

ECONOMIC DEVELOPMENT: THE BRAZILIAN EXPERIENCE

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1. Introduction

The Brazilian economy experienced a remarkable economic growth throughout most of this century, albeit with heavy costs in terms of social equity. From the beginning of the 80's, the economy entered a period of stagflation, that can be explained by two facts. First, the import-substitution industrialization policy growth strategy had been exhausted. Secondly, the deep fiscal crisis that unfolded after the onset of the external debt problem at first was not perceived as such, and afterwards there was not a proper institutional and political environment to solve it.

This paper presents a selected review of the Brazilian experience of economic development during the postwar period. It is organized as follows. Section 2 highlights the main facts of the economic growth process as well as describes the social problems that were not addressed during the rapid growth era and that remain to be solved in the near future. Section 3 analyses the evolution of the Brazilian tax system and shows how the weak monetary-fiscal regime led the government to have to rely on the inflation tax to finance government expenditures. Section 4 presents an overview of the indexation system and shows how this system failed as a substitute for a sound currency. Section 5 gives an account of the role played by the state intervention in the economy by creating the proper mechanisms and incentives for the Brazilian society to become a rent seeking society where almost every organized group with political representation would try to get a share either of the government budget or of resources managed by the government. Section 6 deals with the lost decade, permeated by the external debt crisis and by the several failed heterodox stabilization plans. Section 7 gives a summary of the main conclusions of the paper.

2. Economic Growth Without Equity

The Brazilian economy had a remarkable growth record from 1920 to 1980 when it achieved one of the highest rates of growth in the world. During this period gross domestic product grew at an annual average rate of 6.2%, while real GDP per capita increased at an annual rate of 3.6% (see Table 1). The average growth rate increased progressively in each successive ten-year period. The first setback occurred in the 60's when the average rate of growth was 5.9%. In the following decade, the Brazilian economy had its best performance in this century.

Throughout this sixty year period, the growth strategy adopted was based on the import substitution industrialization (ISI) policy. This strategy started to take shape in the 30's, when the world depression affected Brazilian import capacity, due to the decrease of exports earnings as a result of the plunge of coffee prices, the main product exported by Brazil.

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Table 1

Average Rates (annual percentages) of Economic Growth

Period	Real GDP	Agriculture	Industry	Real GDP Per capita
1920-30	4.2	3.7	3.9	2.2
1930-40	5.1	2.0	8.9	3.0
1940-50	5.9	3.1	7.7	3.4
1950-60	7.4	4.6	9.2	4.2
1960-70	5.9	2.9	6.9	2.9
1970-80	8.6	5.5	9.3	6.0
1920-80	6.2	3.6	7.6	3.6

Source: Zerkowski and Veloso (1982)

Import substitution started by the non-durable consumer goods industry. During the 50's and 60's, import substitution occurred in the durable goods sector and in the second half of the 70's, the whole cycle was completed when priority was given to substitute imports of basic raw materials and capital goods.

The ISI policy encompassed the following instruments: i) very high tariffs and quantitative restrictions to foreign trade, such as the so called 'similar goods law', which foreboded importing goods that resembled domestically produced goods, import licensing and foreign exchange restrictions; ii) exemption of taxes, tariffs and even tax credits for importing capital goods by selected industries; iii) long-run credit at low interest rates (in some cases, even negative real rates of interest) by the National Economic Development Bank; iv) direct state intervention through state-owned enterprises in the steel, power, telecommunications, oil, petrochemical and other sectors; v) fiscal incentives for direct foreign investments; vi) fiscal and credit incentives to promote exports, after the balance of payments crisis in the first half of the 60's.

The ISI strategy changed the structure of the Brazilian economy. In 1950, 25.1 percent of Brazilian GDP was produced by the agricultural sector (see Table 2); in 1990 only 11.5 percent of the total output was coming from agriculture. The share of the industrial sector increased from 24.9 percent in 1950 to 42.1 percent in 1990. The labor force shifted from rural to urban areas; in 1950, 59.90 percent of the labor force was working in the agricultural sector, while in 1980 this share declined to 29.23 percent; thus, from 1950 to 1980 the share of the labor force working either in industries or in the service sector increased from 40.10 percent to 70.77 percent.(see Table 2).

Table 2

Distribution of GDP and Labor Force Among Sectors
(%)

Year	Sectors					
	Agriculture		Industry		Services	
	GDP	Labor Force	GDP	Labor Force	GDP	Labor Force
1950	25.1	59.20	24.8	14.19	50.0	25.91
1960	18.3	53.96	33.2	12.92	48.5	33.12
1970	12.3	44.28	38.3	17.92	49.4	37.80
1980	10.9	29.23	44.1	24.38	45.0	46.39
1990	11.5	NA	42.1	NA	46.4	NA

Source: IBGE

During the first half of the 80's, the Brazilian economy entered a period of stagflation and, in 1981, the first recession occurred after four decades of uninterrupted growth. (see Table 3). In spite of Brazilian GDP being 21.0 percent higher in 1993 than in 1980, GDP per capita was lower. Thus, in the beginning of the 80's, the ISI strategy was exhausted.

Table 3

Real Gross Domestic Product: 1980-1993

Year	GDP	Per capita GDP
1980	100.0	100.0
1981	95.8	93.7
1982	96.5	92.4
1983	93.7	87.8
1984	98.8	90.6
1985	106.5	95.7
1986	114.5	100.8
1987	118.6	102.4
1988	118.5	100.5
1989	122.2	101.8
1990	116.8	95.7
1991	117.1	94.4
1992	116.2	92.2
1993	121.0	94.6

Source: IBGE

The sad heritage of this growth era is the income distribution record. Table 4 shows the Gini coefficient for selected regions of the country and for Brazil as a whole. From 1970 to 1980, the Gini coefficient remained stable, although at a higher level than Japan's (Yamaguchi Prefecture) before the second world war (in the range of 0.476 to

0.563); from 1963 to 1986 the Gini coefficient for Japan was in the interval 0.336-0.361 [see Minami (1944), p.300] while the Brazilian coefficient has been around 0.60. Thus, one can notice from this data how badly the Brazilian income distribution is.

Table 4

Income Distribution: Gini Coefficient

Regions	Year				
	1970	1976	1980	1988	1990
North	0.54	N.A.	0.59	N.A.	N.A.
Northeast	0.59	0.59	0.61	0.64	0.64
Southeast	0.61	0.61	0.58	0.59	0.58
South	0.57	0.60	0.57	0.58	0.58
Middle	0.59	0.60	0.62	0.64	0.62
West					
Brazil	0.63	0.63	0.62	0.63	0.62

Source: Tolosa and Rocha (1993)

Another dimension of the income distribution problem is poverty. Table 5 shows the percentage of population below the poverty line in some selected metropolitan areas of the country, with data covering some years of the period 1981-1990. Two points are noteworthy in this table. First, poverty is much higher in the North (Belém) and Northeast (Fortaleza, Recife and Salvador) than in the other regions of the country. Second, although some progress has been made during the last decade in some regions, the overall picture remains the same. Table 6 presents some data on the distribution of per capita GDP for several regions, during the period 1970-1990. Per capita GDP has been increasing in the North, Northeast and Midwest compared to the whole country, but the inequality remains too large.

Table 5

Percentage of Population Below the Poverty Line: Selected Metropolitan Areas

Metropolitan Areas	Year							
	1981	1983	1985	1986	1987	1988	1989	1990
Belém	50.9	57.6	43.8	45.9	45.1	46.6	39.6	43.2
Fortaleza	54.0	56.2	43.6	30.1	37.8	35.8	40.7	41.3
Recife	55.6	56.6	47.5	39.9	42.8	43.9	47.2	47.4
Salvador	43.1	43.8	39.5	37.5	39.4	33.9	39.0	38.0
Belo Horizonte	31.3	44.1	36.1	26.4	27.7	28.9	27.2	29.6
Rio de Janeiro	27.2	34.7	36.8	23.2	25.9	25.1	32.5	32.2
São Paulo	22.0	34.4	26.9	16.9	20.0	17.5	20.9	21.6
Curitiba	17.4	29.6	24.3	10.5	10.9	10.7	13.5	12.2
Porto Alegre	17.9	29.7	23.3	16.3	18.7	21.2	21.0	20.9
Total	29.1	38.2	33.0	22.8	25.5	24.4	27.9	28.9

Source: Rocha (1992)

By and large, this highly unequal income distribution is due to the quality of education in the Brazilian schooling system. Nowadays compulsory primary education is almost universal. However, Table 7 shows that in a period spanning for more than fifty years (1932-1988), the participation of the repeating students enrolled in the first year of primary schooling is roughly the same. Other indicators of the quality of primary education in Brazil would confirm this diagnosis. Thus, to break the vicious circle of poverty, it is essential to enhance the quality of education.

Table 6

Regional GDP Per Capita
(Brazil = 100)

Year	Regions			
	North	Northeast	Southeast	Midwest
1970	56	38	150	69
1975	51	39	147	73
1980	63	41	143	87
1985	70	48	138	88
1990	79	54	132	89

Source: FIBGE (apud Prates Rodrigues (1993))

Table 7

Participation of Repeating and New Students in First Year Schooling
(%)

Year	Repeating	New
1932	0.57	0.43
1933	0.60	0.40
1934	0.61	0.39
1935	0.59	0.41
1936	0.60	0.40
1937	0.58	0.42
1938	0.59	0.41
1939	0.60	0.40
1940	0.59	0.41
1941	0.58	0.42
1981	0.55	0.45
1982	0.52	0.47
1983	0.59	0.41
1984	0.58	0.42
1985	0.56	0.44
1986	0.57	0.44
1987	0.51	0.49
1988	0.50	0.50

Source: Ribeiro (1989)

3. Public Finances and the Government Deficit

In the early sixties, inflation was on the rise in Brazil and several attempts at stabilization were made without success. The stabilization plan of the Castello Branco administration, put into effect in the period from 1964 to 1967, was certainly successful in lowering the rate of inflation, from the 90% level in 1964 to 20% in late 1967. This plan fought inflation through a combination of an austere fiscal policy and an incomes policy that used wage and price controls.

The stabilization plan of the Castello Branco administration carried out a two stage fiscal reform to resolve the public finances situation. In the first stage (1965-1966) it promoted an increase of the tax burden within the existing legal framework. The second stage of the fiscal reform consisted of a complete modification of the national tax system inherited from the Constitution of 1946 and from Constitutional Amendment nº 5 of 1961.

The fundamental objective of the reorganization of the tax system was to create a solid, modern tax base to face the problems of economic growth. Modernization of the tax system took place with the following measures: i) elimination of the sales tax (a cascading tax that encouraged vertical integration of companies and was chief source of revenue for the state governments) and its substitution by a value-added tax, the so-called tax on the circulation of goods (ICM); ii) transformation of the consumption tax into another tax of the value-added type, called the tax on industrialized products (IPI); iii) elimination of the various taxes charged by states and municipalities, which very often had the same base as taxes charged by other levels of the government; iv) transferring of the right to charge taxes which are instruments of a national policy to the federal government (export taxes, taxes on financial operations, and rural property taxes).

Another restriction which was followed in the reorganization of the national tax system was that the different levels of government should maintain their relative shares in tax collection after introduction of the new system. As the states and municipalities faced a reduction in the number of taxes they were allowed to charge, State and Municipality Revenue Sharing Funds were created with part of the revenue from the value-added and income taxes.

The situation of Brazil's public finances has been slowly deteriorating since the late 70's (see Table 8). The causes that lie behind this new fiscal crisis of the Brazilian State are multiple. The lowering of the tax burden may be explained by the following facts: i) increase in the rate of inflation, causing a reduction in real collection because the time-lag between accrual and collection of the tax; ii) increase in the share of production exported, with a consequent fall in tax collections due to export exemptions; iii) substantial increase of tax evasion, either as a reaction against the increase of tax rates or because of more inefficient inspection; iv) increase of tax waivers by the state due to the indiscriminate use of tax incentives.

On the government spending side the following factors contributed to the fiscal crisis: a) increasing indebtedness of the state with the growth of spending on the servicing of foreign and domestic debts; b) control of the prices of goods and services produced and sold by state companies for the purpose of fighting inflation; c) increase of the government's current expenditures.

This fiscal-crisis situation led to the government's systematic use, throughout the eighties and the first years of the nineties, of different fiscal packages with measures meant to tackle the public-deficit problem. None of these packages has been successful, as their action has been sporadic and transitory.

Table 8

Tax Burden: 1970-1993
(% GDP)

Year	Gross (1)	Transfer (2)	Net (3) = (1) - (2)
1970	26.0	8.2	17.8
1971	25.1	7.0	18.1
1972	26.0	7.3	18.7
1973	26.4	7.0	19.4
1974	26.2	6.3	19.9
1975	26.3	7.0	19.3
1976	25.2	7.2	18.0
1977	25.6	7.3	18.3
1978	25.6	8.1	17.5
1979	24.2	7.7	16.5
1980	24.7	7.7	17.0
1981	24.7	8.4	16.3
1982	25.3	8.9	16.4
1983	25.1	9.0	16.1
1984	21.8	8.6	13.2
1985	22.5	7.7	14.8
1986	25.4	8.3	17.1
1987	23.3	7.8	15.5
1988	21.9	7.7	14.2
1989	21.9	8.1	13.8
1990	27.4	9.0	18.4
1991	24.8	8.9	15.9
1992	25.1	10.1	15.0
1993	26.4	11.0	15.4

Source: IBGE

In October 1988, Congress approved a fiscal reform within the new Constitution. The main innovations introduced were as follows: i) elimination of the single taxes (fuels and lubricants, electric power and minerals), and the tax on transportation and communications that became part of the tax on circulation of goods and services; ii) introduction of a tax on wealth over a certain level, to be regulated by a complementary law (still not approved by Congress); iii) creation of a surcharge to tax on capital income to the an a tax on retail sales of fuels.

In formulating the new national tax system, the members of the Constituent Assembly were fundamentally concerned not with the level of the tax burden, but rather with its distribution among the various levels of government. Their clear intent was to increase the share of the states and municipalities and decrease the participation of the federal government. This attitude of the politicians was a reponse to the concentration of resources that was determined in the 1969 Constitution and granted by the Military Junta that ruled the country for a short period of time in late 1969. That Constitution changed the

system of participation introduced by the Castello Branco Administration by cutting from 22% to 12% the share of states and municipalities in the revenue from income tax and the tax on industrialized products. Throughout the 1976-83 period, successive changes were made to the quotas of the Revenue Sharing Funds, increasing the shares of states and municipalities. In 1984, a new Constitutional Amendment raised the quotas. The new Constitution has increased them even more, and, in 1993, the participation of states and municipalities was equal to 47% of the total revenue from income tax and the federal government value added tax.

This transfer of federal government resources to states and municipalities was carried out without the corresponding transfer of duties to the two levels of government. As a result, the federal government deficit has increased with the new Constitution.

The data presented in Table 9 shows the operational public deficit (which does not include monetary correction) from 1981 to 1993. This deficit had to be financed by increasing public holding either of real debt or real monetary base. During the eighties, the lowest level of the operational deficit was 1.9% of GDP in 1986, rising to 6.9% in 1989. In 1990 there was an operational surplus of 1.2% of GDP, due to the once and for all taxes created by the Collor Plan. In 1993 there was a small surplus of 0.3%, although the fiscal problem has not been solved in a permanent basis.

Table 9

Operational Deficit: 1981-1993
(% GDP)

Year	Operational Deficit
1981	5.2
1982	6.2
1983	1.9
1984	3.1
1985	4.4
1986	3.6
1987	5.7
1988	4.8
1989	6.9
1990	-1.2
1991	0.1
1992	1.6
1993	-0.3

Source: IBGE

The end result of the lack of solid foundations of the Brazilian fiscal regime is the financing of the Government by means of issuing money, collecting inflation tax. Figure 1 show quite clearly that inflation tax has been an important source of Brazilian government financing. The systematic use of inflation tax has produced a very unstable economy and Brazil's fiscal crisis will have to be solved by means of a broad reform of the fiscal regime, that would free the central bank from the task of issuing money to finance the government.

Figure 1



Source: Cysne (1993)

A necessary condition for this regime change is a broad fiscal reform. However, as the past experience of fiscal reforms described here shows, it is not sufficient. The Brazilian society has yet to design an institutional framework wherein fiscal discipline (the fulfillment of the intertemporal budget constraint) by all levels of government should be enforced, by closing the loopholes that allow the central bank to finance the fiscal deficit.

4. Indexation As a Monetary Standard Substitute

Since 1964 several indexation mechanisms have been introduced into the Brazilian economy in an attempt to reduce the effects of unexpected inflation on the real side of the economy. In a country with a long tradition of inflation, as in the case of Brazil, these mechanisms are essentially supposed to eliminate the uncertainty that is associated with the prediction of nominal values. The main mechanisms of indexation that have existed in Brazil can be grouped roughly into four categories: i) norms that legalize private contracts with a monetary correction clause; ii) mechanisms that allow income tax to be levied on real gains, rather than on nominal income; iii) financial assets with a monetary correction clause; and iv) the discretionary application of some rules so that certain prices are adjusted by the rate of inflation.

In this section, we shall leave aside the first two items and concentrate our analysis on the latter two, which basically involve three types of readjustment: monetary correction of financial assets, the wages policy, and the exchange rate policy. Before proceeding, it should be pointed out that the term indexation, or monetary correction, has been widely used in Brazil to designate rules that readjust nominal values according to the rate of

inflation and in several cases are not concerned with the negotiation of contracts in real terms, which is the territory of proper indexation.

The first federal government indexed bond (know by its acronym, ORTN) was introduced on July 1964, with an initial value of ten cruzeiros and correction on a monthly basis. The formulas by which the monetary correction of this indexed bond was calculated underwent many changes during its existence, causing it to reach, in 1992, just 8% of its initial value. Brazilian asset indexation was not based on rules but on discretion, with each finance minister introducing changes that would suit his tastes or misconceptions.

In the period between 1945 and 1964, government intervention in the wage policy was basically limited to fixing the minimum wage. Up to 1964, most of the wage increases in the private sector were affected in such a way as to repeat the previous peak reached by the real wage. By designating as S_t the wage in effect from the beginning of the period t , as S_{t-1} the previous wage, as P_{t-1} the price index when S_{t-1} came into effect, and as P_t the price index at the time the new wage was readjusted, then the principle of repeating the peak of the real wage is equivalent to: $S_t/P_t = S_{t-1}/P_{t-1}$; or the new wage must be equal to the previous one adjusted by the rate of inflation π_t : $S_t = (1 + \pi_t) S_{t-1}$.

The fundamental objective of the wage policy introduced by the Castello Branco stabilization plan in 1965 was to preserve the real average wage, without allowing the past inflation to be transferred to the future. Leaving aside technical details, the formula for this policy may be synthesized by the expression: $S_{t-1} / (P_{t-1} + P_t) = S_t / (P_t + P_{t+1}^e)$. That is, the new wage should be such that for the expected price level P_{t+1}^e on the date of the next readjustment, the average wage should be maintained.

A new phase of the wage policy began in 1979, when a variant of the peak formula was adopted. Afterwards several heterodox stabilization plans used formulas based on the average concept. In the time interval between the failure of one stabilization plan and the beginning of another one, the peak formula was used.

Brazil's foreign exchange policy underwent a profound change in August 1968, when it was announced that from that time on the devaluation would occur at short time intervals and that the rule behind the mini-devaluation would aim at maintaining the real exchange rate reasonably constant.

The first two interruptions in this crawling-peg policy occurred in December 1979 and in February 1983. On both occasions the cruzeiro was devalued 30% in relation to the dollar. From February 1983 until February 1986, the exchange devaluation followed closely the behavior of the domestic rate of inflation.

From 1986 on to June 1994 each heterodox stabilization plan tried to fix the nominal exchange rate. Once inflation was on the run again the central bank would either try to peg the real exchange rate or to adjust the nominal exchange rate according to the rate of inflation.

5. Market Versus State Intervention: The Rent Seeking Society

A presumption behind state intervention in the economy is that politicians and public civil servants are just concerned with the public good and not with their self-interests. Unfortunately, that is not the typical case, since government officials, either elected or appointed, have their own objective functions and make their choices given the constraints they face. Thus, society has to constrain the set of actions that government can take otherwise profitable opportunities will be seized by government officials and rent-seeking activity becomes the rule of the game. The proper way to avoid this state of affairs

is to have an institutional design where rules are preferred to discretion. The Brazilian government played a very important role in carrying out the ISI strategy, using discretion not rules thereby yielding an environment where resources were misallocated, disguised lobbying has been acting behind some façade, and a specialist 'government services middle-man' [the Brazilian word for this type of activity 'despachante' has no English equivalent] is a necessity even when the common citizen needs some service from the state, in order to by-pass the red tape created by the bureaucracy.

In some cases unwritten rules were used to guide state intervention, such as the tripartite system, whereby state owned enterprises would take care of some sectors of the economy, and multinational corporations and domestic private firms were allowed free entry in the remaining sectors. Table 10 shows the participation of state owned enterprises in the top 500 Brazilian companies in 1990. Among the top 500,80 enterprises were state-owned, 56 by the federal government and 24 by state governments. In three sectors, mining, utilities and communications, the state-owned enterprises had an overwhelming participation. The privatization process started during the Collor administration has already privatized the steel and the petrochemical sectors. In the case of oil (production, importing and refining) and telecommunications, the Constitution has to be amended for these sectors to be privatized.

The performance of the state as the major shareholder of big state-owned enterprises such as Petrobrás (oil), Eletrobrás (power) and Telebrás (telecommunications) has been very poor. For example, the turnover rate of presidents and directors of these corporations are very high due to the political nature of these positions, and there is no mechanism in place to stimulate efficiency and profitability. In addition, vested interest-groups (workers, suppliers, customers) have been trying to maintain the status quo. In the case of telecommunications, these interests succeeded by including in the 1988 Constitution an article stating that telecommunications is a state monopoly.

Table 10

Participation of State-Owned Enterprises in the Top 500 Brazilian Companies: 1990
(%)

Sectors	Gross Receipt	Net Assets	Physical Assets
Mining	88.6	85.7	83.3
Metallurgical	48.2	65.0	81.8
Chemicals	24.7	42.4	33.4
Utilities	98.8	99.4	97.8
Services	39.0	80.0	82.8
Transports	52.7	90.3	88.8
Communications	98.2	96.7	97.3
Total	37.2	63.6	75.5

Source: Conjuntura Econômica [Pinheiro and Giambiagi (1992)].

The 1965 financial reform failed to create a strong capital market in Brazil, which has a very sophisticated financial system to provide good money substitutes and working capital for the firms. Table 10 shows the inflated size of the Brazilian financial sector.

However, consumer credit is almost nonexistent and the main source to finance car loans is a buyer's consortium. The state-owned National Economic Development Bank is the only source of long-term credit for investment. Almost each state has its own commercial bank, and they have a long tradition of misallocation of resources through political intermediation. The housing loan market was affected by the unnecessary subsidies given to Brazilian middle and upper-class during the 80's and since then has not recovered. Thus, a major overhaul of the Brazilian financial system is needed to resume the growth process.

Table 10

Value Added by Financial Sector Services as a Percentage of GDP

Year	Value Added by Financial Sector
1980	8.3
1981	11.1
1982	11.2
1983	13.3
1984	13.2
1985	13.2
1986	8.4
1987	16.2
1988	16.7
1989	26.4
1990	13.6
1991	8.6
1992	9.8
1993	9.7

Source: IBGE

6. The Lost Decade: External Debt and the Failure to Stabilize

During the period 1974-79, Brazil adopted a debt-cum-growth strategy, due to the 1973 oil shock, that brought about an adverse change in the terms of trade, since oil imports accounted for a large proportion of Brazilian total imports.

The economic policy response of the Brazilian government was to draw a very ambitious plan, the Second National Development Plan, based on large public and private projects with the emphasis on promoting the capital goods and basic raw materials industries. The option for this growth strategy became possible due to the availability of external financing through the international banking system. The balance of payments current account was in deficit during the whole period 1974-79, with corresponding rapid growth of the external debt (from 6.1 in 1973 to 40.2 billion US dollars in 1979).

The commercial policy adopted in 1974 was made up of high tariffs; a compulsory deposit on imports for one year, without payment of interest and no allowance for inflation, prohibition of importing goods considered to be superfluous; and quantitative restrictions on imports by state-owned enterprises. This policy package was indeed the last leg of the import substitution strategy. The exchange-rate policy followed the crawling - peg system introduced in 1968, and the purchasing power parity rule, since the

government refused to make a real devaluation of the cruzeiro believing that the oil shock would be transitory and not permanent.

During the 1979-82 period, the Brazilian economy faced several adverse shocks: i) the 1979 oil shock, ii) declining terms of trade due to falling export prices and increases in the prices of imported capital goods and raw materials; iii) world recession, iv) unexpected increase in the international rate of interest, and last but not least, the v) breakdown of the international financing market for the indebted developing countries in September of 1982, which can be considered a typical case of market failure.

The Brazilian default on external debt in the 80's was the outcome of overlending by the creditor countries commercial banks due to great international liquidity and overborrowing, directly or indirectly promoted by the Brazilian government, due to the growth strategy adopted after the first oil shock. There was no institutional framework to deal with such problems. The main creditor countries organized under the IMF coordination a strategy, which became known as "muddling through" strategy, which did not work out because it did not address the fundamentals of the debt problem. This concerted action of creditor and debtor countries governments with the coordination of international organizations is a good example of government failure.

Only more than ten years after the beginning of the debt crisis, the Brady Plan, proposed by the United States government, created a proper framework of cooperation and understanding between debtor and creditor countries to share the costs of wrong decisions taken in the past by reducing the debt service and the debt itself. In the second quarter of 1994, an agreement was signed between the Brazilian government and the international banks, by which the debt was securitized and transformed into several different bonds.

The chief difficulty of adjustment of the Brazilian economy following the onset of the debt crisis was that one important source of financing the public deficit disappeared overnight. Replacing the external financing of the public deficit would require a combination of the following measures: to cut government expenditures, to raise taxes, to raise internal public debt, or to issue more money, increasing the inflation tax. In addition the Brazilian economy had to transfer resources to creditor countries transforming a trade deficit into a trade surplus. A fiscal adjustment was necessary to make room for the government to have the domestic resources to buy the foreign currency necessary to service the debt. The easiest part was the creation of a trade surplus by means of a real depreciation that had the side effect of increasing the rate of inflation due to wage indexation. For the fiscal problem a muddling-through-cum-inflation-tax strategy was adopted. The outcome of this macroeconomics mismanagement policy was to produce a hyperinflation process that endured several heterodox stabilization plans.

The question that normally arises among the economists who try to understand Brazilian endemic inflation is how to explain the difference between Latin America type of inflation and inflation in others parts of the world. Latin America structuralist economists identify changes in relative prices as the major source of inflation in countries, such as Brazil, which tried to change the rate of output growth by means of economic policy. Another quite popular hypothesis to explain the phenomenon is the distributive conflict between capitalists and workers. Inflation would accordingly be the result of inconsistent demands of the two social classes claiming fractions of the cake that when added up would be greater than the whole. During the first half of the 1980's, Brazilian neostructuralist economists would diagnose Brazilian inflation as being inertial, the result of markup pricing, wage indexation and exchange rate crawling peg, and this process being driven by supply shocks. This theoretical framework underlies several stabilization plans that were unsuccessfully applied to the Brazilian economy, starting in 1986 with the Cruzado Plan.

The most important measures adopted by the heterodox plans were the following: i) deindexation of the economy; ii) a price freezing for an indeterminate period of time; iii) a monetary reform introducing a new currency unit; iv) conversion of wages and other contract prices into the new currency by using the real average value of those prices observed in some previous period; v) use of a conversion table (the so-called 'tablita') to convert liability values, in order to prevent unexpected gains or losses by their holders; vi) fixing the nominal value of the exchange rate, and vii) in the case of the Collor Plan (1990), a disguised capital levy implied by the freezing of assets.

Figure 2

The outcome of the heterodox plans was to become the threshold of a hyperinflation process. Figure 2 shows the Brazilian monthly rate of inflation from January 1967 till July 1994. It can be seen quite clearly from this figure that the inflation process, although shifting to higher levels along the way, was a stable one for a long period of time. From 1986 on, the inflation rate only stopped growing when an heterodox shock was applied, but after a short period of time it returned to its unstable dynamic path. All heterodox plans did fail because they did not attack the roots of the problem: the fiscal crisis and the imbroglio of the monetary-fiscal regime.

7. Conclusion

This paper has shown that in spite of its economic growth record, the Brazilian experience of economic development was very much unbalanced due to frequent mistaken policy decisions, e.g., i) gross mismanagement of stabilization policy; ii) disregard for human capital investment, as governments did not pay attention to the quality of education at the primary and secondary levels of schooling; iii) lack of a sound and stable monetary-fiscal regime that would impose fiscal discipline; iv) recurring balance of payments crisis and foreign exchange bottleneck that constrained growth; v) state intervention providing a proper environment for a rent seeking society to flourish, where corruption became part of the game; vi) failure of the financial system reform to increase savings in a permanent basis. Moreover, the Brazilian elite's complete disregard for creating strong and solid institutions that could bring together all groups to a modern society, left the Brazilian society without the political organizations that could deal in a diligent way with several issues that remains unsolved up to now. The Brazilian military regime experience (1964-1985), contrary to other authoritarian experiences (Chile, South Korea, Taiwan and Singapore), was a complete failure for not creating an institutional structure within the nation that could promote a lasting transformation of the entire society. Once the military left power in 1985, they had already dismantled several mechanisms and destroyed sound reforms that were introduced during the first stage of the military regime (Castello Branco administration).

The positive side of the lost decade is that a new growth strategy is unfolding and it seems that equity considerations will play an important role in this new stage. The main characteristics of this new strategy seems to be the following: i) the old tripartite system of state owned enterprises, multinational corporations and domestic private firms would be replaced by a new structure due to the privatization of state owned enterprises; ii) the degree of openness of the economy will increase due to trade liberalization with the removal of all quantitative restrictions, which were replaced by a system of tariffs; iii) the customs union with Argentina, Uruguay and Paraguay, Mercosul, will benefit all countries involved, on the hypothesis that it would lead more to trade creation than to trade diversion; iv) the balance of payments capital account, will be liberalized by integrating domestic and international capital markets; v) the role played by state intervention in the economy will change, leaving aside the production of private goods and concentrating the state's action on the production of public goods and on improving the social infrastructure (education, health-care, mass-transportation systems and housing for the poor); vi) a new monetary-fiscal regime will be established where inflation is not needed to finance the government and indexation would disappear as a currency standard substitute, and last but not least, vii) democratic institutions are being built up and they will provide a framework to solve the social conflicts that are inherent to the economic development process.

It remains to be seen if the Brazilian society will have the political will to make the structural adjustments that are needed to implement in full this new growth-cum-equity strategy.

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