



Inflation and stabilization in Brazil: a political economy analysis

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Abstract

This article outlines a political economy analysis of Brazilian high inflation and stabilization. The paper explains the distributive and monetary aspects of inflation and the gradual fragmentation of the Brazilian currency. It also reviews the most important aspects of the Real stabilization plan, the de-indexation of the economy, and its rapid “liberalization” and “internationalization.” The paper shows that, in spite of the successful reduction of inflation, the Real plan was highly vulnerable to shifts in international liquidity; partly for these reasons, it led to de-industrialization and high unemployment. In addition to this, the Real plan contributed to an increase in income inequality and the development of sharp social conflicts in Brazil. These weaknesses were the main factors responsible for the currency crisis in January 1999. © 2002 URPE. All rights reserved.

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The Brazilian economy is the largest in Latin America, and one of the 10 largest in the world. Between 1949 and 1980, annual GDP growth in Brazil averaged 7.3 percent (3.8 percent per capita). This impressive performance deteriorated sharply after 1980, when growth rates fell to 1.8 percent per annum (0 percent per capita). In contrast, inflation rates accelerated almost relentlessly, from under 20 percent in 1972 to around 5,000 percent (annual rate) in mid-1994. After several failed stabilization attempts the “Real plan” successfully reduced inflation rates

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to 5 percent or less. This paper outlines a Marxist analysis of high inflation in Brazil,¹ and critically examines the stabilization program implemented in 1994.

Studies of Brazilian high inflation can be classified into two groups. The first, including most structuralist, neostructuralist, post-Keynesian, and Marxist contributions, argues that distributive conflicts and the widespread indexation of prices and incomes were the main causes of inflation. In contrast, neoclassical writers generally blame the large and persistent fiscal deficits for the high inflation (Silva & Andrade, 1996). This article shows that the distributive conflicts were the main underlying cause of inflation. However, this “real” approach is insufficient. In order to explain high inflation, the fragmentation of the currency, and the deterioration of the Brazilian monetary system more fully, this article provides an innovative Marxist interpretation of the Brazilian experience, which integrates theoretically the “real” and “monetary” aspects of inflation.² This analysis builds upon radical monetary theory, especially the hypothesis that money is endogenous and non-neutral. The theoretical analysis of inflation is developed in Section 1. Section 2 contextualizes Brazilian high inflation as a form of monetary crisis. The causes of the deterioration of the Brazilian currency are identified through the relationship between money and production. We look particularly closely at the relationship between the money endogeneity and the reproduction of the general equivalent when analyzing Brazilian inflation. Section 3 analyzes the Real plan, especially its impact upon the distributive conflict and the supply of money. In its final section, the paper explains why the stabilization program was limited and fragile.

1. Conflict, money, and inflation

1.1. Conflict inflation

Non-mainstream writers of different persuasions, especially post-Keynesians, neostructuralists, and Marxists, often argue that distributive conflicts are generally the main cause of inflation or, more broadly, that inflation is the monetary expression of the distributive conflicts (Barkin & Esteva, 1982: 48–49).³ In brief, conflict theories usually presume that the money supply is endogenous, and that important social groups (unionized workers, monopoly capitalists, rentiers, etc.) have monopoly power, and can determine the price of their goods or

¹ Brazil experienced several years of high inflation between the mid-1970s and the early 1990s, but not hyperinflation. This distinction is relevant because, although inflation occasionally exceeded the conventional threshold of 50 percent per month, the domestic currency was never annihilated as it famously was, for example, in Hungary and Germany (see Section 2.2).

² We employ the terms “real” and “monetary” for illustrative purposes only. These categories are generally unhelpful and often misleading, because capitalist economies are necessarily monetary (Itoh & Lapavistas, 1999; Lavoie, 1992).

³ Conflict theories are surveyed by Dalziel (1990) and Lavoie (1992: Chap. 7). Burdekin and Burkett (1996) provide an outstanding theoretical and empirical investigation, but see also Boddy and Crotty (1975), Glyn and Sutcliffe (1972), Marglin and Schor (1990), and Rowthorn (1980: Chaps. 5–6). The Brazilian experience is interpreted in this light by Bacha (1982), Bresser Pereira and Nakano (1983), and Mollo and Silva (1987). The Mexican case is analyzed by Barkin and Esteva (1979, 1982).

services strategically. If some of these groups use their market power to increase their share of the national income, and if other groups react using the same weapons, conflict inflation may be the result. In this case, inflation reconciles *ex post* demands over the national product that are, *ex ante*, incompatible. In this model, the rate of inflation is a positive function of the size of the overlapping claims and the frequency of the price changes, and a negative function of the rate of productivity growth. The conflict approach can be extended to show that inflation rates may become rigid downward if some agents index-link their prices or incomes (inertial inflation). In this case, any negative shock or additional income demand can lead to permanently higher inflation. The conflict approach illuminates several important aspects of persistent inflation, but it is often insufficient for two reasons. First, the process of income generation and expenditure should not be conceptualized independently of the circuit of capital, in which wages and profits are determined sequentially rather than simultaneously; therefore, there is no “cake” to be shared other than in retrospect (Fine, 1980). Second, conflict inflation cannot exist unless sufficient extra money is provided in order to accommodate the income demands (see Section 1.2).

In the conflict approach, three types of conflict are usually critical. First, as indicated previously, when large firms have monopoly power, mark-up target pricing can lead to conflict inflation. Second, organized labor can try to impose a “fairer” distribution of income, or to obtain compensation for losses due to past inflation, through money wage increases. The capitalist sector may accept these pay rises in principle, perhaps in order to defuse conflicts in the production line but, later, respond through higher prices. The third type of conflict is the dispute between financial and industrial capitalists for shares of the total surplus value, especially through the level of interest rates.⁴ Higher wages, prices, or real interest rates increase costs across the economy, and they can spark a conflict with “real” consequences whose winners can be difficult to identify other than in retrospect. More broadly, the persistence of conflict inflation is contingent upon the institutional structure of the economy, the financial system, the fiscal and monetary policies of the state, the balance of class forces, and the mode of expression of the social conflicts at each point in time (see Section 2).

1.2. Extra money inflation

Recognition of the fact that certain types of monetary institutions and policies tend to accommodate high inflation almost automatically, while others are more rigid, led to two important developments in the Marxian inflation literature. First, de Brunhoff (1982), Fine and Murfin (1984: Chap. 7), Kotz (1987), and Weeks (1979), among others, criticized conflict theories for their relative neglect of the monetary sphere. Their critique highlights the need to develop a monetary, but non-monetarist, theory of inflation, in which institutions have an important role to play. Second, Aglietta (1979: Chap. 6), de Brunhoff and Cartelier (1974),

⁴ Inflation benefits debtors at the expense of creditors if the debt service declines in real terms. However, in Brazil most credit transactions were index-linked, which eliminates these transfers. In contrast, the erosion in the real value of bank deposits due to inflation was the source of substantial transfers to the banking system (on average, equivalent to 2.5 percent of GDP; see Cysne, 1994). For a general analysis of these income transfers, see Duménil and Lévy (1999); the Brazilian case is analyzed by Lees et al. (1990).

de Vroey (1984), Fine (1980: Chap. 4), and Lipietz (1983) developed the theory of extra money inflation.⁵ This theory (for a detailed presentation, see de Vroey, 1984; for a critical review, see Saad-Filho, 2002) argues that circumstances intrinsic to the circuit of capital regularly create discrepancies between value production and the supply of (credit or fiat) money, which may be inflationary.⁶ In brief, and somewhat loosely, extra money inflation can happen if extra money (this concept is defined below) validates prices higher than values, or lowers the relationship between the value of the output and the circulating money, and if the original relationship is not subsequently restored by output growth or the destruction of the extra money (de Brunhoff & Cartelier, 1974).

Extra money can be created in different ways, both privately *and* by the public sector. For example, the commercial banking system creates extra money when it refinances the irretrievable debts of the productive sector. The extra money may be inflationary if the ensuing output growth is insufficient to compensate for the increase in liquidity, in which case the relationship between value and money declines permanently. Similarly, the central bank creates extra money when it supports, through the discount window, banks suffering substantial loan losses. Extra money may or may not be inflationary; this outcome is contingent upon the output response and the ability of the central bank and the private banking system to stave off the crisis.⁷

More specifically, extra money increases the nominal national income relative to what it would be otherwise. If the extra money is spent rather than saved or destroyed in the repayment of loans, it may induce a quantity response in those industries operating below capacity, potentially leading to higher investment and demand (the “Keynesian” scenario). In this case, the additional productive capacity and the additional demand may compensate for the extra money, and inflation does not materialize. At the end of the circuit, there will be more money and more commodities in circulation, which may restore the previous relationship between value and money at a higher level of income and output. However, if the extra money increases demand in those sectors operating at full capacity, and if additional imports are not available (the “monetarist” scenario), the relationship between prices and money is not restored. A new relationship is established through an increase in prices in this market, ostensibly because of excess demand; this is extra money inflation.

Extra money inflation is more likely in monetary systems based on inconvertible paper currency than in any other monetary system, because this type of money introduces additional mediations on the relationship between labor, value, and money (Itoh & Lapavitsas, 1999). The monetary role of the state is prominent in inconvertible systems, because the state produces

⁵ Extra money should not be confused with the monetarist concept of “excess money,” as is shown below. Money is not neutral, and extra money may or may not be inflationary, depending on its impact upon the structure of production and the type of expenditure which it induces.

⁶ Post-Keynesian horizontalist writers (e.g. Moore, 1988) argue that if the money supply is endogenous there can never be excess money supply. For a critique, see Lapavitsas and Saad-Filho (2000).

⁷ For example, in the event of a liquidity crisis (scarcity of money preventing the synchronization of the stages of the circuit of capital), a liquidity increase can avoid generalized insolvency. The stimulus which additional liquidity provides to production indicates that extra money is not necessarily inflationary. For a similar approach to the relationship between money and crisis, see Marx (1981: Chap. 34) and Minsky (1980, 1982, 1986).

the legal tender, regulates the financial system (which produces credit money), and it heavily influences the rules of convertibility of the domestic currency into world money. However, the state cannot control all the variables of accumulation across the economy and, when it creates or validates the private production of credit money, the state may sanction prices that are very imperfect expressions of value.⁸ Extra money inflation does not generally interrupt the accumulation of capital, and it may even increase total profits (within limits), because the extra money can facilitate the sale of the output. However, there are limits to extra money-induced economic growth. The continuous production of extra money can introduce distortions into the relationship between prices and values and between economic sectors, because “certain commodities sell above while others sell below their value” (de Brunhoff & Cartelier, 1974: 125). The cumulative effect of these distortions may, eventually, create severe difficulties for economic reproduction because they erode the social stature of the currency.⁹ This may lead to its rejection and currency substitution (see Section 2.2). Obviously, there is a direct relationship between extra money and conflict inflation, because conflicts can lead to long-term, widespread, and substantial price increases *only* if extra money is regularly created, and if the output fails to respond proportionately.

In spite of their apparent similarity, the theory of extra money inflation is incompatible with the quantity theory of money. The quantity theory’s assumptions that money supply is exogenous, that money is only a medium of exchange, and that money is not hoarded, are unacceptable from the perspective of the extra money approach. First, extra money is regularly and endogenously created by the interaction between the central bank, commercial banks, firms, and workers, and its quantity cannot be controlled, or even known precisely, by the state. In contrast, the quantity theory presumes that the banking system is always fully loaned up, and that the central bank can determine autonomously the supply of money directly (through the monetization of government deficits or purchases of government securities in the open market) or indirectly (through changes in compulsory bank reserves, which should lead unproblematically to changes in the outstanding stock of loans). Other potential sources of change in the money supply are usually ignored. Moreover, the quantity theory usually neglects the possibility that changes initiated by the central bank will be neutralized by hoarding, compensatory changes in bank loans, or the repayment of these loans.

Second, extra money is non-neutral in the short and the long run; it may change irreversibly the level and composition of the national product and the structure of demand, depending on how it is created and how it circulates. In contrast, the quantity theory presumes that money is neutral in the long and, in extreme cases, even the short run.¹⁰ Third, the effects of extra

⁸ Marx’s theory of labor, value, price, and money is reviewed by Saad-Filho (1993, 1997, 2002); its relationship with the value of money is critically examined by Fine, Lapavitsas, and Saad-Filho (1999) and Mollo (1991).

⁹ For de Brunhoff and Cartelier (1974: 125) inflation is a form of the crisis which “does not rupture the circulation of commodities but, rather, weakens it.”

¹⁰ In mainstream analyses full employment necessarily holds in the short or the long run, and money is, correspondingly, neutral in the short or the long run; only the length of time until neutrality holds is the subject of dispute. In contrast, extra money can change relative prices and the level and composition of output in the short *and* the long run. There are no necessary proportions between the extra money injected and the price changes, as in the quantity theory, because money affects the “real” economy. In sum, “monetary” and “real” analyses are inseparable, in spite of monetarist claims to the contrary.

money (whether quantity, price, or both) cannot be anticipated. All that one can say is that high rates of capacity utilization and activist state policies increase the probability of extra money inflation, but there is never likely to be a simple relationship between them. In sum, state validation of the private creation of credit money offers no guarantee that the output will be compatible with the circulating money (Itoh & Lapavitsas, 1999). In contrast, for the quantity theory the relationship between money supply and inflation is usually straightforward. Because of the underlying assumptions of perfect competition, full employment, and money neutrality, a change in the supply of money (initiated by the central bank and automatically propagated by the commercial banks through the money multiplier) unproblematically leads to a predictable change in the price level.

In sum, the regulation of the quantity of extra money by the state is always highly imprecise, because the state cannot control the main variables of accumulation, especially the level and structure of interest rates, the rate of return of new investment, and the terms of trade (Lapavitsas & Saad-Filho, 2000; Mollo, 1991, 1999). Since the creation of extra money cannot be fully controlled by the state, and since the state is influenced by, and responds to, a wide range of economic and political pressures, it cannot be naively “blamed” for inflation as if it were fully autonomous. Recognition of this fact further distinguishes the extra money approach from the quantity theory (de Brunhoff & Cartelier, 1974).

1.3. Currency reproduction and fragmentation

The first basic function of money is the measurement of commodity values and their expression as prices. Although the state can choose the standard of prices (dollars, rupiahs, reais, or whatever), the measurement of value involves a social process that is largely independent from the state (Saad-Filho, 1993, 2002 ch5). The second basic function of money is as medium of exchange. In contrast with the quantity theory, and following the endogenous money tradition of Steuart, Tooke, Marx, Schumpeter, Kalecki, and the post-Keynesians, we believe that the quantity of circulating money and its velocity are generally determined by the level of output, commodity prices, value of money, and the economic institutions, regardless of the monetary regime.¹¹ Changes in output, prices, or the value of money can induce changes in the velocity of money or its circulating quantity, especially through changes in hoards or outstanding loans (which are settled by money as the means of payment).

In the international sphere, transactions are settled in international currency (world money). This form of money fulfils the functions outlined previously in the global arena. It expresses the prices of tradable goods, is generally accepted in foreign transactions, and it preserves through time a relatively stable command over commodities and financial assets located or registered across the globe. The convertibility of the domestic currency into world money, and the size of the central bank’s hoards, are important constraints upon each country’s participation in the world market.

¹¹ Lapavitsas and Saad-Filho (2000) and Mollo (1999) show that Marx’s approach to money endogeneity is richer and more convincing than the post-Keynesian horizontalist analysis in Minsky (1986) and Moore (1988).

The functions of money are mutually complementary, and they are fulfilled by a large set of forms of money, potentially including credit money, central bank money, financial assets, precious metals, and foreign currencies. For de Brunhoff (1978, 1985), the smooth convertibility between the various forms of money, and their ability to fulfil all the functions of money, is the *reproduction* of the general equivalent. Its reproduction provides the objective basis for the social recognition of money (see Mollo, 1993).

The reproduction of the general equivalent depends upon a highly specific set of institutions, including the money market and the central bank, usually (but not necessarily) regulated at the national level. However, at least as important as the institutional framework is the rhythm of accumulation. Regular capital accumulation (what is usually called economic growth) indicates that relative prices are not severely distorted, which helps to ensure the social recognition of the currency as the general equivalent. If this is not the case, the currency may be rejected, and substitutes will gradually fulfil certain functions of the currency. Currency fragmentation (when certain forms of money become inconvertible into others) and currency substitution (when certain forms of money become unable to fulfil their previous functions and are replaced by others) create obstacles to the circulation of commodities and, therefore, to capital accumulation. The tendency towards currency fragmentation and substitution under high inflation indicates that inflation can be interpreted as a form of monetary crisis (Barkin & Esteve, 1979, 1982 explore the relationship between crisis and inflation in the context of distributive conflicts).

In contemporary monetary systems, the convertibility between the distinct forms of money depends to a large extent upon the state, which introduces an important discretionary element into monetary circulation. Direct state intervention can help to reduce the costs associated with “market-led” economic fluctuations, such as those under the gold standard or currency board regimes, which are associated with substantial shifts in employment and output levels. However, greater state discretion increases the scope for arbitrariness in currency management, in which case monetary policy can introduce significant distortions into the expression of values as prices. If this leads to the rejection of the domestic currency, there may be a systematic increase in the velocity of circulation, a declining ratio between the circulating currency and the value of output, and the devaluation of the domestic currency *vis-à-vis* world money.

2. Inflation and monetary crisis in Brazil

2.1. Conflict inflation in Brazil

Import-substituting industrialization (ISI) provided the main thrust of capital accumulation in Brazil between 1930 and 1980.¹² Under ISI, a large manufacturing sector was built, producing a wide variety of goods primarily for the domestic market. ISI was associated with highly concentrated market structures, partly because of the technologies used, and partly because of the small degree of openness of the economy until the early 1990s. These market structures

¹² ISI policies are critically evaluated by Bruton (1998) and Gereffi and Wyman (1990). The Brazilian experience is reviewed by Baer and Kerstenetzky (1975), Hewitt (1992), and Tavares (1975).

facilitated the adoption of rigid mark-up pricing rules by the leading firms (Considera, 1981). Mark-up pricing protected the revenue of the largest firms and the highest income brackets against demand shifts or adverse fluctuations in the level of activity, which may have protected investment in certain key industries, especially consumer durables. However, the rigidity of the pricing system helped to make the economy chronically vulnerable to conflict inflation (Bresser Pereira, 1981, 1992; Lafer, 1984).

Rapid industrialization through ISI was also conducive to labor market segmentation. For historical and political reasons, the skilled workers of the leading industries, based mostly in São Paulo, were relatively well organized and their real wages were much higher than the Brazilian median, even under the military regime (1964–85).¹³ The high degree of industrial concentration may have contributed to these gains. Large firms often offered relatively low resistance to wage demands, especially in the 1980s, because their market power allowed them to transfer to prices the impact of wage increases (Amadeo & Camargo, 1991). It is generally accepted that the simultaneous concentration of industrial and union activity in the Southeast has played an important role in the growth of regional and income inequality in Brazil.

Widespread dissatisfaction with the level and distribution of income across categories of workers and regions of the country, and with discrimination based on income, gender, skin color, and other factors, have contributed to the development of severe distributive and other conflicts in Brazil. In addition to this, the attempt by small and medium companies to emulate the pricing behavior of their larger competitors, suppliers, and customers, and income disputes between industrial, commercial, financial, and landed capital, generated a highly conflictive process of price and wage determination. In Brazil, these conflicts developed largely through the indexation of prices and incomes.

Indexation to past inflation was introduced gradually across the economy between the late 1960s and the mid-1990s. Indexation was institutionalized by the federal government in the late 1960s, primarily in order to expand the market for its own securities.¹⁴ At a later stage, it was used as an incomes policy which partly contained the distributive conflicts, and partly shifted them over time. Under the military regime, the rate of increase of wages was generally determined centrally, which helped to repress worker demands and shift the distributive conflict towards the “technical” rather than the “political” or industrial spheres. This shift increased the degree of indexation of the economy, because wage increases became inflexibly determined by past inflation.¹⁵ The exchange rate, household rents, and many other prices were also

¹³ In São Paulo, the largest and most industrialized city in Brazil, executive pay increased by 75 percent in real terms between 1964 and 1985, while skilled workers’ wages increased by 83 percent. In contrast, unskilled worker wages increased only by 38 percent and office workers’ wages by 33 percent. In this period, the real minimum wage declined by 43 percent (Amadeo & Camargo, 1991; Sabóia, 1991).

¹⁴ Usury law restricted annual interest rates to 12 percent. As inflation rates were usually higher (peaking at 90 percent in 1964), there was no scope for the development of a deep financial system. The way around this legal restriction was to index-link most financial assets, and apply the 12 percent limit only to *real*, rather than nominal gains (Studart, 1995).

¹⁵ Nominal wages increased once a year until 1979, twice yearly until 1985, approximately every 3 months until 1987, and monthly afterwards, in which case nominal wages were known only *after* they were paid (see Balbinotto Neto, 1991; Barbosa & McNelis, 1989; Macedo, 1983).

index-linked. The indexation of prices and wages helped to provide social stability in the short-term, because it seemed to guarantee future compensation for the losses due to current inflation. In spite of this, the distribution of income deteriorated sharply in the period of high inflation. The Gini coefficient increased from 0.56 to 0.64 between 1970 and 1989 (this year's Lorenz curve envelops the former completely). By 1990, the top quintile of the population appropriated 64.6 percent of the national income, and the lowest quintile only 2.3 percent (in 1981, the corresponding figures were 61.8 and 2.8 percent), one of the highest concentration ratios in the world (Bonelli & Sedlacek, 1991; Cacciamali, 1997; Ferreira & Litchfield, 1996).

Indexation made Brazilian inflation rigid downwards for three reasons. First, firms and workers tended to adopt simple pricing rules which perpetuated past inflation by simply projecting it into the future. Second, in order to protect their profits firms usually increased their mark-up when inflation was rising, or was expected to rise. Third, indexation made the economy prone to rising inflation after negative supply shocks (especially the oil shocks in 1973 and 1979–80 and the currency devaluation in 1983). These shocks were largely responsible for the stepwise rising inflation between 1972 and 1985 (Amadeo, 1994).

The acceleration of inflation created a tendency for the reduction of the interval between the price and wage increases. This has a clearly regressive distributive effect, because some agents are better able to protect their real income than others. Moreover, it has been abundantly shown in the literature that the shorter the adjustment period and the higher the rate of inertial inflation, the more rigid it becomes, and the more sensitive it is to negative shocks. In the mid-1980s, the Brazilian economy became increasingly disorganized as relative prices became highly variable in the short run. This disorganization introduced substantial uncertainty into economic calculation, which probably contributed to the decline in the level of investment.

Inertial inflation sharply increased the cost of contractionary monetary and fiscal policies, because higher interest rates or lower government expenditures tended to have little effect on firms' pricing strategy. Contractionary policies could even lead to *higher* prices rather than lower, if firms tried to maintain their gross profits in spite of their declining sales and higher financial costs. By the mid-1980s, it was generally accepted in Brazil and elsewhere that conventional fiscal and monetary policies were largely ineffective against inertial inflation, and that disinflation would require the coordinated de-indexation of prices and wages (Calvo, 1992; Dornbusch & Fischer, 1986, 1993; Vegh, 1992). In Brazil, a group of neostructuralist writers developed "heterodox shock" as a policy alternative.¹⁶ This strategy involves the simultaneous freezing of prices and wages at their average real level and the abolition of indexation and changes in contracted interest rates in order to reflect the expected decline in inflation. The currency was often changed in order to help legitimize the stabilization program.¹⁷ Brazil's first experience with a heterodox shock was in February 1986. The "Cruzado Plan" reduced inflation rates from 15 to 1 percent per month for several months. However, this and other

¹⁶ Heterodox shocks are discussed, from different angles, by Arida and Lara-Resende (1986), Bresser Pereira (1987), Bresser Pereira and Nakano (1985), Cardoso and Dornbusch (1987), Feijó and Cardim de Carvalho (1992), and Lopes (1986).

¹⁷ Court challenges against government intervention in contracts between third parties have led to heavy penalties being imposed upon the Brazilian government.

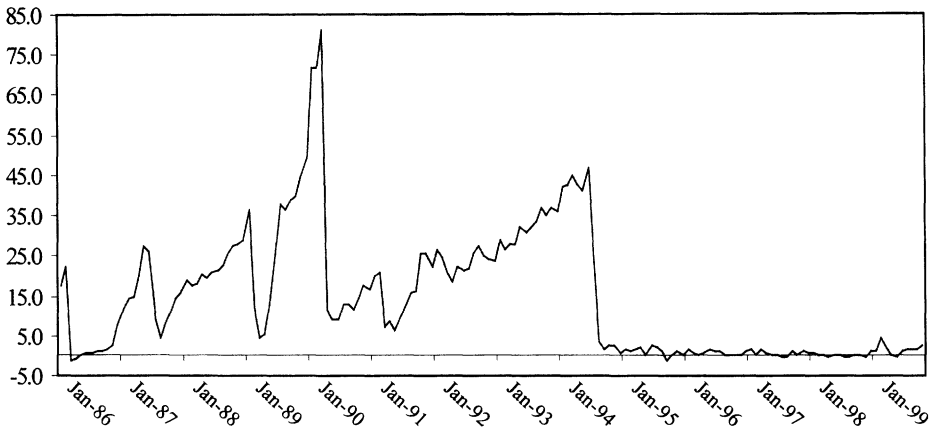


Fig. 1. Brazil: monthly inflation rate, 1986–99 (%). Source: FGV.

heterodox plans invariably collapsed after a few months, and inflation rates tended to explode in the aftermath (see Fig. 1).¹⁸ Their failure was largely due to two reasons.

First, heterodox shocks create a tendency towards real wage decline because, in practice, the wages are frozen at their average real level while prices are frozen at their nominal peak. Suppose, for example, that in the year before the shock the peak real wage for a category of workers was equivalent to \$400, and the trough was equivalent to \$200. The shock freezes the wage at its dollar average, \$300, and turns this average into the new peak wage. The reduction in their peak wage may be acceptable to workers because of the benefits brought about by stabilization, especially the elimination of inflation losses. However, if the stabilization program collapses, leading to a new round of inflation and to another shock, the real wages tend to decline. The newly frozen wage will be determined by its previous peak, equivalent to \$300, and by the new trough, equivalent, say, to \$180. On average, the real wage after the first shock has declined to \$240, which becomes the nominal peak after the second shock. The implementation of several heterodox shocks in rapid succession can reduce average real wages substantially. In sum, real wage levels tended to decline between the mid-1980s and the mid-1990s because of inflation and the failure of the heterodox stabilization programs.

The second reason for the failure of the heterodox programs is that a price freeze transforms short-term imbalances in relative prices, usually created by high inflation, into permanent differences. The shock freezes certain prices at exceptionally high real levels, for example if they had increased the day before the shock, while other prices are frozen at exceptionally low levels (for example if they were due to rise the day after the shock). These imbalances can be substantial. In addition to this, the difficulty of importing competing products allowed the companies operating in the domestic market to avoid the price limits imposed by the government. The heterodox shocks, and the continuing disputes for income under the new

¹⁸ The most important stabilization plans in Brazil were the Cruzado (1986), Bresser (1987), Summer (1989), Collor I (1990), Collor II (1991), and Real (1994). For an account of the differences between them, see Cardim de Carvalho (1993) and Feijó and Cardim de Carvalho (1992).

circumstances, can lead to arbitrary shifts in the profit rates, the breakdown of supply chains, bankruptcies, illegal trading, economic disorganization, and, eventually, the collapse of the stabilization program.

The failure of several heterodox programs contributed to the disorganization of relative prices, increased inflationary expectations, and, at the same time, reduced the social tolerance to high inflation. In addition to this, the failure of these programs sharpened the tensions associated with high inflation, especially the distributive conflicts involving key worker categories such as car assembly workers in São Paulo, employees of state enterprises, and civil servants. In spite of these conflicts, rising inflation did not degenerate into hyperinflation or the dollarization of the economy, mainly because it was contained by the central bank's high interest rate policy. Between the early 1980s and the mid-1990s, the Brazilian central bank systematically increased interest rates and the liquidity of its securities in order to avert the threat of flight from currency into commodities (hyperinflation) or into other reserve assets (dollarization).

2.2. *Extra money inflation and currency fragmentation*

The Brazilian government provided generous quantities of extra money in the postwar era, initially in order to support ambitious public and private investment programs, and later to try to preserve the level of activity in spite of the oil, debt, and other crises. The private financial system was similarly geared to provide extra money liberally (with state support), especially for working capital and consumer credit (large scale manufacturing investment was usually financed by retained earnings, state-owned banks, or foreign capital; see Lees, Botts, & Cysne, 1990 and Studart, 1995). In spite of its obvious shortcomings, this strategy was successful, as is shown by the high growth rates between 1947 and 1980. However, in the absence of a robust tax system (Theret, 1993), fiscal deficits were generally high, especially in the early 1960s and in the late-1970s. Between 1981 and 1993 the operational public deficit was, on average, 3.3 percent of GDP, while the nominal public deficit was 33.4 percent of GDP (see Fig. 2).¹⁹ The domestic public debt increased rapidly during the 1980s and especially the 1990s (see Fig. 3), partly because of these deficits, and partly because of the high domestic interest rates (see Fig. 4), which were allegedly necessary to attract foreign capital, reduce domestic inflation, and avoid the dollarization of the economy.

It was shown in Section 2.1 that, between the mid-1980s and the mid-1990s, the Brazilian government implemented several (failed) stabilization programs. These programs usually included important heterodox elements, plus conventional contractionary fiscal and monetary policies. It is noticeable that the latter gradually tended to become more prominent, while the former tended to lose relevance in each successive shock. This gradual and uneven policy shift was reinforced by the increasingly orthodox policies implemented between the adjustment programs. One of the most important implications of the shift towards orthodoxy

¹⁹ The nominal public deficit (PSBR) is the difference between total government expenditures and total revenues, including all levels of public administration and the state enterprises. The primary deficit is the difference between non-financial expenditures and revenues, and the operational deficit is the primary deficit plus the real interest paid on the public debt. The difference between the nominal and the operational deficits is due to inflation.

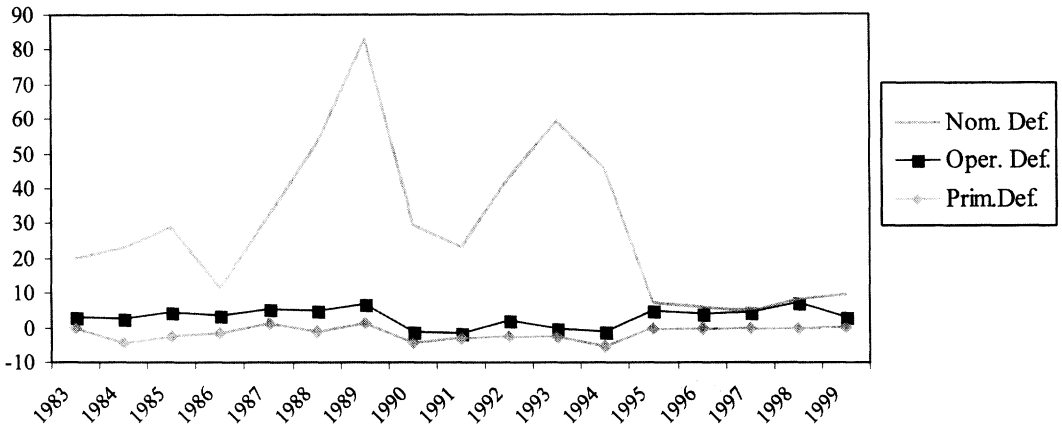


Fig. 2. Brazil: nominal, operational, and primary public deficits, 1983–99 (%GDP). Source: Central Bank of Brazil.

was the compression of the levels of investment and current expenditures at all levels of government (because of the contractionary fiscal policy), and the growing weight of the interest payments on the domestic public debt in the federal budget (because of the contractionary monetary policy).

In addition to this, the increasingly orthodox government policies induced a reduction in the private expenditures, largely because of the demand decline and the rising cost and reduced availability of consumer and industrial credit. Persistently contractionary fiscal and monetary policies go a long way towards explaining the Brazilian economic slowdown since 1980 (Bresser Pereira, 1996). However, the slowdown was insufficient to reduce inflation because of the indexation of prices and incomes, the market power of the oligopolistic groups, and paradoxically because contractionary policies increased the disposable income of the

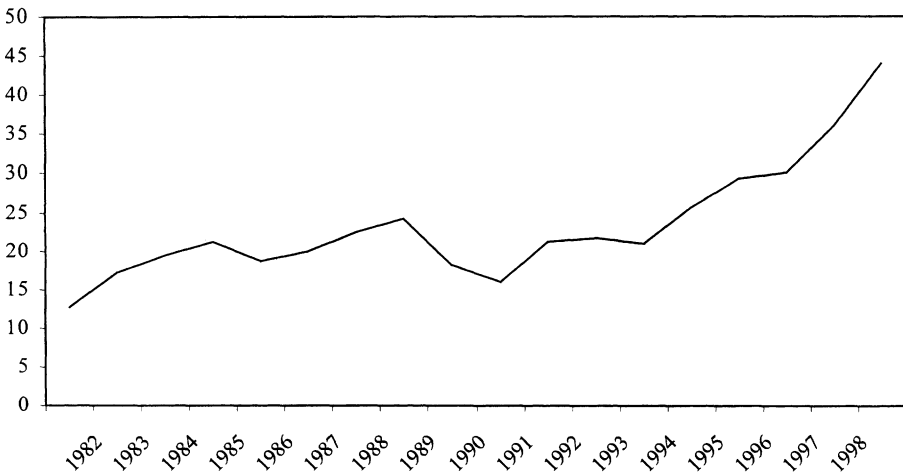


Fig. 3. Brazil: net domestic debt (%GDP). Source: Central Bank of Brazil.

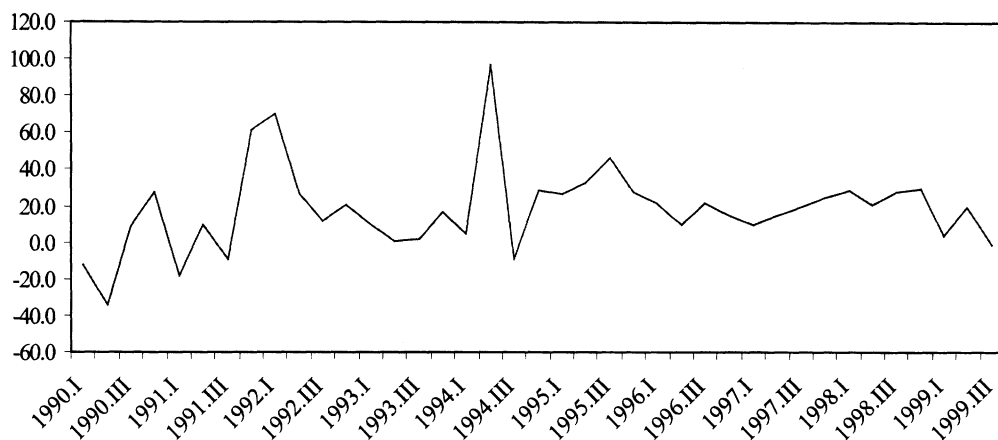


Fig. 4. Brazil: real interest rates, 1990–99 (%). Annualized quarterly Selic (overnight) rates, deflated by the IGP-DI. Source: Central Bank of Brazil.

wealthier sections of the society (see further). In spite of these problems, inflation helped to preserve the continuity of capital accumulation (see Section 1.2). This helps to explain why unemployment rates were relatively low until the mid-1990s (see below).

In order to generate demand for the rapidly growing stock of government securities, and to avoid hyperinflation and the dollarization of the economy, the central bank offered increasingly attractive combinations of liquidity and high interest rates to the financial institutions (see above).²⁰ In the mid-1980s, the central bank allowed the financial institutions to swap government securities for currency on demand, which reduced the cost of the banks' compulsory reserves substantially (*zeragem automática*, see Banco Central do Brasil, 1995: 37–38; Pastore, 1990; Paula, 1996; Ramalho, 1995). The complete liquidity of the treasury and central bank securities for the financial institutions guaranteed the stability of the domestic financial system and created a substantial additional demand for government securities; however, it dealt a severe blow to the Brazilian currency, as is shown by the widening gap between money and securities (included in M2, see Fig. 5) and the rising velocity of circulation of M1 (see Fig. 6).

In the late 1980s, several banks used this opportunity to offer index-linked current accounts to their high-income customers. Money invested in these accounts earned a share of the nominal interest paid on the government securities, which could be anything up to 40 percent per month, depending on the rate of inflation. In addition to these interest payments, the deposits were available on demand because of the central bank liquidity guarantees to the banks. These index-linked accounts were equivalent to the creation of a parallel currency whose value *increased* daily because of the real interest paid on the securities (which is a form of extra money creation). The injection of extra money through index-linked accounts

²⁰ When inflation is very high, treasury bills remain attractive even at negative real interest rates (as long as alternatives such as foreign currency or capital flight remain costly), because of the losses associated with holding the domestic currency. In spite of this, real interest rates in Brazil were generally strongly positive throughout the 1980s and 1990s.

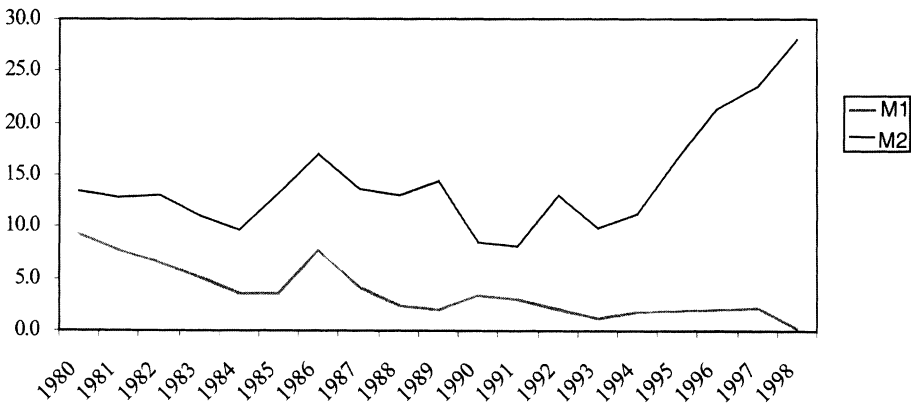


Fig. 5. Brazil: monetary aggregates, 1980–98 (%GDP). M1 includes cash and sight deposits; M2 includes M1 and government securities. Source: Central Bank of Brazil.

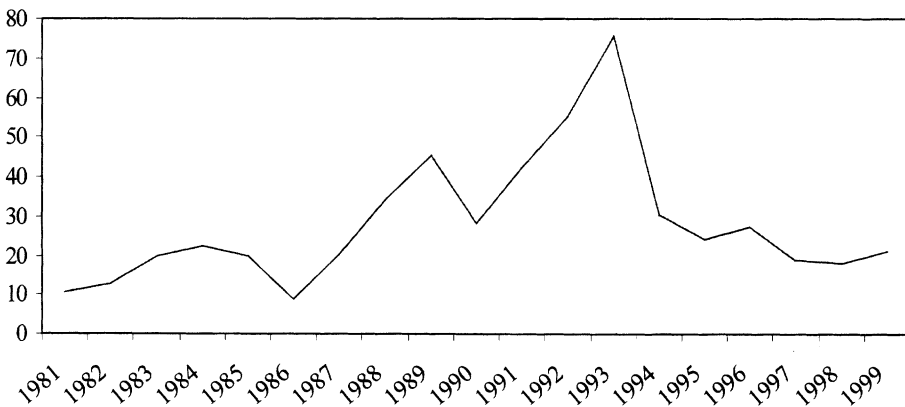


Fig. 6. Brazil: velocity of circulation of money (M1), 1981–99. Source: Central Bank of Brazil.

increased substantially the degree of indexation of the economy, because revenues could be easily swapped for interest-bearing treasury securities through the financial system. However, the interest-bearing accounts helped to increase the severity of the distributive conflict further, because distinct forms of income were index-linked in very different ways.²¹

Contractionary monetary policies were counter-productive, because they increased industrial costs and inflation through indexation. They also increased the cost of the domestic public debt and the size of the government deficit, which could be contained only through further expenditure cuts. The shift of the public expenditures toward interest payments on the domestic

²¹ The banks gradually relaxed the conditions for the supply of index-linked accounts, but they always excluded the majority of the population, who was too poor to qualify. Kane and Morisset (1993) estimate that the asset gains of the higher income brackets more than compensated their losses due to inflation between 1980 and 1989. In contrast, inflation reduced the annual income of the poorest quintile by 19 percent.

debt was regressive in distributive terms, because it contributed to the decline in the living standards of the majority, while raising further those of the rich. These imbalances and vicious circles increasingly distorted the relative prices, put into question the role of money as the general equivalent, and accelerated the loss of its stature. The fragmentation of the general equivalent was visible through the rejection of the domestic currency and the increasingly frequent use of the U.S. dollar and indexed government securities, especially in large value transactions.²² The deterioration of the domestic monetary system was contained by the small degree of openness of the trade and capital accounts of the Brazilian balance of payments until the early 1990s. The exchange rate was determined by the government, mostly through a passive crawling peg based on the daily rate of domestic inflation. This rule of thumb helped to maintain relative price stability, but it validated high inflation because the price of imported inputs increased steadily alongside the domestic prices (imported consumer goods were virtually unavailable until 1990). The gradual collapse of the currency rewarded financial acumen more handsomely than production efficiency, and helped to turn Brazilian banks into highly sophisticated organizations, able to extract large profits from speculation disguised as defensive indexation. These distortions increasingly led to the rejection of the domestic currency, and they helped to legitimize not only the use of alternative forms of money, but also the harsh stabilization policies implemented since the mid-1980s.

3. The Real plan

The Real plan virtually eliminated inflation in Brazil because it shifted and repressed the distributive conflict, and reduced the creation of extra money. The Real plan was initially welcomed by the majority of the population because it reduced inflation drastically, and was associated with rapid economic growth based on the expansion of consumption. The combination of low inflation and falling unemployment led to substantial income gains for the poor, at least initially. It will be shown below that, in spite of its success in reducing inflation, the other beneficial aspects of the plan rapidly petered out. Moreover, the plan was highly vulnerable because of its dependence upon foreign finance, and its social impact was generally negative in the medium run.

3.1. *Curbing high inflation*

The Real plan was the outcome of many years of research by the same group of academics that had designed the heterodox shocks (see Section 2.1).²³ The plan was based on

²² Grossi (1995) shows that houses and second-hand cars were increasingly priced in dollars or treasury bills by the late 1980s. For a neoclassical account of the currency collapse, see Barbosa, Pereira, and Sallum (1995).

²³ See Amadeo (1996), Bacha (1995), and Nogueira Batista (1993). The Real plan was first outlined by Arida and Lara-Resende (1986). This group of academics was based at the Catholic University of Rio de Janeiro. They were mostly neostucturalist writers whose stabilization theory derives from a synthesis of structuralism and mainstream economics (Edmar Bacha, André Lara-Resende, and Pérsio Arida have PhDs from MIT, and Francisco Lopes has a Harvard PhD). This group managed Brazilian economic policy between the mid-1980s and the late-1990s.

the de-indexation of the economy and the liberalization of the trade and capital accounts of the balance of payments. In January 1994 the government imposed the first stage of the plan, including measures to reduce the fiscal deficit and increase its control over the expenditures of all levels of government. In March, when inflation was creeping towards 50 percent per month, the government created the URV (*unidade real de valor*, or real value unit), a unit of account linked to the U.S. dollar. Under this transitory monetary system, most commodities had two prices, one fixed in URV, and the other determined daily in the domestic currency. The URV helped to stabilize real wages and key prices in the economy, and it prevented the decline of real wages in spite of high inflation in the old currency. Stability in these prices provided the anchor for the gradual emergence of a coherent price system in URV, free from most distortions introduced by high inflation.

In July 1994, after the new price system had been established, the URV was transformed into the Real. The government's publicity machine generated excitement because the Real's floor exchange rate, equal to \$1, allegedly "proved" that the Real and the dollar were equally strong. The conversion was effected through the division of prices in the old currency by 2,750 in order to generate their value in reais. In spite of its apparent complexity, the transition was easily managed by most Brazilians, who were highly proficient in price calculations across different currencies. The policy-makers set interest rates at 8 percent per month, because of their belief that stabilization should be accompanied by contractionary policies in order to avoid consumption bubbles. High interest rates, the optimistic turn of expectations, financial liberalization, and high liquidity in the international capital markets attracted large short-term capital flows, which raised the value of the Real to around R\$0.85 per dollar. On a trade-weighted basis, the Brazilian currency appreciated 16 percent in the second half of 1994. The government cheerfully presented these speculative inflows as proof of the confidence of the financial markets in the stabilization program. In sum, the Real plan was a resounding success initially, because it brought low inflation and eliminated the inflationary erosion of wages. Moreover, dollar wages were rising because of the revaluation of the currency, and cheap imported consumer goods became widely available, financed by foreign capital inflows.

Two important problems were addressed in the first weeks of the Real. First, experience had shown that, in the wake of a sudden decline in inflation, money demand rises sharply because the new currency is widely recognized and can fulfil a broader range of functions. This demand must be satisfied in order to avoid a sharp increase in interest rates and a decline in economic activity; however, if the remonetization is too rapid it may lead to extra money inflation. Second, the decline in inflation from over 40 percent per month to 0 reduces drastically the nominal interest rates accruing on savings deposits. If savers suffer from money illusion, or if they anticipate that the stabilization program will collapse shortly, they may decide to spend rather than save, which may also create extra money inflation. In order to control the remonetization of the economy and preserve the stock of savings, the Real plan used high interest rates, a barrage of publicity, and administrative measures such as a 100 percent marginal reserve on bank deposits. The monetary base increased smoothly by 300 percent between July and September 1994, showing that extra money is not necessarily inflationary.

The reversal of the international capital flows in mid-1994, triggered by rising U.S. interest rates, led to capital outflows that were the immediate cause of the collapse of the

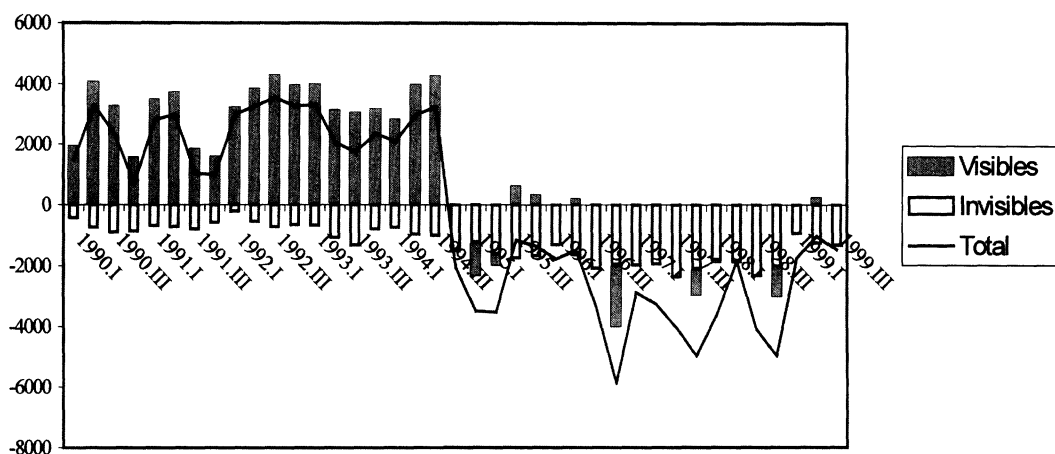


Fig. 7. Brazil: visible and invisible trade balance, 1990–99 (\$ million per quarter). Source: Central Bank of Brazil.

Mexican peso. The Mexican crisis created severe problems for financing of the current account deficits in Argentina and Brazil, among other countries. The rapid loss of reserves led the Brazilian government to raise interest rates to nearly 50 percent, and to introduce a flexible exchange rate band between R\$0.86 and R\$0.90 to the dollar (the central bank often intervened to maintain the currency within tighter “minibands”). The Real was subsequently devalued regularly by a few points in excess of the inflation differential *vis-à-vis* the United States, in order to reduce its overvaluation gradually. This was achieved primarily through manipulation of the base rates, which were also used to maintain the target level of international reserves and to control domestic demand. This is obviously a complex exercise, and, whenever the targets were incompatible, domestic activity was the adjustment variable. The overvaluation of the Real was largely responsible for a rising trade deficit (see Fig. 7), and it led to persistent complaints by the exporters. In spite of the evidence, the government never publicly admitted that the Real was overvalued, until it collapsed in January 1999 (see below).

3.2. Shift and repression of the distributive conflict and limits to the creation of extra money

Certain key aspects of the Real plan were important to maintain the social consent required by the government’s economic strategy. The plan reduced distributive conflict, at least initially, by preserving the level of real wages in spite of disinflation through the URV (see above), and repressed conflict when consent flagged at a later stage. This has been one of the main factors which has prevented the resumption of high inflation in Brazil. Moreover, rising dollar wages and falling unemployment until 1995 (see Fig. 8) led to a larger wage mass. These factors contributed to a substantial increase in the purchasing power of wage earners, which was reflected in rising consumption levels and in widespread satisfaction with the Real plan.

The drastic decline in inflation reduced the real income loss of the lowest strata of the population that had no access to sophisticated financial instruments which might help to defend their real wages. Economic stabilization contributed to a decline in the number of people living

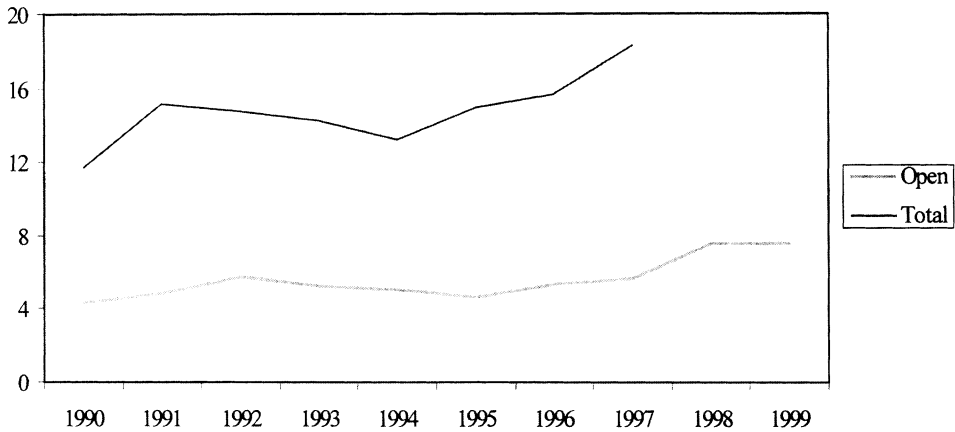


Fig. 8. Brazil: open and total unemployment rate, 1990–99 (%). Sources: IBGE and Dieese.

under absolute poverty by 12.5 million between 1990 and 1996 (Cepal, 1999). Whereas in 1990 47.9 percent of the population (41 percent of households) was considered “poor,” in 1993 the poor were 45.2 percent (37 percent of households), and in 1996 only 37.8 percent (29 percent of households).²⁴ Finally, lower import barriers, the simplification of economic calculation, and the government’s publicity barrage also helped to increase the popularity of the Real plan and to marginalize its critics.

The Real plan inserted the Brazilian economy much more deeply into international financial and productive circuits. In spite of the obvious differences, this process has substantial similarities with the simultaneous trade, financial, and capital account liberalization in such countries as Mexico (Huerta, 1997; Lopez, 1999) and South Korea (Arestis & Glickman, forthcoming; Chang, 1999). In these countries, the allure of relatively cheap foreign capital; pressure from international organizations such as the OECD, the IMF, and the U.S. Treasury; and ideological conviction provided the grounds for the sharply liberalizing turn of economic policy in the early 1990s. In Brazil and other Latin American countries, trade liberalization and currency overvaluation helped to contain inflation because these countries were flooded by cheap consumer goods, while imported machines helped to foster investment and productivity growth in key industrial sectors, especially car assembly. Foreign competitive pressure reduced the monopoly power of the large firms in key industrial sectors, which helped to reduce costs across the economy and repress the distributive conflict. However, trade and capital account liberalization also created a tendency towards the integration of Brazilian manufacturing industry into transnational supply chains. The international integration of production and the substantial rise in imports led to a large number of plant closures and a substantial decline in manufacturing employment, affecting especially the food, clothing, and toy industries

²⁴ For Cepal (1999), the poverty reduction between 1990 and 1993 was primarily due to structural changes in the economy, especially the increasing share of self-employment in trade and services at the expense of urban industry. In 1993–96, the decline in poverty was due to transfers to poor households and the decline in inflation and in food prices.

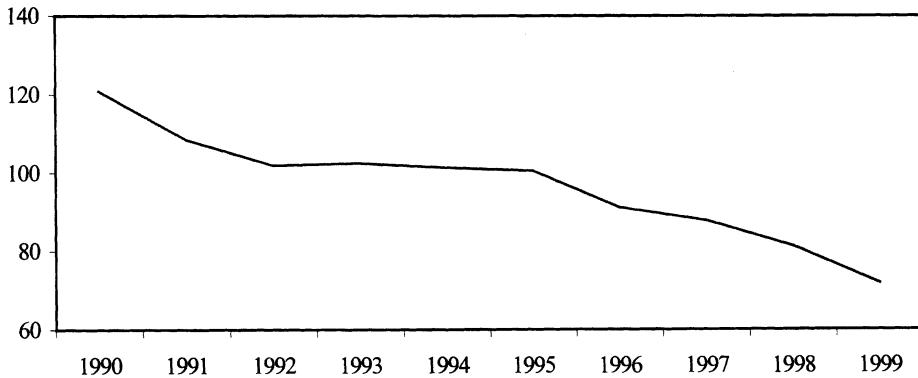


Fig. 9. Hours worked in Sao Paulo manufacturing industry, 1990–99 (June 1994 = 100). Source: FGV.

(1 million manufacturing jobs, one-third of the total, were lost in the 1990s). Largely as a result of the liberalization of trade and high domestic interest rates, unemployment increased rapidly since 1996 (see Figs. 8 and 9).

Capital account liberalization, high interest rates, and the large domestic market attracted substantial inflows of portfolio capital and direct investment under the Real. They were supported by the policy-makers because of their positive implications for the balance of payments, and the presumed technology gains. However, they were also responsible for the persistent overvaluation of the currency and a large increase in foreign takeovers of Brazilian firms, especially banks and manufacturing companies (Gonçalves, 1999). The privatization of state enterprises such as the telecommunications holding was a prime example of government support for foreign takeovers through credit and state guarantees (see Fig. 10 and Saad-Filho & Morais, 2000).

The rapid liberalization of trade and finance in the mid-1990s triggered a round of concentration and centralization of capital, especially through a wave of bankruptcies, mergers,

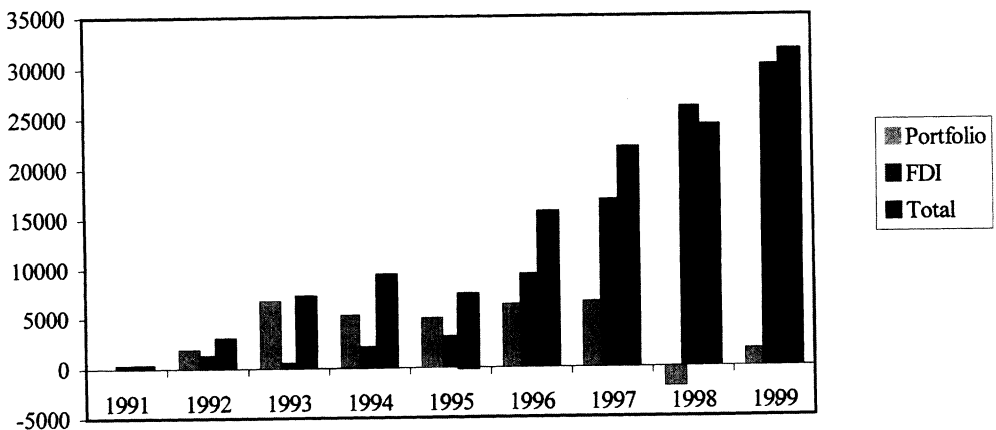


Fig. 10. Brazil: foreign investment, 1991–99 (\$ million). Source: Central Bank of Brazil.

and acquisitions that was an important cause of the rising unemployment in this period. The concentration of the financial system is especially relevant. The number of banking institutions declined from 271 in 1994 to 248 in 1997; 22 of them have fallen under foreign ownership since 1996, and 24 have foreign minority stakes (Barros & Almeida, 1997). The government of President Fernando H. Cardoso supported this process politically and financially, arguing that it would reinforce Brazil's international competitiveness.²⁵ Little was done to alleviate the impact of the rising unemployment or the reduction in the wage mass after 1995. Unemployment increased from 4.2 percent of the labor force in 1990 to 8.4 percent in early 1999, while the central bank's index of the wage mass increased from 107.3 in 1993 to 122.3 in 1995, and subsequently declined to 118.1 in 1998 (1992 = 100).

In sum, the Real plan was successful largely because of the trade and capital account liberalization, which helped to shift and contain the distributive conflict. However, given its inability to solve the causes of the conflict, the plan subsequently repressed it directly (mainly through labor market liberalization, including more flexible rules for dismissal, lower pensions and benefits, and the use of punitive measures against industrial action), and indirectly (the plan reduced the ability of industrial capital to transfer higher wages to prices, which made managers increasingly intransigent when bargaining with their workers). In addition to this, the high interest rates, the government budget surplus, the exchange rate peg, and the credit controls reduced the ability of the system to create extra money. The capital inflows, for example, were diverted to the open market, and the tight credit conditions depressed the economy's ability to finance an expansion of production through extra money.

The ability of the central bank and the commercial banking system to create money was severely limited by the exchange rate regime associated with the Real plan until early 1999. Even though the Brazilian exchange rate system was not as rigid as the currency board of neighboring Argentina, the need to maintain exchange rate stability and high foreign reserves kept interest rates high, which constrained domestic economic activity and reduced the scope for the creation of extra money by the central bank and the private sector. In addition to this, the compression of fiscal expenditures reduced domestic demand, which worsened the deflationary aspects of the Real plan (for a detailed analysis of the macroeconomic impact of the Real plan, see Saad-Filho & Morais, 2000).

The rigid exchange rate bands imposed in 1995 prevented the substantial devaluation of the Real that was necessary to restore Brazil's external competitiveness, largely in order to maintain financial market "confidence" in the currency. The bands also restricted the supply of (credit) money, which depended to a large extent upon the inflow of foreign capital. These

²⁵ In his youth, Cardoso was a well-known dependency school writer (see, for example, Cardoso, 1972 and Cardoso & Falleto, 1972). His intellectual profile has changed substantially since, at least, the early 1980s, and his political trajectory in this period is characterized by a steady movement upwards and towards the right (not necessarily in this order). As minister of finance (1993–94), he famously asked readers to "forget everything he had ever written." He was the minister responsible for the implementation of the Real plan, and was elected president in 1994, and re-elected in 1998, in the wake of the plan's perceived success. Ironically, his analysis of "dependent development" through the integration between the "advanced" parts of the underdeveloped economy and the capitalist center can illuminate certain aspects of the current shifts in the Brazilian economy, implemented by Cardoso's own government (dependency analysis is, however, vulnerable to a wide range of heavy criticisms; see, for example, Barkin, 1981 and Hunt, 1989: Chap. 7).

limitations, and the need to support the stabilization program, implied that the domestic interest rates had to be much higher than the foreign interest rates (Brazilian interest rates reached, on average, 24 percent per annum between 1994 and 1998). De-indexation through the URV, repression of the distributive conflict, and the constraints imposed upon the creation of extra money virtually eliminated inflation in Brazil. The simplification of economic calculation and financial management, the income gains due to lower inflation, and the greater degree of openness of the economy gave legitimacy to the Real plan, and helped to rebuild social recognition of the currency. This was essential for the Real to fulfil the functions of the general equivalent, and to reproduce itself (see Section 1.3).

3.3. *Vulnerability of the Real*

The decline in inflation and the creation of a viable currency are important achievements of the Real plan. The poorest strata of the population gained substantially with the lower inflation transfers, but only in the first few months of the Real. Rising dollar wages and import liberalization made desirable imported consumer goods affordable to many for the first time. These gains have helped to imprint the positive aspects of economic stability deeply into the minds of millions, and they have been used to justify the continuous use of deflationary policies, which are allegedly necessary to preserve low inflation. We have shown above that these policies were later used to repress the distributive conflict, especially through high unemployment, which reduced the bargaining power of the workers substantially.²⁶ Moreover, in spite of the lower market power of the oligopolies, the workers' share of the national income declined, which replicates the result of the previous stabilization programs.²⁷

Two aspects of the Real plan were important obstacles to the translation of lower inflation into sustained welfare gains to the majority: permanently high domestic interest rates and the liberalization of international trade and capital flows. The level of interest rates and the cost of sterilizing the foreign capital inflows are the main causes of the explosive growth of domestic debt after 1994, and of the increasing financial fragility of the state (Morais, 1998). High interest rates have a highly heterogeneous impact on industry, depending on such variables as their size, degree of internationalization, and financial strategy. Large companies heavily involved in international trade can obtain cheap funds from state-owned development banks or the international financial system, which are not generally available to smaller firms producing non-tradables. This has potentially important implications for the country's industrial structure, because it increases its heterogeneity and tightens the balance of payments constraint. It can also worsen the distribution of income and wealth, because heterogeneous growth and industrial fragmentation tend to concentrate economic and

²⁶ The potential complementarity between expansionary policies and repression of the distributive conflict is explored by Barkin and Esteva (1982: 60–61).

²⁷ Since 1993 the wage share of the national income has been below its average for 1985–92. In agriculture, it declined from 20.5 percent of the value added to 15.1 percent, and in manufacturing from 28.4 to 25.9 percent. In contrast, in the services sector it increased from 45.2 to 53.3 percent because of the increase in self-employed income.

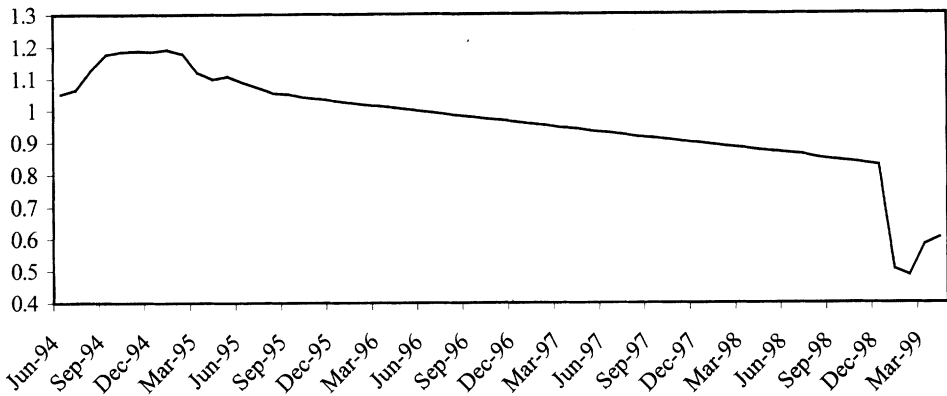


Fig. 11. Brazil: nominal exchange rate (\$/R\$). Source: Central Bank of Brazil.

financial power, reduce the real wage of the unskilled workers, and depress the domestic market.

Rising trade and current account deficits, increasing unemployment and poverty, the concentration of income after 1996, and the increasing centralization of economic power, have eroded popular support for the Real plan.²⁸ This internal legitimacy crisis and the financial fragility of the public sector led to a substantial loss of international confidence in the government's economic strategy in the late 1990s. This was one of the main causes of the vicious circle which fatally destabilized the Real after the Russian crisis in mid-1998. More generally, in spite of the government's best efforts, Brazil experienced several sudden reversions of capital flows after the Real plan (most famously after the Mexican, East Asian, and Russian crises). Each of these crises led to large reductions in Brazil's foreign reserves. For example, \$9.7 billion were lost during the Mexican crisis; and, in November 1997, the central bank had to push interest rates to 43.4 percent in an attempt to stem the outflow due to the Asian crisis (in quieter times, in May 1998, rates were "only" 21.7 percent). Finally, in the aftermath of the Russian crisis Brazil lost reserves worth \$40 billion in 6 months, and interest rates increased to 50 percent in a fruitless attempt to stem the outflow of dollars.

At the same time, the government's finances have been seriously destabilized by the heavy burden of interest payments on the domestic debt, which has increased sharply because of high interest rates and the need to sterilize capital inflows. This source of disequilibrium will tend to become increasingly strong in the medium term, as potential privatization revenues are rapidly being exhausted. These difficulties have contributed to the speculative attacks suffered by the Real, and to the loss of reserves which led to the currency crash of January 1999 (Saad-Filho, Coelho, & Morais, 1999; see Fig. 11).

²⁸ Cepal (1999) shows that the distribution of income worsened between 1993 and 1996, when Cepal's Gini coefficient increased from 0.52 to 0.54.

4. Conclusion

The difficulties currently faced by the government, including speculative attacks, currency instability, and mass protests demonstrate the declining legitimacy of the government's economic policies. The continuing trauma of high inflation, high interest rates, balance of payments vulnerability, and the government's preception of the over-riding need to maintain low inflation and exchange rate stability even after the crash have reduced the government's ability to foster economic growth and engage in an effective poverty reduction program. Unless there are significant policy changes and profound social and economic reforms, high unemployment and labor market, trade, and financial liberalization will continue to be used to repress the distributive conflict, which can lead to the further fragmentation of the economy and society. In sum, there is no reason to expect a substantial improvement in the quality of life of the majority of the population, at least in the medium term (Rocha, 1994; Saad-Filho, 1998).

This depressing prospect could have been avoided. It was shown previously that the Real plan had two main components: the elimination of indexation through the URV (which removed inflation inertia and reduced the pressure to create extra money) and the internationalization and liberalization of the economy, supported by high domestic interest rates. These policies repressed the distributive conflict and reduced the state's ability to tackle the social cost of its own economic policies. In spite of government claims to the contrary, these policies need not follow from one another. It would have been possible to use the political and economic proceeds from an alternative disinflation strategy, possibly including the exchange rate anchor initially, in order to facilitate the de-indexation of the economy. However, this should have been supplemented by a competitive exchange rate, strict limits to short-term capital flows, and by industrial and regional policies leading to higher employment levels; in addition to this, tax and land reforms should have been introduced in order to reduce the inequalities of income and wealth. Policies such as these would have reduced the distributive conflict (rather than merely repressed it), improved the prospects for macroeconomic stability in the long-term, and helped to build a more inclusive society. The ideological climate in Brazil and elsewhere has prevented this option from being considered seriously. Instead, neoliberal policies have been imposed by force, then justified by their purported inevitability.

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