What can African countries learn from Brazil's inclusive growth and development?

Research briefing:

Institutions for Macroeconomic Stability in Brazil

Summary

- In the 1960s, the military government introduced a broad range of structural economic reforms, with a focus on combatting hyperinflation and catalysing growth. However, with exchange rates, salaries, financial asset protection and tax increases all index-linked, inflation was effectively hardwired inflation into the economy.
- The oil shocks in the late 1970s saw inflation spike. A series of weak government plans were largely ineffectual in addressing the growing hyperinflation crisis, but they did provide an opportunity for economic policy makers to build up considerable expertise.
- The Real Plan, introduced in 1994 was able to disrupt the pattern of chronic inflation, stretching back to the 1960s. In the short term, stability was achieved by fiscal adjustment, de-indexing of the economy and the use of a semi-fixed exchange rate. These reforms were largely a response to the hyperinflation crisis, rather than the result of a coherent, strategic plan.
- Economic growth and a desire for 'modernisation' in the 2000s resulted in key fiscal institutions being abandoned. Macroeconomic policy making was based on the tripod of fluctuating exchange rates, primary surplus targets and inflation targets.
- There is an emerging consensus that new macroeconomic reforms are required. The lack of clear government strategy and coordination has led to a contradictory approach to economic policy making.

Hardwiring inflation into the economy

In the 1960s, military governments promoted far reaching structural economic reforms, creating innovative and stable institutions based on standard international theories and best practice at the time.

In this context, the 1960s saw the launch of the Government Economic Action Plan (PAEG), which was intended to promote stabilisation and a return to growth. The fight against inflation took priority because it was impossible for the country to progress while suffering from hyperinflation.

With an initial focus on monetary institutions, financial reform was focused on creating long-term financing mechanisms, avoiding inflationary public sector financing, and re-attracting private sector investment to industry, in order to drive growth.

With these aims in mind, important measures were adopted such as the creation of index linking, under which public debt was issued in Re-adjustable National Treasury Obligations (ORTN) and private securities came under the capital market law. This guaranteed a positive rate of return, protecting savers against inflation and encouraging saving. Compulsory saving mechanisms were also implemented and investment and financial banks and the Central Bank of Brazil (BCB) and National Monetary Board (CMN) were all created.

These measures restructured the financial system and led to a resurgence in the market for public bonds. However, they also introduced problems that later led to a great impasse in controlling the country's inflation. Index-linking had the effect of adapting the economic system to high inflation and led to past inflation being projected into the future.

Brazil increasingly became acknowledged as an inflationary economy, allowing further inflation-linking regulations to be introduced, which enabled Brazilians to peacefully coexist with inflation. Index-linking permeated all reforms, with rules for exchange rate and salary corrections, financial asset protection and tax system adjustment, which resulted in conditions that allowed inflation to assume an apparently automatic trajectory.

The return of hyperinflation

The 1973 and 1979 oil shocks marked the resurgence of inflation in Brazil (see Figure 1), with indexation mechanisms initially allowing the Brazilian population to live with increasingly high rates of inflation.

However as inflation accelerated, the rest of the economy stagnated. The 1980s are now viewed as a lost decade due to the deep crisis the country suffered. GDP growth practically stagnated, with years of major recession (1981: - 4.3%; 1982: 0.8% and 1983: - 2.9%). Inflation accelerated significantly even in years of low growth, reaching 100% per year in 1980, accelerating again after the major devaluation of 1983 and reaching 224% a year (on the General Price Index – IGP) in 1984.

The 1980s crisis represented a crisis for the Brazilian development model that had been in place for almost 50 years, sometimes called the import replacement model. This model had targeted 'final stage' industrialisation, implemented in all sectors of industry, but most companies were unable to withstand international competition.

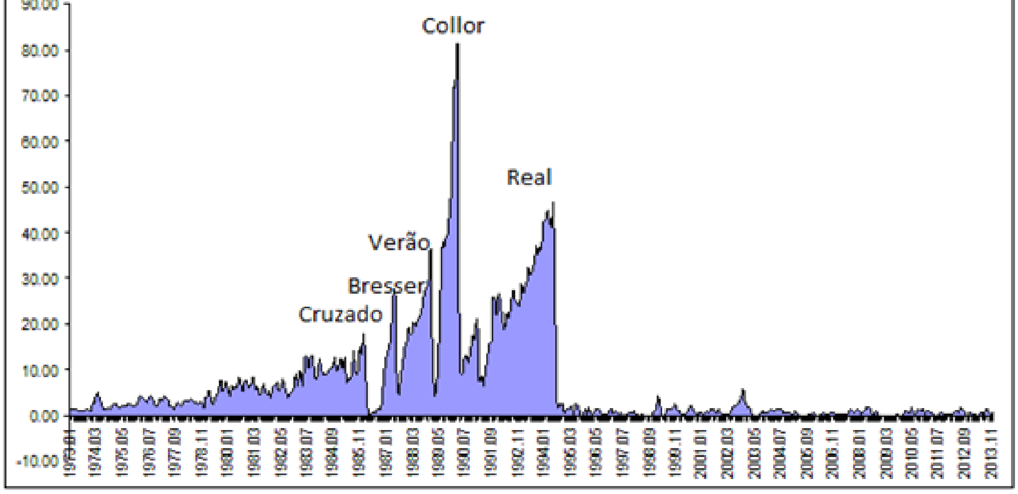
The second half of the 1980s and first half of the 1990s saw weak attempts to fight inflation: the Cruzado Plan in 1986, the Bresser Plan in 1987, the Verao Plan in 1989 and the Collor Plan in 1990, and were characterised by divergent views and theories about controlling inflation. These plans, along with their flaws, eventually helped to formulate the Real plan - a landmark that ended a cycle of nearly ten years of ineffectual attempts to combat inflation.

The Real Plan

The formulation of the Real Plan was a watershed moment. In an economy previously marked by hyperinflation, which had already tried a foreign debt moratorium, confiscation of domestic savings and accentuated fiscal indiscipline, the introduction of the Real led to controlled inflation and rebalanced external and public accounts.

The Real plan, was effectively a price stabilisation policy implemented in three distinct phases between May 1993 and January 1999, which can be summarised as follows:

Figure 1: Inflation in Brazil – monthly change in IGP-DI - 1974 to 2013



Source: IPEADATA (2014)

i) short-term fiscal adjustment; ii) de-indexing of the economy and iii) use of a semi-fixed exchange rate.

Inflation fell significantly and remained at a low level. However, price stability was achieved by using extremely high interest rates and an overvalued exchange rate. It is notable that the period's macroeconomic system was efficient in controlling prices, despite its adverse consequences in terms of reduced growth, balance of payments deficits and expansion in public debt.

The revalued exchange rate policy altered the previous framework of relationships between the exchange rate, fiscal and monetary policies, and reduced uncertainty about the behaviour of basic prices in the economy as agents could base their expectations on a predictable exchange rate.

It can be said that the exchange rate target system was highly successful in reversing the process of chronic inflation that affected the Brazilian economy. However, after the financial turbulence caused by the Mexican crisis in 1995, the Asian crisis in 1997 and the Russian crisis in 1998, the country abandoned its fixed exchange rate system due to speculative attacks that reduced foreign reserves.

The exchange rate crisis in January 1999 resulted in a major devaluation of the Real against the US dollar, seeing it fall from a rate of 1.20 in December 1998 to 1.98 in January 1999. This period saw a three-fold change in the macroeconomic regime: the monetary system of exchange rate targets was replaced by an inflation target system; the system of semi-fixed exchange rates gave way to a managed floating exchange rate; and the fiscal system began to pursue targets to create a primary surplus and reduce net borrowing. These three items came to be called the Brazilian macroeconomic tripod.

It is notable that, by adopting the floating exchange rate, the BCB regained control of monetary policy and the exchange rate became responsible for absorbing external shocks.

In regard to fiscal policy, after agreements with the International Monetary Fund were signed at the end of the 1990s, Brazil put in place a fiscal system with targets for the primary surplus, with the aim of maintaining debt stability and giving the government credibility, thus enabling it to reduce the interest paid on public borrowing at a later date.

In the 2000s, as crises gave way to the longest and most profound economic boom in Latin America since World War II, further reform of fiscal institutions was abandoned.

Table 1 – Selected indicators for the period 1994-98

Indicator / year	1994	1995	1996	1997	1998
Growth in GDP (% p.a.)	5.3	4.4	2.2	3.4	0.0
Gross Formation of Fixed Capital (% GDP)	20.7	18.3	16.9	17.4	17.0
Inflation (% p.a.)	2,075.827	66,008	15,757	6,926	3,196
Current transaction balance	-0,308	-2,388	-2,734	-3,477	-3,944
International reserves (US$ million)	38.806	51.840	60.110	52.173	44.546
Interest rate	__	53.09	27.41	24.78	28.79
Real/dollar exchange rate	0.64	0.92	1.01	1.08	1.16
Primary Surplus	5.2	0.2	-0.1	0.9	0.0
Public Sector Net Debt (% GDP)	30.0	28.0	30.7	31.8	38.9

Source: IPEADATA (2014), IMF (2014) and BCB (2014)

From the commodities boom to household consumption, increased growth enabled good fiscal outcomes without institutional change.

The 2008 global financial crisis naturally changed this scenario, but Brazil faced it in an idiosyncratic way: with state involvement, as in the rest of the world, but not in the form of higher public investment. Instead the authorities offered credit to the rest of the economy via state-owned banks at the below market interest rates.

The response to the global financial crisis broke away from the historic Brazilian tradition of addressing crisis with reform, although the government did still use fiscal policy: current expenditure, particularly on social security and benefits, grew faster than the economy and revenue. Tax benefits rapidly multiplied, from tax breaks to credit subsidies. Tax revenue fell and the federal government resorted to stratagems to create a primary surplus artificially, rather than reducing the fiscal target.

Prospects for the future

Amongst policy makers, there is little impetus to review, much less restructure, monetary, tax and fiscal institutions. Macroeconomic policy remains based on the same tripod as in the late 1990s, with a floating exchange rate, inflation targets and fiscal austerity.

In this context, the outlook, including for the short term, is rather confused and troubling. Public debt and the tax burden have reached higher levels than in other emerging economies. Investment represents an ever-smaller share of the budget, while the overwhelming volume of spending is committed contractually or politically.

Possibly the greatest contemporary challenge for Brazil is to return to the cycles of institutional reform that were implemented at the end of the twentieth century, which could then serve as a reference or example for other emerging economies.

This briefing is based upon an IRIBA working paper 7, Institutions for macro stability: Inflation targets and fiscal responsibility, by José Afonso and Eliane de Araújo, available at **http://www.brazil4africa.org**

Further reading:

- Almeida. M. (2013) “A política fiscal no Brasil e perspectivas para 2015/2018”. In Giambiagi, F.; Porto, C. (2013) "Propostas para o Governo 2015/2018 – Agenda para um País Próspero e Competitivo."
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IRIBA is a DFID funded research programme, based at the University of Manchester. It brings together an international team of researchers, examining how lessons from Brazil's development experience can be learned and adapted for African countries.

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