Stabilization: An unfinished process

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The Real Plan launched in July 1994 to stabilize the Brazilian economy has proven to be a remarkable success. There is no question about that. It appears, however, that the process remains unfinished. This 15th anniversary should celebrate the results achieved, but it also provides an opportunity for reflection and for the promotion of measures and decisions to perfect and consolidate the stabilization process.

Inflation persistence — The celebration is a good time to try to answer a few questions. One of them is how long Brazilians will hold on to the idea of indexation — the practice of changing prices today based on past prices, which in turn perpetuates inflation.

After a long period of high inflation, the culture and practice of indexation have become impregnated in the minds of the population. Complete eradication of this practice from our economic scenario will only occur gradually, as younger generations born during the stabilization period come of age. This does not mean, though, that we should remain passive, waiting for time to pass. Administrative and political measures in particular could be taken to speed up the process of eradicating indexation.

The goal of the Real Plan was, in theory, the immediate and complete elimination of indexation from the Brazilian economy. Theoretically, this could be achieved provided that inflation dropped drastically, to near zero, immediately after the plan was announced; and the indexation "culture" was eliminated swiftly to allow inflation to fall more easily. The expectation was that inflation would drop to near zero if all prices had previously been transformed into a URV (real unit of value) in preparation for the launching of the real, the new currency. However, that failed to happen, for political reasons: the technical calendar conceived by the Real Plan creators did not coincide with the political calendar, which had elections scheduled in October 1994.

Adjustments — In the months after the launch of the real, it became clear that many contracts (principally rentals) continued to be adjusted at relatively high rates because they had not been submitted to URV indexation when the new currency was introduced. Thus, inflation could not fall rapidly to near zero, as the plan technically projected based on the assumption of complete conversion of all prices to the URV before the new currency was introduced. The relatively high adjustments in the value of contracts not previously transformed into URVs meant that inflation did not drop far enough. The problem of the inflationary feedback triggered by the unconverted contracts was mitigated by the initial appreciation of the real against foreign currency: the real was stronger than the dollar in the first phase of the stabilization plan.

The indexation culture, in turn, was and still is difficult to eradicate because it is embedded in the minds of the population. To this day it seems natural, often even expected, that employees and liberal professionals

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get a raise in the nominal values of their salaries, fees, etc. simply because time, say a year, has elapsed. In economies with a long tradition of price stability, nominal variations in the value of salaries, medical fees, etc. may occur upward or downward, depending on market conditions; they are usually not restricted to a single direction, though it is obvious that in the long run nominal values are as a rule adjusted upward because there will always be some residual inflation even in the most stable economies, as in the Japanese and European economies. But the indexation culture helps explain why inflation in Brazil is always slightly higher than it should be.

Another pertinent question is why Brazil has not pursued inflation targets lower than 4.5% (recently defined as the target rate for 2010). It would be correct to say that the government has chosen to tolerate inflation, even at rates that are not completely satisfactory, rather than addressing the real causes of this resistance, even if this entails real interest rates that are high by international standards.

One of the reasons inflation persists in Brazil at levels that are still relatively high compared with countries with a long tradition of stability is the fact that indexation, besides being a cultural factor, has been institutionalized in important segments of the economy, such as public services. Of course, aside from simply breaking contracts, a perfectly feasible alternative would be to conduct a negotiated review of contracts that would allow eradication of the automatic and indefinite indexation of certain strategic services, such as road tolls, which significantly increase the cost of transportation in general.

Political will — The decision to seek more ambitious inflation targets is relatively simple, as long as there is political will; this decision could be taken in an ordinary meeting of the National Monetary Council (CMN), composed of the Ministers of Economy and Planning and the Governor of the Central Bank. (Obviously, the members of the CMN would consult with the President beforehand, because such decisions have wide-ranging implications.)

Official inflation targets should be established below 4.5% — the rate that has persisted over several years and that has come to be regarded as the "normal" inflation rate for the Brazilian economy. There is no reason, however, to consider 4.5% inflation normal. The truth is that there are factors that have prevented inflation from falling lower. What is required, therefore, is to eliminate those factors while refusing to accept an inflation rate that is relatively high by international standards. Defining 4%, 3.5%, and 3% targets must become the goal of economic policy in future. This would privilege action over complacency.

It is common knowledge that Brazil suffered external shocks from the prices of oil and of agricultural and metal commodities that ended up feeding inflation through indexed contracts, which, in turn, prevented inflation from falling despite the practice of high real interest rates over a long period. It is important, however, to stress a couple of additional and very relevant facts that help explain the additional inflationary pressures in the first 15 years of the Real Plan: the abandonment of the exchange rate peg at the beginning of 1999 (introduction of the floating exchange rate) and the sharp depreciation of the exchange rate after the first election of President Lula late in 2002.

Tax burden — Still another question: Has the fall of inflation contributed to the rise of the tax burden? Clearly, federal, state, and municipal administrations, besides being the first to reintroduce indexation as a practice in contracts for privatization of companies and for concessions of services, took advantage of the fall in inflation to raise the tax burden to historically high levels for Brazil. With inflation reduced it became easier (and less costly from a political point of view) to introduce real tax rises, to the despair of helpless taxpayers. As a result, since the Real Plan was introduced, the tax burden has increased from 25% of GDP to the current 36%: a Brazilian citizen today must work more than four months a year to fulfill his tax obligations, compared to three months in the past. The situation is aggravated by the fact that the tax burden has been increased first and foremost to accommodate the expansion of current expenditure rather than to cover investments necessary to improve economic infrastructure (highways, harbors, hydroelectric power plants) or social infrastructure (hospitals, sewage network, prisons). The taxpayer has paid a high price without receiving corresponding benefits.

Institutionalized indexation, the culture of indexation and the high tax burden have helped make inflation resistant to falling despite the real interest rates in force.

Perhaps we should question the idea that "Brazil needs higher real interest rates" to bring inflation down or, more importantly, to ensure that it is kept under control. If the factors that feed inflation were eliminated, would the Brazilian economy begin to resemble that of most developed and emerging countries — where the interest rates necessary to guarantee price stability are much lower? Real interest rates in Brazil, though already much lower than they were a few years ago, are still considerably higher than those in most international financial markets. Should we accept this as a "structural feature" of the Brazilian economy? Or should we seek to eliminate the reasons that inflation persists, so that we can have interest rates comparable with the international market?

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Public administration plays a crucial role in stabilizing the Brazilian economy. The increased tax burden has permitted it to buy time for this process, but stabilization will only be completed when the factors that prevent inflation from falling are eliminated from the practices and the culture of the country. A sustainable fiscal balance that does not depend on a high tax burden is a fundamental requirement for consolidating stabilization of the Brazilian economy.

Reviewing the laws that today help obstruct the fall of inflation should be a priority. The most conspicuous is labor legislation, which does not allow enough flexibility in negotiations, an essential tool in times when there are frequent changes in the economic scenario.

Finally, the 15th anniversary of the Real Plan must certainly be celebrated; but we should not forget that there is much still to be done to consolidate economic stability into a fundamental and long-lasting achievement for Brazilian society.