the structural reforms President de la Madrid had initiated.

In spite of the clear and quite reasonable proposal that Brazil finally made on 24 September, which accorded with what had been agreed with Baker, the negotiations with the commercial banks, permanently intermediated by the Treasury, advanced slowly. Soon Bracher and I realized that the 29 January deadline for the signature of the agreement—the so-called “term sheet,” established with the banks when Brazil signed an interim agreement in October, would not be met. The commercial banks were confused, not knowing how to behave. They probably sensed that they were living through a transition period in the debt crisis.

### Adjustment as a Condition for the Second Phase

Brazil could not and would not allow itself to rest dependent on the banks’ decision indefinitely. As already noted, inflation was accelerating. In November it was already more than 10 percent, above the figure that back in June we had projected for December. According to our team’s initial plans, it was time to start preparing the second phase of the stabilization program, which would include a heterodox shock. But this could not be an emergency stabilization program, as the Bresser Plan had been.

The new plan, scheduled to be implemented in the first months of 1988, would have to be well-planned and obtain the assent of Brazilian society. First, relative prices should be well-balanced, so that on the inaugural day of the plan we would not have a maxi-devaluation or large increases in public prices (*tarifações*). According to the theory of inertial inflation, a shock coupled with a *tarifação* and a sharp devaluation of the local currency would be doomed to failure. Second, a fiscal adjustment should precede the plan. Heterodox policies are necessary when inflation is high and inertial but not yet at the level of hyperinflation.<sup>21</sup> However, their scope is necessarily limited. They are not intended to replace but rather to complement orthodox fiscal and monetary policies. Third, I had to have a precise assessment of what Brazil would be committing itself to regarding the foreign debt. This was important for projecting the balance of payments and for the fiscal adjustment plan. I knew that Brazil would be able to pay around one-third of the interest coming due and none of the amortization.

President Sarney was informed and agreed on the need for a new plan at the beginning of the year. I had been preparing this second phase of the stabilization program from the outset. Relative prices were basically bal-

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21. In open hyperinflation the asynchrony of price increases ends. Thus, to stabilize under such circumstances it is enough to promote a credible fiscal adjustment and to use the exchange rate as a nominal anchor. To do that, the country must have sizable international reserves and the support of the international community.



anced. At the cost of accelerating inflation in the short run, in the last few months of 1987 I had consistently increased public prices at a rate faster than inflation in order to avoid the need of a *tarifação* on the day the new plan was launched. The currency was initially devalued and thereafter kept steady. Wages were still being indexed on a monthly basis. Thus, if the launch of the new freeze came in the middle of the month, wages would not need any special conversion formula but would be automatically consistent with other prices. As for the foreign debt, Sarney agreed that, if we did not come to an agreement with the banks by 29 January, Brazil would have to decide unilaterally how much it would pay and make plans and set budgets accordingly while continuing to negotiate. Sarney also agreed that a fiscal adjustment plan was necessary and urgent, but it was in this area that he eventually withdrew his support in December. My decision to resign would be a direct result.

Toward the end of November I made another trip to Mexico, this time to participate with Sarney at a meeting of eight Latin American presidents in Acapulco. The foreign debt was the major topic. I had little opportunity to talk with Mexico's finance minister at that time, Gustavo Petricioli. He was deeply involved in negotiations with the unions that would lead, a few days later, to the heterodox stabilization plan, involving a price and wage freeze that, coupled with the fiscal adjustment and the structural reforms, marked the stabilization of Mexican inflation that has held to the present day. I did, however, have an important conversation with the other finance minister of the Latin American G-3, Juan Sourrouille of Argentina. We agreed that we would continue until the beginning of February 1988 to seek a reasonable agreement with the banks. Absent an agreement, we would decide in a coordinated way an Argentine moratorium and a unilateral Brazilian policy of paying about one-third of maturing interest obligations to the commercial banks. In this we were not creating a debtors' cartel—such an entity is not viable—but defining a minimum level of coordination of our policies.

The second phase of the stabilization program and the coordination of actions between Brazil and Argentina terminated with my resignation from the finance ministry 20 days later. Following my return from Washington at the end of September, I had defined as my absolute priority a fiscal adjustment plan involving a sizable reduction of expenditures and subsidies, and a tax reform that would increase the overall tax burden. Relying on the support of my team, I worked incessantly on this project for two months.<sup>22</sup> Meanwhile I kept President Sarney informed of the progress I and my team were making. But when the plan was com-

22. The tax reform project was headed by my director of revenue, Antônio Augusto Mesquita; the expenditure reduction, involving a mini-administrative reform, was headed by my vice minister, Mailson da Nóbrega, who I would later recommend to Sarney as my successor. Yoshiaki Nakano, Fernando Dall'Acqua, and Antônio Ximenes also made important contributions.

pleted, in the third week of December, and I presented it to the president, I did not win his support. He cited strong political forces as the reason for his decision. Thus, in spite of his insistence that I stay in my post, I decided to resign. Sarney said more than once that "next year" he would approve the expenditure and subsidy reductions and the tax reform, but that made little sense to me. Why next year, if it could be done this year?

I left the finance ministry without having been able to stabilize the economy. The overall situation was much better than when I took office. Inflation was around 14 percent a month but accelerating slowly. Real wages and consumption had been kept well below the Cruzado Plan highs and were stable. The wave of small-business bankruptcies had been stopped. Financial markets were calm. The exchange rate was realistic, and the balance of payments had been balanced. The moratorium on the foreign debt had not been suspended, but an interim agreement to resume payments existed. The premium on the dollar in the parallel market remained stable at around 25 percent over the commercial rate, without any need for central bank intervention in the gold market.<sup>23</sup> Confidence in public bonds had been partially restored. Brazilian society was beginning to listen to the stern warnings I had been making about the seriousness of the Brazilian crisis, and of its essentially fiscal character. The economy was fully indexed, but practically all private-sector prices were free. The economy was not growing, but a worsening of the recession had been avoided.

Several important institutional reforms had been implemented meanwhile, separating the treasury from the central bank, unifying the fiscal budget, establishing more strict and formal controls on disbursements by the treasury, creating a public servant bureaucratic career track for the treasury and the budget office, and reducing the power of the National Monetary Council to create credit (and thus money). These were preparatory measures for eventual independence of the central bank, which I had planned to achieve in the second stabilization program. Structural reforms had also been initiated. The agricultural credit system had been fully restructured: subsidies had been eliminated, and as a trade-off farmers got more realistic minimum prices. Studies paving the way for tariff reform—the essential condition for the elimination of all nontariff barriers—had been completed, preparing the way for trade liberalization.<sup>24</sup> A new industrial policy, under study at the ministry of

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23. Given the tax on exchange rate transactions of 25 percent, this premium was actually around zero.

24. The need for trade liberalization was far from universally endorsed in Brazil in 1987. Nevertheless, during my administration the first objective steps in this direction were accomplished. José Tavares de Araújo, head of the Comissão de Política Aduaneira (Customs Policy Commission), accomplished a complete revision of the Brazilian customs

industry and commerce, would independently complement trade liberalization. Privatization was marching ahead slowly, but some progress had been made.

Yet this was not enough. The budget deficit was no longer increasing, but it remained high, and without the fiscal adjustment plan, the chances of reducing it were limited. Inflation was, as already noted, on a moderate but clear acceleration trend. Thus, when I decided not to go ahead with the second stabilization program and resigned, I was proud of the advances I and my team had made, but I also knew that, in the final analysis, I had failed to adjust and stabilize the Brazilian economy. I had succeeded in defining the real nature of the Brazilian crisis—the fiscal crisis of the state and the bankruptcy of the developmentalist strategy—and I had been able to tranquilize the economy and initiate the institutional and structural reforms that were required, but I had not been able to implement the fiscal adjustment that was the precondition for a definitive stabilization, and I had not implemented the second phase of my stabilization plan.

## Conclusion

In the introduction, I presented my views on the conditions for successful economic reforms. These in many ways coincide with or complement those in Williamson's introductory paper. First, many stabilization programs, or economic reform programs more broadly, fail because they are inefficient, because they do not take the peculiarities of the current economic situation into account, or because they do not have behind them a competent and cohesive economic team. In my judgment, which is admittedly not unbiased, none of these factors characterized the Brazilian reforms proposed in 1987. The stabilization plan explicitly took into consideration the inertial character of Brazilian inflation and the abnormal times Brazil was experiencing.

Second, economic reforms need political support. And political support depends on the seriousness of the crisis and the sensitivity of society to economic disarray. Lack of political support for my economic program was clearly the central problem. I did not get support from my president, nor from my party, nor from the broader society for the fiscal adjustment that was necessary. The crisis was already serious, although it had not reached the hyperinflation level, but it was not perceived as serious. And the sensitivity of Brazilian society to inflation is low.

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system—an essential condition for the planned trade liberalization. Meanwhile, our negotiations with the World Bank toward a structural adjustment loan were well-advanced. Armeane Choksi and Demitrus Papageorgiou, both of whom have extensive experience on the subject, were directly involved in the negotiations with Yoshiaki Nakano and Tavares de Araújo.

I have stressed how populist views were particularly strong in Brazil in the first two years of the new democratic regime. The Cruzado Plan's failure weakened this vision of the economy, but it was still strong in 1987. President Sarney was not able to provide the support I was seeking for several reasons. First, his own views of economic policy are essentially (although not purely) populist. The failure of the Cruzado Plan was no accident but resulted from Sarney's refusal to modify the price freeze. Second, Sarney was deeply involved in getting support from the Congress to stay in the presidency for five years instead of four (the provision of the new constitution defining the president's term had not yet been decided). To obtain it, he needed to please the "Centrão"—the populist and conservative group in Congress that had been formed in the last quarter of 1987 to give him political support. Third, a conservative group within the president's staff, led by Jorge Murad, Mathias Machiline (a businessman friend of the president), and Antonio Carlos Magalhães (a powerful politician from Bahia), was unhappy with my domestic and foreign policies and pressed the president not to accept my fiscal adjustment plan. They knew that if Sarney did not accept the plan I would resign.

My party, the PMDB, was also unable to provide support because national-developmental views remained dominant within it. I did receive the support of some political leaders, but they were the exception rather than the rule.<sup>25</sup>

Finally, I did not win the support of Brazilian society. When the Bresser Plan was announced, the reaction against a supposed "wage squeeze" (*arrocho salarial*) was enormous throughout society. Resistance came not only from the unions but also from the print media, which mostly represent the middle class in Brazil. That group felt threatened by a possible further reduction of wages and salaries.<sup>26</sup>

Yet the real resistance to reform came from the business community. In December, when I proposed the tax reform, the nine most important business associations in São Paulo, whose presidents held regular informal meetings, issued a communiqué repudiating the tax increase I was proposing.<sup>27</sup> I had very good relations with Brazilian businesspeople,

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25. On several occasions, the president of the PMDB, Ulysses Guimarães, and Fernando Henrique Cardoso, the party's leader in the Senate, had to intermeditate between me and the party, which did not accept my views on the country's fiscal problems, on the need for a positive real interest rate, on the negotiation of the foreign debt, and on other matters.

26. The acceleration of inflation that marked the Cruzado Plan's failure caused an average real wage reduction of nearly 30 percent between November 1986 and June 1987. With the stabilization plan, real wages stabilized a little above a somewhat lower level than the 1985 average real wage (real wages had increased sharply during the Cruzado Plan).

27. The meetings of the Fórum Informal were attended by, among others, the presidents of the Federação das Indústrias do Estado de São Paulo, the Federação do Comércio do

who were feeling more secure with me as finance minister. When I resigned, the president of the most important Brazilian business association called it "a tragedy for the country." But these positive views did not prevent him and his associates from writing their antitax communiqué. Their populism and conservatism, respectively, prevented their acceptance of a tax increase and of some progressivity in that increase.

The net costs of adjusting the Brazilian economy were still positive at the time of the plan—or at least so most Brazilians perceived. Only two years later, when the first hyperinflation episode struck the Brazilian economy, this view was profoundly shaken. It was then realized that the crisis that I so strongly warned of in 1987 was indeed serious and that some sacrifice had to be shared among all. The incoming administration, headed by President Collor, would profit from this change of mood, but the inefficiency of the policies that were tried in the following two and a half years would waste that opportunity.

Given that the net transitional costs were still positive or were so perceived, and that the workers were not ready to accept wage reductions, nor the capitalists tax increases; and given the classical lassitude of Brazilian society toward inflation, the unawareness of the Brazilian élites of the severity of the economic crisis, and the continued strength of populist and national-developmental views in 1987, only a statesman in the presidency, endowed with vision and courage, could have confronted society, anticipated the costs of adjusting the economy, and proceeded with the necessary economic reforms. Statesmen, however, are a rare species, which societies are only fortunate enough to find leading them once in a while. That is probably why Berthold Brecht once said, "Sad are the nations that need a statesman." Sadder still, I would add, are the nations that need a statesman but don't have one, whose people are not yet ready to perform collectively the role that would be his.

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