HOW BRAZIL BEAT HYPERINFLATION

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FORMER HEAD OF BRAZIL'S CENTRAL BANK TELLS HOW THEY WON THEIR TEN-YEAR FIGHT AGAINST 2000% INFLATION.

Imagine that your rent doubled every 10 weeks. That your credit card charged 25% a month interest. That food and clothes went up 40% a month. That the value of your savings declined 2000% in a year! This was Brazil for ten years, from 1987 to 1997. During those ten years 40% of GNP was eaten up by inflation, and everyone got rid of cash as fast as possible, because it lost value in your pocket. No one saved money. And the majority of people were reduced to buying only the essentials of life, which devastated whole industries that produced all kinds of optional goods and services.

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But where did you start to restore normality? No one knew, and it took ten years of painful experiment before state fiscal planners had tested, and discarded, all of the pet theories of the IMF and the academic economists and devised a course of action to beat the monster. UCLA was privileged to hear a report on this epic battle February 21 by Gustavo Franco, former governor of Brazil's Central Bank in 1997-99 and a key member of the economic team that worked for a decade to find a policy that could restabilize the economy. The meeting, at UCLA's Anderson School of Management, was jointly sponsored by the Latin American Center's interdisciplinary Political Economy Group, the Center for International Business Education and Research, and International Studies and Overseas Programs.

Dr. Franco, who holds a PhD in economics from Harvard, said that he had started his career studying the reforms that ended hyperinflation in Brazil in the nineteenth century. "I thought this was a dead subject. I couldn't imagine that Brazil would experience this again. At that time we had only 8 cases of hyperinflation in the history of mankind, half of these only after World War II."

In the 1970s and even most of the 1980s Brazil was the economic miracle, so no one could explain the onset of drastic price increases in 1987. Further, because the country adapted by indexing prices, wages, and contracts to the price increases to keep a floor under buying power, real comparative costs were soon difficult to sift out of the shifting plethora of figures. In retrospect, Franco said, "The Brazilian state had begun to spend twice as much as its ability to collect taxes. But it was difficult to see this from the numbers. Hyperinflation then produced many funny theories about its causes. It took us 10 years to work through these to an actual solution."

The Tanzi Effect

The first theory planners tried to use was the so-called Tanzi Effect. This is named for IMF tax expert Vito Tanzi, and was an article of faith for the IMF advisors. "Tanzi had proved in Argentina that the longer the lag between sending out the tax bill and receiving people's tax payments, the lower the value of the collection," Franco said. At root this approach looks to balance government revenue with government spending. It presumes that spending is inelastic and the problem is to keep revenue levels up. In Brazil, however, while there was some evidence of the Tanzi Effect, government income and expenditure were not badly out of balance--at 2000% per year inflation both were expanding together. "Especially after democracy in 1985 and the new constitution in 1988, every possible desire of social groups could be transformed into a budget allocation. It was written into the constitution that health care would be free, that university education would be free. But these desires did not match tax possibilites. What we got was the unspeakable taxation of inflation. Instead of satisfying desires we only created a debt level of desires."

The spiral worked this way: "Contractors would be paid with checks that had declined in value by 30% in the time it took to deposit them in the bank. Next time, the contractor doubled his price. In this way all prices became inflated. Public servants demanded preemptive wage raises to offset inflation. Other sectors sought to earmark a percentage of the state budget, as in 15% for education, as protections."

In addition to the expansion of the central and state government budgets, official government banks began to finance "off-budget" expenditures by buying up central and state bonds. "We had 5 federal banks, several commercial banks, 23 state banks, a developoment bank, and sometimes a mortgage bank. Half the banking system was official. The state Monetary Council began to take prized areas such as agriculture out of the state budget, where there was a dogfight going on, and putting them into the official bank budgets." Banks started to loan money to continue programs that had formerly been funded by the state budget. "The loans, however, were no good, as they were eaten up by inflation by the time they were repaid."

There was universal public agreement--in congress, in academe, and the press-- "that we did not have a fiscal problem, i.e., that the state budgets were not causes of the price rises. Technically this was true, the state technically had only a small deficit or even a small surplus. The mysterious hyperinflation continued, but it was presumed that its causes did not rest in fiscal policy."

Inertial Inflation

When balancing the state budget to stop the Tanzi Effect did not slow down the inflation, the planners then turned to another theory, called "inertial inflation." According to this theory, championed by Pedro Malan, then chair of the Central Bank and today minister of finance, and known as "Malan's Law," the problem was that no one would believe that prices could be stabilized, so everyone insisted on tacking increases onto their prices or wages to hedge against next month's expected rises. The answer was to halt the inertial slide upward by a price freeze, quickly followed by introducing a new currency. In the time it took people to get used to the value of the new currency the memory of the values of previous contracts would be wiped out and expectations cooled.

"In 1986 they changed the cruzeiro to the cruzado, in 1987 they adjusted the cruzado, but in 1988 they replaced the cruzado with the New Cruzado. In 1990 they changed the cruzado novo back to the cruzeiro, back to the original currency. Then in 1992 we changed the cruzeiro to the cruzero, and in 1994 adopted the Real Plan with the new currency called the real."

But the trick failed. "Inertial inflation theory says inflation exists only because we had it yesterday. We tried the same trick 5 times and it didn't work. We used a price freeze and currency change, but it did not work."

Orthodox Monetary Policy

The next idea was that the problem was printing too much money, one of the basic causes of inflation. "We know from the textbooks that the money supply should equal the money demand. The Central Bank continually set a ceiling for the size of the money supply. They always met their target, but this was because the demand was falling—

people were buying less--so the money supply did not need to grow. These are reasons why our country of 150 million people took 10 years following all of these theories and arguments to finally beat inflation."

How They Finally Did It

"Finally we started the Real Plan in 1993, and had to fight every element of the above doctrines." The number-one reason Gustavo Franco gave for ultimate success was a unique period where none of the political forces of the country were able to intervene in the process to promote the special interests that the state had become committed to supporting in the preceding decades. President Fernando Collor de Mello was impeached in December 1992 and replaced by his vice president, Itamar Franco. "Franco was not interested in economics and signed anything the ministers would bring him. This was unbelievable, but it depoliticized the process." Congress was also sidelined by a major scandal in December 1994 in which 26 members of congress and three state governors were implicated in diverting millions in federal funds into their own accounts. "This kept them out of the discussion. This gave us a window of opportunity where the politicians did not interfere."

Gustavo Franco said frankly that "We empowered the treasury and the Central Bank to subvert democracy." People and their political representatives had voted to give themselves things they could not afford. The finance ministry, treasury, and Central Bank, using a constitutional amendment passed in 1994, simply did not implement the budget. "We changed the composition of the CMN, the monetary authority, to be three members, the Central Bank minister, the finance minister, and the planning minister. This closed of the off-budget spending, while the treasury cut back on implementing the congressionial budget." While congress had passed a budget that authorized, say, $800 million reals for a project, the treasury chose to actually expend only $200 million.

The flood of bad loans from banks to fund government projects the government itself was no longer underwriting was stopped by imposing criminal penalties! "We prohibited--made it a crime--for a bank to lend money to one of its own shareholders. Bank officials in the private sector did not even maintain checking accounts in their own banks, for fear of being prosecuted if their check guarantee cards lent them funds to cover an overdraft. But the state banks could lend to the government. Under the Real Plan we enforced the same rules on the state banks and threatened the bank officials with jail if they lent money to the government. We criminalized a major source of the inflation, especially where regional banks frequently bought government bonds. We made that illegal."

In mid-1994, some 40 banks were actually bankrupt through their lending to government projects. "We began in December 1994 with the intervention in Banespa [Bank of the State of Sao Paulo] and other state banks. Banespa was the largest state bank in the country with claimed assets of $30 billion—but with real assets of a negative $25 billion."

Monetary Reform

"To stop the spiral in the private sector we needed one more monetary reform. In those days, for example, rent contracts called for readjustment according to that month's announced inflation rate. This indexation permeated the private sector and had to stop. We responded by freezing wages, but unlike the previous failed efforts, we left prices free. But we sought to break accounting and payment away from the existing currency. We did this by creating an artificial financial standard, the Unit of Real Value (URV). All prices were computed against this standard, which aimed at de-indexing the economy."

In July 1994 the URV was converted into an actual currency, the real. This policy, Franco said, “Is relevant for what is going on in Argentina now.”
Price increase rates dropped dramatically from July 1994 onward. By 1997 they reached standard international levels and the hyperinflation was over. In one important respect the process Gustavo Franco and his associates followed departed not only from the accepted theories, but also the accepted political process in such situations. “The key,” he concluded, “was to create an impersonal mechanism, not to get into negotiations with parties and unions--or housewives associations. You need market mechanisms. Dialogue doesn't work in this kind of situation.” The assumption here was that each constituency, if consulted, would fight for its particular entitlement, driving the state budget back up and keeping the price spiral virulent. Even business was not offered a chance to insert their favorite demands into the solution. “No industry associations were involved in tariff discussions. They wanted high tariffs, but we lowered them to invite competition and discourage price raising.”
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