BRAZIL’S
CRUZADO
PLAN
NIPPED IN THE BUD

Brazil’s Cruzado Plan was a valiant attempt to turn around an economy in deep trouble. Initially it succeeded, but the government’s failure to implement crucial follow-up measures at the right moment plunged the country back into economic turmoil. IDRC-supported economists helped lay the groundwork for the Cruzado Plan—but also predicted its demise.

by DOUGLAS JANOFF

the Pontificia Universidade Catolica (Catholic University, or PUC) on the outskirts of Rio de Janeiro sounds like it would be a conventional institution. But it’s not.

The campus itself, surrounded by green mountains and the full scent of the neighbouring sea, is a tranquil setting. The inner recesses of the department of economics at PUC, however, are far from calm. Secretaries clang away on typewriters, coffee gurgles in the kitchen, and everyone is vying for a telephone line in the crowded office.

Telephone lines are not the only thing in short supply. There are shortages of many things in Brazil today. One week it’s salt. The next week it may be rubber tires. The people outside the quiet university have had to learn to cope with a recent set of food shortages, inflation, and general economic uneasiness. Inside the office, people are working on answers to the economic malaise.

"Yes, the Cruzada Plan is ruined," says economics professor Eduardo Mediano, referring to the economic package that he and his department helped to produce. "But Brazil is not ruined."

Dr. Mediano, together with the departmental chairman, Dionysio Dias Carneiro, and colleagues Francisco Lopes, has played a crucial role in developing macroeconomic models of the Brazilian economy and using them tosimulate various economic activities. In the early 1980s, when IDRC first funded research in their department, their influence was limited, but controversial. They organized seminars, invited the ministers of planning and finance, and gave the military regime their views on the economy—especially on such touchy subjects.

of Fedesarrollo, Dr. Jose Antonio Ocampo produced a definitive work on savings and investment in Colombia. The information will help the government to mobilize domestic and foreign resources and deploy them more effectively.

IDRC’s involvement with this increasingly influential group of Latin American economists has led to the establishment of a formal network to exchange ideas and publish work of mutual interest. In March 1986, researchers met in Buenos Aires to discuss saving, investment, and related topics. A joint publication will be released shortly.

In February 1987, an important meeting was held in Bogota to allow researchers to compare the Cruzado, Inti, and Austral Plans, along with the more conventional IMF-type program adopted in Bolivia. This group of gifted economists painstakingly critiqued policies that many of them had helped to design and that drew heavily on their research. The intellectual atmosphere was highly charged as the participants comprehended the potentially far-reaching implications of their work for both theory and policymaking.

Intellectual journey

From IDRC’s perspective, the Latin American researchers appear partway along an intellectual journey that could profoundly reshape the way we look at economic behaviour and institutions. One outcome may be profound changes in both economic theory and policymaking.

The intellectual exercise has taken the form of a debate (dating from the 1950s) between the neo-structuralists and the monetarists. In a nutshell, the former believe economic behaviour is shaped by institutional, cultural, and social factors, and that economists should be concerned with the ‘real side’ of the economy—factors such as investment, output, and employment. The monetarists, on the other hand, stress the importance of money and financial variables and contend that the smooth functioning of market forces is not significantly affected by structural features.

This debate has obvious political overtones since monetarists tend to emphasize the innate limitations of direct government intervention in the economy. Neo-structuralists adopted an opposing stance, arguing that unimpeded market forces would result in economic distortions with undesirable social consequences.

By the mid-1970s, Latin America was rocked by a series of economic shocks. In Chile, an extreme form of monetarism eventually led to the collapse of the domestic financial system, a severe economic contraction, and a huge external debt. Meanwhile, similar events in Argentina and Peru eventually led to similar results.

The relaxation of exchange controls in several countries sparked off a rapid flight of capital. Governments encouraged excessive borrowing overseas to finance imports and generate growth. As fresh supplies of capital dwindled and debt servicing became increasingly onerous, governments continued to borrow heavily in order to sustain domestic economic activity.

The growth in public expenditures steadily outstripped revenues and inflation quickly became hyperinflation. By the mid-1980s, most South American economies were afflicted simultaneously by economic recession and inflation, a combination not foreseen in the textbooks.

Faced with the immediate problem of curbing hyperinflation, neo-structuralists had to address the role of money. Moreover, they could readily see that financial variables did influence the behaviour of households, companies, and governments in ways that ultimately affected the real economy. The challenge, in theoretical terms, was how to incorporate money meaningfully into neo-structuralism.

Some of this work has been spearheaded by Roberta Frenkel of CEDES. In an early theoretical paper, he suggested that inflation led to changes in wealth by affecting the real value of assets. People responded by changing their demand for different types of real and financial assets. This behaviour in turn would affect investment, output, and employment, that is, the real side of the economy.

The merit of Frenkel’s approach was confirmed at the meeting in Bogota which looked at the anti-inflation programs in Argentina, Brazil, Peru, and Bolivia. After many hours of heated discussion, the researchers concluded that the outcome of each program appeared to hinge on changes in the distribution of income and assets.

Many important questions remain unanswered, however, and several years of painstaking research still lie ahead. A convincing synthesis of the real and money sides of the economy will have major implications for both economics and policymaking.

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as disinflation, balance of payments, and alternative wage policies.

"The first time we had a strong impact was in 1981," Mr Carneiro recalls. "Modiano was the first economist to forecast a negative growth rate. Naturally his view was immediately dismissed."

Two-year recession

Sure enough, 1981 saw the first year of negative growth in Gross Domestic Product in Brazil's history. The country slid into a two-year recession. Only after a maxi-devaluation of the currency was the country able to make a comeback. The government had the courage to go through with it thanks to a favorable forecast developed at PUC.

The medium-term annual macroeconomic model—providing two- to five-year forecasts—"sed 100 variables designed to examine the consistency of domestic and external policies on inflation, rate of growth, and balance of payments. The researchers concluded that the maxi-devaluation adopted in February 1983, would double inflation but improve the balance of payments. In fact, inflation did go from 100 to 200 percent in 1983, and the balance of payments increased. Exports rose 20 percent while imports fell 20 percent.

In the same study, the PUC economists had declared that import restrictions would have a cost-intensive economic growth. They forecasted the GDP would decline 3.3 percent. The actual decrease was 3.3 percent.

By 1984 the researchers realized that they were now working with a highly controlled economy—a "new animal" as Mr Carneiro describes it. But this new animal was not responding well to policies which attempted to control demand.

The PUC economists decided that a thorough restructuring of the economy was needed. Research indicated that inflation was taking on a life of its own. The shocks caused by the abrupt rise in prices were the major determinate of the future behavior of the rates of inflation.

The research undertaken by PUC's economics department from 1982 to 1985 was the empirical and theoretical groundwork "sed for a radical change: the Cruzado Plan. Six months before the Plan was introduced on February 28, 1986, PUC's economists were ready."

"We were able to test the wage inversion formula, the price freeze, and all the financial instruments of the economy," says Mr Carneiro. "It was the result of the macroeconomic model.