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Brazil's monetarist 'bullets' won't stop inflation

by Lorenzo Carrasco

Just before Brazilian President Fernando Collor de Mello took office on March 15, he compared himself to an expert hunter who could fell the fierce tiger of inflation with a single shot from his rifle. Exactly six months later, the official economic indicators reveal that President Collor and his economic team shot wild, only grazing the tiger. The actual impact of the "bullet" hit the country's real productive activity, creating conditions for an unprecedented depression which threatens to add dramatically to the millions of Brazilians already living in dire poverty.

The violence of his anti-inflation program was recognized by President Collor himself, in statements to the London *Financial Times* reported Sept. 12 in the Brazilian press. "No economic compendium contains an adjustment plan as rigorous as this. . . . Neither the IMF [International Monetary Fund], nor any banker, would dare impose such a far-reaching program on any country in the world."

Collor's program was indeed severe. In one stroke, he froze two-thirds of the nation's money supply ($80 billion in savings, financial assets, bank deposits, and investments), unexpectedly liberalized foreign trade—which now threatens to drive thousands of Brazilian industrialists into bankruptcy—and slashed public spending. But inflation resisted, remaining at a level of 12% per month, and the rate has not increased only because the Central Bank as of June has been pumping liquidity out of the economy.

Eighth letter of intent with the IMF

Despite every indication that his monetary policies have failed, Collor has insisted on aggravating the conditions of economic depression in the country with a suicidal monetarist policy designed to stabilize the inflation rate at 7% per month by the end of 1990, and at an annualized 25% in 1991. At least this is what is solemnly pledged in the latest "letter of intent" signed with the IMF and revealed to the public in mid-September. The letter of intent bears the signatures of Economics, Finance, and Planning Minister Zelia María Cardoso de Mello, and of Central Bank President Ibrahim Eris.

Other promises to the IMF included in the letter of intent are the creation of an operational budget surplus in 1990 of 0.5% of the Gross National Product, which in reality translates into a budget cutback of about 8% of the GNP (approximately $32 billion), given the fact that last year's operational deficit was 7-8% of the GNP. This brutal cutback is being achieved through, among other things, laying off scores of thousands of public employees, and through the sale of national patrimony, prominently including various state sector companies which are being auctioned off to the highest bidders, be they national or foreign.

Regarding the layoff of public officials, the letter of intent says that "the government is determined to achieve a significant reduction in the number of federal officials. . . . Through mid-August, nearly 145,000 officials had been laid off, 43,000 placed on paid suspension, and 13,000 induced to retire early."

On the privatization program, the letter of intent says, "The first group of public companies to be privatized within the first three years includes ten firms in the petrochemical, steel, and fertilizer sectors, with a total value preliminarily estimated at 15 billion liquid dollars. Apart from these companies, the government is also selling its minority holdings in another 16 firms in the petrochemical sector. The resources from privatization will be used to rescue the public debt. As of July 1990, the financial institutions should acquire, in 12 equal allotments, nearly $2 billion in Privatization Certificates which will be used to buy stock in the public companies that will be privatized. . . . The privatization program will be open to the participation of foreign investors."

New monetary shock

In another part of the letter of intent, the Brazilian government commits itself to a new monetary shock: "After the March freeze of financial assets, the money supply grew rapidly. . . . In order to obtain the desired reduction of inflation, it will be necessary to have policies that strictly restrict credit, implying rigid control over the growth of the money supply, independent of the effects of such policies on the levels of interest rates."

The government's stubborn insistence on lowering inflation with monetary policies based on the quantity theory of

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money, is digging the pit still deeper. The Central Bank has already announced a "black September," with new and more drastic measures to cut back the monetary base.

On Sept. 10 alone, 120 billion cruzeiros (nearly $2 billion) were withdrawn from circulation, by a mechanism which increased the banks' reserve ratio. This in turn immediately provoked a leap in bank interest rates. On that single day, time deposits (CDBs) shot up 170 points, reaching a record 620% annualized interest rate. The next day, CDB interest rates rose to 650%. Companies seeking credit on those days had to sign contracts with interest rate levels at between 700-800%.

Further, the Central Bank had already announced that on Sept. 17, national banks would have to hand over 950 billion cruzeiros (about $13 billion), equivalent to the amount the banks had not delivered to the Central Bank on March 15, when the program was first launched. This measure has the potential to drive more than half of the national banking system into bankruptcy. Even Central Bank President Ibrahim Eris recognized that "we created a situation of panic on the market by mistakenly proposing a September monetary adjustment." The banks have reached an agreement to pay off the debts in four installments.

Interest rates in the overnight market, which are used to negotiate Treasury bonds (LFTs) and have stayed at a real negative rate since March, began to go positive as of July. On Sept. 10, in unleashing the panic, the government had to offer LFT buyers interest rates above 22% a month, an absurdly high level compared to the 12% monthly inflation rate.

This policy of drastic cutbacks in monetary liquidity has created a bizarre situation. For example, the fictitious shortage of cruzeiros and high interest rates caused dollar-dumping, which devalued the U.S. currency against the cruzeiro to levels so unreal that they placed the entire Brazilian export sector at risk. This forced the Central Bank, in turn, to buy up more than $800 million in dollars since Sept. 3. That is, the cruzeiros which the Central Bank withdrew from circulation on the one hand, in some cases paying excessively high interest rates to do so, are now returned to the monetary market through dollar purchases. The artificial fall of the dollar has turned Brazil's cities—from one day to the next—into the most expensive cities in the world—with the lowest salaries in the world.

Heading for depression

In revealing its promises to the IMF, the Collor government estimates that its monetary measures will cause a 3% fall of the GNP this year, but promises that next year will show a 3% positive growth. This goal, despite the fact that it offers nothing more than zero growth, is a lie. The truth is that government measures are forcing the economy into a deep depression from which it will be difficult to recover. Harvard economist Jeffrey Sachs was fully aware of this fact, according to *O Estado de São Paulo,* when he candidly told a foreign debt seminar held in São Paulo on Sept. 11 that "society has to understand the new reality, and for this there is nothing better than a painful recession like the one that is coming."

Economics indicators already show signs of a serious depression, much more serious than a mere 3% fall in GNP. For example, the August economic review published by the National Industrial Federation reported that the index of industrial production fell below 1981 levels, according to statistics from the Brazilian Geographic and Statistical Institute.

Comparing industrial production of June 1990 with average 1989 production, the production collapse of the industry in general is 10.41%. The major effects show up in the mechanics industry, with a negative index of 17.81%, the electrical material industry, with −15.21%, and transport material industry, with −35.49%. The social implications of this industrial fall can be clearly seen in the level of layoffs in São Paulo industries.

According to the most recent research on economic tendencies by Price Waterhouse, published in *Jornal do Brasil* Sept. 13, it is estimated that the rate of gross fixed capital formation this year will scarcely reach 14% of GNP, which is the lowest rate in the last 20 years. During the 1970s, this rate reached the level of 25% of GNP. This latest research also reveals that investment plans of the top 500 industrial companies in the country are virtually nil.

According to statements published in *Gazeta Mercantil* on Sept. 13 by Lindolfo Ernesto Paixao, the operations director for Electrobras, growth in electrical energy consumption—which should remain around 2% during 1990—will be the lowest of the past decade. Earlier, a 6% growth rate had been anticipated for 1990. In the 1970s, electrical energy consumption grew 10-12% a year.

The perspective for industrial recovery is almost nonexistent; in fact, the depression tendency is expected to worsen as the result of new monetary measures and the latest orders of President Collor for a new 25% cutback in state company spending for the last trimester of 1990. This will increase the financial difficulties of these public companies, which are already suffering from the controls on public service rates that have been artificially contained by the government's anti-inflation program.

The economic depression is also revealed in the collapse of consumption levels. Between January and June of this year, compared to the same period in 1989, retail sales fell 14.24%. Supermarket sales fell nearly 20%, department stores 30%, and clothing sales 40%.

Given this picture, government estimates of a mere 3% GNP fall this year, and a 3% recovery next year are a cruel hoax. The GNP collapse in 1990 could surpass 6%.

Having fired his last shot, President Collor, in his insistence on taking Brazil down this monetarist path, could well lead to a fatal confrontation with the tiger of inflation.