

The Politics of Monetary Policy in Brazil, 1930-1993

A Política da Política Monetária no Brasil, 1930-1993

Resumo

Este relatório explora fontes primárias e análises secundárias na economia, na ciência política, e na sociologia para uma análise política da gestão monetária e financeira brasileira de 1930-1993. Fontes secundárias da economia financeira, da ciência política e da historiografia permitem distinguir quatro períodos diferentes em termos da relação entre o processo político e a gestão macroeconômica e financeira.

Palavras Chaves: Economia Política, Política Monetária, Política e gestão econômico

Abstract

This report reviews primary empirical sources and secondary materials in economics, political science, and sociology for a comparative political economic analysis of the politics of monetary policy and financial management in Brazil from 1930-1993. Analysis of secondary analyses in financial economics and history will be framed by concerns in political science about the relations between the political process and economic management.

Keywords: Political Economy, Monetary Policy, Politics of Economic Policy

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... while institutions respond to supply and demand or to economic necessity, as the Coase theorem asserts, they do so within a social and political structure that profoundly shapes the outcomes. Supply and demand propose, ... the social matrix disposes...

Kindleberger, Charles. *A Financial History of Western Europe*.

Oxford: Oxford University Press, 1993 p. 410

Introduction

Until price stability in the mid-1990s, Brazil appeared as the most laggard of developing countries in terms of central banking and example of government mismanagement of domestic money, credit, and banking policies.¹ This report focuses on the politics of monetary policy in Brazil from 1930-1993 as part of a manuscript in progress on financial statecraft in Brazilian history, with special emphasis on developments since the Real Plan. The focus of this report on the period of persistent and increasing inflation from 1930-1993 is necessary to dispel notions now circulating among international financial institutions that Brazil has finally got policies "right". That, after decades of poor domestic policies and political institutions, the set of policies adopted since the mid-1990s now proves core concepts and theories in political science and economics about the perverse impact of politics on monetary policy and the need to isolate policies of money, credit, and banking from social and political forces. The central argument of this research is that the achievements in terms of central banking and monetary authority in Brazil since the mid-1990s (and remaining obstacles to economic growth and social inclusion) have to do with the particular trajectory of Brazilian political economy during the 20th century. This argument implies that financial statecraft and the construction of monetary authority involve a mode of politics that depends on the gradual transformation of existing institutions. The particular trajectory of Brazilian policymaking reflects a path-dependent causal process more than an approximation to a single model of independent central banking. In this sense, this report adopts Kindleberger's view of the emergence and

¹ See: Dornbusch, Rudiger. ed. *The Macroeconomics of Populism in Latin America*. Chicago: University of Chicago Press, 1991.

evolution of finance in Western Europe cited in the epigram above: that social and political structures shape domestic financial systems.

Discussion of how politics shaped monetary policy from 1930-1993 is thus divided into four periods that reflect fundamental changes in a particular sequence. First, from 1930-1945 the politics of monetary policy reflect the shift of government policies toward the mobilization of domestic resources and the channeling of finance toward import substitution. During this period, the Banco do Brasil remained the central agent for government policies of money, credit, and finance. Second, from 1945-1964, the politics of monetary policy reflect the syndromes of the macroeconomics of populism sustained by a veto coalition centered in the Banco do Brasil blocking creation of separate government agencies with prerogatives over monetary policy.² Third, after the breakdown of democracy in 1964 until the debt crisis of 1982, the politics of monetary policy turn on the unexpected consequences of reforms that produced a period of state-led development driven by foreign capital inflows under military rule. Fourth, debt and fiscal crises deepened during from 1983-1993 because of a “last dance syndrome,” during the political void of protracted transition whereby regional political elites bankrupt state government banks and exacerbated monetary disequilibria. Far from a consequence of democratization, the monetary and fiscal disequilibria that produced high inflation from 1983-1993 arose in great part due to the lack of transparency, accountability, and horizontal patterns of control during the prolonged transition from military rule in Brazil.

In terms of method, this report adopts an open-ended, empirical, and historical-institutional approach to the politics of monetary policy in the tradition of comparative political economy. This approach is necessary because of the deeply contested, opposing theories about the political economy of finance. Financial deepening approaches and bank-centered finance strategies (and liberal and coordinated political economy approaches) often see the same phenomena from profoundly different perspectives.³ Liberal market-economies are driven by equity markets, thrive on public information, and spurn

² This argument about the veto coalition centered in the Banco do Brasil is based on: Nóbrega, Mailson, & Loyola, Gustavo. “The Long and Simultaneous Construction of Monetary and Fiscal Institutions.” in Sola, Lourdes & Laurence Whitehead. eds. *Statecrafting Monetary Authority: Democracy and Financial Order in Brazil*. Oxford: Centre for Brazilian Studies, 2006. On the politics of veto coalitions, see: Tsibelis, George. *Veto Players*. Princeton: Princeton University Press, 2002.

coordination. Coordinated market-economies are driven by bank credit, thrive on concealing (limited sharing) of firm strategy with financiers, and spurn markets for their excessive volatility that produce sub-optimal equilibrium.⁴ From a market-centered perspective, neo-institutionalism is largely neo-protectionism. From the perspective of coordinated capitalism, excessive financial liberalization and privatization would simply throw babies -- cherished institutions of social policy and domestic control -- out with the bathwater. In terms of financial theory, market approaches insist that policies should free agents to “get prices right,” while coordinated and bank-centered approaches argue that sufficient credit be directed to accelerate innovation and “get planning right.”⁵ This research attempts to deal with these deeply contested matters of theory through case study of the Brazilian experience.

An open-ended case study approach is also in order to explore the Brazilian experience as a developing nation. Scholars in comparative political economy and financial economics now emphasize varieties of capitalism and different configurations of domestic money, finance, banking, and government policies. However, most research focuses on advanced economies with deeply leveraged financial systems. Furthermore, scholars and policy makers urgently seek alternatives to the single model for developing and emerging economies favoring liberalization, privatization, and central bank independence that prevailed during the 1990s. In this broader sense, this review of the Brazilian experience with monetary and financial policies from 1930-1993 seeks to improve understanding of the political economy of finance through case study relevant to broader concerns in politics, economics, and policy debates about development, democracy, and social inclusion.

Although the pros and cons of liberalization and privatization remain beyond the scope of this study, the question of central bank independence is at the core of politics and monetary policy.⁶ Arguments in favor of central bank independence must be qualified in the Brazilian case for several reasons. First, rather than the imposition of orthodoxy, the

³ On bank-centered and market centered financial systems, see: Zysman, John. *Governments, Markets, and Growth Financial Systems and the Politics of Industrial Change*. Ithaca, NY: Cornell University Press, 1983

⁴ The terms of this dichotomy are from: Hall, Peter & David Soskice eds. *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press, 2001

⁵ This distinction between prices and planning is from: Dymski, Gary A. “Banking on Transformation: Financing Development, Overcoming Poverty.” Paper presented to UFRJ Economics Institute, September 2003.

trajectory of monetary policy in Brazil involves heterodox policies of inertial inflation that were used to reduce high and persistent inflation. Second, the successful reduction of inflation while redistributing wealth to the poor provided the political impetus and legitimation for statecraft during the transition to democracy, both in terms of economic policies and in terms of party politics.⁷ Third, important developments in central bank authority and capacity have emerged in Brazil precisely in the reverse causal order expected by economists: Contrary to causal claims about the need to establish central bank independence to ensure price stability, the reverse occurred in Brazil. The Central Bank of Brazil expanded its prerogatives and capacities after price stability in 1994.

The Literature on Brazilian Monetary Policy in Political Science and Economics

For most economists and political scientists, the inability of Brazilian Finance Ministers to control inflation before 1993 is explained by the weakness of government and regulatory institutions and the ability of social and political actors to control policies of credit, money, and banking.⁸ The persistence of traditional oligarchies,⁹ inchoate economic policies and institutions,¹⁰ the predominance of fiscal deficits and banker's coalitions over monetary and financial policies,¹¹ and supposed skews in the electoral system that provide incentives against correct monetary policies.¹² These diverse perspectives retain a common

⁶ See: Sola, Lourdes & Whitehead, Laurence. eds. *Statecrafting Monetary Authority: Democracy and Financial Order in Brazil*. Oxford: University of Oxford Centre for Brazilian Studies, 2006

⁷ On the Real Plan and party-electoral politics, see: Mettenheim, Kurt. "Critical Elections, Multi-Party Realignment, and Supercoalitions: New Concepts for Understanding Party Change in Brazil." Manuscript, 2006

⁸ This overview of explanations of inflation in economics and political science is based on: Armijo, Leslie E. "Mass Democracy: The Real Reason that Brazil Ended Inflation?" in Sola & Whitehead (eds). op. cit., pp. and Hirschman, Albert O. 'The Social and Political Matrix of Inflation: Elaborations on the Latin American Experience,' in A.O. Hirschman, *Essays in Trespassing: Economics to Politics and Beyond*, Cambridge: Cambridge University Press, 1981 and Baer, Werner 'Social Aspects of Latin American Inflation,' *Quarterly Review of Economics and Finance*, (1991), 31:3, pp. 45-57.

⁹ Hagopian, Frances. *Traditional Politics and Regime Change in Brazil*. Cambridge: Cambridge University Press, 1996 and Geddes, op. cit.

¹⁰ Tyler, William. *The Brazilian Industrial Economy*, Lexington, MA.: Lexington Books, 1983; Syvrud, Donald E., 1974. *Foundations of Brazilian Economic Growth*, Stanford, CA.: Hoover Institution Press, 1974; Weyland, Kurt. 'The Brazilian State in the New Democracy,' in Peter R. Kingstone & Timothy J. Power, eds., *Democratic Brazil: Actors, Institutions, and Processes*, Pittsburgh: University of Pittsburgh Press, 2000

¹¹ Maxfield, Sylvia. *Gatekeepers of Growth: The International Political Economy of Central Banking in Developing Countries*. Princeton, NJ: Princeton University Press, 1998.

¹² Mainwaring, Scott. *Rethinking Political Systems in the Third Wave of Democratization: The Case of Brazil*. Stanford, CA: Stanford University Press, 1999; Ames, Barry. *The Deadlock of Democracy in Brazil*. Ann Arbor: University of Michigan Press, 2001; Geddes, op. cit.

thread of structural dysfunctionism; that the politics of monetary and financial policies in Brazil from 1930-1993 remained at odds with a set of policies that should have or could have been implemented to avert the escalation of inflation. This powerful counterfactual pervades perceptions of the perverse impact of politics on Brazilian macroeconomic policy generally and, especially, government policies toward money, credit, and finance.

This perception of Brazilian economic policies is shared by many political scientists. For example, Weyland, Mainwaring, Ames, Hagopian, and Samuels argue that transition from military rule exacerbated the traditionally weak Brazilian state, rendering political institutions unable to implement correct economic policies and address questions of social exclusion.¹³ From this perspective, the 1988 Constitution made matters of monetary policy worse by further by delegating authority and spending prerogatives to states and municipalities.¹⁴ Furthermore, hyperinflation during the early 1990s was the fundamental cause that reversed these historical tendencies and permitted the centralization of economic policy making and the creation of a political coalition supporting correct domestic financial policies. This perception is consistent with comparative and theoretical analyses in political economy that emphasize the reality that severe crises are necessary to build support for adjustment policies.¹⁵

This study also builds on scholarship in political science and sociology that traces the tensions between technical knowledge among economists and the politics of economic policy making.¹⁶ Since the classic works of Hall, Gourevitch, and Aberbach, Putnam, & Rockman, the tension between professional and technical knowledge in the bureaucratic agencies charged with economic policy has been debated in longstanding democracies. The Brazilian experience has also been examined from a variety of perspectives concerned with the structure and characteristics of elites, tradeoffs between politicians and technical knowledge about economic policies, and the emergence of economists at the center of

¹³ Weyland, Kurt. *Democracy without Equity: Failures of Reform in Brazil*. Pittsburgh, PA: University of Pittsburgh Press, 1996

¹⁴ Sola, Lourdes. 'Estado, Regime Fiscal e Ordem Monetária: Qual Estado?,' in Lourdes Sola and Leda M. Paulani, eds., *Lições da Década de 80*, São Paulo: Edusp, 1995; Montero, Alfred P. 2000. 'Devolving Democracy? Political Decentralization and the New Brazilian Federalism,' in Kingstone & Power, op. cit.

¹⁵ Alesina, Alberto & Allan Drazen. 'Why Are Stabilizations Delayed?,' *American Economic Review*, (1991), Vol. 81, No. 5, December, pp. 1170-1188; Weyland, Kurt. *The Politics of Market Reform in Fragile Democracies: Argentina, Brazil, Peru, and Venezuela*. Princeton, NJ: Princeton University Press, 2002.

¹⁶ Gourevitch, Peter, "Democracy and Economic Policy: Elective Affinities and Circumstantial Conjunctions," *World Development*, 21 (8), 1993, pp.1271-1281

policy making. Transitions from military to civilian rule in Latin America and other developing nations during the 1980s increased the importance of understanding the relations between technical expertise and the political process of sustaining economic policies. In this respect, Loureiro traces the emergence of economists at the center of Brazilian government policy making as a process that presents a series of new challenges after the transition from military rule for the organization of democracy.¹⁷ In this respect, one of the central sources for this report is Sola's analysis of the relation between economic policy ideas and the politics of policy implementation from 1945-1964 in Brazil.¹⁸

It should also be noted that this report is a draft chapter of a manuscript into the politics of monetary policy in Brazilian history based on the concept of financial statecraft, a concept that reflects the approaches and methods of historical institutionalism and comparative political economy. Conaghan & Malloy define statecraft broadly as the elaboration of procedural rules and public policies by agents empowered to act in the name of the state, which mandates and regulates the basic relationships among actors in the state, civil society, and market.¹⁹ The statecraft of interest in this study is the politics of government policies of money, credit, and banking: In other words, the resolution of financial problems by ministers, political elites, and government representatives in Brazil.²⁰ The concept of financial statecraft thereby combines the broader notion of statecraft as a particular mode of political action and the specific concerns about finance and government policies during development in Brazil. In sum, the focus of this report is on the politics behind central policy decisions and designs in Brazil regarding money, credit, and finance from 1930-1993.

The Debate about Central Bank Independence

Since Alesina reported correlations between central bank independence, lower inflation, and higher levels of economic growth,²¹ many economists and political scientists

¹⁷ Loureiro, Maria R. *Os Economistas no Governo*. Rio de Janeiro: Editora FGV, 1997

¹⁸ Sola, Lourdes. *Ideias Econômicas, Decisões Políticas*. São Paulo: Edusp, 1998

¹⁹ Malloy, James & Catherine Conaghan. *Unsettling Statecraft: Democracy and Neoliberalism in the Andes*. Pittsburgh, PA: University of Pittsburgh Press, 1994.

²⁰ Sola & Whitehead, op. cit.

²¹ See: Alesina, Alberto et al. *Political Cycles and the Macroeconomy*. Cambridge, MA: MIT Press, 1997

have argued that a strong causal relation exists.²² Economists argue that central bank independence (from the executive and party politics) can reduce inflationary expectations and wage demands by labor and other organized groups. From this perspective, politics threatens correct monetary policy due to either electoral cycles that fuel inflation or excessive government spending that slows economic growth. Globalization is also seen as further constraining governments and increasing the stakes for the delegation of monetary authority to build and sustain the confidence of markets.²³ Central bank independence is interpreted as both emerging from and legitimizing a type of contract whereby governments are induced to accept delegation of monetary policy in return for better economic performance.²⁴ Policies of inflation targeting increase the importance of this contract by concentrating the attention of investors, consumers, and international finance on matters of monetary policy and central banking.

Recent research into advanced industrial economies suggests that explanation of monetary performance and central bank independence has to do with a variety of intervening variables such as the relation of labor and business organizations, and the partisan composition of governments.²⁵ However, formal comparison of governments according to standard typologies such as minority/majority, multi-party/two-party, short-lived/longstanding suggest that none of these specific dichotomies or different forms of government provide significant explanation for the success or failure of monetary policy. Like past studies of political institutions, this lack of evidence linking different forms of government to monetary performance in aggregate data suggests that these causal relations are more complex, more context specific, and more path dependent than may appear in formal comparative analysis across countries.

²² Cukierman, Alex et al. *Measuring Central Bank Independence and its Effect on Policy Outcomes*. San Francisco, CA: ICS Press, 1994, Cukierman, Alex & Lippi, Francesco. "Central Bank Independence, Centralization of Wage Bargaining, Inflation, and Unemployment: Theory and Some Evidence." *European Economic Review*, Vol. 43, June 1999, pp. 1395-1434, and Barro, Robert. *Determinants of Economic Growth: A Cross Country Comparison*. Cambridge: Cambridge University Press, 1977

²³ Clark, William R. & Hallerberg, Mark. "Mobile Capital, Domestic Institutions, and Electorally Induced Monetary and Fiscal Policy." *American Political Science Review*, Vol. 94., June 2000, pp. 323-346 and Garret, Geoffrey. *Partisan Politics in the Global Economy*. Cambridge: Cambridge University Press, 1998

²⁴ Walsh, Carl. "Optimal Contracts for Central Bankers." *American Economic Review*. Vol. 85, 1995, Rogoff, Kenneth. "The Optimal Degree of Commitment to and Intermediate Monetary Target." *Quarterly Journal of Economics*. Vol. 100, November 1985, pp. 1169-1190, and Jensen, Henrik. "The Credibility of Optimal Monetary Delegation." *American Economic Review*. Vol. 87, 1997.

Central Bank Independence in Emerging and Developing Countries

Regarding specific comparative claims about monetary policy new democracies, Johnson argues that independent central banks emerged quickly in the post-communist world because of a transnational epistemic community that shared both a neoliberal ideology and sufficient material resources to guide the creation of these institutions.²⁶ For Johnson, this process created new institutions but dramatically reduced policy autonomy and sovereignty throughout Eastern Europe. Johnson's emphasis on the role of epistemic communities shifts away from theories that see central bank independence as an inevitable consequence of globalization, or as simply being imposed by international financial institutions or actors such as the IMF or the US government. In the Brazilian case, a tempered and reluctant support for central bank autonomy seems to have emerged among political elites across a variety of political ideologies and alongside policy cleavages supporting government banks for developmental reasons.

In a broader sense, this report emphasizes the need to examine the politics of monetary policy outside the experiences of advanced economies and old democracies in Europe and North America. The Brazilian experience suggests that cycles of boom and bust, foreign capital flows, and greater volatility of prices and markets provide a series of greater challenges to government policy. The record of Brazilian financial policies suggest a particular tradition forged amidst this greater volatility that seeks to ameliorate its impact on the allocation of domestic resources through credit, banks, and government investment in infrastructure.

And unlike stable currencies, consolidated party systems, and clarity of economic and social interests at secure point on the Phillips curve, the politics of monetary policy in Brazil often have to do with the organization of broad coalitions during times of national crisis. Unlike the settled coalitions and consolidated party systems of the advanced economies and old democracies that permit the clear tracing of policy coalitions based on economic and social interest, the negotiation and sustenance of governing coalitions in

²⁵ Hibbs, Douglas. (1977). 'Political Parties and Macroeconomic Policy.' *American Political Science Review*. Vol. 71, pp. 1467-1487

²⁶ Johnson, Juliet. "Financial Globalization and National Sovereignty." Paper prepared for delivery at the 2002 Annual Meeting of the American Political Science Association, Boston, August 29-September 1, 2002.

Brazil is, by force of necessity, a more ad-hoc process involving shifting alliances and repeated political negotiations. The tendency of Latin American presidents to overbuild coalitions in anticipation of changing circumstances has been noted since Chalmer's article in 1977. And contrary to the minute adjustments to gains and losses to labor, capital, and government in the advanced economies, wealthy societies, and old democracies of Europe and North America, Brazilian financial policies and political coalitions tend to be constructed in permanently problematic conditions amidst social exclusion and underdevelopment. Consequently, the relation between financial and economic policy and politics in Brazil is more reactive than pro-active, more ad-hoc than ideological and more gradualist and incrementalist in terms of confronting a seemingly endless series of crises or near crises that demand the attention of policy makers.

In a more empirical and comparative approach, Whitehead also explores political dynamics in the construction of monetary authority in emerging markets and new democracies.²⁷ For Whitehead, economic imperatives and domestic political institutions in new democracies present a variety of challenges to policy makers in the sense of reconciling these often opposing forces. The creation of domestic monetary authorities alongside constitutions and democratic political institutions is thus at the center of political economy of emerging market economies and post-transition democracies:

The governments of many new democracies are heavily dependent upon access to international capital markets in order to maintain the economic stability necessary to address the other demands of the electorate. In such conditions it becomes a high political priority to design and manage a system of monetary authority that can command 'credibility' in financial markets. Whitehead, 2002, p. 136

Furthermore, the contemporary experiences of central banks in longstanding democracies and advanced economies may not provide sure benchmarks for the construction of monetary authority in emerging economies and new democracies. On the origins and development of central banking, Whitehead notes:

Although today's new democracies know the US as prime backer of a standard model of monetary discipline and the 'insulation' of central bank authority, this is

²⁷ Whitehead, Laurence. *Democratization: Theory and Experience*. Oxford: Oxford University Press, 2002 (especially chapter 6 "On Monetary Authority").

not how the USA itself developed from a new democracy and emerging market into the world's dominant liberal power. Nor is it an accurate depiction of how the Federal Reserve presents itself to the American people. In the words of Alan Greenspan, "You cannot in a democratic society have an institution which is either fully or partly disassociated from the electoral process and which has the powers that central banks inherently have." *ibid*, p. 136

In sum, the emergence and development of monetary authority and central banking in emerging and developing nations differs from the consolidated practices and longstanding institutions and markets in advanced economies.

In this respect, Polanyi's analysis of the development of central banking in European and North American history is surely relevant to current debates in new democracies. Polanyi argued that central banking emerged as part of a regulatory wave in Europe after 1870 that reflected the reaction of financiers against the classic doctrines of economic liberalism – especially belief in equilibrium and self-regulating markets. Given that unemployment, class conflict, exchange devaluation, imperialist rivalries, and protectionism predominated in Europe after the 1873 depression, the core assumptions of economic liberalism about the gold standard, domestic banking, and credit markets had to be revised. Polanyi argues that central banks were designed throughout Europe and North America to centralize and regulate exchange markets, provide clearer references for interest rates, avert the impact of recessions on firms, and reverse the persistent disinflation caused by a fixed exchange rate. Polanyi's description of central banking as part of a self-protective movement against the doctrine of self-regulating markets and equilibrium a century ago provides strong justification for a more open-ended analysis of the Brazilian experience.

Sola & Whitehead explore further the "delicate balance" between market confidence and political legitimacy in a recent volume of collected essays.²⁸ Chapters review the Brazilian experience in terms of tensions between international markets and financial institutions and the domestic policy process and party-electoral politics. Chapters by Sola and Marques focus on the political strategies for the implementation of government policies

²⁸ Sola, Lourdes & Whitehead, Laurence (eds). *Statecrafting Monetary Authority: Democracy and Financial Order in Brazil*. Oxford: University of Oxford Centre for Brazilian Studies, 2006

and central banking reforms. Whitehead presents a nine stage tree of political determinants of policy making and financial crises in emerging economies from 1995-2003. From this perspective, the relation between domestic politics and international financial markets depends on the particular configuration of a series of economic and political variables.²⁹ Kugelmas stresses the importance of developments during the latter 1990s in international financial institutions such as the IMF, World Bank, and regional development banks that have changed the context of domestic financial policy making in emerging markets and developing nations.³⁰ Nóbrega & Loyola place the politics of monetary policy in contemporary Brazil in historical perspective, suggesting that the gradual construction of specialized government agencies is behind the recent gains of financial reforms and price stability since the Real Plan in 1994.³¹ Nóbrega & Loyola present a powerful political explanation for the late development of central banking in Brazil that is explored further in this report: The importance of a veto coalition against orthodox monetary policies centered in the Banco do Brasil. For Sola & Kugelmas, economic policy making during the 1990s in Brazil involves a balance between political discretion and technical innovation.³² Armijo presents a much stronger argument: That only after the transition to mass democracy in the late 1980s was it possible to end policies and social coalitions that sustained inflation during much of the latter half of the 20th century.³³ Finally, Santiso traces the market recommendations of major institutional investors and bankers on Wall Street to better understand the interplay between the electoral campaign of 2002 and the overshooting of risk perceptions and finance premium.³⁴

In sum, for political scientists, the relations between the construction of monetary authority and democracy remain open ended, often in apparently inexorable opposition, but

²⁹ Whitehead, Laurence. "The Political Dynamics of Financial Crises in 'Emerging Market' Democracies." in Sola & Whitehead, op. cit.

³⁰ Kugelmas, Eduardo. "Recent Modifications of the International Financial System." in Sola & Whitehead, op. cit.

³¹ Nóbrega & Loyola, "The Long and Simultaneous Construction of Fiscal and Monetary Institutions" in Sola & Whitehead, op. cit.

³² Sola, Lourdes & Kugelmas, Eduardo. "Crafting Economic Stabilization ; Political Discretion and Technical Innovation in the Implementation of the Real Plan." in Sola & Whitehead, op.cit.

³³ Armijo, Leslie E. "Mass Democracy: The Real Reason that Brazil Ended Inflation?" in Sola & Whitehead, op. cit.

³⁴ Santiso, Javier. "Wall Street and Emerging Democracies: Financial Markets and the Brazilian Presidential Elections." in Sola & Whitehead, op. cit.

sometimes providing convergent forces.³⁵ This report reviews the Brazilian experience from 1930-1993 to explore the relations between politics and monetary policy.

The Brazilian Monetary Policy Epistemic Community and the Separation of Powers

This report also explores two further concerns in political science that appear at the center of monetary policy and politics from 1930-1993. The gradual emergence of an epistemic community of economists and policymakers specializing in monetary economic and creation of institutions responsible for government policies of money, credit, and banking is related to a broader process of the separation of powers and the specialization of government. Without the gradual emergence of economic research and understanding of money, credit, and finance in Brazil, and the gradual creation of specialized agencies capable of monitoring, regulating, and controlling banking and financial market forces in Brazil, the critical juncture of the Real Plan and the price stability it produced would have been unsustainable. This report attempts to clarify these causal processes. Historical and sociological accounts of the development and evolution of Brazilian economics and economic policy making permit a closer look at the relation between monetary policy and politics. The core argument in this respect is that the emergence and evolution of debates within monetary economics and monetary policy making in Brazil reflects what is described in political science as an epistemic community.

In terms of an epistemic community of economists and monetary policy making in Brazil, it is of note that the description of vicious cycles of underdevelopment in terms of financial structures and policies are shared by scholars from diverse methodological and theoretical perspectives. For example, Tavares argues that:

... income distribution, its concentration over profits, in detriment of wages, tends to stimulate self financing and restrict the access of financial institutions to long-term funds. In such cases, the predominance of self-financing is more a cause than an effect of the weakness of the financing mechanisms. This condition does not per se limit the aggregate saving, but only its conversion into financial savings.

Tavares, Maria C. *Da Substituição de Importações...* 1979

This explanation of financial underdevelopment seems consistent with orthodox treatments in the tradition of Gurley & Shaw, and McKinnon such as Langoni, Gudin, and Porto

³⁵ Gourevitch, "Democracy and Economic Policy..." op. cit.

Gonçalves. From this more orthodox tradition, the precarious development of long-term financial instruments narrows investment and economic growth rates.³⁶ In sum, scholars of monetary economics in Brazil share the perception that income concentration and the tendency for self-financing reduce the country's capacity to save and invest.

Another example of shared perceptions and an epistemic community of economics and monetary policy is the agreement across different theoretical traditions about the impact of banking on the money supply in Brazil. For Porto Gonçalves and Conceição Tavares, the impact of credit cycles on the money supply is not primarily matter of more complex and/or more accurate measures of money, but instead the direct impact of credit expansion on M1; patterns already apparent in measures available since the 1960s.³⁷ Finally, another example of the Brazilian epistemic community of economists and monetary policy makers can be seen by arguments from Dornbusch and Aman & Baer that emphasize, from 1986 through 1993, the experience of economic policy teams involved. For these scholars, the group of economists involved in heterodox policies from 1985 through 1993 developed technical knowledge and shared understandings of the character and impact of policies needed to sustain heterodox anti-inflation policies.³⁸ In sum, this report explores the emergence and development of monetary economics and monetary policy making among academic and technical elites in Brazil to emphasize their shared experiences with the politics of monetary policy.

This emergence and development of an epistemic community of economists and monetary policymaking is related to another concern in political science about democratization and political institutions in Brazil: the separation of powers. Since the 1988 Constitution, scholars of Brazilian political institutions have emphasized the empowerment of each branch of federal government; executive, judiciary, and legislature, as well as the increased power of state and local governments, the media, and non-governmental organizations. The separation of powers is therefore at the center of research and study of Brazilian democracy. The argument presented in this research is that the

³⁶ Gurley & Shaw, "Financial Aspects..." 1955; Shaw, *Financial Deepening*, 1973; McKinnon, *Money and Capital...* 1973.

³⁷ Porto Gonçalves, Antonio C. "A Definição da Moeda." *Revista Brasileira de Economia*. (1981). Vol. 35, No., 1, pp. 43-57

specialization of monetary policy making is an example of this separation of powers within the agencies of Brazilian federal government. From this perspective, the gradual extraction of specialized matters of monetary, credit, bank supervision, and other matters traditionally associated with central banking and monetary policy from the Banco do Brasil and Finance Ministry to specialized agencies and, since 1965, the Central Bank of Brazil reflects this broader process of the separation of powers. In sum, the specialization of monetary policy reinforces the separation of powers.

Having introduced the central themes, methods, and concepts developed in this research, this report turns to the politics of monetary policy in Brazil from 1930-1993 according to the standard periodization of Brazilian political and economic history.

1930-1945 The Politics of Monetary Policy under Vargas' Estado Novo

The 1930 revolution is widely regarded as a critical juncture and fundamental period of change in Brazilian politics and economic policy making. The collapse of the single-state party system of governor's politics that reinforced oligarchic society and export oriented agriculture gave way to the formation of provisional revolutionary government, attempts to create new political institutions during the early 1930s, and the shift toward authoritarian rule and the Estado Novo under Getulio Vargas by the mid-1930s. Standard accounts of the Brazilian economy and economic policy making during this period also emphasize rupture from agricultural exports to import substitution industrialization, the devaluation of the mil-reis, exchange and import controls, and expenditure switching toward domestic markets.³⁹ This section explores the relation between politics and policies of money, credit, and banking from 1930-1945.

Since Fausto's *A Revolução de 1930* was published in 1970, the picture that emerges from recent scholarship is that the collapse of the Old Republic (1889-1930) has more to do with the exclusive character of single state parties and the emergence of political opposition within states than the impact of the 1929 crash and subsequent

³⁸ Dornbusch, Rudiger. 'Brazil's Incomplete Stabilization and Reform,' *Brookings Papers on Economic Activity*, No. 1, 1997; Amann, Edmund & Werner Baer. 'The Illusion of Stability: The Brazilian Economy Under Cardoso,' *World Development*, (2000), Vol 28, No. 10, pp. 1805-1819

³⁹ For an overview of the economy and economic policy making, from 1930-1945, see: Abreu, Marcelo. P. "The Brazilian Economy, 1928-1945." in Bethell, Leslie (ed). *Cambridge History of Latin America*. Vol. IX, Cambridge University Press, 2002.

depression in advanced economies on the Brazilian economy. Indeed, the domestic Brazilian economy pressured incoming revolutionaries for cyclical reasons of coffee production and a severe contraction of the monetary supply underway since late 1928. Abreu claims that the monetary base fell 14 percent from late 1928 through 1930 while bumper coffee crops and collapse of foreign demand forced prices from 11 pence per sack in 1929 to 4 pence per sack by 1931. The impact of these trends was to confront the provisional government with economic crisis and shortage of foreign currency reserves soon after taking power in November 1930.

The first Finance Minister of the provisional government, José Maria Whitaker hoped that, like during the Old Republic, a funding loan from abroad could bridge the period of adjustment. Orthodox policy recommendations are exemplified by the British mission under Otto Niemeyer that called, in a July 1931 report, for the gradual elimination of coffee price support policies, greater fiscal discipline, reduced prerogatives for state and municipal governments to secure foreign finance, and creation of an independent central bank to lead Brazil back to the gold standard. The abandonment of the gold standard by the UK in September 1931 reinforced a shift away from orthodoxy and the search for alternative policies amidst escalating economic crisis. After the São Paulo state government failed to secure foreign finance to continue stocking coffee supplies, and the Federal government refused support, bankruptcies spread through coffee producers. Crisis deepened as the monetary base declined, moratoria on foreign debts were declared by states and municipalities, the cruzeiro devalued abroad, foreign currency reserves fell, and exporters were forced to barter. In mid-September 1931 the government suspended payments on foreign debt and granted monopoly of foreign exchange transactions to the Banco do Brasil.

The politics of monetary policy shift in 1931 with the resignation of Whitaker in favor of Oswald Aranha at the Finance Ministry. Aranha inherited negotiations with foreign creditors toward a funding loan and continued much of Whitaker's policies designed to reduce state and municipal debt, while increasing interest rates and the reserve requirements of commercial banks held at the Banco do Brasil. Moreover, Aranha burned 400 million cruzeiros gained from sale of treasury notes and created a Bank Mobilization Account at the Banco do Brasil to support banks in trouble with five year loans against the

assets of these financial institutions. By 1934, agreement between creditors and Finance Minister Aranha reduced foreign debt payments by an estimated two thirds.⁴⁰ All of this seems standard, even orthodox in terms of monetary policy. However, Aranha's policies toward coffee were less orthodox. Abreu estimates that 70 million bags of coffee were incinerated from 1933-1937 (volume equal to three years world consumption). The Economic Readjustment package of 1933 forgave half of coffee debts, introduced new coffee subsidies under the National Department of Coffee.⁴¹ Furthermore, Finance Minister Aranha saved domestic banks first through the Banco do Brasil Rediscount Facility (Carteira de Redescontos) and, after 1932, through a new Bank Mobilization Facility (Caixa de Mobilização Bancária) also at the Banco do Brasil.

In sum, this centralization of financial policies in the Banco do Brasil was followed by strong recovery of the economy during the mid-1930s. In terms of the politics of money, credit, and banking, the emergence of institutions and policies during the 1930s thus became a critical juncture in terms of cementing the legitimacy of Banco do Brasil and policies adopted during this period in terms of a state-led, national-populist tradition. A variety of positive economic circumstances converged with these unorthodox policies to produce strong and sustained economic recovery from the 1930s that would last through the 1950s. The apparent success of combining financial centralization in the Banco do Brasil, coffee price supports, and the mobilization of domestic savings channeled toward import substitution came to reinforce these aspects of economic policymaking in Brazil throughout the 20th century.⁴²

Two pieces of legislation during the early 1930s also shaped the politics of monetary policy and the domestic financial system throughout much of the 20th century. First, an anti-usury law imposed a ceiling of 12 percent on annual interest rates, largely as an attempt to reduce the debt payments of agricultural producers.⁴³ This law became a defining, albeit largely ineffective feature of the Brazilian financial system. Second, legislation banned use of foreign currency and coin, establishing the national currency as

⁴⁰ See: Fausto, *História do Brasil*. São Paulo, Edusp, 1994 and Moreira, Regina L. "Aranha, Osvaldo." in *Dicionário Histórico-Biográfico Brasileiro, Pós-1930*. Rio de Janeiro: Editora FGV, pp. 281-310

⁴¹ On the politics of coffee policies, see: Bates, Robert.

⁴² On economic growth in Brazil and Latin America during the 1930s, see: Thorp, Rosemary (ed). *Latin America in the 1930s*.

⁴³ Law n°. 22.626, 7 April 1933

legal tender.⁴⁴ This permitted looser policies of monetary expansion according to political necessities.

Wartime finance also shaped the politics of monetary policy in Brazil during the Estado Novo.⁴⁵ In 1942, the Vargas government first issued three million contos de réis in war bonds discounted from income taxes, public employee salaries, and pensions. A further million contos de réis in Treasury Bonds were sold to commercial banks, while the government also authorized the Banco do Brasil to expand rediscount operations. This dual policy made it possible to maintain the discourse of anti-inflationary moderation via the Treasury and, at the same time, expand the scope of action of rediscounting to avert contraction in economic activity. Justification of these currency issues was based on the need to respond with credit to stimulate domestic production, given that WWII blocked imports of capital goods and materials for domestic production. A second justification was to provide protection to domestic consumption and production not directly involved in war efforts. The lack of co-ordination of these policies and the difficulties encountered in attempting to control internal liquidity and credit brought to the fore, once again, debates about creating a central bank.

The Banco do Brasil, 1930-1945⁴⁶

Although the Old Republic (1889-1930) is beyond the scope of this report, it is important to note that, even before the national populist regime of Vargas, the Banco do Brasil occupied a central and expanding role in Brazilian political economy. Before 1930, the Banco do Brasil was responsible for management of foreign exchange, domestic liquidity, and coordinated the national banking system, alternating prerogative for the emission of money with the National Treasury. Furthermore, both private domestic and foreign banks lost market share during the old republic, while the Banco do Brasil and state government banks increased their share from 1906 to 1930.⁴⁷ After the 1930 revolution, the provisional government hoped that reserves in the Banco do Brasil and its Currency

⁴⁴ Law n° 23.501, 27 November 1933

⁴⁵ See: "Finanças de Guerra" Part II of *Proposta Orçamentária para 1943*, Relatório. Finance Ministry, Budget Commission. Rio de Janeiro: Imprensa Nacional, 1943

⁴⁶ This section, along with the other sections on the Banco do Brasil below, are taken from a draft chapter co-authored with Maria Antonieta del Tedesco Lins that is part of a manuscript on the politics of federal government banking in Brazil.

Board (Caixa de Estabilização) would be sufficient to cover foreign exchange requirements. Nonetheless, like the fate of a previous Conversion Fund (Caixa de Conversão) in 1914, the Currency Board was liquidated in 1929. Experience with two failures left a clear impression among domestic policy makers and economists that conversion of foreign capital into domestic currency during times of crisis was not viable.

Thus, the Currency Board was liquidated and its functions were transferred to the Banco do Brasil in November 1931.⁴⁸ The revolutionary government sought thereby to rebuild the credibility of the Banco do Brasil overseas while demands for direct payments increased from foreign investors. The dismantling of monetary policy led to a deepening of the coffee crisis and the domestic banking system. The return of the Rediscount Facility to the Banco do Brasil placed the bank once again in the role of supervisor of the banking system. It is also of note that Finance Minister Whitaker settled accounts between the Banco do Brasil and Treasury, leaving the bank with a large sum of foreign currencies to cover withdrawals abroad. Operations were settled as purchases and sales of pounds sterling between the Banco do Brasil and the Treasury.

As noted above, Finance Minister Aranha created a Bank Mobilization Fund (Caixa de Mobilização Bancária) in 1932 to increase the pace of domestic recovery.⁴⁹ This fund set reserve requirements for commercial banks to be held at the Banco do Brasil. This measure worked in the sense that it reversed the drop in credit while guaranteeing that banks could mobilize their assets, meet existing contractual obligations, and increase loans.⁵⁰ This fund rebuilt the confidence of depositors in commercial banks while increasing the capacity of the Banco do Brasil to assist banks by acting as lender of last resort. The Fund also provided for the financial requirements of the Treasury and the National Department of Coffee (Departamento Nacional do Café).

Under Finance Minister Oswaldo Aranha, the Banco do Brasil also became central for coffee policies. Resources allocated to the Bank for coffee policy were increased fourfold:

⁴⁷ See: Triner, Gail. *Banking and economic development: Brazil 1889-1930*. New York: Palgrave, 2000

⁴⁸ Law n°. 19.423

⁴⁹ Law n°. 21.499

⁵⁰ “The Fund would extend loans to the banks in relation to assets. In turn the loans could not be used for other upcoming bank operations; the resources received from the Fund would only be used for operations

In December 1931, the rediscount portfolio of the Banco do Brasil was given the right by the Federal government to increase its operating capital to 400 thousand contos. At the same time the Carteira was given the right to discount the bonds of the Conselho Nacional do Café (National Coffee Council), basing this change on the '10 shillings tax'. Later, the Counsel shifted to depositing all the income from that tax in the Banco do Brasil." (Villela e Suzigan, 1973, p.195)

Thereafter, the Banco do Brasil continued to play an important role for the Departamento Nacional do Café –DNC (National Department of Coffee), created in 1933 to substitute the Conselho Nacional do Café, and directly subject to the Ministry of Finance. The Banco do Brasil supported the institution through rotating credits (créditos rotativos) to be reimbursed through coffee export tax receipts. After 1937, policies attempted to reduce subsidies to coffee production. As it was clear the DNC could not pay the credit it held with the Banco do Brasil, the Treasury itself took out a loan from the Banco do Brasil Rediscount Facility to be credited to the DNC after canceling repayment of 300 thousand contos due Treasury.

The Banco do Brasil also financed government expenses incurred during defeat of the Constitutionalist revolt in São Paulo and intense drought in the Northeast region. State and municipal governments unable to repay foreign investors also appealed to the Banco do Brasil to cover debts. The bank did so by direct financing with the National Treasury as guarantor. This placed the Banco do Brasil at the centre of politics and economics. As Vieira notes:

With the increasingly fragile state of the economy and of the monetary system, there was fertile ground for the loss of confidence in the public sector, this favored changes and revolutions, which, as they were new expenses, made the situation even worse." Vieira, 1981, p.272

The Foreign Exchange Facility of the Banco do Brasil also excluded participation of the private sector in foreign exchange operations.⁵¹ The Bank gained monopoly over import permits (letras), these funds being used to pay remittances and duties owed by the federal, state and municipal governments and for the payment of imports, duly certified by staff at

linked to the active assets that were shown to the Fund. The loans could be extended for up to 5 years."(Villela e Suzigan, 1973, p.182)

⁵¹ Law n°. 20.695, 20 November 1932

the Banco do Brasil. The Banco do Brasil thereby also remained the operational arm of various types of foreign exchange rate policies adopted during the following fifteen years.

In 1942 the Banco do Brasil was reorganized to adapt to new corporate laws (Lei das Sociedades Anônimas), reforms that clarified the tensions within the bank arising from both exercising monetary policy prerogatives and conducting commercial bank operations. Furthermore, as financial agent for the government, the Banco do Brasil collected federal revenue, authorized payments, advanced payments to government agencies, and continued to act as federal agent for exchange operations. Meanwhile, as a commercial bank, it continued to be the largest single source of finance for private economic activity. After the 1942 reforms, the activities of the Banco do Brasil came to be organized into five portfolios (carteiras): the Exchange Rate Portfolio (Carteira de Câmbio), that undertook the exchange rate policy of the government, supervision of banking and ran the Special Agency for Economic Defense (Agência Especial de Defesa Econômica); the Agricultural and Industrial Credit Portfolio (Carteira de Crédito Agrícola e Industrial) that set directed credit policies; the General Credit Portfolio (Carteira de Crédito Geral), that centralized commercial credit operations; the Export and Import Portfolio (Carteira de Exportação e Importação), that was responsible for services relating to foreign transactions, market research, and the promotion of Brazilian commercial interests; and the Rediscount Facility (Carteira de Redesconto), responsible for rediscounting operations with domestic financial institutions. The Banco do Brasil emerged as financial monolith from 1930-1945, dominating both government policies of money, credit, finance, and commercial bank supervision, as well as directed and commercial lending.

Conclusions about the Politics of Monetary Policy in Brazil, 1930-1945

After crisis and recovery, the period of sustained expansion from 1930-1945 reinforced the institutions and policies set in place under Getulio Vargas' Estado Novo, despite the "exceptionally peculiar" character of the concentration of financial policies in the Banco do Brasil. Credit expanded rapidly, and would continue to do so at average levels of 20 percent per year after 1942. However, the accumulation of gold and foreign currency reserves kept apace, reinforcing confidence and undercutting orthodox economists and critics concerned about the pace of money and credit on prices and the sustainability of

growth. Politics also appears central to the reaching of a permanent settlement of Brazilian foreign debts in 1943, with US banks reducing foreign obligations by half "in the interests of Pan-Americanism."⁵²

Policies during the 1930s also came to determine the basic structure of the domestic Brazilian banking system. Contrary to the letter of the 1937 (authoritarian) Constitution, the government granted waivers to a select number of foreign banks to continue operations in Brazil, creating thereafter the privileged position of a select number of foreign banks and barriers to entry that remained in place until gradual liberalization of the domestic market in the 1980s and more substantial measures opened the banking system in the 1990s.

In terms of epistemic communities of policy-makers, the statecrafting of unorthodox financial institutions during the 1930s and 1940s under Getulio Vargas' Estado Novo provided a strong legacy reinforcing state-led planning, money, credit, and finance policies. Debate emerged during the 1940s between advocates of more orthodox liberal policies arguing that Brazil need liberalize trade and reduce government spending to reduce protection of domestic industry and commerce, sustain productivity increases, and free market forces from fiscal dominance and financial repression. In opposition, industrialists and interest groups from São Paulo argued that state-led growth and protection from unfair practices of foreign firms were essential to deepen industrialization and sustain growth. These differences are exemplified by debate between Eugenio Gudin and Roberto Simonsen about economic planning, differences that implied fundamentally different views of proper government policies toward money, credit, and finance.

In this respect, the 1930 revolution and organization of the Estado Novo provide a critical juncture in terms of financial statecraft: During this period the Banco do Brasil and a variety of unorthodox institutions and policies emerged in terms of money, credit, and finance that nonetheless underwrote a period of strong and sustained macroeconomic growth. Developments of this period are still widely debated by orthodox monetary economists and state-led developmentalists. However, the conclusion drawn from this analysis is that the unorthodox policies and institutions created in Brazil reflect the core position of Shonfield about the particular configuration of domestic policy traditions and the importance of context. Given the trajectory of Brazilian development before 1930 as a

⁵² Abreu, op. cit., citing British protests of US deal.

primary exporting and underdeveloped economy, the set of policies designed during world depression and wartime differ from policies pursued in advanced economies at the center of the world economy. This difference has long been recognized in standard conceptions of Brazilian development. What is less recognized is the importance of the emergence and consolidation of political coalitions and policy communities at the center of the financial institutions created during the 1930s and 1940s. To trace the implications of these policies and coalitions, this study turns to the further developments of politics and financial policies during the 1950s and the crisis and breakdown of democracy by 1964.

The Politics of Monetary Policy, 1945-1964

Politics and Brazilian government policies from 1945-1964 have been analyzed from a variety of perspectives and disciplines. This study focuses on the politics of federal government policies in terms of money, credit, and finance. The central argument is that the unorthodox configuration of financial institutions and policies were sustained during this period through a national-developmental coalition centered in the Banco do Brasil, but involving epistemic communities of economists and policy advisors, domestic industrial and agricultural interests, and politicians that sustained veto of legislation and policies designed to reform the Brazilian financial system in the direction of more orthodox monetary theory and financial markets. While most Latin American countries created central banks during the early 20th century, Brazil created an advisory Superintendancy of Money and Credit (SUMOC) in 1946 and the Central Bank of Brazil in 1965. The central argument of this section is that politics is at the center of this extremely late development of more orthodox financial institutions and policies. Specifically, the capacity of a national-developmental coalition to veto independent central banking and monetary policy until after the breakdown of democracy in 1964 suggests that politics were the most important causes of this late development.

In a broader sense, the politics of financial statecraft from 1945-1964 in Brazil center around divergent groups advocating reform toward more orthodox liberal and monetarist economic policy and, on the other hand, a national-developmental tradition advanced by programs under the aegis of the United Nations Economic Commission on Latin America and centered in the BNDE (National Development Bank) and Banco do

Brasil.⁵³ New diplomatic collaboration after 1945 also attempted to build on the institutions left by Vargas, albeit in terms that disappointed Brazilian elites expecting a southern hemisphere equivalent to Marshall Plan funds in Europe. Instead, US policy sought to free market forces and secure confidence among foreign investors. Two US-Brazilian working committees on finance during the 1940s led to creation of the National Bank for Economic Development (Banco Nacional de Desenvolvimento Econômico, BNDE) in 1952, followed by a shift toward policies advocated by the UN Economic Commission on Latin America.

The national-developmental coalition centered in the Banco do Brasil that included broad sectors in industry, labor, commerce, and agriculture systematically defeated attempts to slow growth, reduce credit, control monetary expansion, and liberalize the domestic banking and financial system. The sustained period of post-war economic growth provided further legitimacy to this national-developmental coalition and its veto power. How these unorthodox policies worked for over two decades requires a closer look, given the contested interpretations of this period. For orthodox theories of money and finance, the Brazilian experience from 1945-1964 is a classic case of the macroeconomics of populism. For Dornbusch, Cardoso, Gudin, Nóbrega & Loyola, the state-led policies of directed credit exacerbated income inequality and caused fiscal imbalances and economic disequilibria. However, for developmentalists, the unorthodox policies of the post-war period provide a positive legacy in terms of a domestic policy tradition that maximized economic growth given the specific circumstances of Brazilian dependent development.

First, it is of note that, unlike the cycle of uncontrolled lending and finance through state government banks during the transition from military rule of the 1980s discussed below, the transition from Vargas' Estado Novo to competitive electoral politics in 1945 did not appear to produce a wave of official lending. Indeed, Bulhões reviews credit policies and markets in the years proceeding 1947 to suggest that the Banco do Brasil and credit supply were not excessive.⁵⁴ Furthermore, Abreu argues that credit shrank from 1945 through 1950 by one quarter in terms of GDP. In sum both the data reported by Abreu and

⁵³ On epistemic communities, politics, and policy making from 1945-1964, see: Loureiro, Maria R. *Os Economistas no Governo*. Rio de Janeiro: Editoria FGV, 1997, Sola, Lourdes. *Idéias Econômicas, Decisões Políticas*. São Paulo: Edusp, 1998

the IBGE time series data on money and credit suggest that the Banco do Brasil was not the primary mover of monetary excess during this period - at least not in terms of a credit bubble or substantial monetarization of financial transactions among monetary authorities (Banco do Brasil, Rediscount Facility, Bank Mobilization Facility).

Furthermore, after the 1950 election returned Getulio Vargas to the presidency, conservative policies appear to have been imposed by Finance Minister Horácio Lafer.⁵⁵ The approach of the 1950 elections appears to have weakened Finance Minister Correia e Castro, leading to his replacement by Guilherme de Silveira in 1949 in order to shift policies toward more generous credit policies. Lobbies of industrial, agricultural, and populist electoral machines converged on Banco do Brasil for increased lending during the electoral year. Nonetheless, under the second Vargas administration, Finance Minister Lafer imposed spending reductions during 1951-1952 to generate federal government surpluses of 0.9 and 0.6 percent of GDP. However, Banco do Brasil president Ricardo Jafet pursued expansionary policies, increasing Banco do Brasil credit in real term 66 percent in 1951 and 40 percent in 1952. This tension between adjustment policies pursued by the Finance Minister and expansionary policies pursued by the Banco do Brasil remained at the center of the politics of financial policies throughout a variety of presidencies and political coalitions during the period of post-war democracy. This tension between the Finance Ministry and Banco do Brasil overshadowed design and reform of new institution for financial policy.

Abreu argues that national development policies created an "extremely peculiar ... institutional arrangement."⁵⁶ A closer look at these arrangements is in order. In 1946, a new Superintendancy for Money and Credit (Superintendência de Moeda e Crédito, SUMOC) gained prerogative to set the rates for rediscount operations and compulsory deposits of commercial bank reserves, foreign exchange policies, registry of foreign investment, and domestic bank supervision. However, the Banco do Brasil retained its Rediscount Facility and Bank Mobilization Facility that let the bank provide lending of last resort and exercise

⁵⁴ Bulhões, Octavio G. & Kingston, Jorge. (1947). "A política monetária para 1947". *Revista Brasileira de Economia*, Rio de Janeiro, v. 1, n. 1, p. 9-50, Sept.

⁵⁵ On Lafer's views of financial policy, see: Lafer, Horácio. *O Crédito e o Sistema Bancário no Brasil*. Rio de Janeiro, Editora Nacional, 1948 (Report submitted to Federal Chamber Finance Committee as Federal Deputy and rapporteur).

⁵⁶ Abreu, op. cit. p.

de facto control of the supply of credit. The National Treasury (subordinate to the Finance Ministry) also retained an Amortization Facility (Caixa de Amortização) with prerogative to print or amortize money, but Treasury could not directly place or remove money from circulation without operating through the Banco do Brasil Rediscount Facility. These mechanisms meant that the Banco do Brasil could generate cash by rediscounting commercial paper at its Rediscount Facility covered by a loan for the value discounted from Treasury to the Banco do Brasil. Upon maturing, the Banco do Brasil would return commercial paper to Treasury for incineration at the Amortization Facility. Abreu notes that 1942 regulations capped Treasury rediscounting to 25 percent of foreign reserves. However, Congress averted this limit by simply canceling debts across the Rediscount Facility, Treasury, and the Banco do Brasil.

In sum, instead of creating a central bank in the 1940s, a gradualist, even minimalist strategy for the creation of monetary policy was pursued. Given the veto coalition of developmentalists centered at the Banco do Brasil, the generation of monetarist economists such as Gudin and Bulhões focused on the training of personnel and the development of independent monetary data for subsequent policy initiatives. Indeed, after the creation of SUMOC, the Banco do Brasil retain core functions of central banking and finance ministries such as supervision of domestic banks, monopoly on foreign exchange operations, regulation of domestic bank reserves, discretion to rediscount to domestic banks and management of the money supply. SUMOC became an agency responsible for the creation of economic data and studies of the domestic financial and monetary system.

From 1950-1954, the broader conflicts between the US government, foreign investors, and the Vargas administration overshadowed matters of domestic monetary policy. Political and economic impasse led to power vacuum and policy paralysis in the Vargas government. Announcement of a 100 percent increase in the minimum wage served to escalate confrontation, culminating in the suicide of Vargas and swearing in of his Vice-President, Café Filho. During this period, the Banco do Brasil remained a national-developmental stronghold determined to act counter cyclically and maintain investments and growth. Ricardo Jaffet was dismissed from the presidency of the Banco do Brasil in 1953 for abuses of linked operations by the bank. However, the Banco do Brasil continued to increase lending contrary to Ministry of Finance policies of adjustment. The suicide of

President Vargas and the interim government of Vice President Café Filho brought a more orthodox financial and economic policy team led by Eugenio Gudin to government. However, unable to pursue broad measures of monetary reform, Gudin issued a series of SUMOC instructions to increase discipline over currency. Caps were set for interest rate payments on deposits, while both discounting rates commercial bank reserve requirements were increased. This transfer of prerogatives to SUMOC was designed to reduce the role of the Banco do Brasil in money management. However, reforms were abandoned under political pressure during 1954 and Gudin resigned after seven months as Finance Ministry.

In 1955, Whitaker returned as Finance Minister, arguing that three adverse economic developments required the implementation of adjustment policies.⁵⁷ The first factor was the fallout from the trade conflict with the United States over Brazilian coffee exports that had cut export prices and volumes. The second disequilibria arose from the May 1954 increase of the minimum wage by 100 percent, an estimated 60 percent over retail price increases for the same period. According to Whitaker, the third disequilibria arose from generous credit allocation via the Banco do Brasil and financial assistance to commercial banks via the Banco do Brasil, rediscount operations, and the Bank Mobilization Account. Data reported by Whitaker are presented in Table 1).

Table 1) Banco do Brasil Lending and Government Financial Assistance, 1950-1954

	Banco do Brasil (Cz billion)	Financial Assistance (Cz billion)
1950	14.9	5.0
1951	24.7	6.5
1952	34.4	8.1
1953	40.4	11.3
1954*	55.5	13.6

Source: Whitaker, *Seis Meses, de novo, no Ministério da Fazenda*. 1956, p. 16

* 9 months to September

The resignation of Gudin and the return of Whitaker occurred amidst the escalation of military and liberal opposition to Vargas allied to US policies, foreign investment, and

⁵⁷ Whitaker, José M. *Seis Meses, de novo, no Ministério da Fazenda*. Rio de Janeiro: 1956

the UDN, while the suicide of Vargas averted military intervention and secured conditions for the election of Juscelino Kubitschek and a PSD-PTB alliance in the 1956 elections. The election of Kubitschek inaugurated another period of strong economic growth and expansionary money, credit, and banking policies. President Kubitschek's audacious Target Plan (Plano de Metas) was designed to achieve 50 years of development in five. Remarkably, plans lacked specific consideration of financial sources able to underwrite the targets for infrastructure development and the substitution of imports. While the Banco do Brasil increased its share of domestic credit to between 48 and 53 percent during the Kubitschek administration, other sources of finance outpaced bank credit. Policies focused on concessions to private sector, subsidies and incentives for foreign investors, and facilities granted to foreign investment under Instruction 113 of SUMOC to import equipment at favorable exchange rates. Abreu argues that President Kubitschek retained an "utter disregard for macroeconomic constraints" and that severe disequilibria were left by the development programs and policies pursued during his administration.⁵⁸ In this respect, broader designs of reform paled against the political and financial forces within the Banco do Brasil. As noted, SUMOC Instruction 113 of January 1955 also facilitated the entry of foreign capital and provided alternative sources for long-term investment in the domestic economy.

Lucas Lopes and Roberto Campos participated in the Kubitschek administration and proposed a Program of Monetary Stabilization to stabilize the economy in 1957. However, Kubitschek refused to slow the broader investments and programs underway seen as necessary to reach the development targets set early in his administration. Substitution of Finance Minister Lucas Lopes in July 1958 for Paes de Almeida (former president of the Banco do Brasil) signaled a return to developmentalist policy and generous credit, finance, and bank policies. Nonetheless, the relation between Banco do Brasil lending and policy teams signally adjustment and/or expansion was not linear. Indeed, during 1959, Banco do Brasil lending decreased 16 percent, while total credit in terms of GDP fell a full 23 percent from 1956-1960.

Furthermore, the conflicts between economic advisors stressing the need to adjust the economy and developmentalists seeking to sustain growth were derailed because of the

⁵⁸ Areu, op. cit. p.

refusal of President Kubitschek to adopt adjustment policies suggested by the IMF. In terms of epistemic communities of economic policy makers, the escalation of differences had to do with a debate about the causes of inflation. On the one hand, economists such as Roberto Campos and Lucas Lopes argued in more orthodox terms that the overheating of the economy and excessive money and credit had driven inflation to record levels (40 percent) by 1959. On the other hand, economists described as structural, emerging from the UN ECLA argued that inflation was driven by the inability of the Brazilian economy to keep pace with demand; and that further investments, credit, and finance were needed rather than adjustment in the traditional sense. In terms of politics, the nationalist appeal of confrontation with the IMF increased President Kubitschek's popularity, already considerable given the experience of rapid growth (average GDP growth of 8.1 percent from 1955-1960) and the clear signs of success (despite shortfalls) in achieving the audacious development goals during his administration. Furthermore, in terms of politics, orthodox economists and those advocating the need for policies of adjustment failed to counter the veto coalition in congress, and across the financial institutions of the federal government.

Much has been written about the legacies of this period of rapid economic growth under Kubitschek. In retrospect, the years of rapid expansion during the late 1950s were followed by political confrontations that exacerbated the underlying structural problems in the economy, decreased the confidence of foreign and domestic investors, and, ultimately, led to the breakdown of democracy in 1964. The breakdown of democracy in 1964 remains beyond the scope of this study. Instead, the focus is on the politics of money, credit, and finance during the period of escalating conflict, military intervention, and military government. From this perspective, the conflicts between national-developmentalists and more orthodox liberal economists were channeled into the core political conflicts during the early 1960.

The Banco do Brasil, 1945-1964

Once again, the importance of the Banco do Brasil in Brazilian politics and monetary policy-making requires a closer look at this institution. The above noted set of relations across the Banco do Brasil, Treasury, and SUMOC had important implications for

the Banco do Brasil as a financial institution. For example, as noted above, currency issues were controlled by Treasury, but implemented by the Banco do Brasil through its Bank Mobilization Facility and Rediscount Facility. Furthermore, the financing of deficits at Treasury by the Banco do Brasil could be made either through deposit in the name of SUMOC, or through resources originating in exchange rate operations, or through increases in the debit of rediscounted government paper through the Bank Mobilization Facility. The latter operation, known as “camping paper money” (*encampação de papel-moeda*), consisting of the following accounting procedures. Part of the debts due Treasury at the Banco do Brasil was cancelled in return for canceling an equivalent part of the debt of the Banco do Brasil at the Rediscount Facility. This maneuver was used to make federal government budget deficits “disappear.” Debts were, in fact, removed both from the Banco do Brasil Rediscount Facility and Treasury balance sheets. However, this procedure intensified inflationary pressures, demonstrated the loss of government control over monetary policy, and placed the Banco do Brasil at the center of political tensions.

Another example of the de facto prerogatives of the Banco do Brasil over monetary policy can be seen in terms of regulation and supervision of domestic commercial banking. SUMOC was granted control over compulsory commercial bank reserve requirements and regulation of open market operations. Nonetheless, rediscounting remained the responsibility of the Banco do Brasil, with resources from the federal government and issues from Treasury provided when necessary. Finally, foreign currency trading also remained under control of the Banco do Brasil. Indeed, the Banco do Brasil also managed foreign trade policy through a Foreign Trade Portfolio – *Carteira de Comércio Exterior*, CACEX, created in 1953 to authorize exports and imports.⁵⁹

Given these substantial prerogatives over monetary policy at the Banco do Brasil, political tensions between adjustment and developmentalism often involved this financial institution. During 1947 and 1948, the government pursued austere policies to combat inflation through controls on government spending and bank credit. These measures led to an increase in the number of bankruptcies in São Paulo and Rio de Janeiro, a decline in industrial growth, and increasing unemployment. The Banco do Brasil acted in an opposite,

⁵⁹ Founded in December 1953, but closed in response to frequent accusations of corruption and abuse, the government substituted the Cacex with the *Carteira de Exportação e Importação* (Export Import Facility).

counter-cyclical direction. The bank was essential for appeasing dissatisfied groups because, unlike commercial banks, it could lend against deposits of the federal government and was not constrained by reserve requirements. The Exchange Rate Facility of the Banco do Brasil also provided a route around limitations imposed by SUMOC on profit remittances: The bank could consider profits and dividends generated in Brazil as foreign investments for registry by banking supervisors, thereby facilitating capital flows out of the country. The Banco do Brasil also increased provisions to liquidate bad credits during this period. Bad credits increased from approximately 11 million cruzeiros in January 1946 to 151.8 million cruzeiros by December 1950.

Opposition groups denounced these practices. However, this counter-cyclical stance of the Banco do Brasil launched its president, Manoel Guilherme da Silveira, to the Finance Ministry in mid-1949. With a former president at the Ministry of Finance, the Banco do Brasil thereafter continued generous credit policies and defended further agricultural credits to induce larger harvests. The bank thus represented a more structuralist position toward monetary policy and inflation that saw rising inflation as a natural consequence of the increase in currency and the purchasing power of the working class. From this developmentalist perspective, instead of monetary austerity, increases in production and a greater supply of basic consumer goods would lead to a drop in prices. In sum, the Banco do Brasil retained centralized control over monetary policy during this period.

Other political and policy disputes also crossed groups within the Banco do Brasil. As noted, accusations of under- and over-factoring and capital remittances deepened political confrontation between the Vargas administration, foreign business, and the US government from 1952-54. While Banco do Brasil president Joffit sought restrictions on foreign capital, director of the bank's Exchange Portfolio (Carteira de Câmbio), Otávio de Bulhões, defended maintaining the more liberal policies. After June 1953, Finance Minister Aranha and Director of the Banco do Brasil Exchange Rate Portfolio, Sousa Dantas, attempted to control the exchange rate market through new reforms and markets.⁶⁰

⁶⁰ The Banco do Brasil was authorized to buy foreign currency at a fixed rate, received this sum in cash, with repayment due in up to 90 days. The operational limit of commercial banks was expanded and *swap* operations were permitted; operations of purchase and sale of foreign exchange, that is, arbitrage in cash rather than arbitrage over a period. The gains from these operations were not interpreted as a return of capital, as the period (90 days) did not allow for enough time for the fulfilment of the advantages that accrued to capital that was invested

Nonetheless, the country once again faced a serious exchange rate crisis while the government became unable to finance expenditures without recourse to monetary issues and credits. In response, Finance Minister issued SUMOC Instruction 70 in October 1953 that: Re-established a monopoly on foreign exchange at the Banco do Brasil; ended import controls; created foreign exchange auctions from public savings; created auctions for notes of foreign exchange futures (promessa de venda de câmbio – PVC). Coffee exports also received allowances over CR\$5 per US\$. This new set of policies led to an increase of exports, the stabilization of imports, and increased government revenue, albeit insufficient to erase deficits.⁶¹

During 1953, political and economic pressures converged against the intent to continue more orthodox economic policies. Inflation increased from 12 percent in 1952 to over 20 percent in 1953, especially due to the pass-through of exchange rate devaluation originating in Instruction 70. Economic growth slowed and investment declined despite attempts to collaborate with foreign investors and financial institutions. The Banco do Brasil played a central role in the expansion of currency during this period of reform, adjustment, and stagnation:

Contemporary records show that the Banco do Brasil played a crucial role in the expansion of the currency stock through its various funds. Paper-money issued in rediscounting reached 5,3 billion cruzeiros. Of this total, the Banco do Brasil Rediscount Account absorbed 4,8 billion; the rest of the banking sector 0,5 billion. Of the total increase in credit, the Banco do Brasil was responsible for 68.6 percent, summing 17 billion for Government projects and three billion for the private sector.” Peláez e Suzigan, 1981, p. 247

After 1953, the Banco do Brasil used resources from the Rediscount Facility, Bank Mobilization Facility, and deposits more intensely in order to pay late commercial agreements and meet borrowing and payment needs of federal, state and municipal administrations. These resources would be used also to support banks in financial difficulty and raise finance for production. In order to pay for this increase in loans, the Banco do Brasil fell back on sale of coffee and other stocks. The Banco do Brasil Agricultural and

⁶¹ Expenditures increased for public works and counter drought in the Northeast. The government also granted bonuses to public employees while the Banco do Brasil took over payment of overdue commercial agreements and credits of the São Paulo state government.

Industrial Credit Facility also exceeded its budget; while checks were covered by Banco do Brasil funds to avoid a run on commercial banks in Rio de Janeiro and São Paulo.

During 1954, declining coffee exports and prices emptied the Banco do Brasil Exchange Portfolio (Carteira de Câmbio) and required a turn to international credit. Again, instead of adjustment through reduction of credit, Banco do Brasil policy was based on a strategy to support agriculture toward both adjusting foreign accounts and increasing domestic supply to (from the structuralist view) control inflationary pressures. Despite deficits in government and foreign accounts, the Banco do Brasil nonetheless pursued new reforms in May 1956 involving a public offering of shares that doubled the resources available from the bank to two hundred million cruzeiros. In 1956, Finance Minister Lopes negotiated agreements with the US government that included promises to pursue policies that would limit Banco do Brasil rediscount operations, introduce controls on its manifold credit operations, and redirect funds to export financing.⁶² While these measures produced a credit crunch during 1956-1957, increasing inflation led to further stabilization policies. New controls over Banco do Brasil credit and finance operations sought to reverse the expansion of paper money. However, fiscal and monetary measures failed to satisfy orthodox reformers while alienating developmentalists, structuralists, and the diverse interests associated with Banco do Brasil lending. By mid-1957 adjustment targets were abandoned. Search for alternative financial resources led to proposals for creating government bond markets by SUMOC during 1957. Banks failed to respond. By 1958, conflicts between inflation stabilization and accelerated growth were resolved in favor of the latter. This shift included abandonment of the National Stabilization Plan and hardening of the Brazilian government's position in negotiations with the IMF. During 1958, currency grew approximately 30 percent: For the most part through Banco do Brasil operations involving finance to Treasury, credit to the private sector, and rediscount operations that freed commercial banks to increase domestic finance and credit.⁶³ Lucas Lopes left the Finance Ministry in August 1959 and was succeeded by then Banco do Brasil President, Sebastião Paes de Almeida. Given the pressure of increased imports and the absence of

⁶² The banking system suffered due to caps on credits from the Banco do Brasil Rediscount Facility and limits on loan terms. The Banco do Brasil also decreased liquidity through sale of dollars to importers, a measure that led to a reduction in the domestic currency supply. Although an anti-inflationary measure, this operation actually increased funds at the Banco do Brasil account of "*Ágios e bonificações*".

finance from the IMF, the Banco do Brasil re-established swap operations to improve the terms of Brazilian foreign debt.

In sum, this overview of Banco do Brasil policy from 1945-1960 suggests that the monopoly of monetary policy by the bank generated opposition from orthodox economists and policy circles, an opposition that would advance further financial reforms at the beginning of the 1960s.

Conclusions about the Politics of Monetary Policy, 1945-1964

Having briefly reviewed the course of events, policies, and Banco do Brasil operations from 1945-1964, several conclusions about the politics of monetary policy from 1945-1964 are in order before turning to developments under military government. Politics, policy, and markets deteriorated during the early 1960s and produced the breakdown of democracy and military intervention on 31 March 1964. Policies at the beginning of the Quadros administration (1960-61) briefly pursued austerity in response to increasing inflation, foreign debt and imbalances inherited from the 1950s. However, policies of adjustment betrayed the populist discourse employed in his campaign.⁶⁴ After the resignation of Jânio (seven months after taking office) in August 1961, political instability intensified and further exacerbated macro-economic problems, especially inflation and balance of payments shortfalls. A Three Year Plan (Plano Trienal) was launched in December 1962 by Celso Furtado, Minister of Planning (Ministro do Planejamento) of President João Goulart, with the aim of combining stabilization with a return of industrial growth.⁶⁵ Once imbalances were resolved, public planning was expected by Furtado to accelerate growth. However, the plan faced obstacles in the renegotiation of the foreign debt and was criticized by national-developmental and political leaders of the left close to the president. Inflation persisted and a recession marked the end of the expansionary cycle of the Plano de Metas under the Plano Trienal, with restrictive monetary policy and a rise in interest rates braking the economy.

⁶³ Pelaez & Suzigan, op. cit. (p. 254) estimate a 30 percent increase in M1 and a 28,8 percent increase in M2.

⁶⁴ Abreu, Marcelo P. (ed). (1990). *Ordem do Progresso: Cem Anos de Política Econômica Republicana, 1889-1989*. Rio de Janeiro: Campus

⁶⁵ The entry of foreign capital as an alternative source of finance also received regulation in the same period. Law nº 4131, 1962, deals with the capture of resources in other countries by Brazilian firms. As a result of

Review of both general events surrounding the politics of monetary policy and the trajectory of the Banco do Brasil from 1945-1964 suggests both the unusual arrangement of Brazilian monetary policy institutions and the late development of specialized agencies for government money, credit, and bank supervision policies. The escalation of conflict between national populist groups associated with the Goulart presidency from 1962-1964 and internationalist groups associated with military and US alliances led to the breakdown of democracy and military intervention on 31 March 1964. The causal processes that led to the failure of competitive electoral politics and the breakdown of democracy have been widely debated. Although in a general sense, perceptions of economic mismanagement and lax monetary policy can be cited as part of the problems leading to the escalation of political conflicts, monetary policy seems to this observer as secondary and amenable to reforms such as those proposed by Furtado and Dantas under the Goulart presidency. Monetary policy fades into the background as political confrontation escalated during 1963 and early 1964. To complete this overview of the 1930-1993 period, the following section examines the reforms introduced under military rule after 1964.

The Politics of Monetary Policy under Military Government, 1964-1982

The events reviewed above during the late 1950s and early 1960s reinforced consensus among military elites and more orthodox economic policy circles about the necessity of reforming the domestic financial system. Economists of the new government believed that inflation was responsible for financial disintermediation, reduced savings, and the disorganization of value and prices. Their views were diametrically opposed to structuralist theories and developmentalist policies that had predominated for much of the 20th century. Instead, studies carried out under military government suggested the need for more orthodox policies to reduce inflation and create conditions for long-term development. Consensus emerged in favor of gradual stabilization strategies to avert further shocks or distortions in income distribution.⁶⁶ The new policies embodied by the 1965

this law significant sums of resources came into the country over the following decade. Resolution n° 63 allowed Brazilian banks to raise funds abroad and pass them on to domestic firms.

⁶⁶ Adjustment policy in the *Plano de Ação Econômica do Governo* (Economic Action Plan of the Government, PAEG) contained cuts in spending and subsidies to reduce the budget deficit and wage and monetary controls. Monetary correction was introduced to: “improve the prestige of the public bonds, in this way to finance government expenditure with resources that were not subject to inflation.” (Peláez e Suzigan,

PAEG increased greater control over currency issues and reduced inflation through 1967. Further institutional reforms were characterized by the centralization of policy, fiscal reform, financial reforms, the creation of the Central Bank of Brazil, new exchange rate and industrial development policies, and the implementation of adjustment under agreement with the IMF.⁶⁷ Perhaps the most important reform was the establishment of monetary correction over fiscal deficits with the intent of eliminating the common practice of delaying government payments under accelerating inflation.⁶⁸ Reforms were designed to create financial institutions with clearly defined roles driven by new savings channels and monetary correction, a practice that spread rapidly through the financial sector.

At year-end 1965, SUMOC was replaced with a National Monetary Council (Conselho Monetário Nacional, CMN) charged with elaborating monetary, financial, budget, and government debt management policies. These reforms marked the beginning of a profound change for the Banco do Brasil and the politics of monetary policy in the country. While the Banco do Brasil retained its hybrid character as both executor of government policy and largest commercial bank in the country, it increasingly ceded prerogatives of credit, banking, and monetary policy to specialized agencies and the Central Bank of Brazil. The functions of SUMOC were remodeled and redistributed in ways that indicate this separation of monetary policy from banking at the Banco do Brasil. The Central Bank of Brazil was designed to assume functions associated with monetary authority such as the regulation and supervision of credit and financial institutions; monitor and control of foreign capital and foreign currency reserves; and the control of money supply and currency issues according to recommendations set by the National Monetary Council.

After 1965, the National Monetary Council and Central Bank of Brazil significantly constrained the role of the Banco do Brasil in macroeconomic management. Although the Banco do Brasil continued to serve as government bank, especially in terms of focusing credit policies on rural and commercial sectors, its lending policies became increasingly those of a normal commercial bank and market conditions. Within this new context of

p. 277). See also: Fishlow, Albert. "Thirty Years of Combating Inflation in Brazil: From the PAEG (1964) to the Plan Real (1994)." University of Oxford Centre for Brazilian Studies, Working Paper, 2005

⁶⁷On reforms under military government, see: Simonsen, M.H. *Inflação*, 1970, pp. 23-56

⁶⁸Law nº 4357, July 1964, established monetary correction.

financial reforms under military rule, the Banco do Brasil acted and undertook large-scale operations anchored by new resources captured at home and abroad. The bank continued to operate as financial agent of Treasury, while gaining several new functions including: The management of check and cash payments for the banking system (delegated to the Banco do Brasil by the Central Bank); new strategies for management of international trade through a Foreign Commerce Account (Carteira do Comércio Exterior, Cacex); and the management of various official funds and programs. The Banco do Brasil continued commercial bank operations, albeit closely set by government development policies, particularly in agriculture and through further expansion of its branch network in the interior of the country.

Hermann argues that the PAEG reforms led to an increase in the number of domestic banks, the deepening of the Brazilian financial system and financial intermediation, and that this deepening made possible the sustained period of rapid economic growth under military rule.⁶⁹ However, financial market reforms during the 1960s also led to the concentration of the Brazilian domestic financial system in a select number of banks, while government paper indexed against inflation became the focal point of domestic finance instead of long-term investments. Welch and Studart also emphasize the dual trend away from long-term liabilities and the widespread use of indexed financial instruments as producing consequences for the domestic economy substantially different than designers of 1965 reforms anticipated.⁷⁰ Despite legislation during the 1960s designed to encourage stock markets, the crash of equity prices in 1971 delegitimized stock market finance and reinforced the bank-centered character of the Brazilian financial system. Instead, the reforms introduced during the 1960s after military intervention led to the consolidation of a select number of private and public financial institutions.⁷¹

Creation of the Central Bank of Brazil, 1965

Nóbrega & Loyola trace the political and legislative history behind the creation of the Central Bank of Brazil in 1965. Despite the escalation of political and economic crisis

⁶⁹ Hermann, 2003, Lees, Botts & Cysne, *Banking Financial*, 1990, pp. 242-248, Castro & Souza, *A Economia Brasileira*, 1985; Serra, "Ciclos e Mudanças", 1984

⁷⁰ Studart, Rogério. *Investment Finance*, 1995, pp. 122-123

⁷¹ Lees et al, op. cit. pp. 112-113.

during the early 1960s that culminated in military intervention on 31 March 1964, several legislative initiatives were presented to congress designed to redefine financial policies and prerogatives in Brazilian government. Federal Deputy Daniel Faraco presented a new legislative proposal in 1962 that called for a Monetary Council and Central Bank, while splitting off rural lending from the Banco do Brasil to a new rural bank. Alternative legislation presented by Federal Deputy Ney Galvão was followed by a third bill presented by Miguel Calmon and San Tiago Dantas that called for creation of a Monetary Council, while retaining SUMOC for supervision and regulation of domestic credit and money. After military intervention in 1964, a fourth bill was presented by Federal Deputy Jose Maria Alkmin, while Finance Minister Bulhões advocated the development of legislation for an independent central bank. However, once again, opposition from the Banco do Brasil and rural caucuses led the government to promise creation of a new rural credit facility. By September 1964, congress had approved legislation submitted by Ulysses Guimarães to create the National Monetary Council and retain SUMOC. However, the Senate amended the bill to create a central bank in place of SUMOC. The Federal Chamber approved the Senate version over opposition from the Banco do Brasil and rural caucuses and presidential sanction (under military rule) was granted by year-end 1964. Nonetheless, the Banco do Brasil caucus inserted provisions in this legislation that assured continued autonomy within the bank in terms of credit and finance, while core functions of rediscounting, foreign exchange operations, bank supervision, and money supply management were officially ceded to the Central Bank.

After creation of the Central Bank of Brazil, several developments impeded traditional prerogatives and policies. For Roberto Campos, Planning Minister from 1964-1967, the impact of these developments is clear: “The Central Bank, created independently, later became a subservient organization. From a severe sheriff became a depraved money printer.”⁷² Two matters stand out: The creation of a separate “monetary budget” in government accounts and a “movement account” between the Banco do Brasil and Treasury. Regarding the monetary budget, Sola and Marques note that this separate budget soon outpaced the “fiscal budget” approved by congress and would only be

⁷² Campos, Roberto *A lanterna na popa - Memórias*. Rio de Janeiro: Topbooks, 1997 cited in Nóbrega de Nobrega & Loyola, op. cit. p.

controlled after the 1988 Constitution ended this dual budget system that left monetary authorities with substantial prerogatives and policy discretion under military rule.⁷³ Regarding the creation of the “movement account” that would impede central bank control over the money supply for two decades, Nóbrega & Loyola note:

The preservation of Banco do Brasil as the depository of the voluntary commercial bank reserves and the executor of decisions of the Central Bank generated the necessity for the creation of a special account to register the transactions between the two institutions. This account, which also became known as ‘movement account’ supposedly would be in balance every week, but this rarely happened, with Banco do Brasil becoming systematically in debt, with rising negative balances. The vices of the old system - monetary budget and the open ‘movement account’ - had survived." (Nóbrega & Loyola, "The long and simultaneous...", p.)

Nóbrega & Loyola note two further unorthodox sources for revenue and monetary policy in the central bank. First, the Central Bank of Brazil also received tax revenues directly from financial operations and export taxes introduced in 1965, revenue that became part of the monetary budget and independent of legislative or executive policy making. Second, the involvement of the Central Bank of Brazil in agricultural and development banking placed the central bank very far from traditional monetary policies. After 1965, central bank officials became responsible for negotiating program finance with the Inter-American Development Bank and World Bank as well as the creation of internal department for analysis and approval of agricultural and agro-industry credits and development finance.

Regarding the relations between the Banco do Brasil and Central Bank of Brazil, Nóbrega & Loyola provide a further institutional insight. In terms of the central bank as an organization, Nóbrega & Loyola note that over 90 percent of staff hired at the Central Bank of Brazil during the 1960s were, or remained, employees of the Banco do Brasil on leave. This reinforced the importance of the Banco do Brasil in the politics of monetary policy.

Despite these unorthodox prerogatives, the creation of the Central Bank of Brazil was an important part of financial, monetary, and fiscal reforms under Planning Minister

⁷³ On the monetary budget, see: [World Bank. *Brazil: Financial Systems Review*. Washington D.C., The World Bank, 1984.](#)

Roberto Campos and Finance Minister Bulhões during the Castello Branco presidency that embodied more orthodox monetarist conceptions. Indeed, from 1964-1967, the Brazilian Central Bank refused extend financial assistance to banks and liquidated private banks during this period.⁷⁴ However, the unorthodox mechanisms described above and a clear shift away from orthodoxy after 1967 under military president Costa e Silva and Planning Minister Delfim Netto reversed the intentions of reformers. Adjustment ceded to period of rapid economic growth spurred by foreign financial investment, a stock market rally (that collapsed in 1971), and state-led finance and investment policies driven by substantial foreign capital inflows. These state-led policies would continue under military presidents Medici (1969-1973) and Geisel (1974-1979), despite two oil price shocks, rising international interest rates, and increasing foreign debt levels.

Sola & Marques also note that the influence of the private financial sector on monetary policy in Brazil increased throughout the period of military rule, especially after the Costa e Silva administration (1967-69). For example, the National Monetary Council (CMN), responsible for monetary policy and the country's newly created Central Bank. Under the aegis of Minister of Finance Delfim Netto, the National Monetary Council increased its membership to include members from the private industrial and financial sectors.⁷⁵ In other words, the military government established an explicit policy to include the private financial sector in the decision making apparatus for monetary policy. This became a crucial decision making arena where negotiations between private interests and the government took place. Maxfield also argues that the formation of a banker's coalition at the center of relations between domestic financial institutions and federal government agencies is critical for understanding the policies adopted by large developing countries such as Mexico and Brazil. From this perspective, the relations between a select number of large private domestic banks and government monetary, credit, banking, and finance policies have to with the emergence and consolidation of a coalition between political elites and banks under military rule in Brazil.

⁷⁴ On bank failures and government policies, see: Lundberg, Eduardo. "Saneamento do Sistema Financeiro – A Experiência Brasileira dos Últimos 25 Anos." Central Bank of Brazil, Memo, 2005

⁷⁵ Barker, W. J. *Banks and Industry in Contemporary Brazil; Their Organization, Relationship and Leaders*, Yale University: 1990.

The shift away from orthodoxy was embodied in the new directives of economic policy in the Program of Strategy and Development (Programa de Estratégia e Desenvolvimento PED, 1967) that sought to both spur development and control inflation. Credit policy targeted consumer durables and real estate. To stimulate internal demand and recovery, the government channeled foreign capital flows by investing heavily in infrastructure through state owned enterprises, while industrial policy subsidized private sector investments and projects. Direct foreign investment also accelerated economic growth. In December 1974, President Geisel launched the Programa Nacional de Desenvolvimento (National Development Program, PND II). This plan contained ambitious goals for GDP growth (averaging 10 percent per year), with priority toward heavy industry, and capital goods in an attempt to complete import substitution industrialization. As a complementary measure, imports were made more expensive by tariffs and financial policies. The public sector focused on long-term investments such as infrastructure, oil exploration, and hydroelectric dams. The PNDII was based on the assumption that financial changes would make targets feasible. In this respect, foreign finance became an attractive, given the shallow domestic credit market and high liquidity with cheap money.

Further reforms during the 1960s that sought to deepen private domestic credit markets also produced unexpected consequences. In 1965/66⁷⁶ private investment banks were created with the aim of providing long-term credit. State government development banks secured specific regulations by the end of the 1960s.⁷⁷ The BNDE consolidated its activity as the main agent for government investments and source of special lines of credit to the private sector via intermediary banks and BNDE subsidiaries. The great majority of long-term credit came from the BNDE. In 1965, the Law of Capital Markets Lei de Mercado de Capitais (Law n°. 4.728, 14 July 1965) also attempted to deepen capital markets and provide longer-term financing. Bond issues did indeed become important during the 1970s, but neither bonds nor equity markets became central for public or private finance. Instead, the collapse of the stock market in 1971 and the emergence of secondary markets for short term government paper indexed against inflation reinforced both the

⁷⁶ Law n° 4728, 14 July 1965 and Resolution n° 18 of the Central Bank, 18 February 1966.

⁷⁷ Teixeira (1978): Resolution n° 93, 25 June 1968, Resolution n° 119, 16 July 1969 and Circular n° 128, 16 July 1969 – this legislation was altered in 1976.

bank-centered character of the Brazilian financial system and the Banco do Brasil as largest domestic financial institution.

The reforms of the mid-1960s did indeed lead to the dramatic increase of financial sector in Brazilian political economy. However, instead of indicating financial development, this trend indicates the indexation of assets against inflation and the increasing importance of short-term government paper. According to Zini, the percentage of financial investment / GDP increases from approximately 25 percent in 1955 to 44 percent in 1975. Paradoxically, the market share of government banks increases during this period, suggesting a greater role of the state in the allocation of resources under military rule. This involvement of the state is particularly marked in terms of directed credits, public lending for long-term investments, and a significant increase in domestic government paper indexed against inflation and widely traded in a new open market. The open market for government paper indexed against inflation involved a variety of operations across financial institutions, companies, and individuals that involved private and public paper indexed against inflation and liquid in the sense of changeable into currency.

This development is of critical importance for the politics of monetary policy under military rule. The Central Bank increasingly used this open market to implement monetary policy: By selling bonds it would withdraw means of payment from circulation, reduce liquidity, and increase interest rates. The Central Bank, Treasury, and federal government banks remained the largest participants in this market for short-term government bonds. Since the creation of government paper indexed against inflation during the 1970s (ORTN & LTN), this open market became a focal point for Brazilian political economy.

These financial developments were also critical because tax receipts declined and expenditures on subsidies and transfers increased during this period.⁷⁸ Loans thereby became the main source of revenue for the public sector. Under military rule, both foreign capital inflows and the domestic market for government paper increased substantially during this period. Conceição Tavares argues that this implied a shift away from government bank lending, at least while capital flowed from abroad:

⁷⁸ FUNDAP op. cit.

"In the boom, of 1970 to 1973, the Banco do Brasil and BNDE markedly decreased the rhythm of their loans, since the relative demand by public funds for investment dropped considerably. The private sector, in the full euphoria of the boom, received considerable profits; the rates of self-financing of large companies grew and even small and medium firms found themselves in enviably lucrative positions with easy credit from the private banking sector. (...) The period 1970-73 was the only one, in the post-war period, in which there was a joint sense of euphoria across all segments of private capital: national and international, large and small, agricultural, industrial, and mercantile."⁷⁹

However, once rates of growth began to fall, the tendency inverted. The government intervened to stop a cyclical downturn in the economy, especially using the BNDE to maintain the level of investments in heavy industry. The scarcity of credit became increasingly marked after 1975, as a consequence of the contractionary monetary policy to combat inflation, as well due to speculation in government bond markets.

Indexed government paper thereby became increasingly utilized in public and private transactions as well as in secondary markets. Once negotiated in the primary market, public bonds could be resold in a secondary market. The excessive circulation of these bonds led the real liquidity of the economy to become distanced from the financial liquidity in force in the market. Faced with this separation, it became necessary to issue currency for the liquidation of the papers. The core problem of monetary policy became the relationship between these two spheres of money. While prices in secondary markets for government paper increased, the *de jure* currency, outside of the financial sphere, continued to lose value. Credit thereby became scarcer and more expensive. In response to the growth of government paper indexed against inflation as *de facto* currency during this period, theories of inertial inflation and heterodox policy proposals for the reduction of inflation emerged among economists.

Conclusions about the Politics of Monetary Policy, 1964-1985

From 1964-1985, the politics of monetary policy provide a compelling example of unexpected consequences of orthodox reforms. Although the Government Economic

⁷⁹ Tavares op. cit. p.121

Action Plan (PAEG) and agreement between the military government and International Monetary Fund exemplify the ascendance of orthodoxy, the details of institutional design and state-centered trends after 1967 suggest substantial divergence from traditional institutions of central banking and monetary policy. Instead of stock market-centered financial system and economy driven by private investments, several loopholes of reforms and an unprecedented period of foreign capital inflows produced a period of state-led development under increasingly hard-line military rule. The declaration of moratorium on foreign debt payments by Mexico in August 1982 marked the beginning of the end of this cycle of strong economic growth underwritten by the government and foreign investment. Indeed, the dual foreign debt and fiscal crises persisted throughout the 1980s in Brazil. This report turns to the politics of monetary policy during the sequence of heterodox anti-inflation policies after 1985 that marked the transition from military rule to democracy.

The politics of monetary policy in the wake of fiscal and foreign debt crisis during the 1980s also involved the peculiar characteristics of transition from military rule in Brazil. The consequences of the protracted transition from military rule in Brazil have been widely noted by comparative politics scholars.⁸⁰ In terms of government credit, finance, and monetary policies, the unprecedented coexistence of directly elected governors and military control of the presidency from 1982-1985 produced a further series of irrationalities and unorthodoxies. Upon taking office in January 1983, the new governors of many states realized that state government banks retained independent policy prerogatives in terms of finance, credit, and money management. Given the political stalemate between federal military government and newly elected governors, the political economy of transition focused on state government autonomy over fiscal, monetary, and credit policies. State governments became central motors of debt, moral hazard, and lack of control over money management.⁸¹

Recognition of institutional dysfunctions and policy proposals emerged gradually within the specialized agencies of the federal government. The National Monetary Council commissioned studies and the preparation of reforms, encouraged by international financial

⁸⁰ Hagopian, 1996; Mainwaring, 1999

⁸¹ On governors during the transition to democracy, see: Abrucio, Fernando. *Os Barões da Federação*, op.cit., (1998) and Abrucio, F. and Samuels, D. 'The New Politics of the Governors: Subnational Politics and the

institutions aghast at government accounts and accounting procedures and deeply concerned about the cost of foreign debt and fiscal deficits under inflation that breached 100 percent per year in 1982. Nóbrega & Loyola report that National Monetary Council reforms toward rationalizing government accounts, closing the movement account, eliminating rural lending by the Central Bank, and reinforcing the independence of the central bank were overturned by the courts in 1984. However, once again, a veto coalition centered in the Banco do Brasil was able to suspend monetary and fiscal reforms during the period of transition from military rule. Instead of the gradual implementation of fiscal and financial reforms, the politics of monetary policy in Brazil came to be determined by the sequence of heterodox anti-inflation packages from 1986-1993 that sought to unify markets for government paper and *de jure* currencies.

The Politics of Monetary Policy after Transition from Military Rule: The Last Dance Syndrome, 1985-1993

The politics of monetary policy after transition from military rule changed given the profound impact of heterodox anti-inflation packages in 1986, 1987, 1989, 1990, and 1992 and the gradual centripetal pull of federal government monetary authorities over state and municipal government policies that ballooned public debt. This complex dual track of dramatic anti-inflation packages and gradual institutional reforms defines the politics and monetary policy until the Real Plan stabilized prices in 1993. During this final period under study in this report, central banking and the politics of money, credit, and banking have to do with repeated attempts by teams of economic policy makers to coordinate price and wage freezes designed to shock inflationary expectations. Officials at the Central Bank of Brazil, Ministry of Finance, and other economic policy making ministries consequently attempted to coordinate policies under rapidly changing circumstances. Until the stabilization of prices under the Real Plan in 1993, the politics of monetary policy remained that of creatively coordinating policy among small teams of economists reporting directly to presidents that staked their prestige on bringing and keeping inflation down.

[Brazilian Transition to Democracy,' *Comparative Politics*, 1997; Samuels and Abrucio \(1997\), and Kugelmas and Sola, 2002, \[op.cit.9\]\(#\)](#)

The sequence of economic packages designed to reduce inflation and stabilize the economy defined this period after transition from military rule. The Cruzado Plan (1986) under President José Sarney replaced the cruzeiro with the cruzado as currency, froze prices and wages, ended monetary correction of government paper, introduced unemployment insurance and a wage trigger to protect salaries, and declared a moratorium suspending payment of foreign debt. The political and economic consequences of the Cruzado Plan have been analyzed from a variety of perspectives by those involved in government policy and diverse social science disciplines.⁸² From the perspective of this report, the Cruzado Plan inaugurated a period of rapid and complex experimentation with heterodox policies that, temporarily, both reduced inflation and substantially increased economic growth, especially in terms of real income gains among salary and wage earners after price freezes eliminated the rapid erosion of income under high inflation and, simultaneously, reduced the gains of asset holders indexed against inflation. The strong growth experience in the months following the Cruzado Plan transformed the 1986 national elections (lacking direct presidential elections to be held in 1989) into a strong plebiscitary vote in favor of President Sarney and the PMDB that won 22 of 23 governorships and increased its share of state and federal assemblies.

The technical mistakes and political disappointments associated with the unraveling of the wage freeze under price triggers despite the target of zero inflation set in the Cruzado Plan led, in 1987, to the Bresser Plan attempting to salvage anti-inflation policy and stabilize the economy.⁸³ The Bresser Plan attempted to maintain the price and wage freeze and moratorium while eliminating the trigger that automatically adjusted salaries. Finance Minister Luiz Carlos Bresser Pereira argues that the technical faults of the plan paled in comparison to the lack of political support for further fiscal policies and renegotiation of foreign debt: “The lack of political support for my economic program was clearly the central problem.”⁸⁴ Given the predominance of national developmentalism in the PMDB, given the opposition of organized labor to the elimination of the wage trigger clause, and

⁸² See interviews of policy makers in Rego, J.M. & Mantega, G. eds. *Conversas com Economistas Brasileiras*. São Paulo, Editora 34: 2000 and Belluzzo, Luiz G. & Almeida, Júlio G. *Depois da Queda: A Economia brasileira da crise da dívida aos impasses do Real*. Rio de Janeiro: Civilização Brasileira, 2002, Bresser Pereria, Luiz Carlos. *Economia Brasileira: Uma Introdução Crítica*. São Paulo: Editora 34, 1997 (3rd edition)

⁸³ On the Bresser Plan, see: Bresser Pereira, Luiz C. “Estabilização em um ambiente adverso: a experiência brasileira de 1987.” *Revista de Economia Política*. Vol. 13 no. 4 (52), Oct./Dec. 1993, pp. 1636

given the centrist coalition of President Sarney and business leaders opposed to fiscal and foreign debt policies at the center of the Bresser Plan led to the resignation of Bresser Pereira on 20 December 1987.

In 1989, months before the end of the Sarney administration, the Summer Plan (Plano Verão) declared another price and wage freeze, while attempting to impose fiscal discipline and set an agenda for the privatization of state owned enterprises and the elimination of indexation clauses in government paper and private contracts. Once again, politics undercut the implementation of policies, given that the first direct elections for president in October 1989 reduced the ability and interest of President Sarney to sustain policies and public opinion in favor of anti-inflation policies. President Collor reasserted executive authority and shocked investors on 16 March 1990 (the day after inauguration) with another package of policies designed to reduce inflation, lower the government deficit, liberalize trade, and modernize the economy. Despite his party's controlling only five percent of the Federal Chamber upon inauguration, President Collor confiscated an estimated 80 percent of Brazil's liquid financial assets. Indeed, the Collor administration achieved many of its short-term economic policy goals, producing government surpluses, reducing interest rates, extending the terms for government paper, and stabilizing the exchange rate. Meanwhile, markets and the political opposition remained dazed as the new administration received support from the media and public (confiscated savings were returned), and faced surprisingly little opposition from congress and governors, many of whom appeared more concerned with organizing for the 1990 elections than national policies at the end of their term. The Collor Plan thereby deepened monetary disorder, produced a recession, and damaged confidence in the banking system.

The complex interaction between economic policies and politics during this sequence of economic packages will requires further study. However, the politics of monetary policy appear to involve the shift away from the consensus among policy makers that price and wage freezes were required to shock inflationary expectations and surprise markets to succeed. Although beyond the scope of this report, the subsequent success of the Real Plan in securing price stability after 1993 appears to involve a fundamentally different approach involving the gradual implementation of measures, a more transparent policy

⁸⁴ *ibid*, p. 33 (author's translation).

making style, and a more permanent political coalition.⁸⁵ This implies a shift among economists and policy makers away from the idea that plans need shock to work to the idea that gradual implementation respects contracts, avoids disequilibria, and permits the maintenance of political support for anti-inflation policies.

From 1986-1993 a series of more gradual institutional (and constitutional) developments occurred alongside the more dramatic efforts of monetary authorities to accompany the volatile impacts of anti-inflation policy packages and their consequences on prices, wages, government accounts, the money supply, credit, and banks. This dual trajectory of monetary and financial policies can be reconstructed, in retrospect, by comparing the gradual institutional changes and legal framework for central banking and financial policies, alongside the sequence of seven anti-inflation packages and several intermediate measures designed to reinforce these plans. This final section of the report provides a brief overview of this dual trajectory of dramatic economic packages and gradual institutional reforms.

In terms of gradual institutional development, measures during 1986, the 1988 constitution, and a variety of regulations that accompanies anti-inflation packages sought to abolish the unorthodox prerogatives and financial loopholes inherited from the period of military rule. In 1986, the Banco do Brasil lost prerogative to balance accounts through the movement account. Development and agricultural lending was also transferred from the Central Bank of Brazil to Treasury while the 1988 Constitution prohibited further lending directly from Treasury. This redefinition of policy prerogatives reflects a broader process of the separation of powers during and after the transition from military government. Instead of the centralization of policies and politics in select economic superministries during military rule, policy making increasingly became delegated to specialized agencies responsible for management of the money supply and bank supervision while subsidized and directed credit, fiscal policy, and development programs were delegated to other federal government ministries and agencies. Indeed, Nóbrega & Loyola note that measures designed to create institutional advances were inserted into policy packages:

⁸⁵ On the political dynamics of the Real Plan, see: Mettenheim, Kurt von. "Observations on the Brazilian presidency, democracy, and governance." *Revista de Administração de Empresas*, Vol 39, no. 3, Jul/Set. 1999, pp. 53-72

"During the Cruzado and Bresser plans, there was a list of legal changes prepared by the staff of the Central Bank to improve the performance of the institution and financial markets. The majority of the changes were introduced in legislation associated with the plans, although they were not directly related to the stabilization process. This technique became known within the Central Bank as 'smuggling'.

Reforms also eliminated the separate monetary budget while management of public debt was transferred from the central bank to the Ministry of Finance. Thereafter, the Finance Ministry was required to seek congressional approval for issue of government debt.

In 1988, a Single Account (Conta Única) of the Treasury at the Central Bank also attempted to control the movement of resources between federal banks and the National Treasury. This was carried out by the substitution of the movement account of the government at the Banco do Brasil, by the. The Single Account eliminated more than five thousand government bank accounts, permitting a more efficient control of the flow of deposits of the government. The National Treasury also assumed administration of activities related to the Programs of Support for Agriculture and Exports, transferred from the Central Bank, as well as the management of the portfolio of problematic housing loans from the period of military rule.

However important these gradual improvements of monetary policy and central banking practices were, they also coincided with the escalation of inertial inflation and the emergence of a peculiar type of politics described by Sola & Kugelmas as brinksmanship.⁸⁶ Indeed, the impact of the foreign debt and fiscal crises during the 1980s on the politics of economic policy has been treated from a variety of perspectives. For most observers, the persistence of high inflation during the latter 1980s and early 1990s placed Brazil on an explosive path that brought the country repeatedly to the brink of hyperinflation.⁸⁷

The experiences with anti-inflation policies during the 1980s also cemented support for liberalization policies for perhaps the first time in the history of Brazilian economic policy making during the 20th century. In 1987, the National Securities Commission

⁸⁶ On brinksmanship, see: Sola & Kugelmas, in Sola & Whitehead...

⁸⁷ On the political economy of high and hyperinflation in Latin America, see: Fanelli J.M. Frenkel R. & Rozenwurcel, G., 'Growth and Structural Reform in Latin America: Where We Stand' in Smith, W.C, Acuña,

introduced the first of a series of measures designed to open Brazilian financial markets to foreign investors.⁸⁸ In 1991 tax exemption was granted to foreign investment in domestic capital markets and privatization funds were opened to foreign investors, while in 1992 Brazilian firms were authorized to float shares abroad (American depositary receipts). Although important indications of the type of policies to be pursued after price stability in 1994, the increasing economic instability during the latter 1980s and early 1990s undercut the potential contribution of reforms in domestic banking and monetary policy.

Sola and Marques also argue that the Central Bank of Brazil exerted control over state banks in an incremental process that tightened with each successive state banking crisis. Furthermore, these periodic crises were induced both by the political use of such banks at the time of elections and by the various, and inevitably failed, stabilization programs which temporarily ended inflation. Each state banking crisis has coincided with the electoral calendar (1982, 1986, and 1990) and stabilization plans (1986, 1989-90).⁸⁹ Sola & Marques emphasize four financial channels involving state government banks: 1) direct loans to state governments, 2) finance of state owned enterprises, 3) holding of state government bonds not absorbed by financial markets, and 4) extending Revenue Anticipation Grants (*Antecipação de Receita Orçamentária*). For Sola & Marques, the rounds of state and municipal government debt rescheduling during the 1980s and early 1990s reflect a gradual assertion of monetary authority on the part of the federal government and the reduction of the autonomy of state governments. For example, following the state bank crisis of 1987, the central bank (Decree 2321) gained the ability to assume temporary control over insolvent state banks and introduced legal accountability of state administrators for banking abuses. While state banks placed under federal intervention in 1987 were eventually returned to their respective state governments with no significant judicial action taken against their managers, the Central Bank gained a new tool to

C.H. & Gamarra, E.A (orgs.) *Latin American Political Economy in the Age of Neoliberal Reform*, Miami: North South Center, 1994, and Giambiagi, F., *Finanças Públicas*, Rio de Janeiro: Campus 1999

⁸⁸ Resolution 1289, 1987

⁸⁹ [Loyola, Gustavo J.L. "Os bancos públicos estaduais." Brasília: Banco Central, 1992; Andrade, E.C. Os bancos comerciais estaduais no Brasil: do final dos anos 1960 à crise dos anos 1980. Master's Thesis, Rio de Janeiro: PUC, 1992. Eduardo de Carvalho Andrade, 1992. "Os Bancos Comerciais Estaduais no Brasil: do final dos anos sessenta à crise dos anos oitenta" Master's Thesis, PUC RJ., Paes, *op.cit. op.cit.*; See also, Francisco Lopreato, F.L. *Crise de Financiamento dos Governos Estaduais \(1980/88\)*. Doctoral Dissertation, Campinas: IE/Unicamp, 1992. F. " 'Crise e Financiamento dos Governos Estaduais 1980-1988,' Campinas: IE/Unicamp](#)

discipline state banks. Sola and Marques argue that the following state government financial crises in the early 1990s placed further limits on state banks and state government finances: In 1990 the National Monetary Council imposed new limits on state bank loans to the public sector. In 1992, legislation to hold administrators in state enterprises were also increased and the Senate further limited the ability of subnational governments to contract new debt.⁹⁰

The Banco do Brasil, 1985-1993

Once again, the importance of the Banco do Brasil requires separate, albeit brief consideration of this financial institution in the politics of monetary policy during the 1985-1993 period. The trajectory of the Banco do Brasil from 1985-1993 involves a series of substantial reforms that delegated specialized matters of monetary policy to the Central Bank of Brasil and Treasury while reforming bank policies in the direction of commercial banking. The Banco do Brasil shifted policies away from directed credit to market-based lending, and commercial and investment banking operations. This separation of monetary policy from banking is an example of the broader process of the separation and specialization of government policies during democratization. In 1986, important changes were introduced in the relationship of the Banco do Brasil with the Central Bank and the National Treasury. On 30 January 1986, a 45/86 vote, led to freezing of the movement account (*conta movimento*), that the Central Bank had with the Banco do Brasil to carry out the operations of interest of the federal government, with new operations occurring inside the system of prior supply of resources. The movement account (*conta movimento*) meant that the BB had co-responsibility for currency issue via the adjustment of the accounts of the monetary authorities and of the National Treasury. In the new system, the Bank lost the resources originating in the flow of the deposit of the budget of the Treasury and it became necessary to capture in the market the resources destined for rural credit. This elevated the risks of the action of the BB, especially regarding agricultural operations. In return, it was authorized to practice all the operations permitted to financial institutions.

In 1986, the Banco do Brasil also created a distributor of real estate bonds and shares (*valores*). In that year, the BB needed to cover the operations of rural credit with its

⁹⁰ Sola & Marques, *op. cit.*

own resources, as it was faced with the impossibility of the Treasury providing resources. Difficulties, such as this one faced by the Treasury, became quite frequent in this decade characterized by the crisis of the State. In the year of the Cruzado, the Banco do Brasil succeeded in recovering the presence in the market that it had lost during the crisis of the previous years. By the expansion of its operations and by the re-ordering of the commercial banks in the new monetary situation, the bank moved from a participation of 7.5 percent of loans in the national financial system in March 1985 to 14.8 percent at the end of the first semester of 1986. This was a position that, in general terms, would be maintained in the following years. In the same year, of the total loans, 40 percent were financed by internal resources and by capture in the market. Agriculture received 37 percent of the investment, industry 9 percent, commerce and service industries 27 percent and the public sector, including state-owned enterprises, 27 percent. Loans to states and municipalities were carried out with resources of the National Treasury. As with private financial institutions, during short periods of falling inflation, inflationary gains decreased and it was necessary to implement administrative reforms and a rationalization of activities. Even so, the number of service units at the end of 1989 was 4449, including 2377 agencies.

From 1987, the Banco do Brasil deepened its aims in the direction of expanding space in the financial sector, inaugurating non-banking activities such as financier, a leasing company, an administrator of credit cards. Furthermore, it created a savings book (Savings Gold Poupança Ouro), to be able to direct resources towards rural credit, replacing the support of the Treasury. In 1989, diversification of activities led to the creation of the investment bank of the BB. These reforms within the Banco do Brasil reinforced trends since the 1960s in terms of separating specialized matters of monetary policy from commercial and investment banking at this federal government bank. The Banco do Brasil thus ceded agencies and prerogatives for management of domestic money, credit, and finance to the Central Bank of Brazil and Treasury while implementing reforms called for in 1988 Basle Accord to improve the transparency and accountability of banks. This shift away from monetary policy toward commercial and investment banking and market criteria in lending consolidated the Banco do Brasil as the largest domestic bank, but severed the link between federal government credit policies and lending decisions.

Conclusions about the Politics of Monetary Policy, 1985-1993

In sum, the politics of monetary policy from 1985-1993 have to do with the dramatic impact of heterodox anti-inflation packages that temporarily froze prices and wages, briefly increasing real wages and eliminating losses of non-indexed asset holders and wage earners. This powerful electoral cycle set in place a sequence of attempts to end inflation and sustain political coalitions. Another trend in the politics of monetary policy from 1985-1993 has been described as a last dance syndrome whereby political coalitions in states and municipalities abused state government banks and enterprises in the expectation that central government would assume debts and reverse monetary impact of excessive credit and money expansion. This last dance syndrome increased domestic government debt dramatically and led to the privatization of state government banks during the 1990s. Finally, gradual institutional reforms were pursued during this period, often accompanying the more dramatic anti-inflation packages. Thus, the politics of monetary policy from 1985-1993 involves complex interactions between a sequence of heterodox shocks designed to reduce inertial inflation, a centrifugal pull against central bank and federal government monetary authority, and, nonetheless, gradual reforms of financial and monetary policy in terms of the specialization and separation of powers and policies.

Conclusion

This report explores the trajectory of politics, policies, and institutions from 1930-1993 to better capture the relations between politics and monetary policies in Brazil. Review of primary and secondary sources suggests a particular causal trajectory and configuration of policies. First, the inward oriented policies after the 1930 revolution generated a period of domestic mobilization of savings, capital, and investment that created several enduring aspects of the Brazilian banking and financial system. Second, the period of competitive electoral politics from 1945-1964 produced a series of increasingly unsustainable macroeconomic policies described succinctly by Dornbusch as the macroeconomics of populism. Third, monetary, financial, and banking reforms after military intervention in 1964 produced unexpected consequences. Instead of generating a more open liberal market economy and private banking, reforms from 1964-1967 produced a period of state-led growth funded by foreign capital inflows. The impact of financial

repression under military government whereby subsidized credit and government policies crowded out market forces are far from the experiences with neo-liberal policies under military government among Brazil's neighbors during the 1970s.

Fourth, from 1982-1993, foreign debt and fiscal crises severely constrained Brazilian government financial policies. Furthermore, the protracted transition from military rule produced a perverse political cycle we describe as a "last dance syndrome" that exacerbated already severe disequilibria in terms of domestic money, credit, and finance. In sum, rather than a consequence of democracy, the bankrupting of state government banks regional political elites and the loss of control over credit, money, and spending occurred during the political void of transition from military rule. Traditional regional elites recast their political machines during this decade of protracted transition and usurped central government prerogatives over monetary policy.

This report reviews the trajectory of politics and monetary policy from 1930-1993 to set the context for analysis of the Real Plan and subsequent developments to be pursued in further research. This particular sequence suggests that the specific configurations of politics and policymaking during the 1990s are an example of statecraft; that is the exercise of policymaking and the creation of new political coalitions that sustain new policies.

In general terms, this sequence from 1930-1993 suggests both the incremental institutional advances behind the construction of monetary authority in Brazil and the importance of critical junctures in the recasting of broader relations between domestic financial institutions and government. An important feature of the politics of monetary policy has to do with the veto coalition against orthodox policies centered in the Banco do Brasil for much of the 20th century. Nóbrega and Loyola argue that the "Banco do Brasil was the most important state run organization in Brazil" given its monopoly or predominant market share and/or control of policies and funds for credit, finance, foreign exchange, trade, industry, agriculture, and prerogative to print money and rediscount to banks. The monolithic role of the Banco do Brasil produced strong returns at the bank and reinforced developmentalist ideas and favor of state-led development.

The broader conclusions about the politics of monetary policy thus reinforce the core ideas in the literature on comparative political economy we summarize in the concept of financial statecraft; that the construction of monetary authority involves a path dependent

sequence and particular domestic configuration of markets and institutions, as well as the reconciliation of a variety of tensions and feedback relations between financial markets, government policies, organized interest groups, and epistemic communities. This report has reviewed primary and secondary materials in an attempt to summarize the particular path of Brazilian monetary policy and the political and social context that determined events. In this respect, the report attempts to follow Kindleberger's core conclusion about the history of finance in Western Europe: That social and political forces shape financial development.

In this respect, recent developments suggest a gradual separation and specialization of institutions responsible for monetary policies in the federal government. If one takes as point of departure the late 1980s and early 1990s, then the institutional trajectory of central banking in Brazil is clearly one that shifts from a core nucleus of economists responsible for adapting policies to the dramatic economic flux during high inflation and the severe consequences of economic packages. Although beyond the period under study in this report, the purpose of focusing on events from 1930-1993 is to better understand developments since price stability in 1994. Even before 1994, the trend toward specialization, differentiation, and the separation of power and prerogatives is unmistakable. Instead of centralizing a variety of decisions and reacting to dramatic change by attempting to coordinate monetary, fiscal, tax, and finance policies, government officials increasingly delegated decisions to specialized departments able to monitor markets, regulate banks, and anticipate crises rather than react to events.

This specialization and differentiation of monetary policy authorities in Brazil suggests the gradual process of statecraft and the importance of the separation of powers in Brazilian democracy. Scholars of Brazilian political institutions have emphasized the simultaneous empowerment of legislative, judiciary, and executive since the 1988 Constitution. This report suggests that, not only congressional oversight, judicial review, and contested policy debates, but also executive capacity and the emergence of an epistemic community of monetary policy specialists are all essential aspects of development and democratization. Review of the politics of monetary policy from 1930-1993 suggests an increasingly complex interaction between increasingly separate and specialized agencies and the branches of federal government. The politics of monetary

policy from 1930-1993 in Brazil thereby confirm Kindleberger's conclusion that politics shapes financial development.

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