Lecture 2
Stagflation and Hyperinflation

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Last class I talked about what Latin American economists and political leaders thought back in the mid 80's. Before going into today's subject, I would like to mention the article entitled "Market Reforms" by Javier Corrales. When I read it, I was impressed by its clarity and precision. Javier Corrales, by the way, is a young Professor at Amherst College, who received a PhD in Political Sciences from Harvard University.

Corrales synthesizes the state of the economy before the reforms using the expression "Increasing Statism, Declining Stateness" and characterizes the reforms as "More Markets as a Recipe for More Stateness." I strongly suggest that you read the article thoroughly because it will be a very useful reference throughout the course.

Accelerating Inflation: the clearest manifestation of declining "Stateness"

Inflation, a phenomenon that in most Latin American countries evolved into stagflation and in some cases into hyperinflation, has been the most obvious expression of the lack of capacity of the state to manage the economy. That is, the lack of "Stateness" using Corrales' terms.

To a greater or lesser extent, until the 80s almost all economies in Latin America suffered persistent inflation. Every time they tried to stop it, inflation reappeared even stronger.

In the 1950s and 1960s the Keynesians and the Structuralists understood inflation as a consequence of the adjustment of relative prices in a context where nominal prices and wages were downward inflexible.

Notwithstanding, in the 1970s and 1980s the economic thinking started to change. Economists started to blame the fiscal deficits and the distributive tensions in the economy as the main cause of persistent and accelerating inflation.

Fiscal Deficits

By that time, Latin American economies faced two kinds of abnormalities. On the one hand, economies in Latin America functioned in such a way that expenditures and investments that in a normal economy are undertaken by the private sector became the responsibility of the government and were included in the Budget. On the other hand, the Government was unable to collect the necessary taxes to pay for the increased spending.

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To make matters worse, the tax system grew more and more complex including taxes at the same time very discriminatory and difficult to administer.

The consequence of this double problem was increased budget deficits, which in turn tested the capacity of the state to finance them whether through tax collection or raising debt. When the tax collection proved to be unable to fund all this spending, and governments were also unable to raise more debt, monetary emission was the answer.

Printing money is a subtle way to collect a not-approved-by-law tax, the inflation tax. "Socialism without a Plan" does not find another way to fund its disequilibria than imposing a tax on people's monetary holdings, including savings and wages.

Distributive tensions

Lack of competition in markets and government intervention on a case-by-case basis deciding the level of the most important prices in the economy, such as wages, rates of public services and the rate of exchange cause intense distributive tension in the economy. When one sector's income lags behind, the Government tries to compensate this lag granting subsidized credit, which in turn is also funded by printing money.

Furthermore, inflation is higher not only due to the printing of money but also due to abrupt devaluations of the currency. Usually, a fix exchange rate accompanied by fiscal and monetary expansion ends in an abrupt devaluation. The inflationary tax ends up being the main source of financing for private sector disequilibria when the economy operates as "Capitalism without a Market." This was the case in Latin America in those years.

Increasing indebtedness

There are, and there were in those years, also periods when, due to special circumstances credit is abundant. In such moments, fiscal disequilibria and private sector financial needs get satisfied via increasing debt. Then, economies can avoid printing money, at least for a while. Nonetheless, when the distributive tension between debtors and creditors gets unleashed, inflation reappears as a means to reduce the value of monetary assets and debts causing a massive transference of wealth from creditors to debtors.

Consequences of inflation

Inflation not only causes arbitrary redistribution of income and wealth, but also discourages voluntary savings and financial investment within the countries' borders.

When inflation turns erratic and hyperinflation looms, governments are totally unable to handle not only the public budget but also the relative prices. None of the usual economic tools bring about the outcome sought by the authorities. Hyperinflation is the most dramatic expression of the incapacity of the State to govern the economy. It means that "Stateness" evanishes.

Persistent and erratic high inflation hinders the economic performance because it negatively affects investment and the productivity of factors of production. Therefore, in Latin America the usual outcome is not a combination of economic expansion and accelerating inflation, as it is very commonly the case in mature economies. On the contrary, the phenomenon that dramatically spread across the region at that time was the so-called "stagflation", which is the combination of recession and inflation at the same time.

The strategy to defeat hyperinflation: a complete overhaul of the "Rules of the Game"

In the presence of Stagflation and Hyperinflation, every leader in Latin America was convinced that that it was necessary to introduce deep economic reforms. Economists who advised political leaders thought of a set of reforms that would seek to reorganize the economies by enhancing the functioning of the markets via the introduction of competition and by improving the capacity of the State to govern the economy via fiscal equilibrium and transparency. This is how, in my view, the reforms of the 1990s were born. Not in Washington, but rather in the capital cities of each and every country in Latin America overwhelmed by stagflation or, worse, immersed in hyperinflationary chaos.

Bolivia: the first democratic country to implement a complete reform

Bolivia's case is a clear example of what I am describing. Hyperinflation exploded in 1985 when former President Hernán Siles Suazo was about to end his term in office. By that time, Washington did not have a clue regarding how to approach the debt trap Latin American countries were experiencing. Victor Paz Estenssoro's Administration, which had Gonzalo Sanchez de Lozada as its Minister of Planning, decided to implement a set of economic reforms that stabilized the Bolivian Economy once and for all.

Four years later, in a conference in which John Williamson coined the term "Washington Consensus", Juan Cariaga, who had been Minister of Finance during Victor Paz Estenssoro's Administration, gave the following speech. I assume that he said these words in order not to make feel uncomfortable the person who had organized the meeting.

"Although introduced in an emergency basis, the Bolivian adjustment program led, however inadvertently, to the implementation of what might be called, following John Williamson, the Washington Consensus".

The quote is taken from the chapter 3 of the book <u>Latin American Adjustment: How much has happened</u>, edited by John Williamson in 1989.

Bolivia was the first country to successfully fight hyperinflation with a plan decided and implemented by a democratic regime. Chile in the mid-70s had implemented an economic reform along the same lines of what Bolivians did in the 1980s but back then it had still a military regime. Chile had sought to stop the Stagflation process unleashed by Salvador Allende's socialist experiment. At the time Chile launched its reform package Washington had not achieved any consensus regarding how to stop the increasing inflationary process that the American economy itself had started to suffer in the 1970s.

Of course, at that time and in that context, officials at multilateral institutions in Washington had not come up yet with the idea of developing a recipe for economic reform in Latin America.