Statecrafting Monetary Authority

Democracy and Financial Order in Brazil

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Chapter 4

Crafting economic stabilization: political discretion and technical innovation in the implementation of the Real Plan

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THIS CHAPTER FOCUSES on the decision-making process that led to the adoption of the Real Plan and the reasons for its success in overcoming the threat of hyperinflation and anomie that hung over Brazil during the early 1990s. This period was a crossroads. From political and economic perspectives, this time may be represented as a critical juncture. The economic changes that made price stabilization possible are accounted for here, as is the emergence of new criteria of political legitimization in Brazilian society in tandem with the process of democratization. By starting from the decisions taken by government elites and the political class in response to the dilemmas and opportunities that characterized this crossroads, subsequent policy choices become more intelligible. Likewise, many of the dilemmas which have confronted the policy-makers and the political elite since price stability in 1994 derived from changes in the economic and political context that came together during the critical juncture of the Real Plan.

Thus, one of the major analytical challenges posed by the profound changes in Latin America during the 1980s related to the extreme economic instability created by the debt crisis is addressed. How were processes of democratization reconciled with changes of economic regime imposed by the policies of structural adjustments? To what extent did convergence between processes of democratization, stability, and economic reform depend on the implementation of solutions of a type 'one model fits all', as economic orthodoxy and Bretton Woods institutions appeared to support?

Taking these questions of general order into account, it is worthwhile to briefly introduce our position in relation to the literature that deals with the links between economic reform and democratization. This is a preliminary step to assess whether or not they apply to the Brazilian experience. The economic and political background to the Real Plan is examined in the light of some common features shared with other Latin American countries at that time. It will be followed by an analysis of the conception and implementation of the relevant stabilization policies whose analytical interest may well be represented (and anticipated) in the following manner. One is dealing with an agreed economic strategy of problem solving, which emerged in the context of extreme political uncertainty associated with acute macroeconomic instability. Its technical and political effectiveness resulted from the re-blending of institutions, practices and pre-existing political resources – which we define as a mode of recombination. Two components were key factors for the success of this re-blending: the exercising of a specific type of political discretion by the relevant leadership and the availability of a technically innovative and heterodox set of economic prescriptions, derived from a diagnosis in line with the specificity of Brazilian inflation at that time.

The literature: where do we stand and why?

One of the trade marks of pioneering political literature that deals with the transition from authoritarianism has been the caution shown in relation to the prospects of democratic consolidation, above all in economic contexts such as those of Latin America, marked by the impact of their external debt crises, by stagnation, and most importantly, by the emergence of hyperinflationary pressures.[1] Later, the post-Cold War scenario and the widening of the scope for comparison with post-communist countries, presented the opportunity for a more fertile and complex vision of the possible routes of democratization cum liberalization. The emphasis, in this case, was mirrored around the significant differences in the observed routes of various countries, based on their distinctive starting points and also on whether or not democratization coincided with economic liberalization or followed it.[2]

This more pluralistic approach to dual regime change was validated by the experiences of young Latin American democracies, given their observable diversity in technical guidelines, in timing, in the manner of presentation and sequencing by which their stabilization programs and market-oriented reforms were implemented during the 1980s and 1990s.

At the same time, the effort to redeem a common denominator as a base for generalizations could be salvaged in new terms. That is to say, there was enough accumulated evidence of convergence among countries as to the final directions of such changes, in particular those concerning the basic guidelines of government agendas: economic liberalization and adherence to the principles of representative democracy.[3]

The variety of possible routes and the multiplicity of effective results, already observable during the period of interest here (1992–94) shaped a problem that proved to be long lasting. This characteristic is due to two main factors. One, a virtue in itself, is that of having introduced the component of uncertainty into the conceptual framework. The beneficial results of the combination between economic liberalization and that of political liberalization were no longer taken for granted. Calling into question the 'final point of arrival' as uncertain was in a large part due to the observation of the experiences of adjustments observed in Latin America. These did not confirm one of the crucial optimistic assumptions of orthodox analysis – and of the prescription of the Bretton Woods institutions. These were that political liberalization and economic liberalization would mutually reinforce one another and almost automatically their elective affinities would lead the relevant countries to follow the example of the dominant democracies.

This more critical approach to economic and political transitions resisted the changes in the international economic and political scenario throughout the 1990s – giving continuity to the discussion that began in the previous decade concerning the links between democratization and the neoliberal modalities of economic transformation. It centred upon two other questions, namely: What are the costs that are incurred in terms of the quality of democracy, in situations of extreme economic uncertainty, such as those marked by debt crises? And what is the place of democratic politics during such hard times? Another dimension refers to the experiences of policymaking at those early stages of democratization. As elected politicians and the new governmental elites took power, they urgently faced a policy relevant task: How do we determine the adequate mix between economic restructuring and democratic legitimization? And which is the more adequate sequencing of prescriptions, taking into consideration the differences in the relevant countries' starting points and above all the various possible routes of economic and political development?

Questions such as the incremental character of the strategies of change, their timing and their manner of presentation have gone on to occupy the domestic political scenarios. As well as this, the adoption of adjustment policies with a neoliberal stamp introduced another distinctive characteristic of regional experiences and added yet another type of uncertainty onto the domestic scenarios. In the Bolivia of Paz Extensoro, as in the Argentine of Menem, or in the Brazil of Collor de Mello one could observe an enormous hiatus, which in itself posed an important political challenge. There was an enormous gap between the content of the economic policy acceptable to the international financial institutions and foreign creditors on the one hand, and the expectations and the political composition of the electoral coalitions that supported the recently elected civilian governments on the other. More often than not, the political parties that integrated into such coalitions, to a large part, moved in the ideological universe of the 'state centred model' that had prevailed since the 1930s. This second type of uncertainty brought to centre stage the question of governance as defined by Malloy and Cunningham: how to convert an electoral coalition into an effective governing coalition supportive of liberalizing economic policies?

One of the merits of the political literature which aimed at responding to such challenges was that it made possible a change in perspective in relation to conventional orthodox analyses and prescriptions that had prevailed up until then – of the type 'one model fits all'. It is beyond the scope of this chapter to examine the contribution of those authors. The interest here is to show, in broad terms, a simultaneous advance on three fronts. First, the assumption (frequently explicit) that the processes of democratization and of economic liberalization respond to distinct logics, each following a political dynamic of its own, which may or may not mutually reinforce each other in the short term. In other words, the initiation of a virtuous cycle was not seen as a necessary outcome. From this high level of uncertainty two other components followed which were looked upon as structural problems of dual transition. One of them is the presence or absence of the qualities of statesmanship in the elected politicians, seen as the capacity to coordinate and eventually bring together the aforementioned logics. This capacity would be required especially when the gap between the content of the economic policies needed to start (or proceed with) structural adjustments and the system of interests that make up the winning electoral coalition widened. As a

consequence, one of the key questions broached by this literature may be stated as follows: Is there any space open for elected politicians to exercise political discretion when the room to manoeuvre, in terms of economic policy options, is excessively meagre?

Another related advance is the specification of the types of political discretion and the quality and the skills necessary for political leaders to manage a successful transition. The concept of *statesmanship* was rescued and adapted to these contexts. Statesmanship may be defined as the capacity to build consensus around a given set of policies and institutional framework, stabilize expectations, and reconcile economic change and democratization. Contrasting successful and unsuccessful experiences suggested that statesmanship was a necessary condition of governance. Malloy defines statesmanship as "the capacity to generate new power resources from given institutions" – that is to say, from a fragile institutional framework put into their hands at the starting off point.[4]

During the early 1990s, positive changes in the international context reinforced the necessity for a more contextual analysis. On the one hand, the resumption of financial flows and the Brady Plan in 1991 opened the way for the return of private capital to Latin America. The shift of capital towards emerging countries was encouraged by low interest rates in advanced economies. On the other hand, these benign conditions benefited Latin American countries differently, according to whether or not they had carried out economic stabilization and solved their domestic fiscal crises. In comparative terms, within this new context, Brazil revealed itself as being a loser, an atypical case of 'muddling through'. Its tardy and patchy structural adjustment deprived it of taking advantage of this opportunity at the level attained by neighbours. Unlike its experience for most of the twentieth century, Brazil seemed unable to accompany international economic change and maximize benefits from new opportunities. In short, whilst international changes improved the time horizons of Latin American policy makers, Brazilians remained prisoners of short-term tasks and calculations.

The reasons for this pattern of adjustment, by 'muddling through' are various and have been explored by us elsewhere. What is important here is to highlight one explanatory variable, of a technical order, relevant to our objectives. The distinctive characteristics of Brazilian mega-inflation – of a predominantly inertial character due to the generalized indexation of assets and of income – demanded special diagnosis and remedies. These were alien to mainstream economics and policies within the Bretton Woods institutions. At the same time, although a 'theory' of inertial inflation had been framed and had been available in Brazil since the early 1980s, the failure of several stabilization plans could be blamed, in part, on the use of heterodox mechanisms of inflation control. In this context, innovations conceived by Brazilian economists during the Real Plan can be seen as a by-product of years of experimenting. Technical innovation emerged from a learning process during the failed attempts at stabilization from 1985–93. Furthermore, whether innovations became political resources depended on the existence of 'elective affinities' between political leaders and economists.

This chapter examines select aspects of the relationships between economic liberalization and democratization seen during the Brazilian experience of stabilization. Of several justifications, one has already been mentioned: Brazil was a latecomer with respect to stabilization – one of the preliminary goals of any structural adjustment. For this reason, until mid-1994 the bonanza in the international context was under-utilized in comparison to Mexico and Argentina. Also, in comparative terms, one of the weaknesses of the Brazilian political transition was its institutional fragility – thus increasing the tenor of political uncertainty inherent in the process of dual regime change. In this context, one may mention the difficulties of consolidating the party system, a feature reinforced by a type of federalism hardly coherent with the definite solution of the fiscal crisis.[5] Also for this reason the goal of self-sustained stability would strongly depend on the manner of equating some of the major factors of political and institutional uncertainty. There is as well a further reason to examine the Brazilian experience: the manner in which the economic and political legacy of the State Centred Model reflected on the cognitive maps of the sectors of the entrepreneurial and political elite and on the aspirations of wide sectors of Brazilian society. Opposition to stability programs, to economic liberalization, and to more transparent regulatory frameworks was centred in economic and political interests entrenched within the state. Resistance to change also had to do with past successes in economic policy and a Brazilian style of problem solving. On the one hand, the model of import substitution industrialization was comparatively more successful and advanced than those of the other Latin American countries. On the other

hand, the long period of generalized indexation, while accommodating acute distributive conflicts, had given to mega-inflation an inertial character that commanded rather unorthodox treatment.

The polyhedral character of veto groups in this context of institutional uncertainty, points to the centrality of political coordination. Under such circumstances, the activity of equating political and economic problems – inseparable from whatever reform strategy might be chosen – depended on repeated balancing acts by the incumbent President. This also applies to any strategy of institutional reconstruction that, over a longer period, would have as its objective routines and depersonalization of decisions, in particular, the solutions for distributive conflicts. From this perspective, the question of 'political coordination', led us to take, as part of the equation to be solved, the quality of the new political leadership in a very precise manner: in their capacity to generate new resources of power starting from existing institutions.

Our analysis of decision making during the Real Plan uses an analytical framework based on the concept of statecraft as a special mode of political discretion. The concept of statecraft applies especially to situations of exceptionality, of critical junctures; situations where the parameters that regulate political and economic decisions tend to change in a non-routine manner. The direction of change, however, is a matter of strategic policy options and not fully predictable. These coordinating capacities required in times of acute uncertainty we define as statesmanship.

It is important, therefore, to point out why and in what senses the episode under analysis may be characterized as a critical juncture for the Brazilian economy and politics. This is, without a doubt, an empirical matter. We believe it is possible to rephrase this question in the following terms: as the *expected* tasks which ought to be performed by elected politicians if statesmanship was to have been exercised in the conditions prevailing throughout Latin America during the 1990s. The problem of identifying the diverse paths through which successful stabilization and liberalization were achieved during democratization, requires that another distinction be made between the different types of coordination required under specific situations. The notion of a threshold of crisis, suggested by Laurence Whitehead is a convenient point distinguishing between two different forms of coordination. One refers to exceptionally critical circumstances and another where the principal task for policy makers consists of stabilizing expectations, both economic and political. Thus it would be possible to determine some 'threshold of crisis' above which the conventional relationships between economic and political variables are no longer applicable. It would also be possible to say that below this threshold, gradualism and the negotiation of conflicts around public policies would be the most efficient forms of reconciling political participation with economic reform. Nevertheless, beyond this threshold, it seems that more radical restructuring and greater centralization of authority must substitute incremental methods of policymaking based on consultation.[6] Our study of the Real Plan and subsequent institutional developments suggest that this latter hypothesis describes the Brazilian path to stabilization.

Uncertainty and contingency: the background to the Real Plan

Economic plans may also be approached as political instruments designed to reduce uncertainty through the way they order priorities and assumptions about policy options. More often than not, plans involve redistribution of political and material resources. This is also valid for plans for stabilizing an economy undergoing hyperinflationary pressures on their way to an explosive path. In this case, the crafting of plans confronts a double-edged problem. One is dealing with the restoration of shaken confidence, of major economic agents whose behaviour is strategic in terms of the price system, by way of a drastic reversal of inflationary expectations. Moreover, in the context of democratization, it also implies obtaining the confidence of the political players in order to carry out the crossover into the direction of a new monetary regime.

Various factors were responsible for the high level of uncertainty that preceded the 1994 stabilization experiment in Brazil known as the Real Plan. Most of these factors were shared with other countries in the region, while others were specific to the local economic and political context. These differences relate to different modalities of uncertainty, from 'normal' forms of uncertainty, such as those centred on elections, to more extreme forms such as hyperinflationary crises. The latter are disruptive of productive system and contracts. From this point of view, the key question is the following: How to exit from an explosive path in the economy, in an ordered manner, exactly when the new institutional and judicial arrangements are still precarious, since they are still under

construction? This exit, among other conditions, presupposes the existence and the legitimacy of an agreed economic strategy.

One of the modes of uncertainty, shared by new Latin American democracies in the late 1980s and early 1990s was that the formulation and implementation of a minimally agreed economic strategy had been constrained by three orders of factors:

- Institutions of an effectively representative party system were not yet consolidated;
- Identities of emerging political players and organized interests remained fluid, which affected the nature of the distributive conflicts;
- Distributive conflicts were not limited to distributive questions *strictu sensu*, i.e. in terms of participation in national income; during regime change, confrontations included broader strategic calculations of future positions in the new order. Hence, the intransigency of this modality of conflict in times of political regime change.[7]

The 1982 debt crisis introduced more acute uncertainty about the state and its relations with economy and society. The abrupt interruption of foreign capital flows implied a radical change in the pattern of financing and expenditures of Latin American states. This external shock increased debt and placed countries onto a new explosive path whose principal manifestation was a dramatic change in the nature and pace of inflation.[8] The mechanisms were as follows. The political decision of governments to 'nationalize' the external debt of the private sector caused a dramatic rise in already high public debt. Debt financing came to depend exclusively on internal savings and, in particular, on the borrowing capacity of states in domestic financial markets. Such markets, comparatively restricted and vulnerable, converted themselves into referees of the capacity of the state to honour its public debt. Rolling over public debt became subject to financial markets through ever-shortening bond maturities and higher interest rates. In the absence of more profound fiscal or administrative reforms, one of the few mechanisms available to finance the fiscal gap was the inflationary tax, at ever-increasing rates.

The 1980s, then, signalled a structural change towards the acceleration of inflation and the prospect of hyperinflation. This decade also meant a change in the manageability of inflation and the starting point for change in the relationship between the economy and politics. Economic policy became more and more subject to the scrutiny of markets. Market volatility came to be linked with expectations concerning solvency (i.e. state capacity to honour public debt). Political instability came to be perceived as an economic threat. This progressive weakening of the state and its growing dependency on local financial markets was one of the distinctive characteristics of democratic transitions in most of Latin America. For comparativists, the success of economic liberalization in new democracies was attributed to the coordinating capacities inherent in strong and mature states.[9] This prerequisite was not only absent in Latin America but worse; states in the region had experienced unprecedented fiscal crises. Under these circumstances the question about policy was of a different order. Given the need to reform state finances, what restrictions could prevent the imposing explosive paths of economies?

In Brazil, the solution to the state fiscal crisis depended on a set of context specific responses, of technical as much as of political order, which further increased uncertainty. The Brazilian experience had to do with the adoption and subsequent generalization of monetary correction or indexation that began in 1964. This institution had worked as a useful tool to accommodate distributive conflicts under inflation. In the 1980s, as the debt crisis gave rise to a new inflationary regime, generalized indexation made it possible for the new governmental elites during transition from military rule to circumvent the pending threat of a hyperinflationary crisis. It also made it unnecessary to confront vested interests rooted in the state apparatus opposed to reforms or restructuring the existing pattern of state financing and expenditure. After the debt crisis, indexation in Brazil fulfilled two roles. It acted as a stabilizing mechanism for conflict management and as a conflict-minimizing device by postponing structural reforms. On the other hand, it also became an important cause of inflation – as any inflationary shock would be transmitted to the whole economy, and distributive conflicts would centre round the rate of adjustments in prices and incomes. This is why curbing mega-inflation in Brazil, more than in other countries in the region where indexation was not institutionalized, required far more than fiscal and monetary discipline. Ending high inflation required the diagnosis of inertial inflation and the difficult, complex and uncertain process of de-indexation. The diagnosis had been available since the early 1980s. But five heterodox stabilization plans before 1992 failed for different reasons. Brazil was often cited as a case of 'muddling through'. A concept favoured here, however, is that of brinkmanship, a dance on the

brink of an abyss, as it captures both the economic and political reasons for postponing the hour of reckoning.

Immediately prior to the Real Plan, indexation appeared no longer efficient. The analytical and political resources of different groups and schools of economic thought also appeared to be at the end of their resources. Nonetheless, these experiments produced a cumulative learning process, intense technical debates, and the following consensus between economists, sectors of the governmental elite and the political class: First, the nature of inflation demanded de-indexation; second, this presupposed a modicum of fiscal equilibrium (since under the conditions described the state was an active factor in inflation); and third, the restoration of confidence of economic agents demanded respect for contracts and the abandonment of shock therapy, whether heterodox or orthodox.

A brief reconstruction of the process through which these conditions came to a head during the extreme uncertainty of 1992–93 suggests the complexity of challenges in Brazil. Nonetheless, agreement of economic strategy was forged, one well adapted to the Brazilian context thanks to the recombination of institutions, practices, and existing political and analytical resources. The importance of this type of recombination is two-fold. On the one hand, new power resources, starting from the given resources and institutions, were engendered. On the other hand, the coordination of these resources, under the context of extreme political and macroeconomic uncertainty, presupposed a modality of political leadership that merits attention. The concept of statesmanship, adapted from classics by Malloy and Cunningham to analyse the central Andes, seems well suited to explain the Brazilian experience. It allows for taking into account the specific mode of leadership necessary for exiting a situation where economic and political order verge on hyperinflationary crisis, as was the case in Brazil in 1992–93, toward a moment when conditions of democratic governance and price stability were restored. The concept of statesmanship also emphasizes contingency under extreme uncertainty and the capacity of leaders to exercise political discretion and pursue strategic vision able to break a vicious cycle and initiate a virtuous one.[10] While, as Gourevitch suggests, space exists for political discretion and unpredictability is inherent to all economic decision making, the experience of Latin American countries is often more extreme. A further component of contingency surrounds statesmanship, which is even more distinct and remarkable when it is most necessary, that is to say, when political leaders confront the task of exiting an explosive economic path to one toward political-economic stability.[11] New forms of integration of Latin American countries into the global economy have reduced the discretion of politicians to shape economic policy. However, the Brazilian experience confirms studies of statesmanship in the sense that the space and importance of discretion may actually increase during these moments. What does this space consist of and what factors determine these critical junctures?

In the case of the Real Plan, the task is to explain how space was created for the generation of new power resources within existing, precarious institutions and, in turn, how an agreed economic strategy was developed for the specific critical juncture. The efficacy of the Real Plan is as much political as economic. From a longer-term perspective, conditions were created for surmounting the type of brinkmanship that had prevailed since the early 1980s. This was made possible by eliminating the principal factor of inertial inflation, which originated in 1964, i.e. that of generalized indexation. As will be seen, contrary to the stabilization proposals of the type 'one model fits all', the Real Plan depended on two conditions. On the one hand, the existence of an adequate diagnosis of Brazilian inflation as being inertial and the use of technological innovation, sketched out during the years of learning by way of the fiascos of successive plans. On the other hand, we have the recombination of the 'genetic' properties of the institutions that had characterized the Brazilian political and economic system. The Real Plan created conditions to overcome a pending crisis of authority and of legitimation by means of a new institutional framework. The category of statecraft best defines the decision-making process through which price stability and improved conditions of democratic governance were made viable.

Crafting the Real Plan: a recombination of political institutions and economic practices

By 1992, the economic problems and political tensions observed during the previous decade had acquired new momentum as the result of a synergy between three factors: the fiscal crisis of the Brazilian state; a crisis of legitimation of the state centred paradigm; and the re-acceleration of inflation.[12] This brought to centre stage, in an especially sharp manner, the ineffectiveness of orthodox approaches to stabilization, originally

conceived to solve short-term disequilibria in the balance of payments, in fiscal accounts, or monetary aggregates. Once economists understood the inertial nature of protracted high inflation, alternative frames and analytical tools were sought. These were developed in Brazil and Argentina through a learning process involving some eight years and intense debates among Latin American economists. This situation also prompted a change of perceptions about the technical and political constraints to stabilization. Brazilian and Argentinean economists reviewed stabilization experiments and drew lessons from successful experiences of other countries (such as Israel).[13] The failure of the first experiment at stabilization in democratizing Brazil, the Cruzado Plan (1985–87) was frequently cited as proof of the inefficiency of heterodox experiments. Nonetheless, the attempt at orthodox gradualism under Minister Marcilio Marques Moreira (May 1991–September 1992) also failed to check inflation.[14]

By the 1980s, the system of monetary correction introduced in 1965 had emerged to protect practically all forms of income and assets against inflation.[15] During the final military administration under President Figueiredo (1979–83), when inflation reached levels of 200 percent per-year, the first academic papers on the theory of inertial inflation appeared. André Lara Rezende and Pérsio Arida first discussed the need to combine whatever 'classic' procedures were required to check inflation with strong measures of de-indexation. The majority of the stabilization plans, going back to 1986 under the first civilian government to take office, through those of 1990–92, had, in fact, experienced short-term success but failed to stave off the return of inflation.[16] For the purposes of this chapter, it is enough to consider a dramatic change of perception: from the Collor Plan II (1991) onwards, well-known heterodox prescriptions were discredited in both the eyes of policy makers and elected politicians. Price freezing, as with all other forms of rupture of contractual relationships, had been experimented with but none of them had had a lasting effect in curbing inflation. By the same token, the shock therapy associated with heterodox economic packages, which initially took the economic agents by surprise, had lost their efficacy. On the contrary, after each bout of inflation agents responsible for strategic pricing tended to anticipate a probable heterodox package by marking up prices before the event – thereby neutralizing even the temporary effect of the heterodox measures. The end of 1991 reinforced this adaptation by the tendency of the judicial authorities to question the legality of the interventionist measures adopted by the executive authority. Also, to this has to be added the concern of avoiding the flight of foreign capital. These factors had turned the adoption of 'shock' measures excessively difficult and ineffective: Brazilian society tended to reject the surprise inseparable from that mode of heterodox therapy.

It is against this background that the orthodox policies adopted by Marcilio Marques Moreira (1992), Collor de Mello's finance minister, become relevant. They were geared to avoiding open hyperinflation by means of classical remedies: raising interest rates while trying to restore the country's credibility in the eyes of the international financial institutions. This policy meant the reinforcement of the indexation system, and reflected an effort to put off the moment of explosive hyperinflation. Nonetheless, during second semester 1992, political developments led to crisis and the impeachment of President Collor, effectively suspending economic management while the nation awaited installation of the Itamar Franco government.

Uncertainty became the major constraint to economic policy and brought market expectations close to paroxysm during early 1993. The spectre of hyperinflation and possible social crisis hovered over Brazil from October 1992, when Itamar Franco took over as the acting vice-president (awaiting the conclusion of the impeachment process), until the indication of Fernando Henrique Cardoso as finance minister in May 1993. The unstable personality of President Franco, his lack of commitment to the liberalizing programmes of Collor de Mello and his erratic economic policy involved the substitution of three finance ministers in a space of seven months (Gustavo Krause, Paulo Haddad and Eliseu Resende). Political and economic instability fused in a perverse synergy that reinforced both the explosive path in the economy and the disenchantment with politicians unable to agree on an economic strategy to avoid crisis. Compared to this situation, the brinkmanship and muddling through that prevailed during the 1980s seemed close to normality.

While the appointment of Fernando Henrique Cardoso as finance minister in May 1993 was not sufficient to reverse economic expectations, it reduced the level of uncertainty. This was due to his prestige as a social scientist, his experience as senator, and performance as foreign minister in the Itamar Franco government. His first step was to appoint an economic team with marked predominance of academics from the Catholic University of Rio de Janeiro (PUC–Rio), including Pedro

Malan, Edmar Bacha, Pérsio Arida, André Lara Resende, Winston Fritsch and Gustavo Franco.

International conditions became far more favourable. A new window of opportunity, absent during the 1980s, had been created although, during the politically turbulent year of 1992, the Brazilian authorities were late to perceive it as such. Starting from 1991, private capital had returned to Latin America, thus overcoming one of the principal obstacles to stabilization policies, namely the shortage of foreign reserves. Shortage of foreign reserves had prevented the adoption of a stable exchange rate as anchor for prices. As mentioned above, Latin America during the 1980s had been marked by a 'feedback' relationship between the external debt crisis and high inflation. This was especially so in Brazil where the government had depended enormously on exports by the private sector to obtain foreign exchange – which had worsened even more the poor situation of public finances. In fact, the external shock of 1983 and the debt crisis deeply affected the balance of socio-economic forces within the country. The state fiscal crisis and the need to close the external gap had made the government more and more dependent on two economic sectors which up until then had been secondary in the political scenario, namely: the domestic financial market and the export (private) sector.

A number of factors explain why the international setting improved. In 1989, the Brady Plan opened up the way to re-schedule the external debt of Latin American countries and private capital flows returned. Whilst during the decade of the 1980s the flow of foreign capital had remained below one percent of regional GDP, in the 1990s it totalled some six percent. During 1994, the inflow of capital reached US$57 billion (up from US$13.4 billion in 1990).[17] This bonanza may be explained as the result of the ongoing changes in the international financial markets: the preference of private investors towards greater geographical diversification of their portfolios and the attractiveness of higher interest rates practised in the emerging economies as compared with those in the USA. The latter was the by-product of the anti-recessive policy of the United States Federal Reserve. In Brazil, even with the threat of hyperinflation and lack of market-oriented reforms, the inflow of foreign capital resumed in 1991 and increased steadily thereafter. In sum, the steady accumulation of reserves through 1994 was one of the principal conditions that made the Real Plan economically viable. Reserves rose from US$9.4 billion year-end 1991, to US$23 billion in

1992, US$32.2 billion in 1993, and, at the launch of the new currency in July of 1994, close to US$42 billion.

Another novelty was the almost total disappearance of advocates of orthodox solutions in Brazil. In the words of an economist who was far from sympathetic towards heterodoxy and an expert on monetary theory, "the experience of the Geisel government and above all that of the Figueiredo government, left an explicit message: within a formally over-indexed economy, to combat inflation by simple monetary and fiscal recipes is to turn your back to the point of the knife." In this way, Brazil had been sacrificed by shortsightedness among both orthodox economists and the IMF.[18] Most economists gradually perceived the unique features of Brazil during this time. Given a significant reduction in the public deficit, it was the innocuous character of monetary squeezes that had become the object of consensus among experts and businessmen alike. This was because in Brazil a rare phenomenon in complex economies had occurred: an almost complete 'de-monetization' of the economy. The reason for this goes back to the fact that "the monetary base (money held by economic agents plus bank reserves kept in the Central Bank) represented a very small fraction of the GDP"; this combined with a mode of bank regulation that opened the door for an endogenous monetary expansion.[19] This situation, which now severely restricted stability, had only been possible thanks to the sophistication of the indexation mechanisms and to the degree of bank modernization. The result was a highly efficient system of deposits with balances for transactions that rendered interest; which for its part had allowed the holders of the money in Brazil to escape the direct use of currency and/or the indirect use of banking reserves.[20] One of the important social implications of this system was the creation of a privileged cast of depositors, well protected from inflation because their bank balances were indexed. Such sectors included not only the middle classes but also formal sector workers and organized interests. The result was an unprecedented social cleavage under inflation; that of being either 'protected' or 'unprotected' from accelerating inflation in bank accounts.

At this point, the analysis of Brazilian inflation as basically inertial and caused by indexation became consensual. Debate turned on what kind of policies would make de-indexation possible without falling into the traps of previous heterodox attempts. The resistance of economic agents towards price and wage freezes or other violations of contracts, as

well as the opposition from and through the judiciary also came into play. While the existence of foreign exchange reserves implied new degrees of liberty, policy makers still would have to deal with the expectations mobilized by hypothetical formulas for 'dollarization' and other imitations of the 'Argentine example'.

At this point, the discussion above about the specific nature of political leadership, contingency, and statecraft gain relevance. Mega-inflation weighed over the country, generating a mixture of despair, anxiety, and demands for drastic solutions. A peculiar piece of reasoning had been circulating in the press and media about the 'cleansing' character of open hyperinflation and a desperate race to real assets and the United States dollar; only with a 'wildfire' or 'volcanic eruption' of this type would it be possible to break with the resistance of vested interests to effective anti-inflationary policies. It became common to attribute the difficulties of the situation to a political and institutional framework that produced successive impasses, to stand-offs between the main socio-political players, and paralysis of the decision-making process. This theory of governance crisis was reinforced by two political events. On the one hand, the electorate had opted to maintain the presidential system of government and defeated the option of a parliamentary government in the April 1993 plebiscite. On the other hand, revisions of the Constitution of 1988 remained stalled in Congress.[21] Both appeared as further proof of structural difficulties for governance. Perhaps never before had these themes and concepts of political science been so freely discussed in economic debate. The presence of a social scientist as finance minister boosted this tendency.

The economic and political strategy

How did the strategy of Cardoso unfold? If he and his team had gone strictly by the book, according to the evaluation of many of his colleagues in the academic world, they would have focused first on changing the institutional and political framework and/or economic institutions. For more conservative economists, who had been searching to redesign the orthodox platform, the requisite for de-indexation was to produce a definite solution to excessive expenditures and the generation of primary surpluses. For heterodox analysts, one would have established a pre-fixed rate of price adjustments as a soft substitute to freezing. From financial markets came an emphasis on the exchange rate as anchor, (with greater or lesser proximity to the Argentine policy), looking to maximize what appeared to be the only trump card available; the existence of strong foreign currency reserves.

The strategy that was implemented was a far cry from these approaches and suggestions for economic policy making. Instead, it consisted in combining ingredients from a number of proposals into a distinct and consistent form. The first step was to take advantage of the favourable moment for constitutional revision to negotiate, in Congress, the transfer of budgetary resources to the federal government (the Emergency Social Fund FSE). This transferred funds (three percent of GDP) earmarked for state and municipal governments under the 1988 Constitution to the federal government instead. This was of course a temporary solution, given the political difficulty of sustaining constitutional reforms that would definitely increase such a participation of the federal government in national income. The economic team opted for this way out of the fiscal constraints to stabilization. Although only provisional and patchy, as various critics justly pointed out, this initiative attended to the need to promote a reversal of the pessimistic expectations of the private sector, largely the major holders of public debt.

As to political strategy, an important component consisted in the decision of the executive to seize the opportunity offered by contingency, which weakened resistance of representatives to the transfer of state government resources by the federal government (FSE). The bargaining power of the executive had increased over Congress, whose veto powers had been seriously weakened by scandals involving the Congressional Budget Committee.[22] However, in spite of this advance, few results against inflation and delay in the preparations to see things through to the end created new difficulties for the government. The proximity of presidential elections and the almost certain candidature of Finance Minister Cardoso soldered three types of uncertainty into one. One was related to questions of governance centred on a deep popular mistrust of Congress and politicians. A second came from deep misgivings toward what appeared as another set of heterodox anti-inflationary policies. Finally, uncertainty centred on the national elections to be held in October 1994 involving for the presidency, Congress, state governors and assemblies. It is important to remember that the front-runner was Luiz Inácio Lula da Silva for the Workers' Party (PT), then favouring a radical change of economic policies and a unilateral rescheduling of foreign debt.

Understanding the economic strategy adopted under Finance Minister Cardoso must take into account how its prescriptions relied on the sophistication of indexation. One of the major causes of inertial inflation was to be converted into a key part of its solution. As is well known, inflation tends to affect, sequentially, the three basic functions of money: as a value reserve, as a counting unit, and as a means of payment. The technical innovation at the centre of the Real Plan was the creation of the URV (Real Value Unit), as a general index for measuring salaries, taxes, prices and incomes between February and July of 1994, the first stage of the plan.[23] During four months, two currencies coexisted side by side. One, the Cruzeiro Real, was expected to go on depreciating under inflation and was accepted by the Central Bank at a crawling daily parity to the URV. This debasing of an old currency against a new unit of value (URV) was described as 'laboratory hyperinflation'. Inflation in Cruzeiro Real terms reached 45 percent per month, whilst inflation in URV terms reached around 2 percent. The approximate nominal parity between the relatively stable URV and the United States dollar implied the adoption of an exchange rate anchor rather than 'dollarization' as in Argentina.

To a certain extent, one of the ideas advocated by the authors of the Real Plan was taken from the 1980s. In early debates about the inertial nature of Brazilian inflation, they had contended that policy solutions implied the co-existence of two different currencies for a determined period of time. This recognition facilitated the transition to the next phase, as it made possible for policy makers to resort to three devices. The first was an unprecedented synchrony between adjustments of prices and incomes. Second, the absence of contractual ruptures was favourable, especially after years of price and wage freezes and other shock treatments had only served to deepen mistrust among economic agents. Third, the conversion of salaries at fixed values in URVs by the average of the previous four months on the date of payment averted past losses. It must be noted that the gradualism and caution exercised during the preparation and implementation of the URV reflected a learning process and the accumulation of experience during previous heterodox stabilization plans. The difference during 1994 was that widespread indexation in Brazil was used for policies rather than set against.

The second stage of the Real Plan involved monetary reforms, a task completed only by July 1994. The new currency, the real, substituted the old (cruzeiro real) as means of payment and the URV as counting unit on

1 July 1994. This reunited the traditional functions of currency. Although price indexes for July exceeded expectations (reflecting anticipatory price adjustments in the final week of June), the Real Plan was widely perceived as successful in public opinion. It brought about a dramatic reversal of expectations among the government's creditors and the place of Cardoso, now an ex-finance minister, as presidential candidate in the polls.

Misconceptions among critics of the Real Plan and political opposition are worth noting. Neither perceived that the plan had averted the scourges normally associated with price stabilization policies that, in general, further erode the real income of popular sectors. On the contrary, the end of the 'inflationary tax' signified a notable increase in real income among these classes – a fact reflected in an increase in consumption of basic products. As expected during the preparation of the plan, the most serious problem in terms of macroeconomic equilibrium became the increase in consumption spending, not trends toward recession.[24]

The crucial element for stabilization was a well thought out strategy to recombine political and economic elements. This strategy demonstrated the limits of conventional diagnoses in political science and economics that conditioned the solution of impasses to the creation of a new government coalition and/or political reforms involving constitutional amendments and/or a change in the form of government. A more economistic vision saw success as the outcome of sustained 'good behaviour', that is to say, via monetary and fiscal discipline and the correct implementation of structural reforms along the lines recommended by the Washington Consensus. When compared to the manner in which the Real Plan was conceived and implemented, such prescriptions leave a bitter taste of deductive fundamentalism. Although the Emergency Social Fund (FSE) was far from providing a safe fiscal route to achieve self-sustained stabilization, it nonetheless made it possible to eliminate two principal veto points to stabilization. It introduced a modicum of flexibility in the rigid fiscal federalism of the 1988 Constitution, namely the importance of governors and their state delegations in Congress. Fruitful interaction between the executive and legislature was created within the existing political system, instead of seeking broad change that risked paralyzing the decision-making process. The path followed began with giving up earmarked institutional and political

resources. The stabilization strategy consisted in selectively mobilizing existing institutional and political resources toward a two-fold task. First, technical innovation was to create a 'breakthrough', which in turn made it possible to revert the explosive path of the economy. Second, political effectiveness was due to the enormous improvement in governance made possible by a kind of statesmanship that may be described as the capacity to generate and extract new resources of power from existing institutions. This recombination may be described as creative bricolage.

The breakthrough strategy proved far more effective than maximalist approaches. It was based on recombining existing economic and political resources to open the way for a new economic strategy. This made it possible to generate new power resources, ones that made it politically viable to free pathways towards important economic reforms. This ran contrary to recommendations and common sense that emphasized the need for completing political and economic policy prerequisites. The success of this alternative strategy made it possible to re-concentrate power resources in the hands of the government, beginning with the reversal of the electoral prospects. The outcome of the presidential election, contrary to initial expectations, ended with the victory of the government candidate, former minister Cardoso, by majority in the first round vote. This outcome also belied theories of political cycles that suggest stabilization policies tend to be initiated at the beginning of a mandate, whereas governments abstain from imposing severe fiscal and monetary discipline during and preceding electoral campaigns.

This suggests the need to consider contingency in the analysis of economic re-structuring in young democracies. Under conditions of extreme uncertainty, Gourevitch's argument about space for economic policy makers to exercise political discretion because of uncertainty and contingency gains even greater force. At the same time, the use of political discretion to create institutional improvements toward better conditions of democratic governance – this kind of *virtù* – is a political resource not necessarily at hand when most needed. Stated in Gourevitch's terms, substantive choices by policy makers are not fully or automatically deductible from objective conditions, such as the institutional framework or the social process through which preferences are formed. This is because 'decision-makers are not passive registers' of such conditions, even when the level of uncertainty is low, as in longstanding market democracies. There is always a space of indetermination and of contingency that can be explored by the political leadership. Policies cannot be deduced directly from international or socioeconomic conditions. The capacity of leaders to evaluate and initiate a chain of cumulative solutions, as well as the existence of adequate technical knowledge, become strategic variables, even more so when a country is at a critical crossroads. We do not adopt a voluntarism that ignores constraints imposed by economic necessity and the political system. Instead, we focus on the eternal methodological problem of human sciences, i.e. that of structure versus agency, from an angle that seeks to identify critical junctures during which, for better or worse, the action of strategic agents may have profoundly transforming effects.

The politics of inflation and stabilization in neo-democracies: one model *does not* fit all

The Real Plan suggests the need to bring into theoretical frameworks the distinctive character of the interactions between political and economic change in countries where reversal of the explosive path of the economy had to be carried on during democratization, that is to say, by means of an agreed economic strategy. To judge by the popular support for the first heterodox shock, the Cruzado Plan of 1986, the stabilization of prices had already become a priority for policy makers and a valued asset for society in Brazil (and Argentina). Price stability quickly became an important source of political legitimacy and popular support during the first civilian government of President José Sarney. The proof of this was the thundering victory of his PMDB in the 1986 elections when the Cruzado Plan converted itself into the principal arm of electoral competition. But it took some time before stabilization acquired the status of a first priority 'public good'. Only after the temporary character of economic stability (whether achieved by means of heterodox or orthodox experiments) became apparent – especially so for low-income groups – was it possible that stabilization could be presented as a consensual policy goal and yield strong electoral pay-offs. This qualifies conventional political theories on inflation and stabilization in three ways.

First, regarding economic fundamentals, the Brazilian experience demonstrates that policy alternatives are context specific. This implies that policies and strategies for accelerated inflation may not be of the

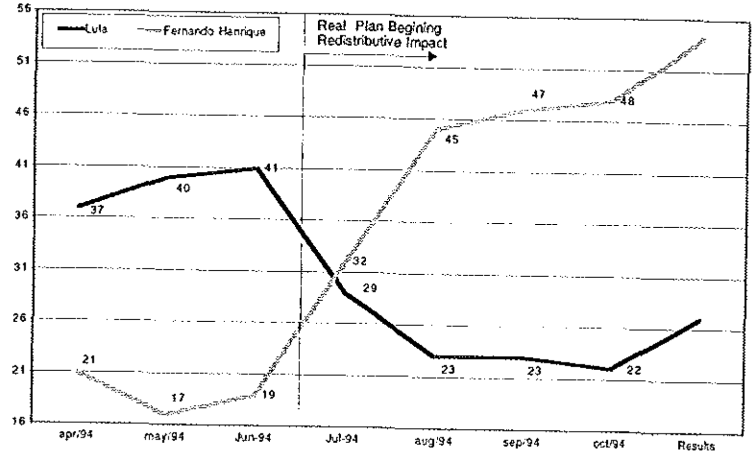
'one model fits all' variety, as was thought in the political economy literature at that time, namely that of viewing stabilization as a bitter pill to swallow and a measure that consequently lacking popular support. The political science literature on structural adjustment does take into account the diversity of political and institutional conditions as being the key factor in the explanation of the different degrees of success or failure of structural adjustments. However, it nonetheless tacitly accepts the existence of a unique model for stabilization and fails to adequately conceptualize different kinds of inflationary regime. For this reason, this literature highlights the social and political costs involved in resorting to monetary and fiscal disciplines, which in fact are unavoidable, especially so in the initial stages of democratization. Whilst we agree that stabilization and economic liberalization pose difficult dilemmas for elected politicians and involve threats to democratic governance, we disagree with treating inflation in generic terms, as a single phenomenon. Inflation was not the same, for example, in post-communist countries and Latin America in the wake of the external shock of 1982. Nonetheless, Przeworski attempted to build a formal model from Eastern Europe and Latin American experiences with stabilization.[25] A similar assumption, in which economic stabilization is equated with a unique model likely to be resisted by local populations, was especially noticeable in the refusal of the IMF to accept the diagnosis and prescriptions underlying the Real Plan, dubbed by one of their major analysts as 'voodoo economics'.

Behind this position lie two postulates that do not correspond to the Brazilian reality (nor, indeed, to those of either Argentina or Bolivia where the explosive path of economies acquired momentum exactly when they had begun a change of political regime). The first postulate is the theoretical (and quite normative) assumption that, when dealing with inflation and stabilization, 'one model that fits all'. This supposition is based on a false separation between fiscal and monetary discipline that are necessarily unpopular and the logic of politicians whose behaviour and expectations are predominantly (if not exclusively) determined by electoral calculation. This disjuncture is dramatized by the metaphor of a 'bitter pill' or by citing the spectra of economic populism whenever electoral calculations enter into the picture.

On the contrary, the experience of extreme situations during hyperinflationary crisis, as in Argentina, or the risks of its occurrence, as in Brazil, may well bring about profound political and cultural changes in social preferences and voting patterns.[26] One of the most important historical changes in Brazilian society consists in the conversion of price stability into criteria of both economic performance and, simultaneously, political legitimation. Consequently it became an important condition of electoral success, especially among the social sectors least protected against inflation. This change was not exclusive to Brazil, but extends throughout Latin America. The electoral success of politicians who led successful stabilization policies, however diverse from the technical point of view and despite differences concerning its social and political costs, is indicative of a profound transformation in the political culture of the region. This change has laid the roots for a greater convergence between economic credibility and political legitimacy – away from a hyperinflationary economic context. This is alien to the conventional economic wisdom that assumes divergence between economic credibility and political legitimacy.

Thus, in a regional perspective, the election of Cardoso confirms two unprecedented developments in the history of Latin America not sufficiently integrated into the analysis of structural adjustment in the democratizing countries of the region. First, under conditions of pending hyperinflation, price stability converted itself into a public good priority. Second, economic 'populism' thereby ends as a technique of governmental action and problem-solving style, because it no longer renders electoral dividends. This came to be true, as is well known, for economies, political regimes and systems of representations as distinct as those of Bolivia, the Argentine and Brazil at that time.[27] Such political developments were dramatized by the Brazilian experience. The Real Plan represented the major political asset and the principal item in the electoral platform of the former finance minister – under circumstances of great uncertainty. After all, the 1994 elections were the first combined elections since 1950 for the presidency, state governorships, federal chamber, two thirds of the senate, and state assemblies.

It is important to note that this political and economic turnabout was reinforced by aother positive impulse in terms of the legitimacy and the popularity of the official candidate. The full redistributive impact of price stabilization in favour of the least protected against inflation was felt from July–August of 1994 onwards – exactly when the electoral competition intensified. The end of the inflationary tax reflected itself in a process of income transfers, previously appropriated by the state,



Fonte: Datafolha/TSE

Graph 4.1 ***Presidential Polls: performance of the official and of opposition candidates before and after the Real Plan***

towards society in general. This re-distribution, nevertheless, was proportionally greater for the lower popular sectors and working classes, who had not had any protection against inflation as they did not have bank accounts.

Opinion polls left little doubt concerning the motivation – and also the political and economic calculations of the electorate, above all lower-income voters. The question at stake was the continuity of the anti-inflationary experiment, which reduced monthly inflation of around 50 percent to an average of 1.8 percent during the first few months after the implementation of the Real Plan. The victory of the official candidate, Cardoso, in the first round of elections represented a dramatic reversal of the expectations registered from April until May of 1994, the period immediately prior to the introduction of the new currency, the Real. Up until then, as can be observed on Graph 4.1, opinion polls had pointed to the favourite as being the main opposition candidate, Luiz Inácio Lula da Silva, whose party, the PT (Workers Party), had already been preparing for a victory in the first round.[28]

Fernando Henrique Cardoso was elected with 54.5 percent of the total votes, the highest winning percentage in this type of election since 1945. This result, for its part, is consistent with the index of popularity of the incumbent president, Itamar Franco, of around 80 percent at the end of his government, and explains to a large extent the fact that he was the first president to secure the election of the official candidate since the elections of 1950. This was a surprising result for two different reasons. First, we are dealing with a President at the end of his term of office, and in particular, one with a short mandate of only two years. Second, this was a government that was born weak, starting with the impeachment of President Collor and that had been incapable of exercising the necessary leadership to form a stable governmental coalition.

It is worth exploring a second set of political implications. These refer to an official candidate, responsible for a government that had found itself in the middle of an anti-inflationary experiment, technically and politically different from previous heterodox experiences. The architects of the Real Plan had pledged themselves to respect contracts and avoid shock therapy or devices that would take the population by surprise. On the contrary, the trademarks of the Plan were: communicating each stage of the process in advance; taking into consideration the responses of markets; and counting upon the acquiescence of economic agents to price stabilization, that is, that strategic price makers would not mark-up their prices. The salvationalist style that had prevailed in the past and price freezes defended by opposition candidates were thereby left behind.[29] As well, it is important here to register the change both in the style and in the manner of presentation of the economic policy measures. Now the condition that would make possible the adoption of these directives was the capacity of the political leadership to detect changes in society and hence place their wager on the political viability of the innovative techniques developed by the economic team.

In sum, the Brazilian experience leads us to qualify deterministic theories that established a necessary and perverse relationship between political-electoral cycles and the capacity of governments to implement stabilizing policies. Anti-inflationary policies were not initiated by recently elected governments, while expansionist policies were not pursued at the end of a mandate.

Technical assumptions about inflation in the comparative political economy literature lead us to a third group of implications. The concept of inflation is based on a particular inflationary regime, while little discrimination is made between the different types of inflation as mentioned above. We suggest that an important change in *inflationary*

regime occurred in the early 1980s brought about by the fiscal crisis of the state and, in part, the external shock of 1982.[30] This combination in Brazil is fundamental not only for an understanding of economics and policy differences but also for the political dynamics of stabilization. Without this distinction, analysis slips toward the diagnosis of the Latin American crisis established by the 'Washington Consensus', which ignored the role played by external shocks, in particular that of 1982.[31] Instead, crises were ascribed predominantly to the type of industrialization – import substitution and the state centred paradigm – an interpretation that abstained from discussing the reasons why that mode of industrialization had worked reasonably well, especially in the case of Brazil. We believe that one of the most striking shortcomings of recent research is the urgency to generalize about common denominators across experiences of structural adjustment during democratization. The outcome has been the uncritical acceptance of what Hirschman, many years ago, qualified as mono-economics, that is to say, the prevalence of a unique economic theory, independent from specification and of the form of insertion of a given country (or region) in the international scenario.

Structural adjustments and the integration of countries to the global economy involve more than price stabilization. In reality, price stability may well become a curse in disguise, if policy-makers perceive it as an end in itself. Thus, the expansion of demand and GDP growth following the Real Plan gave rise to what later on was perceived as excessive optimism. This is because during the time interval between the election and the inauguration of the new president of Brazil, i.e. October 1994 until January 1995, the Mexican crisis of December 1994 would bring to centre stage the risks – and the policy dilemma – underlying the stabilization process. While resorting to the exchange rate as a stable price anchor proved to be an efficient instrument for counteracting the threat of hyperinflation, it would also generate a deficit in the current account. This in turn would put additional strains on the balance of payments – a risk that became clearer when the first trade balance deficits were reported in November 1994, that is to say, before the inauguration of the new president. It signalled a reversal of trade surpluses for over a decade. This was seen by some as not only inevitable, but also as desirable on the assumption that international liquidity and the flow of capital to Latin America would remain stable. However, the Mexican crisis of 1994 brought to the fore the volatility of financial markets and triggered controversy in Brazil about the desirability of a fixed exchange rate as price anchor. This became the most controversial topic during Cardoso's government until January of 1999, when a speculative attack on the overvalued Real led to an exchange rate crisis. The outcome was the adoption of new exchange rate and monetary policies, ones prevailing until the present day: a floating foreign exchange rate and inflation targeting.

Conclusion

This chapter has sought to show that the Real Plan interrupted a hyperinflationary cycle at a pre-crisis situation. A number of conclusions can be drawn. One relates to the factors that explain the success of stabilization, involving both technical and political dimensions that became inseparable. The Real Plan was an ingenious economic policy innovation conceived by Brazilian economists based on theories of inertial inflation. They were able to draw analytical tools from the experiences of other countries, especially through intense exchanges with economists in Argentina and Israel. The accumulation of technical and political experience from the failure of the Cruzado Plan (1985–87) through seven failed experiments in stabilization that preceded the Real Plan also was critical. What appeared to be technical innovation was also the result of adjustment to more immediate political requisites. The final content, timing and intensity of measures were defined in accordance with the political parameters set by President Itamar Franco and Finance Minister Cardoso. Another important factor explaining the economic efficiency of the Real Plan is the reality that trade liberalization and the deregulation of the economy preceded the plan, that is to say under the administration of President Collor de Mello (1990–92). Competition from imported goods had reduced the power of domestic oligopolies to set prices.

The political strategy contained an implicit wager: that successful stabilization would generate new power resources to overcome the pending threat of social anomie that threatened under hyperinflation and disenchantment with democracy. Part of the political calculation, which proved to be correct, was that price stability would become the decisive asset in the formation of electoral alliances and governmental coalition led by the PSDB (Party of Brazilian Social Democracy), the party of the

finance minister. This in turn was seen as a precondition to proceed with the economic reforms needed for the completion of the structural change – thus breaking a perverse pattern of adaptive policies in the Brazilian economy dubbed as 'muddling through'. The success of the Real Plan brought to centre stage new problems, issues, and challenges including the Herculean task of elaborating an economic model that would allow for more equitable development. A crucial element in this project became reforms designed to re-structure the financing and spending patterns of the Brazilian state. This implied a profound change in the traditional role played by the state as political actor in Brazil and Latin America.

A decade on, this problem continues, now challenging President Lula da Silva. Nevertheless, a line has been crossed which we describe as the threshold of crisis. If we were to assume the view of the critical juncture of 1993 described above, and therefore the development route already trodden, the amount of progress is incontestable. Having overcome this extreme conjuncture, space became available for addressing tasks beyond what one might call the 'dictatorship of the short run pressures'. It became possible to design, with greater clarity, an agenda of policies and reforms for challenges of medium and long term duration. The central themes have been the formulation of a development project, in tune with both central questions such as the social debt and the search for new forms of insertion of Brazil in a very unstable international system. Overcoming the threat of hyperinflation and social anomie created space for the re-arrangement of complex structural problems and re-equilibration of political forces. Looking back to 1993, the extent of change in the political and economic agenda of the country is marked. How these changes were incorporated during the presidential elections in 2002 and first years of PT coalition government are addressed separately in Chapter 9.

Notes

1 See G. O'Donnell, P. Schmitter and L. Whitehead, eds., *Transitions from Authoritarian Rule: Prospects for Democracy*, Baltimore: The Johns Hopkins University Press, 1986.

2 J.C. Torre, *El processo político de las reformas económicas en América Latina*, Buenos Aires: Paidós, 1998; L.C. Bresser Pereira, A. Przeworski and J.M. Maravall, *Economic Reforms in New Democracies*, Cambridge, Cambridge University Press, 1991, and L. Whitehead, 'On reform of the state and regulation of the market', *World Development*, 21/8 (1993). See also S. Haggard and R. Kaufman, *The Political Economy of Democratic Transitions*, Princeton, NJ: Princeton University Press, 1995, and L. Sola, 'The state,

economic transformation and democratization in Brazil', in W. Smith, C. Acuña and E. Gamarra, eds., *Democracy, Markets and Structural Reform in Latin America*, New Brunswick, NJ: Transaction, 1994.
3 See J. Malloy and C. Conaghan, *Unsettling Statecraft – democracy and Neoliberalism in the Central Andes*, Princeton, NJ: Princeton University Press, 1995; Torre, op. cit.; L. Bruszt and D. Stark, *Pathways from State Socialism*, Cambridge: Cambridge University Press, 1998.
4 See specially Malloy and Connaghan, op. cit.
5 On Brazilian federalism, see: 'Federalisme, stabilisation monétaire et démocratization au Brésil', *Critique Internationale* no. 11 (2001), 84–99 and 'La construccion del federalismo democrático en Brasil', *ICE – Informacion Comercial Española – Revista de Economia*, no. 810 (2003), 105–22.
6 On stabilization of political and economic expectations, transparency, and institutional accountability, see Whitehead, op. cit. In these terms, the efficacy of economic policy decisions and political legitimacy intertwine.
7 See, in particular, J.C. Torre, *El proceso politico de las reformas económicas*, op. cit.
8 On the concept of an 'explosive path' advanced by Latin American analysts, see J.M. Fanelli, R. Frenkel and G. Rozenwurcel, 'Growth and structural reform in Latin America: where we stand', in W.C. Smith, C.H. Acuña and E.A. Gamarra, eds., *Latin American Political Economy in the Age of Neoliberal Reform*, Miami: North South Center, 1994; F. Giambiagi, *Finanças públicas*, Rio de Janeiro: Campus, 1999; and L.C. Bresser Pereira, *Economic Crisis and Reform of the State*, Boulder: Lynne Rienner, 1996.
9 S. Haggard and R. Kaufman, *The Political Economy of Democratic Transitions*, Princeton, NJ: Princeton University Press, 1995.
10 One of the virtues of the comparative analysis between Bolivia, Peru and Ecuador, by these authors is that of having demonstrated, also from this angle, the reasons by which the experience of stabilization with democratization was highly successful only in Bolivia.
11 Peter Gourevitch, 'Democracy and economic policy: elective affinities and circumstantial conjunctures', *World Development*, 21/8 (1993), 1271–81.
12 For the crisis of the state centred paradigm see E. Kugelmas and B. Sallum Junior, 'O leviatã acorrentado', and L. Sola, 'Ajustamento estrutural como política e como história', in L. Sola, ed., *Estado, mercado, democracia, politica e economia comparada*, Rio de Janeiro: Paz e Terra, 1993.
13 J.M. Fanelli, R. Frenkell and G. Rozenwurcel, 'Growth and structural reform in Latin America: where we stand', in W.C. Smith, C.H. Acuña and E.A. Gamarra, eds., *Latin American Political Economy in the Age of Neoliberal Reform*, New Brunswick, NJ: Transaction, 1994.
14 This experiment in orthodoxy was adopted by the government, once the initial positive impact of the extremely heterodox Collor Plans I and II had passed.
15 See M.H. Simonsen, *Trinta anos de indexação*, Rio de Janeiro: FGV, 1995 and G. Franco, *O Plano Real e outros ensaios*, Rio de Janeiro, Francisco Alves, 1995, pp. 30–1.
16 See Lourdes Sola, ' Heterodox shock in Brazil. Tecnicos, politicians, democracy', *Journal of Latin American Studies*, 23/1 (1991), 163–95.
17 M. Nain, 'Latin America: the morning after', *Foreign Affairs*, 74/4 (1995).
18 M.H. Simonsen, op. cit., 6–7.
19 J. Sachs and A. Zini Jr., 'Brazilian inflation and the Real Plan', *Revista de Economia Política*, 15/2 (1995), 27.
20 Sachs and Zini, op. cit., 31.
21 Problems of governance were first raised during 1988 and 1989 when economists and political scientists in government realized that the Constitution earmarked spending and reduced executive and congressional prerogatives to approximately eleven percent of the federal government budget.
22 This episode, known as the Parliamentary Commission of Inquiry (CPI) into the

'budgetary dwarfs' led to the loss of mandate for those involved. In the wake of the impeachment of President Collor two years before, this further increased scepticism.
23 Provisional Measure no. 434 of 27/02/94.
24 We thank José Roberto Mendonça de Barros for calling our attention to this point.
25 A. Przeworski, *Democracy and the Market. Political and Economic Reforms in Eastern Europe and Latin America*, Cambridge: Cambridge University Press, pp. 162–87.
26 On the socio-economic and political roots of this transformation, see Chapter 5, by Leslie Armijo, in this volume.
27 This has not made the region immune to populism, but that populism would assume new forms at odds with the traditional description of populism in the economic literature.
28 At the time the PT committed a strategic error by opposing the Real Plan, identifying it as a purely electoral manipulation.
29 Respectively, Lula da Silva, Orestes Quercia (from the majority party in the Chamber of deputies, which though formally integrated into the government of Itamar Franco, projected and confirmed himself as an opposition candidate) and Leonel Brizola (PDT – the Democratic Workers Party).
30 The debt burden of each country before the shock also mattered. This impact was greater in Brazil because, during the 1970s under President Geisel, the import substitution model of industrialization which had proved successful in the past was pursued much farther than in other Latin American countries; this in response to the previous oil shocks of 1974 and 1978. The strategy of external borrowing to 'finance development' had to do with three factors: 1) avoiding administrative and tax reforms and confrontation with vested interests, given the new government strategy to initiate political liberalization; 2) to placate military hard-liners who were deeply committed to economic nationalism; 3) the economic ideology of Geisel advisors whose alleged 'liberalism' was balanced by commitment to 'autonomous development'.
31 For criticism of conventional economic interpretations of inflation, see: L.C. Bresser Pereira, op. cit. and Frenkel, et al., op. cit. On political science, see: Sola, op. cit. and Lourdes Sola, 'Economic reform, democratization and legal order in Brazil', Economic Commission for Latin America and the Caribbean, Reform Series of Public Policy, no. 37.