Inflation: Are We Next?

Hyperinflation and Solutions in Argentina Brazil, and Israel

edited by
Pamela S. Falk

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Mr. Herbert M. Singer

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Foreword

Herbert M. Singer

Inflation has had a powerful effect on the course of history. The decline of great empires has been triggered by this economic disfunction. Some historians argue that inflation is the *effect* of factors underlying the fall of a world power. Others argue with great effectiveness that it is the *cause.*

It is generally agreed however, that it is part of a syndrome of economic disease. This study examines three cases of inflation where the nations involved have taken dramatic steps to counteract rampant inflation. Certain aspects of the anti-inflation efforts of these nations have been successful, some have failed. Some have been tolerable to the public, some have been subject to dangerous discontent. Let us hope that these three case histories may give guidance in coping with rampant inflation should it occur on a more global level. It is my hope that this project can throw some important light on the problem of inflation, which not only confronts Third World countries but threatens to engulf the total global economy of the world, including the major industrial powers.

It is important to know what can be done to curb this destructive trend in a nation's economy and its cost to government, to social institutions, and to the people. It is essential to know whether such curbing of inflation is merely a palliative or a cure, and whether, in curing inflation, it is necessary to pay the heavy price of economic chaos, loss of personal freedom, and the establishment of autocratic control to deal with this difficult economic disease.

We need to know the limits to which the affected public can sustain the pain and sacrifice of programs seeking to curb inflation and what happens when the public ignores or rebels against anti-inflation curbs and how vital the resolve of governments and the public is in the fight against inflation.

We know that overwhelming debt and unbalanced budgets contribute to runaway inflation. We must learn how to deal with debt, which today engulfs the economy of most nations of the world; and how budgets, both in the public and private sectors, can be brought under control so that credit can be restored and so that trade, vital to buyer and seller, can be restored.

This book brings together the planners, the architects, the implementers,

and the interpreters of comprehensive anti-inflation. Their planning, their experience, their successes, and their failures are profoundly enlightening in diagnosing and seeking to establish relief and, possibly, a cure for the economic disease we call inflation.

Acknowledgments

Inflation is a moving target, and writing and editing a study on the subject requires patience, careful monitoring, and a keen eye for the subtleties of economic theories in each of the different prescriptions for change. All this was done with meticulousness and aplomb by Lynne Rienner Publishers. I want to thank Lynne Rienner for her devotion to and care with the project and Steve Barr, the project editor, for his hard work in coordinating the production of the volume.

All of the contributors to this book are distinguished in their field—several are the policymakers who formulated the programs the book discusses. But even with their busy schedules, all of the authors were a delight to work with. They read and reread the manuscript. I particularly thank David Hale for his synthesis of the different analyses as well as his careful attention to his own research on the applicability to the U.S. economy.

In addition, several sponsors of the project helped make sure that the quality of the research was unparalleled and I thank the Herbert and Nell Singer Foundation—Mr. Herbert Singer in particular—and the Pew Charitable Trusts for their contributions to the work. Generous support was also provided by the Consuls General of Argentina, Brazil, and Israel, particularly Liliana Iribarne of the Argentine Consulate.

Several Columbia University students and staff assisted in the preparation of the project. The school's dean, Alfred C. Stepan, participated in the initial conference. The project would not have taken place without the skill and management of Laura Rich. Gabrielle Brussel sheparded it through its early development, and background research was skillfully completed by Norberto Terrazas, Fernando Sanchez, Lisa Bhansali, Lisa Markowitz, Stephen Gaull, Harry Jeffcoat, and Efrot Weiss.

Inflation has taken a devastating toll on dozens of countries, not only the nations we featured in this project. We hope that this study contributes to the control of this often-misunderstood economic phenomena and that future research continues the analysis.

Pamela S. Falk

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Introduction

Pamela S. Falk

Inflation is the scourge of modern economies. The massive U.S. federal and trade deficits that exist today give rise to the fear that Washington will promote inflation in order to ease the repayment of our national debt. The consequence will be that our purchasing power and, ultimately, our standard of living will be eroded.

Controlling inflation once the spiral upward has begun, however, is enigmatic. A Brazilian finance minister, Mailson Ferreira da Nobrega, once likened it to a tiger running wild in a populated town. The dilemma was how to capture the tiger. You must kill it, he said, for to wound it would only make it angrier.

How have other nations coped in recent years with triple digit inflation, or worse, inflation that reached 1,000 percent to 21,000 percent annually? The three countries of Argentina, Brazil, and Israel present alternate models, but all three have implemented far-reaching stabilization programs and issued new currencies (seven currencies have been used in the three countries during the past decade) to respond to inflation that they could not control.

The economists, political analysts, and finance ministers that have contributed to this book analyze the phenomena of inflation and its economic and political consequences. In all three countries, inflation was considered endemic. In Israel, a dramatic program was introduced in 1985—the Economic Stabilization program—which sought to curb inflation by reducing government intervention in the economy. That program included tax reform, cutbacks of government workers, privatization of state-owned corporations, and a reduction of government participation in capital markets. The author of the program, Foreign Minister Emanuel Sharon, describes in this book its conceptual and practical formulation. And, while the initial effects of the 1985 program were two years of steady economic growth and controlled inflation, the subsequent years were not as kind. By mid-1987, growth began to slow in Israel, and by 1988 economic growth had slowed to

1982 levels. Political consequences increased with the unemployment level, which in 1989 rose to the highest point since 1967.[1]

In Brazil, 1990 witnessed a new "radical" effort by the economic team of President Fernando Collor de Mello to curb hyperinflation by reducing the government direction of the economy and by privatizing large segments of Brazilian industry previously run by the state. The "New Brazil" program took some steps similar to previous programs, but Collor de Mello's plan, announced the day after the new president took office in March 1990, was far more comprehensive. It included a program of frozen wages and a block on withdrawals from all bank accounts of over $1,000 (amounting to almost $80 billion, 25 percent of Brazil's gross domestic product) in an effort to repay Brazil's massive $62 billion debt. The plan included a variety of anti-inflationary measures tailored to Brazil's debt service dilemma. Unlike previous economic programs, this one hit Brazil's middle and upper classes hard, and over a short period of time the popularity of the program dropped precipitously. One poll showed a drop in popular support for the program from 81 percent a few weeks after the program was announced to 54 percent support only two months later.

With the latest program came the costs as well as the benefits. The hasty schedule proposed for the privatization of industry encouraged bankers to swap Brazil's loans at a discounted rate for shares in the new companies. The short-term economic hardship to the economy was devastating: small businesses went bankrupt, the stock market dropped, and almost 400,000 state employees lost their jobs—additionally difficult because the 1988 Brazilian Constitution bars the dismissal of certain categories of civil service positions. Yet, for the lower classes, the price freeze finally allowed families to resume the purchase of basic necessities, after consumer prices had jumped 5,000 percent in the year before Collor de Mello initiated the plan. For the government, the bank swap programs allowed for the reduction of state subsidies and a significant decrease in debt service, since a large segment of the government debt could be retired. The effect was that, in the month immediately following the introduction of the new plan, Brazil's rate of inflation dropped from the previous month's 80 percent to 10 percent. But the long-term prognosis for Brazil's hyperinflation remains unsettled.

In an effort to answer the weightier questions about hyperinflation and its causes, this book does not attempt to monitor daily changes in inflation or evaluate the latest round of inflation-fighting programs in each of the three countries. New programs are introduced quarterly. Rather, the analyses in the book seek to evaluate the twists and turns of inflation in each of the three countries and what has contributed to the upward spiral, as well as to examine the initial "inflation-buster" packages in the three cases and describe the successes and failures of the programs from the points of view of those who drafted them. Explaining the spiral of inflation, one economics

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correspondent comments, "from small price acorns do mighty hyperinflation oaks grow."[3] The added uncertainty, he said, "wreaks havoc on the daily lives of ordinary people," explaining in part why the remedy for hyperinflation, particularly in Latin America, combines a change in the names and looks of currencies along with more substantive changes in economic programs.[4]

Inflation in the United States is more difficult to assess, and economists do not agree on the solutions. James K. Galbraith's recent contribution on the subject suggests that Americans learn to live with inflation—as long as it is not excessive. Some inflation, along with low interest rates and dollar devaluation, might accomplish the principal objective of the U.S. economy: preeminence as a manufacturer and exporter of capital goods. Others caution that, in the United States, the shocks of inflation take far longer than they do elsewhere to be felt after the programs that feed them are put into place. And, there are the optimists who argue that inertial forces are more likely to keep down inflation today than they were during the oil-price shock days of 1974 and 1979: they point to the Federal Reserve Board's and the financial markets' ability to keep interest rates above the inflation rate, thus dampening the economy as needed; also, due to foreign competition, U.S. businesses are less likely than before to be able to pass on rising costs, and they consequently pressure suppliers to keep costs down.[5]

Looking at the overall relationship between inflation and large government deficits, David D. Hale, in Chapter 1, distinguishes the three models of Argentina, Brazil, and Israel and describes their lessons for the United States. The budget deficit and trade account no longer are the major contributors to inflation and the exchange rate, Hale argues. Rather, international capital transfers, which enable both developing nations and large industrial countries to have fiscal deficits while controlling inflation, is the major factor. Thus, the question, "Inflation: Are We Next?" is answered by U.S. domestic and foreign economic policy, including the ability to adjust to changes in international financial markets in Asia and Eastern Europe, as much as the ability to control savings imbalances and fiscal excesses at home.

Notes

1. U.S. Department of Commerce, "Foreign Economic Trends and Their Implications for the United States." International Trade Administration: Washington, D.C., September 1989.
2. Data Folha poll, in James Brooke, "Belt-Tightening in Brazil Brings Anguished Gasps," *The New York Times*, 23 May 1990, p. 1.
3. Peter Passell, "Translation of Inflation," *New York Times*, July 6, 1989, p. 6.

4. Ibid.

5. James K. Galbraith, *Balancing Acts.* New York: Basic Books, 1989.

6. Barry Bosworth cited in Paul Blustein, "The Inflationary Inflation Talk," *The Washington Post* Weekly Edition, September 26–October 2, 1988, p. 23.

1

Why Large Government Deficits Cause Inflation in Latin America But Not the United States

David D. Hale

One of the most interesting features of the world economy during the 1980s was a sharp rise in the inflation rates of most Latin American nations coincident with a decline in the inflation rates of the major industrial nations to their lowest level in nearly two decades (see Table 1.1). In the period 1975–1981, inflation rates averaged 9.2 percent in the United States, 7.1 percent in Japan, 11.2 percent in OECD Europe, and 58.4 percent in Latin America. During the years 1981–1988, inflation rates fell to 4.7 percent in the United States, 1.9 percent in Japan, and 7.8 percent in Europe, but rose to 132 percent in Latin America. Four Latin nations (Brazil, Argentina, Peru, and Nicaragua) had inflation rates of several hundred percent or more, but in the rest of the world there was not a single case of triple-digit inflation. Four other Latin nations also had inflation rates in 1988 between 50 percent and 125 percent—Mexico, Uruguay, Ecuador, and the Dominican Republic.

The remarkable divergence in the inflation performances of the Northern Hemisphere industrial nations and Latin America during the 1980s was not accidental. The disinflation in the industrial countries resulted in part from global economic shocks, which helped set the stage for Latin America's hyperinflation. In 1981/82, a sharp rise in dollar real interest rates and break in commodity prices caused a suspension in bank lending to Latin America, which forced governments in the region to choose between severe fiscal austerity or financing public spending by creating domestic money. The high real interest rates and commodity price depression of the early 1980s also inflicted great damage on other commodity-producing nations, such as Australia, New Zealand, Indonesia, and South Africa; but the Latin nations suffered the greatest adjustment shocks, for two reasons. First, their 1970s borrowing upsurge had not been used to finance productive investment; much of it was instead consumed by a large rise in public consumption or private capital flight. Second, as the economic crisis struck, many Latin nations were embarking upon experiments in democracy after several years of

Table 1.1 World Inflation Rates[a]

	1975–1981	1981–1988	1982	1983	1984	1985	1986	1987	1988
Industrialized countries									
United States	9.2	4.7	6.2	3.2	4.4	3.6	1.9	3.7	4.1
Japan	7.1	1.9	2.7	1.9	2.3	2.0	0.6	0.1	0.7
Germany	4.6	2.6	5.3	3.3	2.4	2.2	–0.2	0.3	1.2
France	11.0	7.1	12.0	9.4	7.7	5.8	2.6	3.3	2.7
United Kingdom	15.4	6.1	8.6	4.6	4.9	6.1	3.4	4.2	5.1
OECD-Europe	11.2	6.8	10.1	7.8	6.9	6.1	3.5	3.5	4.2
OECD-Total	9.9	5.4	7.8	5.3	5.3	4.6	2.7	3.2	3.7
Latin America									
Mexico	21.4	82.0	58.9	101.9	66.5	57.6	86.2	131.8	125.4
Brazil	56.3	212.7	98.0	142.0	196.7	227.0	132.7	217.9	582.0
Argentina	191.6	307.8	165.2	344.2	626.7	672.2	90.1	131.3	328.9
Chile	114.9	20.2	9.9	27.3	19.8	30.7	19.5	19.9	14.7
Colombia	24.7	22.8	24.6	19.8	16.1	24.0	18.9	23.3	28.1
Latin Composite	58.4	132.3	79.1	129.2	157.6	168.3	84.5	129.4	246.7
Other commodity producing nations									
Australia	11.1	8.3	11.1	10.1	4.0	6.8	9.0	8.5	7.2
New Zealand	14.9	12.0	16.2	7.4	6.2	15.4	13.2	15.8	6.4
Philippines	11.7	15.0	10.3	10.0	50.3	23.1	0.8	3.8	8.8
Malaysia	5.2	3.4	5.8	3.7	3.9	0.3	0.7	0.9	2.0
Indonesia	15.6	9.0	9.5	11.8	10.5	4.7	5.9	9.3	8.0
Nigeria	41.6	18.5	7.7	23.2	39.6	5.5	5.4	10.2	35.9

Sources: International Financial Corp. and Data Resources.
[a]Global inflation rates diverged greatly in the 1980s because of falling inflation in the Northern Hemisphere and rising inflation in the Southern Hemisphere.

military rule. The transition to democracy made it difficult for them to control public spending, because outgoing governments had often used their final months in office to give favors to their supporters, while the incoming leaders had campaigned on platforms promising to boost the real incomes of urban voters. In most cases, such promises could be satisfied only through increased public expenditure.

Paradoxically, at the start of the 1980s, many economic commentators had been optimistic about Latin America's prospects because of the expectation that commodity prices would continue to rise, and pessimistic about the U.S. economic outlook as a consequence of the Reagan administration's commitment to a fiscal program that threatened to produce large multiyear government deficits. Although it will be several years before economists concur about the all theoretical implications of 1980s economic history for future textbooks, one conclusion clearly stands out. The contrasting inflation performance of the United States and its southern neighbors during the 1980s demonstrates that the size of budget deficits is a less critical determinant of a country's inflation performance than the size of its domestic debt markets or its government's access to foreign capital.

Although the U.S. federal debt expanded from $1 trillion in 1980 to $2.7 trillion at the end of the Reagan era, the inflation rate averaged only 4–5 percent during most of the decade because several factors combined to lessen pressure on the Federal Reserve (the Fed) to monetize the large growth in public borrowing. First, much of the initial upsurge in the federal deficit resulted from an anti-inflationary monetary policy that increased the size of the deficit by pushing up interest rates and depressing the growth of tax receipts. Second, the growth in U.S. public borrowing during the early 1980s coincided with a movement towards global financial integration and restrictive fiscal policies in other countries, which made it possible for the United States to reemerge as a large-scale capital-importing nation for the first time since the nineteenth century. Finally, when private capital flows to the United States ceased during the dollar crises of 1987 and 1988, the Japanese Ministry of Finance came to the rescue of the Reagan administration through a series of policy actions designed to stabilize the U.S. dollar and interest rates. If the United States had been a small or medium-size country, the balance of payments crises of the late 1980s might well have forced it to go to the International Monetary Fund (IMF), but other countries provided support for the dollar because they recognized its role as "a key currency" and wanted to avoid the potentially nasty economic and political consequences of U.S. election year recession. As a result, the second great policy lesson of the 1980s is that the large size of the U.S. economy and its strategic importance to Western security permits the United States to operate under different fiscal and monetary rules than other industrial countries.

Inflation Theory

In 1981, the Federal Reserve Bank of Minneapolis published an article by T. J. Sargent and N. Wallace that argued that large deficits would ultimately force governments to pursue inflationary monetary policies. According to Sargent and Wallace, large deficits would set in motion a chain of events that would make debt monetization difficult to resist. First, large deficits would push real interest rates to levels well above the growth rate of real output. Second, this upsurge of real interest rates would cause the stock of public debt to rise sharply in relation to real income. Third, the growth in the debt stock and its servicing costs would ultimately overwhelm the absorption capacity of both investors and taxpayers, forcing central banks to buy the government's paper to prevent it from defaulting. Because of the potential linkages between government debt creation and political constraints on central bank autonomy, Sargent and Wallace argued that countries could achieve price stability only if

governments pursued fiscal policies that were compatible with noninflationary monetary growth.

Although the Sargent and Wallace thesis was regarded as heretical by many monetarists, it enjoyed considerable historical support from the experience of Europe after the First World War. The war had a devastating impact on the economies of all the European participants. In eastern Europe, new nations emerged with large public debts and no tradition of public respect for the tax system. Since they could not collect revenue, the new governments extinguished the real value of their debt through Central Bank purchases of government paper and through hyperinflation. In western Europe there was no hyperinflation after the war, but there was a debate about how to finance the resulting debts, which demonstrated an awareness among policymakers of the tradeoffs posed by the Sargent and Wallace model. In Britain, a few commentators advocated a rise in the inflation rate to lower the real costs of debt servicing, but there was strong opposition on the grounds that Britain's long-standing tradition of honoring war debts had played an important role in helping her defeat Germany. The British people had been prepared to buy war bonds on a scale that could not be duplicated in countries with less responsible traditions of public finance. In fact, John Maynard Keynes had written in 1916, "If we can go on giving the army what they want longer than the Germans can do this to theirs, we may appear to win by military prowess. But we shall really have won by financial prowess" (Grossman 1988, p. 8). Hence, instead of proposing currency depreciation to lessen the cost of satisfying bondholder claims on taxpayers and workers, British socialists proposed the imposition of a special capital tax on bondholders. Although the idea was not accepted, the very fact that such taxes were discussed indicates how strong Britains' commitment to price stability was before the Second World War. France had an even more divisive debate than Britain about how to pay for the war, because France had a much weaker tradition of public respect for the tax system; but the French also rejected the inflation option. In fact, France remained on the gold standard for several years longer than Britain during the 1930s and thus experienced a period of deflation, which increased the real cost of France's debt servicing. This large interest-payment burden was one of the factors that produced recurring crises in French politics during the 1930s and crippled the country's response to the rise of German military power.

When the Sargent and Wallace paper appeared, it was considered to be a major challenge to the economic policies of the Reagan administration because its principal monetary advisers, such as Beryl Sprinkel, had argued that there was no automatic inflation link between fiscal and monetary policy. According to Sprinkel, the country would be able to enjoy prosperity with low inflation if the Fed merely adhered to a low monetary growth target and let the Treasury worry about financing the fiscal deficit.

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