20 years after the Real Plan, why does growth remain elusive?

Brazil celebrates two decades of monetary stabilization and introduction of the real but has yet to find the formula for sustained growth.

Solange Monteiro

IN ITU CITY IN THE STATE of São Paulo, Allan de Oliveira Melo works in his mother’s cleaning products business. He already has his own car and wants to study law. He loves going out with friends but now “gasoline, restaurants, and entertainment have become more and more expensive,” he says.

The almost 6% inflation that worries Melo is quite different from the 2,477% hyperinflation that afflicted Brazil in 1993, the year he was born. His generation has been able to enjoy monetary stability thanks to the plan that introduced a new currency—the Brazilian real—to deal with out-of-control prices.

At that time, after six stabilization plans had failed in seven years, with the population frightened by a roller coaster ride of price controls, currency changes, and traumatic confiscation of banking deposits, President Itamar Franco nominated Senator Fernando Henrique Cardoso to be the fourth Minister of Finance in less than a year.

In late February 1994 the new economic team unveiled its plan: First, all Brazilian prices and wages were converted to a temporary unit of value pegged to the price index (URVs). The URV was then replaced in July 1994 with the Brazilian real at parity with the U.S. dollar.
The new plan worked beyond expectations. The hyperinflationary cycle was broken, bringing stability to the Brazilian currency. Later in the same year Finance Minister Cardoso was elected president, in no small measure because of the plan’s success.

“President Fernando Henrique Cardoso brought in the best possible team. And his administration excelled in transparency, making sure the people knew everything that would happen,” says former Finance Minister Antônio Delfim Netto. “There were no wage controls, income distribution was stabilized, and prices were freed, allowing the economy to adjust. It was brilliant.”

Today, 20 years later, the economy is still stable. Yet despite numerous achievements, real interest rates in Brazil are among the highest in the world; inflation, though happily not astronomical, is high and edging up; and economic growth is disappointing.

THE NEED FOR FISCAL REFORM

Why can Brazil not grow in a sustainable way? The Real Plan did bring about reorganization of state finances, privatization of state-owned enterprises and banks, adoption of macroeconomic targets, and the Fiscal Responsibility Law. “We managed to make the necessary changes to fight inflation, but . . . the end of growth led by import substitution in the 1980s required a fiscal reform focused on investment,” says Fernando de Holanda Barbosa, professor of economics at the Graduate School of Economics of Getúlio Vargas Foundation (EPGE). Instead of dealing with low domestic savings that still limit investment and growth,

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Taming inflation

Source: Government Statistics Agency (IBGE).
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However, governments adopted far less promising policies. Efforts to address the economy’s imbalances, such as excessive currency appreciation and rising tax burdens, slackened. Recently, the problems have been exacerbated by policies to increase consumption. Even as Brazil benefited from rising prices for commodities exports, it became dependent on external investment to finance its excess spending and the external current account deficit.

“Public investment was sacrificed to allow more income redistribution. Less accumulation of capital contains the seeds of its own destruction,” says Delfim Netto, pointing out how the economic winds have changed since 2011. “Without a doubt, the last decade has been a period in which we practically ended absolute poverty and improved school attendance. But to grow, we need now to harmonize improving income distribution with investment.”

THE EXCHANGE RATE PEG

Talking about the Real Plan, Renato Fragelli, EPG lecturer, argues that, in hindsight, “Any knowledgeable economist who could make policy decisions would plan differently, starting with fiscal adjustments for a more consistent plan to end inflation quickly, without excessive exchange rate appreciation and high real interest rates, which cost the country so much … But if we take into account the decisions that had to be taken in the face of so much uncertainty, it was a success.”

Gustavo Franco, a member of the Real Plan economic team and president of the Central Bank from mid-1997 to early 1999, remembers that “Many of my colleagues on the Real Plan (such as Périco Arieda, André Lara Resende, and Edmar Bacha), who had participated in previous stabilization attempts, warned that it was possible to bring inflation down, with wonderful effects, but if politicians did not carry out reforms, inflation would come back, and another politician would call us again to do the same trick.”

Franco compares the second phase of the plan, from 1995 to 1998, to an infantry battle. “It was hand-to-hand combat against inflation, painful and exhausting,” he says. “It was natural to lose allies, suffer casualties,
and have difficulties with Congress. … All those affected by the reforms who did not like its consequences become hostile—they liked the Real Plan until its effects were not favorable for them,” he recalls.

Holanda Barbosa points out that it took four years to complete the adjustment by ending the peg of the new currency to the dollar, establishing a primary fiscal surplus regime with a flexible exchange rate system, and the central bank adopting an inflation target, which had negative effects on economic growth. Consequently, many grew dissatisfied because the cost of the protracted adjustment was large. “Maintaining an exchange rate peg to the dollar during that period meant that the average inflation-adjusted interest rate at the end of the first Cardoso administration was about 22% per year. It was blistering, but keeping the exchange rate peg was necessary [to break the back of inflation],” he says.

Flavio Castelo Branco, executive manager of the Economic Policy Unit of the National Confederation of Industries (CNI), says that monetary stability was essential for extending the planning horizon for businesses. Lia Valls Pereira, IBRE researcher, adds that, “The problem was that the peg was carried too far, until 1998, which reduced our external competitive edge.” The impact of the exchange peg on the export sector was large, as was reflected clearly in the external trade balance deterioration.

At the time, rising imports helped to contain inflationary pressures after the 1990 tariff reform program—on average, in four years import tariffs plunged from 45% to 14%. “The textile industry was one that sacrificed, losing 250,000 jobs. Trade barriers to importing computers in the 1980s had delayed the process of modernization, and the impact was great,” says Valls Pereira.

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Gustavo Franco

Julio de Almeida, lecturer at the University of Campinas (Unicamp), estimates that the losses were necessary for monetary stabilization. “We can say that the exchange peg lasted longer than it should have, that there was no industrial and innovation policy to support industry, but the gains are undeniable,” he says. After the severe exchange rate devaluation in 1999, “The problem was that in the last decade we let the currency appreciate again. Prolonged exchange rate appreciation reduces the incentive to invest to export more; companies turn to the domestic market and lose potential to innovate to increase productivity.”

SOARING TAX BURDEN
Since the Real Plan was introduced, the federal budget has been balanced mainly by increased tax collections; meanwhile, public spending has surged relentlessly. With the Real Plan having reduced inflation, the government could no longer print more money and pay for its spending with a
The imbalance between revenues and expenditures became clearer, requiring a prolonged process of adjustment that included substantial tax increases. In addition, points out IPEA's Mansueto de Almeida, the 1988 Constitution had significantly expanded social programs by introducing the Unified Health System, universal public education, and expanded income transfers.

Fiscal tinkering and cuts in public investment were not enough to pay for the spending on new social programs. The tax burden increased from 25% of GDP in 1994 to 36% today. "Brazil entered a perverse dynamic that still continues—government spending (even excluding interest payments) growing at double digits and taxes rising to ensure a primary budget surplus. But we cannot do in the next 10 years what we did in the last 20 unless the tax burden reaches 40% of GDP. As a middle-income economy with low productivity, that is too high for us to support," Mansueto de Almeida says.

NEW GOVERNMENTS, OLD POLICIES
To ensure its consolidation, monetary stabilization had to overcome political uncertainty during the 2002 transition from the moderate Social Democratic Party government to the leftist Workers' Party. Market anxiety about the policies of President Lula triggered capital flight and devaluation of the exchange rate. But in a
remarkable political U-turn the President and Finance Minister Antonio Palocci stuck with the Real Plan.

The Lula administration enjoyed enviable international and domestic conditions for introducing pro-growth policies. “Between 2003 and 2010, credit in Brazil doubled in relation to GDP. Adding 25% of GDP in credit in 10 years and doubling the size of the banking system could be considered a bubble, but Brazil did it without undermining the quality of bank assets, because banks were well-capitalized,” says Franco. Thanks to buoyant Chinese demand for agricultural commodities and minerals and high commodity prices, surging exports allowed Brazil to accumulate large international reserves. At the same time, the entry of many young people into the labor market and the social programs gave the country a thriving new middle class.

But consumption-led growth eventually proved to depend too much on external financing at the expense of Brazil’s competitiveness. Since 2011 the less favorable international outlook and exhaustion of consumption-led growth has brought about a steep deterioration of the external current account, to a deficit of US$81 billion in 2013.

According to Franco, there has also been a shift in policy focus. “Instead of the pro-growth policies of a market economy, we see a government-led investment growth policy, with little results,” he says. “The National Development Bank tripled its lending, but fixed investment and domestic savings remain low.” EPE’s Fragelli argues that Brazil needs to recognize that its domestic policies affect its attractiveness to international investors: “If Brazil has foolish policies, investors will take their business to Chile, Mexico, and India.”

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Mansueto de Almeida

RETHINKING POLICY
How can Brazil achieve sustained growth? The solutions are old and unpopular: tighter control of public spending, structural reforms, and meeting macroeconomic targets. “For 10 years the 4.5% inflation target has not been changed. … We need to think about lower inflation targets as Chile does, between 2% and 4%,” says Salomão Quadros, IBRE prices expert. Holanda Barbosa points out that the foundation of inflation targeting has to be trust: “On the day the central bank can convince society that it will deliver the inflation target, we all will adjust our prices to the inflation target,” he says.

Rubens Penha Cysne, EPEE director, points out that adjusting policies is a process that takes time: “If we compare Brazil to Portugal, France, England, and the United States, our institutional evolution is very recent. Behind institutions there is culture, and behind culture there is history, which in our case is still very short,” he says. He believes what is needed to address public expenditure and administration is a broad debate on institutional development.
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_Fernando de Holanda Barbosa_

Delfim Netto argues forcefully that policies should aim to harmonize income redistribution and investment, although he recognizes that “Politically coordinating changes to approve budget cuts is always tricky.”

Holanda Barbosa believes that Brazil needs to fundamentally rethink its growth strategy. The difficulty resides in reaching political consensus, so that everyone sacrifices some consumption to increase savings and investments today so that the economy can grow faster, benefiting all. If Brazil grew at 6% a year, in 15 years Brazilian incomes would double.

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**Brazil's growth has been relatively low for an emerging country.**

(\% change)

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*Source: Government Statistics Agency (IBGE).*

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**Today Brazil has one of the highest interest rates in the world at 10% a year.**

(Central bank’s benchmark interest rate)

*Source: Central Bank of Brazil*