



# The *Real Plan*: Stabilization and Destabilization

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**Summary.** — The paper analyzes Brazil's *Real Plan*, an exchange-rate based stabilization program, implemented in 1994, which mixed a spectacular price stabilization with some serious macroeconomic destabilization. The paper focuses on two of these imbalances: the consumption boom and the financial destabilization; showing that the former represented nothing but the reverse side of a collapsed investment boom, which, in turn, led to the financial (banking) crisis. We hold that these instabilities were produced by a policy arrangement in which monetary and fiscal policies alone had to compensate for a largely appreciated, almost fixed, exchange rate anchor. © 2000 Elsevier Science Ltd. All rights reserved.

**Key words** — stabilization program, *Real Plan*, Brazil, inflation, exchange rate anchor, consumption boom

## 1. INTRODUCTION

On July 1994, following other Latin American economies living under hyperinflation, the Brazilian government took the decisive step of a comprehensive stabilization program, named the *Real Plan*. As can be seen in Figure 1, the program produced an immediate and steady decline in inflation. Already by 1996, yearly inflation had fallen below two digits, reaching 1.7% in 1998.

The success of the *Real Plan* in fighting a big and protracted inflation is principally related to three elements. The first was the previous search for fiscal balance, so as to prevent a likely deterioration in the government budget—the public sector budget was already balanced in 1993. This deterioration, related to what Bacha (1995) called the *reversed Olivera-Tanzi effect*, stems from government's loss of discretion in reducing real expenditure below that programmed, due to ongoing inflation. Second, the institutionalization of an indexed currency tied to the US dollar functioned as a nominal anchor for all prices and contracts, which was the URV (Unit Value of Reference), on March 1, well before the introduction of the new currency. This anticipation facilitated both the coordination of all prices to this unit of value, and the correction of imperfections in indexation associated with differing readjustment periods among factor prices. Finally, on July 1, the URV was issued as a *de facto* currency called the *real*. Accordingly, the previous stability of the price level in URV remained

when the *real unit of value* finally became the national currency.<sup>1</sup>

Under this Exchange Rate Based Stabilization (ERBS) program, however, price stabilization was achieved in such a way that both external and fiscal balances were compromised. Brazil's trade balance shifted from a surplus of US\$ 13.3 billion in 1993, to a deficit of US\$ –3.2 billion in 1995, due to a large appreciation in the nominal (and real) exchange rate. At the same time, heavy reliance on the interest rate anchor, aimed at correcting the external imbalance, crowded out the opportunity for achieving a balanced budget. The interest rate bill raised fiscal expenditures, on one hand, while the expected recovery in tax receipts, which took place in 1994, was not fully realized because of the severe drop in business already in 1995—see Table 1.

Another important aspect of this stabilization experience was the manifestly unstable adjustment to the new macroeconomic equilibrium. The economy experienced a *stop-go cycle*, which simultaneously culminated in an

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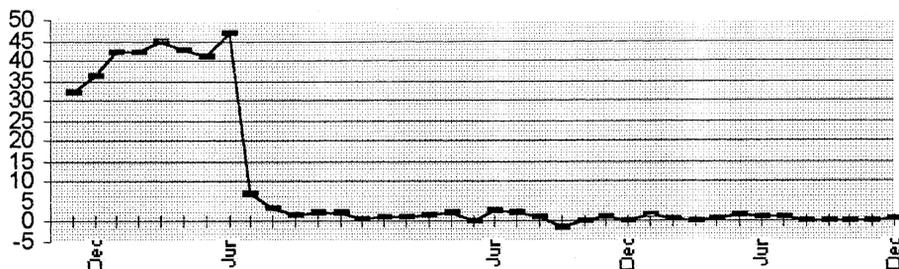


Figure 1. Monthly price inflation. Source: Conjectura Económica, various numbers. Inflation according to the IGP-DI price index. The first period data correspond to average monthly inflation in 1993. The July 1994 inflation taken from IPCA (IBGE) due to the great lag in collection of the IGP-DI.

Table 1. Public sector budget—in % of the GDP

	Receipts		Expenditures		Deficit	PSBR operational <sup>a</sup>
	Total	Taxes	Total	Net of interest		
1992	28.9	26.0	35.9	26.1	7.1	1.8
1993	32.8	25.9	42.7	28.3	9.9	-2.3
1994	30.5	27.9	38.5	27.7	8.0	-1.1
1995	31.1	27.7	35.6	29.6	4.6	4.8

Source: Instituto Brasileiro de Geografia e Estatística (IBGE, 1996) and Bacen, *Boletim Mensal*, various numbers.

<sup>a</sup> Excludes the expenditures due to the nominal correction of the public debt.

unsustainable consumption boom and a domestic financial crisis. Analyzing the dynamics of these two events is the central purpose of this paper. It will be demonstrated, in opposition to a certain dominant paradigm, that the consumption boom was nothing but the reverse side of a short-lived investment boom, and that the banking crisis was mainly a side effect of this business oscillation. The analysis will also find that these unfortunate events resulted from the joint effect of the exchange and the interest rate anchors.

Summarizing, the main goal of this paper is to analyze the dynamics of this ERBS with respect to the mentioned macroeconomic problems: the investment oscillation, which culminated in a consumption boom, and the banking crisis. The analysis will be preceded by an examination, in section 2, of management, justifications for, and consistency of exchange rate policy in the *Real Plan*. The next section focuses on the mentioned macroeconomic imbalances that followed the *Real*: the investment and consumption boom, on one side, and the banking crisis, on the other. Section 4 concludes the paper.

## 2. THE EXCHANGE RATE ANCHOR AS A STABILIZATION INSTRUMENT

In examining the exchange rate anchor policy, we must begin by recalling that the *Real Plan* was formulated in light of the *Cavallo Plan*, the Argentinean stabilization program adopted in 1991, which combined the exchange rate anchor with a tough *metallic* rule for money creation.<sup>2</sup> Although the exchange rate anchor was not new to the Brazilian economic team (they had previously employed and written about it<sup>3</sup>) the experience of the *Cavallo Plan* led to a new appraisal. The main conclusions drawn were three (see Franco, 1993): (a) indeed, the exchange rate anchor was very effective in stabilizing prices in a new currency, though (b) it entailed a serious risk of substantial appreciation in the real exchange rate. Therefore, (c) to shield against such a risk it was inconvenient to tie the anchor to a fixed parity with the US dollar (introduced as an amendment in the Argentinean Constitution), and to enforce currency convertibility. The latter was justified in Argentina, where the inflationary process had led to a pervasive

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