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SOCIAL CONFLICT AND POPULIST POLICIES IN LATIN AMERICA

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ABSTRACT

The central hypothesis of this paper is that high income inequality in Latin America contributes to intense political pressures for macroeconomic policies to raise the incomes of lower income groups, which in turn contributes to bad policy choices and weak economic performance. The paper looks in detail at one common type of policy failure: the populist policy cycle. This particular type of Latin American policymaking, characterized by overly expansionary macroeconomic policies which lead to high inflation and severe balance of payments crises, has been repeated so often, and with such common characteristics, that it plainly reveals the linkages from social conflict to poor economic performance.

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Social Conflict and Populist Policies in Latin America

I. Introduction

One of the great themes of Ezio Tarentelli's research was that social conflict can be a major impediment to successful economic performance. He recognized that the industrial economies differed markedly in their mechanisms for resolving social conflicts, particularly in the institutions for regulating the distribution of income between labor and capital. These differences, Tarantelli pointed out, could help to account for the differing success of the various European economies in adjusting to the adverse shocks of the 1970s.

Tarantelli was one of the first to recognize that the neocorporatist institutions of Northern Europe provided a particularly successful mode of moderating social conflict, that allowed the Northern European economies to absorb the shocks of the 1970s without a major rise in unemployment. Taratelli's insights have been supported in a number of later studies, including those by Bruno and myself (1985), McCallum (1983), Calmfors and Driffill (1988), and others.[1]

This paper is about the Latin American economies, almost all of which demonstrate a continuing <u>inability</u> to moderate social conflict, in stark contrast to the corporatist economies of Northern Europe. In the corporatist welfare states, labor militancy is low, and a broad-based

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[1] As mentioned in Bruno and Sachs (1985, p. 222), "Tarantelli's work was a major stimulus to our own investigation of this topic".
I first benefitted from Tarantelli's research in an unpublished paper on "The Economics of Neocorporatism", 1981, which was an early draft of the beginni

consensus exists on the distribution of income and the redistributive role of the public sector. In Latin America, by contrast, bitter economic conflict is one of the central phenomena of economic life. In Argentina, for example, there has just occurred the 12th general strike during the Presidency of Raul Alfonsin, and like many of the others, this one was marked by widespread mobilization, deep political rancor, and violence. Economic policymaking in Latin America remains a battleground of conflicting interests of class, sectors, regions, and ethnic groups. It is not by accident that one of the most highly regarded studies of Argentina is titled Economic Policymaking in a Conflict Society.[2] This title could apply equally well throughout most of Latin America.

Because of the salience of distributional issues in Latin America, leading Latin American economists have long specialized in dissecting the distributional implications of macroeconomic policies, and have often made such distributional analysis the cornerstone of their theorizing. Examples include Carlos F. Diaz-Alejandro's (1965) celebrated analysis of "contractionary devaluation", based on the idea that devaluation reduces real wages, and thereby transfers income from low-saving workers to high-saving landowners; Albert Hirschman's (1971) remarkable essay on the political bases of the import-substitution strategy; and the highly influential "dependency theory" of Cardoso and Falleto (1979) among others.

The bitterness of class and sectoral conflicts throughout Latin America almost surely reflect the extreme inequalities of income

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[2]The study is R.D. Mallon and J.V. Sourrouille, Economic Policymaking in a Conflict Society: the Argentina Case. Cambridge, Mass.: Harvard Universi

	Quintiles lowest	highest	Ratio	Rescheduler
		Other		
Egypt	4.6	48.4	10.52	no
Hungary	10.0	34.0	3.40	no
India	4.7	53.1	11.30	no
Israel	8.0	39.0	4.88	no
Ivory Coast	2.4	61.4	25.58	yes
Kenya	2.6	60.4	23.23	no
Mauritius	4.0	60.5	15.13	no
Morocco	4.0	49.0	12.25	yes
Portugal	5.2	49.1	9.44	no
Spain	6.0	45.5	7.58	no
Sri Lanka	6.9	44.9	6.51	no
Tunisia	6.0	42.0	7.00	no
Turkey	2.9	60.6	20.90	yes
Yugoslavia	6.6	41.4	6.27	yes
Average	5.3	49.2	11.7	29%
Overall average	4.8	51.7	14.1	43%

Definitions and source :

Rescheduler: Countries which are reschedulers rescheduled their foreign debt owed to commercial lenders between 1982 and 1987. Source: World Bank (1987b, 1986).

Income Distribution Data: Data is originally from surveys of households, yielding estimates of the country-wide size distribution of income by household. The surveys were generally taken in the late 1960s or early 1970s.

Source: Taken from Berg and Sachs (1988). See that essay for further details on primary sources.

Table 1: Income Distribution and Debt Rescheduling
middle-income countries

	Income Distribution			
	Quintiles			
	lowest	highest	Ratio	Rescheduler
		Latin America		
Argentina	4.4	50.3	11.43	yes
Brazil	2.0	66.6	33.30	yes
Chile	4.5	51.3	11.40	yes
Colombia	2.8	59.4	21.21	no
Costa Rica	3.3	54.8	16.61	yes
Ecuador	1.8	72.0	40.00	yes
Mexico	4.2	63.2	15.05	yes
Panama	2.0	61.8	30.99	yes
Peru	1.9	61.0	32.11	yes
Trin&Tob	4.2	50.0	11.90	no
Uruguay	4.4	47.5	10.80	yes
Venezuela	3.0	54.0	18.00	yes
Average	3.2	57.7	21.1	83%
		East Asia		
China	7.0	39.0	5.57	no
Hong Kong	6.0	49.0	8.17	no
Indonesia	6.6	49.4	7.48	no
Korea	6.5	45.2	6.95	no
Malaysia	3.5	56.0	16.00	no
Philippines	3.9	53.0	13.59	yes
Singapore	6.5	49.2	7.57	no
Taiwan	8.8	37.2	4.23	no
Thailand	5.6	49.8	8.89	no
Average	6.0	47.5	8.7	11%

throughout the region. As shown in the first column of Table 1, the income inequalities in Latin America tend to be much larger than in other regions in the world.[3] The difference is particularly marked with respect to East Asia, which has an unusually low degree of income inequality in comparison with the rest of the developing world. As discussed below, we also can note in the second column of the table that countries with high income inequality were especially prone to suffer a debt crisis in the 1980s (as indicated by the need to reschedule their external debt payments).

Many of Latin America's economic ills seem to be rooted in the intense conflicts prompted by the extremes of income inequality, just as East Asia's economic successes seem to be tied to the social stability engendered by the greater income equality. In Latin America, necessary devaluations are frequently delayed because of their adverse impact on real wages in favor of rents earned on land and primary commodities. Trade policies remain excessively inward oriented in many parts of the region in part because of the presumption that outward orientation reduces urban wages at the expense of profits of exporters, who include wealthy landowners and producers of primary commodities. Fiscal austerity is often rejected, even in highly inflationary circumstances, because of the fear that the austerity will provoke widespread unrest. Whether these concerns are realistic or not, they form much of the basis for widespread opposition in Latin America to the "orthodox" recipes for adjustment to macroeconomic disequilibria.

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[3] This remains true after controlling for per capita income. See Berg and Sachs (

The paper looks in some detail at one common type of policy failure in Latin America: the populist policy cycle. Carlos F. Diaz-Alejandro provided a brillant and succinct account of economic populism in a 1981 essay on "Latin American Stabilization Plans", that is very much in line with the findings of this paper. This particular type of Latin American policymaking, characterized by overly expansionary macroeconomic policies which lead to high inflation and severe balance of payments crises, has been repeated so often, and with such common characteristics, that it plainly reveals the linkages from social conflict to poor economic performance.[4] Economic populism helps to explain the fact that in 1988, no less than four countries (Argentina, Brazil, Nicaragua, and Peru) in Latin America had inflation rates of several hundred percent or more, while in the rest of the world there was not a single case of triple-digit inflation.[5] Four other Latin American countries had inflation rates between 50 and 100 percent: Ecuador, Mexico, Dominican Republic, and Uruguay. Of course, external factors also contributed importantly to

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[4] Note that the term "populism" has several meanings, both in the economic and the political sphere. I will not be much concerned here with the concept of populism in its various political usages, but mainly with regard to the management of the macroeconomy. Of course, as explained below, a crucial point in understanding economic populism is a proper understanding of the political base and political objectives of populist leaders

[5] The countries were Argentina, with inflation of 372.0 percent for 1988 over 1987; Brazil, 816.1 percent; Nicaragua, 7778.4 percent; and Peru, 1307.1 percent. Data are from ECLAC (1988), Table 5, p. 21. Data are November to November, except for Nicaragua which are September to September. Mexico had triple digit inflation in December 1987 over December 1986, of 159.2 percent, but that rate came down to 70.5 percent for

Latin America's current crisis.[6]

The paper is highly critical of the populist approach, and provides considerable historical evidence that populist experiments tend to end in economic and political disaster. But the paper should not be read as an indictment of the aims of the populist leaders (e.g. a more equal distribution of income in societies with extreme income inequality), but of the specific

macroeconomic strategies used to try to achieve the aims. Neither is it an endorsement of the extreme forms of "orthodoxy" that often follow the collapse of a populist experiment (e.g. in Pinochet's Chile, after the fall of Allende in 1973). The swings from populism to extreme orthodoxy, more than anything else, prove the failure of Latin America to have found a basic consensus, and middle way, in political, social, and economic terms. Note, finally, that economic populism (at least as the term is used in this study), has been adopted by governments representing a wide range of the political spectrum, and has not been the exclusive province of the left or right. Governments of the right (as in the case of the Brazilian military in 1979-80) have employed populist economic tactics of the same style as employed by left-wing governments (such as in Chile under President Allende). Also, "revolutionary" governments, such as in the case of the Sandinistas in Nicaragua, often follow in their macroeconomic tactics a fairly traditional populist mode.

[6] Much of the reason for high inflation and internal instability results from the vast overhang of external debt. The reasons for this debt accumulation are complex, but include both domestic factors (including populist policies which are at the focus of analysis in this paper) and external shocks. The external factors include: extraordinarily high world interest rates throughout the 1980s; the sudden cutoff of external finance

II. Distributional Conflict and Macroeconomic Policies

The central hypothesis of this paper is that high income inequality in Latin America contributes to intense political pressures for macroeconomic policies to raise the incomes of lower income groups, which in turn contributes to bad policy choices and weak economic performance. The chain of causation from inequality to economic policy to economic performance is, of course, highly complex and variable across time and countries. It is also difficult to prove. Before turning to the central example of populist policies, it is useful first to examine some circumstantial evidence.

In a recent paper, Andrew Berg and I (1988) looked for structural characteristics of middle-income developing countries that helped to account for which countries succumbed to a debt crisis in the 1980s and which ones did not. The paper developed a cross-country statistical model of debt rescheduling, which linked the probability that a particular country rescheduled its debts in the 1980s to several structural characteristics of the country, including the extent of income inequality (as measured in Table 1). Our most striking finding was that countries wih high income inequality had a significantly greater liklihood, _ceteris paribus_, of having rescheduled their debts than did countries with low income inequality.[7]

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[7] Other variables that helped to account for the cross-country pattern of debt reschedulings were: (1) the nature of trade policy (more outward-oriented economies were less likely to have rescheduled); (2) the importance of agriculture in the economy (countries with a large share of agriculture in GNP were less likely to have rescheduled); and (3) per capita income (wealthier countries were less likely to have succumbed to debt

We attribute the correlation between high income inequality and debt rescheduling to the nature of political management in economies with extreme inequalities of income. Berg and I listed several reasons why countries with extreme income inequality might be prone to excessive foreign borrowing. We suggested, among other reasons, that high income inequality:

raises the pressures for overly expansionary redistributive bugetary policies;

enhances the power of economic elites to resist taxation needed to balance the budget;

contributes to direct, destabilizing labor militancy;

decreases the political support for export-promotion measures, which tend to threaten urban real wages in the short run.

It is probably true as well that high social conflict, rooted in high income inequality, contributes in many countries to weak political institutions and a rapid turnover of governments. Moreover, governments with a brief expected tenure, representing particular constituencies, may find it attractive to maximize the current income of those constituencies by running down the country's future purchasing power (e.g. by depleting the international reserves). Alesina and Tabellini (1987) have demonstrated this point in a formal theoretical setting.

The debt crisis of the 1980s is only the most recent case in which the Latin American countries have displayed a special proneness to large budget deficits that produce high inflations and balance of payments crises. There are numerous cases in Latin America where governments have <u>rapidly and significantly</u> increased budget deficits in order to meet various distributional goals. I term these extreme cases "populist" episodes. In all of these experiments, governments have explicitly argued that the policies are necessary to correct glaring inequities in the income distribution, and to raise the living standards of the poor. Much of the temptation of such policies (despite the fact that they generally fail to achieve their goals except in the very short term) relates to the factors just outlined: high pressures for increased living standards of the lower income groups; short tenure of governments; inability to tax elites in order to cover social spending; etc.

There is also a particular structural characteristic of many Latin American economies that increases the populist temptation. Because of the sharp sector division in many Latin American countries between a labor-intensive nontradeables sector and a primary resource-intensive export sector, monetary and fiscal expansions can raise urban real wages markedly in the short run, as well as profits in the nontradeable sector, at the expense of the wealthy primary-resource owners. In the context of the deep and on-going distributional battle between these groups, expansionary policies are thus particularly attractive in the short run for governments based on an urban, working-class constituency.

Before turning to a macroeconomic framework for understanding economic populism, it is worthwhile to note some of the historical roots of these policies. As described by a large number of studies in political science and economic history, Latin American politics underwent an enormous change in the 1920s and 1930s with the rise of extensive urbanization.[8] After a long history in Latin America of elite-based

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[8]For an excellent series of articles on the politics and history of Latin A

politics centered on a rural landowning class, a new wave of <u>urban-based</u> political leaders emerged, drawing their support on a multi-class base of the urban proletariat, urban government employees of a growing public sector, and the marginalized urban population (i.e. the informal sector). In political terms, "populism" signifies these urban, multiclass movements, which at least initially were headed by a charismatic leader who arrives to power through electoral competition with the support of the newly enfranchised urban proletariat. As stressed by Drake (1982), the leaders of the new populist movements came to power promising the "immediate psychic and material gratification of the needs of society's underdogs." (p. 218)

As summarized Conniff (1982) and Drake (1982), the early populist movements, such as in Argentina under Juan Peron and in Brazil under Getulio Vargas, shared many basic characteristics, including: the urban, multiclass base; the accession to power through electoral competition based on an extension of suffrage to the urban working class population; the charasmatic leadership; and the focus on <u>state activism</u> to incorporate workers "in a process of accelerated industrialization through ameliorative redistributive measures" (Drake, 1982, p. 218).

Interestingly, these populist leaders and their successors generally relied more on <u>distributive</u> policies rather than <u>redistributive</u> policies, i.e. they looked for ways of raising the incomes of the bottom part of the income distribution without resorting to explicit taxation or confiscation of property of the upper classes. Sometimes, this neglect of taxation of the upper incomes was the result of the temperment of the populist leader and his followers, and sometimes it resulted simply from the fact that the populist leader lacked the political power to implement and enforce new forms of progressive taxation.

A macroeconomic framework for economic populism

Consider the following macroeconomic model, which is spelled out in more detail in Sachs (1989). Suppose, as is typical of Latin America (at least as a crude simplification), that the economy has two major sectors: an export sector based in primary commodities and a nontradeable sector of services and manufactures (where many manufacturers survive behind a protectionist barrier). The nontradeables sector is heavily labor intensive relative to the export sector. Aside from labor inputs, the nontradeables sector also relies heavily on imported intermediate inputs in the production process. In the export sector, there is an important fixed factor of production (e.g. land in the Argentine Pampas) whose ownership is highly concentrated among wealthy households. It is assumed that the export sector also uses some of the nontradeable good (e.g. transport) in the production process.

Assume fixed exchange rates in the short run, and capital controls on private outflows. The exchange rate is fixed by the central bank as long as the central bank has foreign exchange reserves available for that purpose. When the central bank runs out of reserves, the exchange rate collapses and there is a shift to floating rates. During the time that the nominal exchange rate is fixed, the domestic currency price of commodity exports, as well as the price of imported inputs for the nontradeable sector are both fixed, under the assumption of purchasing power parity (PPP) and a given world price for these goods. When the exchange rate eventually depreciates, after the loss of reserves and a balance of payments crisis, the domestic prices of the tradeable goods rise in equiproportion to the exchange rate depreciation. Now consider a monetary expansion (for simplicity, assume that the money growth is increased on a sustained basis in order to finance a higher level of real government transfers or subsidies to the private sector). With capital controls in place, the money expansion raises real money balances, lowers domestic interest rates and expands demand. Because the exchange rate is fixed, the domestic price of the import and export goods remains unchanged. The rise in domestic demand pushes up the demand for nontradeable goods and that in turn leads to a rise in demand for labor used in the nontradeable sector. The rise in labor demand pushes up the nominal wage. Higher wage costs in turn push up the price of nontradeables.

Under reasonable assumptions, the nominal wage will tend to rise by a greater proportion than the increase in the nontradeables price, since the nontradables price is a markup over both wage costs and imported input prices, and the latter do not increase. The nominal wage therefore rises relative to the price of nontradeables, imports, and exports. We can therefore safely conclude that the expansion leads to an increase in real consumption wages, defined as the ratio of nominal wages to the price of consumption goods.[9] To put the same result another way, real

[9] In the model in Sachs (1989), consumption is assumed to fall exclusively on nontradeables. All production of exportables goes abroad, and all imports are used as intermediate inputs in nontradeables production. The specific assumptions about the consumption basket should obviously be varied by country. In Argentina, the primary commodity exportable (mainly grains and meat) i

wages rise as the real exchange rate appreciates (where the real exchange rate is defined as the ratio of tradeable goods prices to nontradeable goods prices, and an appreciation signifies a <u>fall</u> in the relative price of tradeables).

Several other phenomena will accompany the real exchange rate appreciation. The price of exports will fall relative to the price of nontradeables. To the extent that the export sector uses the nontradeable good as an input, the real appreciation will lead to a profit squeeze in the export sector, and to a decline in export production. This export decline will accompany a rise in import demand for the input to nontradeable production, leading to an overall trade deficit. Note that in some countries (especially Argentina, which exports food), export goods are also important consumption goods. In this case, the rise in the wage relative to the export good is another reason to to expect a rise in the real consumption wage.

If this were the end of the story (as most populist leaders want to believe!), there would be a happy ending to the expansion. Real wages and nontradeable output go up. If household labor supply rises in response to higher real wages, so too does overall employment. Profits earned in the export sector would go down, but since the ownership of resources in the export sector is highly concentrated among upper income groups, the political ramifications of the profit squeeze would be slight, or even favorable, for a government based on urban wage labourers. The problem, however, is the trade deficit that accompanies the expansion. That must be financed by a loss of foreign exchange reserves (or equivalently, a growing foreign debt, if foreign creditors are willing to make new loans). And eventually, the reserves or the borrowing capacity will run dry.

The overall expansion may continue until a balance of payments crisis hits, when the economy runs out of the foreign reserves and borrowing capacity needed to continue to peg the exchange rate. At that moment, the nominal exchange rate depreciates sharply, by enough to create a real depreciation that lowers real wages, restores export profitability, and reduces internal demand by reducing the level of real money balances and thus tightening credit once again. The real wage gains of the expansion phase are eliminated. The real depreciation must be large enough to bring the economy back immediately into trade balance, since there is no more external financing available to run trade deficits. Under realistic circumstances, in fact, the real depreciation must be greater than the initial real appreciation, since in the expansion phase the economy has lost the income of its initial stock of foreign exchange (which is now depleted), and has probably lost capacity in the export sector, due to decapitalization in that sector. By extension, the fall of the real wage on the way down must almost surely be greater than the initial real wage boost.

If the initial budgetary expansion which started the process is not reversed at the time of the balance of payments crisis, the economy will be left with an expansionary monetary policy under floating exchange rates. The results will be a sustained rise in inflation. In effect, after the exchange rate collapse, the budget deficit is financed by the inflation tax under floating exchange rates, rather than by running down reserves under fixed exchange rates.

It should be noted that populist governments in the collapsing phase of the cycle tend to improvise to try to forestall a reversal of the initial gains. Instead of allowing a discrete devaluation of the currency, for example, at the moment that reserves dry up, they may implement exchange controls to ration the scarce foreign exchange. This leads to a black-market premium on foreign exchange, that tends to raise the domestic price of importables (which are paid for, on the margin, with black-market dollars) relative to exports (which must be remitted to the central bank at the official rate). The short-term result is a further anti-export bias, and the incentive for export underinvoicing and smuggling. Eventually these distortions prompt an official devaluation and a reunification of the exchange rate for current account transactions. Governments almost always flirt as well with wage and price controls in the final stages of the populist cycle, in order to try (unsuccessfully) to prevent the collapse of real wages. As with the exchange controls, the price controls simply lead to black markets, hidden price premia and shortages, and eventually to an elimination of the controls after the distortions become unbearable. They may even turn to more extreme measures, such as the nationalization of the banks in Mexico in 1982 and in Peru in 1987.

Note that it is the environment of unresolved social conflict that spurs this kind of populist policy cycle. In practice, there are always voices of opposition to excessive domestic expansion, who warn correctly that the benefits are likely to be short lived because of the balance of payments constraint. It seems to be the <u>urgent political pressure</u> for real wage increases that pushes the policymakers in favor of an otherwise risky, indeed imprudent, strategy. Moreover, the expansionary policy is attractive only when the interests of the nontradeables sector politically dominate the interests of the tradeables sector, and when there is no basic social norm for the distributive shares between these two sectors. In other words, there needs to be a fairly stark battle over distributive shares between sectors to make the policy attractive, and the advocates of the nontradeables sectors must have political control.

Countries with a diversified export sector or a politically important import-competing sector (one that is not fully protected by trade barriers), are likely to have political constituencies that would fiercely oppose the real appreciation. The agricultural sector is many East Asian countries, for example, is based on millions of smallholders, whose sheer number give them political power. As suggested in Sachs (1985), this difference with Latin America, where the agricultural sector is seen to be in the hands of a rural "oligarchy", may explain the greater political opposition to currency overvaluation in East Asia, and the overall greater resistance to populist measures.

Historical episodes of Latin American economic populism

The populist cycle in Latin America has been often repeated, always with disastrous effects. The theme of this section is that the mechanisms of expansion and collapse in the several cases have been so similar as to justify a clear common description of these experiences. To demonstrate the point, we focus on four historical episodes: (1) Argentina, 1946-49, under Juan Peron; (2) Chile, 1971-73, under Salvador

Allende; (3) Brazil, 1985-1988, under Jose Sarney; and (4) Peru, 1985-88, under Alan Garcia. There are many additional cases that could have been included, such as Bolivia, 1982-85, under Hernan Siles Suazo; Brazil, 1962-64, under Joao Goulart; Chile, 1952-55, under Carlos Ibanez; Mexico, 1979-82, under Lopez Portillo; and Nicaragua, 1980-87, under the Sandinista government.[10]

I will now provide a brief historical overview of the four central experiences considered in the paper, and then demonstrate quantitatively the commonality of these episodes.

(1) Argentina, 1946-49

Juan Peron began his rise to power in the 1943 military coup, which toppled the conservative regime which had been in power since the military coup of 1930. The old regime, centered on the conservative, landed interests in agriculture, was replaced by a nationalist and illiberal movement with the goal of rapid industrialization. Peron served first as a labor advisor to the new government, then successively as Labor Secretary, Minister of War, and Vice-President, before winning a resounding election as President in 1946. Peron cultivated the political base of the urban workers as his stepping-stone to the Presidency. As Labor Secretary he pressed for a dramatic extension of social security benefits, collective bargaining, a system of wage bonuses, and increases

[10] The Sandinista experiment is often interpreted as a distinct, revolutionary experiment. In my view, such an interpretation exaggerates the novelty of the Sandinista policy direction, which is firmly rooted in the Latin American populist tradition. Note that by 1987, the combination of populist initiatives and the heavy wartime burden contributed to an inflation rate of about 11,000

in the minimum wage. The main labor confederation, the CGT, grew enormously in strength, and supported Peron's bid for the Presidency.

Peron's economic policies during 1946-49 virtually define the mechanics of urban-based populist policies. Monetary and fiscal spending were highly expansionary. The exchange rate was maintained at a fixed nominal rate, which became highly overvalued in real PPP terms. Real wages rose both because of the expansion, and also because of direct government backing of the negotiations of the CGT. Trade policies were highly protectionist, with the intent of building a domestic industrial base behind tariff walls. The redistributive goals were explicit, including both the aim of raising the urban wage and of squeezing the former agricultural oligarchy for the benefit of the ascendant urban sector. The share of wage income in GNP grew from 38.7 percent in 1946 to 45.7 percent just three years later in 1949. Real wages grew by 62 percent in these three years.

The end of the boom became evident as early as 1948, when agricultural production began to drop, and foreign reserve holding dwindled (falling from $1.11 billion in 1946 to just $258 million in 1948). Inflation accelerated and GNP fell by 4.5 percent in 1949.

In 1952, when Peron finally turned to a more orthodox strategy, he was candid about the social and political motivations of his original program. In a speech to a workers delegation, cited by Mallon and Sourrouille (1975, p.12), Peron stated:

> The <u>justicialista</u> [i.e. Peronist] economy asserts that the production of the economy should first satisfy the needs of its inhabitants and only export the surplus; the surplus, nothing more. With this theory the boys here, of course, eat more every day and consume more, so that the surplus is smaller. But these poor guys have been submerged for fifty

> years; for this reason I have let them spend and eat and waste everything they wanted to for five years . . . but now we undoubtedly must begin to reorder things so as not to waste any more.

In the event, Peron had little time for such reordering, since he was ousted in a coup in 1955.

(2) Chile, 1971-73

Salvador Allende, like Peron, came to power on a base of urban workers. Allende received a slight plurality of the vote (36 percent) in the 1970 Presidential election, and was voted into office on the basis of that plurarlity after the electoral decision reverted to the Chilean Congress. Allende's program was expansionist and redistributive in the same mold as Peron's, though there were also formal Socialist goals (e.g. widespread nationalisation, and extensive land reform) motivating the program. The Popular Unity government identified three major problems with the Chilean economy: (1) the concentration of ownership of the means of production; (2) the dependence of the economy on foreign markets; and (3) the unequal distribution of income.

In the first year of the government, the fiscal policy turned highly expansionary, with the budget deficit rising from 2.7 percent of GNP in 1970 to 10.7 percent in 1971. By the fourth quarter of 1971, the rate of credit expansion to the public sector exceeded 300 percent at an annual rate. GNP growth boomed (9 percent in 1971, compared with 2.1 percent in 1970), and real wages grew by an astounding 17 percent in 1971! The share of labor income in GNP rose in one year from 52.3 percent in 1970 to 61.7 percent in 1971.

The crash phase came fast, however, even faster than in Argentina. By 1972, GNP growth turned negative, and inflation jumped to 163 percent. International reserves collapsed, leading to the implementation of a system of tight exchange controls, with 15 different exchange rates (with a ratio from top to bottom of 60 to 1). By 1973, GNP growth was -5.6 percent, with inflation averaging 500 percent for the year. Allende was overthrown in a military coup in September 1973.

(3) Brazil, 1985-88

After 21 years of military rule, the military ceded power to a civilian president elected by an electoral college, whose members had been chosen by election in 1982. Because of the death of the President-elect, Tancredo Neves, on the eve of his inauguration, Vice-President-elect Jose Sarney became President. Sarney was truly an accidental President. He had been selected as Vice-President by Tancredo to assuage the military, as Sarney had long been a member of the conservative party that had supported the previous military regime. Sarney now headed Tancredo Neves' government, which was supported by a broad-based progressive opposition party, the PMDB, which had opposed the military rule. Popular demands ran high at the time of democratisation, particularly after two decades of military rule that had suppressed worker rights, and after four years of austerity in the midst of the Latin American debt crisis.

In early 1986, Sarney endorsed the goals of the PMDB in backing a "heterodox" stabilization program, called the Cruzado Plan. Whatever the original intentions of the program with regard to fiscal and monetary instruments, the Plan was implemented in a highly populistic fashion, with significant real wage increases, an overvalued currency, and a large budget deficit. As in the Argentine and Chilean cases, the early outturn of the program was outstanding: rapid growth, higher real wages, and low inflation. The pro-worker rhetoric of the regime increased markedly as the Cruzado Plan achieved its early successes.

The Cruzado Plan collapsed very fast, no doubt because of the highly unfavorable initial conditions, especially the very high inherited external debt. The Brazilian trade surplus shrunk from a monthly average of about $1 billion in 1985 to a deficit of $326 million in the last quarter of 1986. As the reserve situation deteriorated, the exchange rate had to be devalued sharply in late 1986, which led to an explosion of inflation, and a reversal of the real wage increases and real GDP growth that had been achieved at the outset of the program.

By 1987, a new finance minister, Luiz Carlos Bresser Pereira, attempted to shift policy towards stabilization through a reduction in the budget deficit (see Bresser Pereira, 1988a, for details). President Sarney, in the midst of a political battle to maintain power for as long as possible under a new constitution then in prepartion, failed to back his Minister, and bowed instead to the continuing populist pressures that were widely supported in the Congress. Moreover, as Bresser has written, real stabilization would require a social pact, but:

> I always have been very skeptical about a social pact in Brazil, because first you need a political pact -- a broad agreement between the main political forces in teh country regarding, besides wages, social reforms. (p. 28)

By the fall of 1988, and the accession of yet another finance minister, the prospects for Brazil to avoid a hyperinflation still hang in the balance, with inflation during the summer months running at a 1000 percent annual rate.

(4) Peru, 1985-88

After 12 years of military rule, Peru reverted to civilian rule with the election of President Fernando Belaunde in 1980. The Belaunde government vacillated between the conventional austerity cum liberalization policies favored by the IMF, and "developmentalist" policies (involving heavy expenditure on public works) favored by the President. In 1983, adverse weather conditions combined with heavy external debt payments and internal macroeconomic imbalances to produce a remarkable 12 percent decline in GNP, combined with domestic inflation of 125 percent. By the end of Belaunde's term in 1985, inflation was running at an annual rate of over 150 percent, and real wages had declined by about 40 percent between 1980 and 1985.

Alan Garcia came to office in July 1985, intent on slowing inflation while reviving real wages and growth. The President's APRA party had a long populist tradition, and had previously been kept out of the Presidency by the military fearing the APRA's populist tendencies. Garcia began with a policy based on: (1) a unilateral partial suspension of debt-servicing payments, limited to 10 percent of export earnings; (2) a modest devaluation and increase in public sector prices, followed by an exchange rate and price freeze; (3) a large increase in public sector wages, with the stated goal of raising internal demand.

Under this policy mix, the economy boomed in 1986, with GDP growing by 8.6 percent, and real wages growing an astounding 26.7 percent in the year. The public sector deficit went from 4.4 percent of GDP in 1985 to 7.9 percent of GDP in 1986. Under the restraint of a fixed nominal exchange rate, domestic inflation slowed markedly, from 158 percent per year in 1985 to only 63 percent in 1986. As might be expected, the President's personal popularity soared, reaching an approval rating of more than 90 percent in 1986. As is typically true of such programs, the only telltale signs of trouble were on the external front. The trade balance went from a surplus of $1,172 million in 1985 to a deficit of $65 million in 1986. The real exchange rate appreciated markedly.

In 1987, the financial aspects of the situation deteriorated further, with inflation approximately doubling relative to 1986, back up to a level of 114.5 percent for the year. The public deficit widened (to over 10 percent of GDP); the trade balance became more negative ($460 million deficit); and the real exchange rate appreciated even more. Nonetheless, growth of real wages and real GDP remained high for the year.

By 1988, the foreign exchange reserves were depleted, and the situation fell into total collapse. Real GDP is widely forecast to be -4 percent for year, while inflation might top 1000 percent. In the month of September 1988 alone, prices rose by approximately 117 percent! The President's popularity plummeted to a 16 percent approval rating in the fall of 1988, and the press reported rumours of Garcia's offer to his cabinet to resign.

Common features of the historical episodes

A major theme of this paper is that the populist episodes have a common economic and political dynamic, despite the fact that they take place in very different countries and even in different decades. We have noted several common factors. On the political side, the experiences all involve the accession to power of an urban-based government, intent on raising -- sharply and quickly -- the living standards of the urban workers. In three of the four cases (Argentina, Brazil, and Peru, but not Chile), the new government took power after a long conservative interlude, so that social pressures were highly pent-up. On the economic side, all of the programs were characterized by: an early phase of rapidly rising GNP and real wages, with fairly stable prices; and a late phase of falling GNP and real wages, with explosive inflation.

The turning point comes with the collapse of the fixed exchange rate, at the time that the government runs out of foreign reserves and access to new foreign credits. Indeed, the length of the upswing phase is almost wholly a function of the foreign exchange reserves on hand for the government. In the case of Argentina under Peron, the wartime trade surpluses of Argentina meant that Peron inherited an enormous stockpile of reserves, so that his program could continue for years without grave collapse. In Chile, Allende had a more modest initial reserve position. In Peru, Garcia created the part of the needed reserves by a policy of unilateral debt servicing suspension. In Brazil, the Cruzado Plan was especially short lived, since it was entered into in the midst of a serious external debt crisis, and since Brazil did not choose to emulate Garcia by suspending debt servicing during the Plan (interestingly, Brazil waited to suspend debt servicing until after the collapse of the program, at a time of much more limited international bargaining power and less internal political cohesion).

Figures 1-6 provide a striking visual confirmation of many of these common attributes (the basic data and sources are given in the data appendix). In these figures, we superimpose the experiences of the four episodes, dating them according to the start of the populist policy measures. Figure 1 shows the GDP growth. In all cases, growth starts high, and turns negative in year 4. Note that the 1988 growth rates for Brazil and Peru are forecasts taken from the financial press as of September 1988. In Argentina, Chile, and Peru, growth actually accelerates from year 1 to 2, then slows in year 3, and turns negative in year four. In the Argentine, Chilean, and Peruvian cases, the downturn in the fourth year was very sharp, with GDP falling by more than 4 percent.

The second figure shows the inflation experience, which once again looks similar across the cases. In all four countries, the populist episode begins with a slowdown of inflation, which seems to come about because of the fixity of the nominal exchange rate during each episode. By year 3, the inflation begins to accelerate, especially sharply in the case of Brazil (where the Cruzado Plan collapsed with remarkable quickness). Remarkably, by year four in Brazil, Chile, and Peru, the inflation has reached several hundred percent. In Argentina under Peron, inflation reached levels (just over 30 percent) that were high by comparison with the price stability in Argentina in the late 1930s and early 1940s, but very low in comparison with later years. Peron started with in an economy with very low inflationary expectations and a large inherited stock of international reserves.

Figure 1

GDP growth in populist experiences

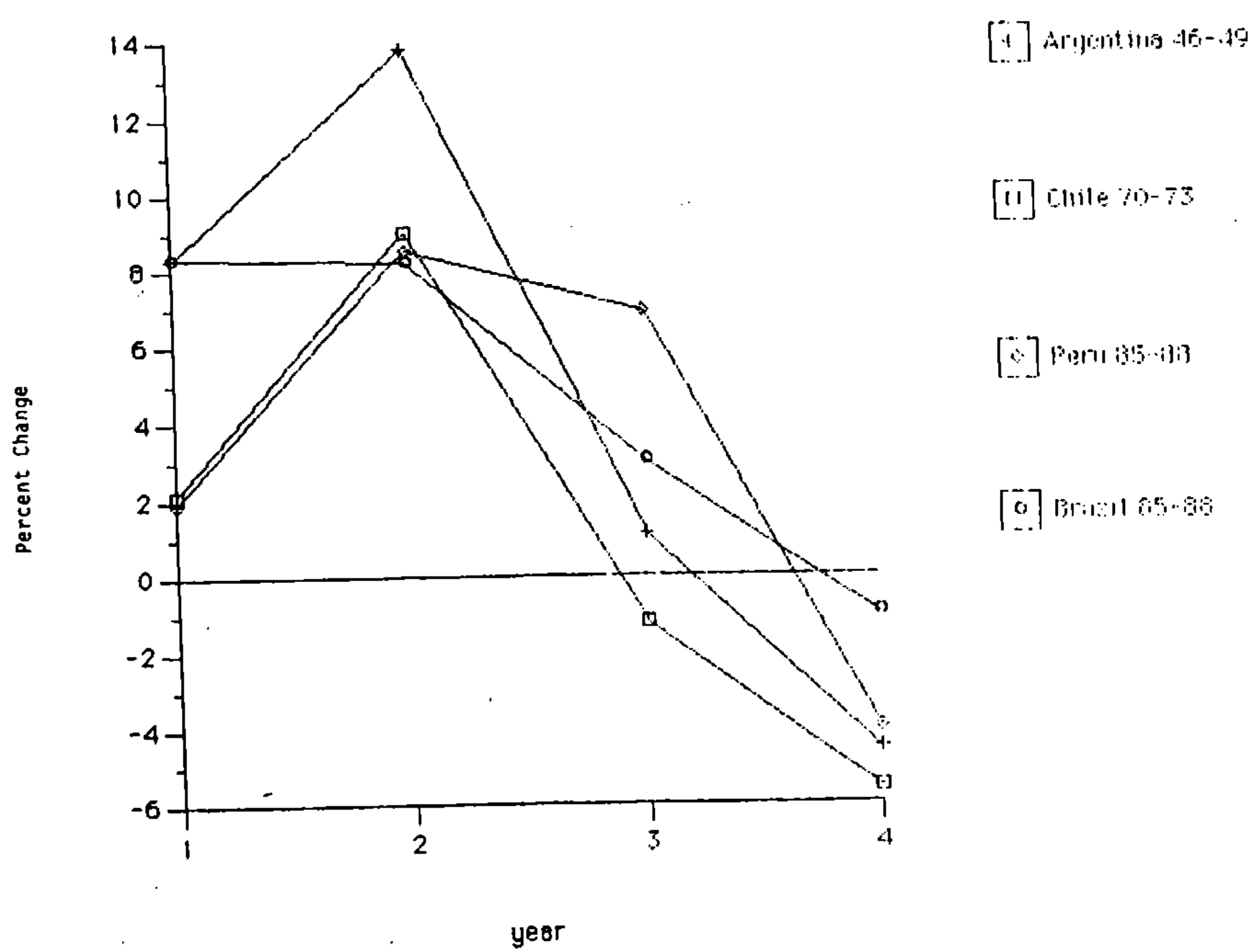

Figure 2

Inflation (CPI)

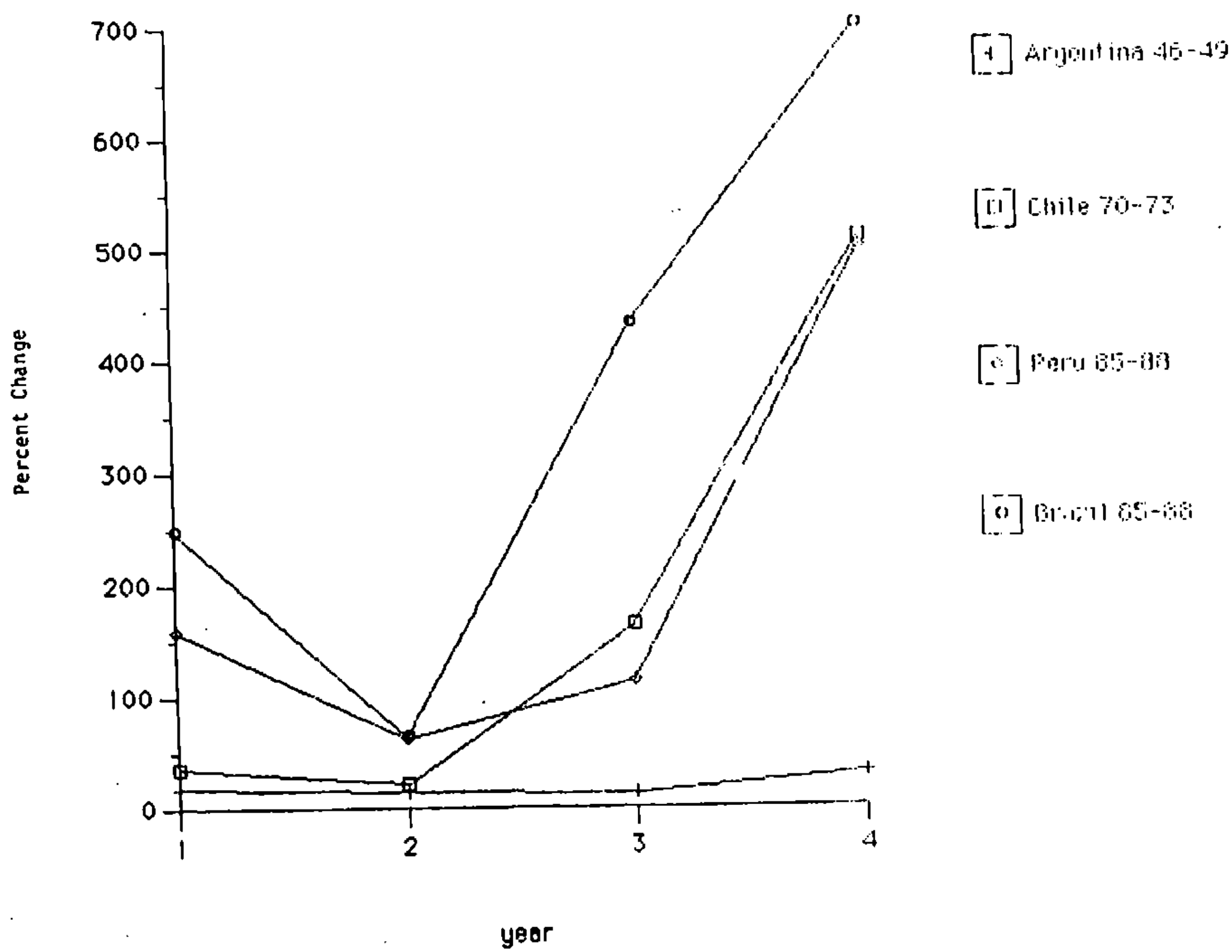

Figure 3

Real Wages

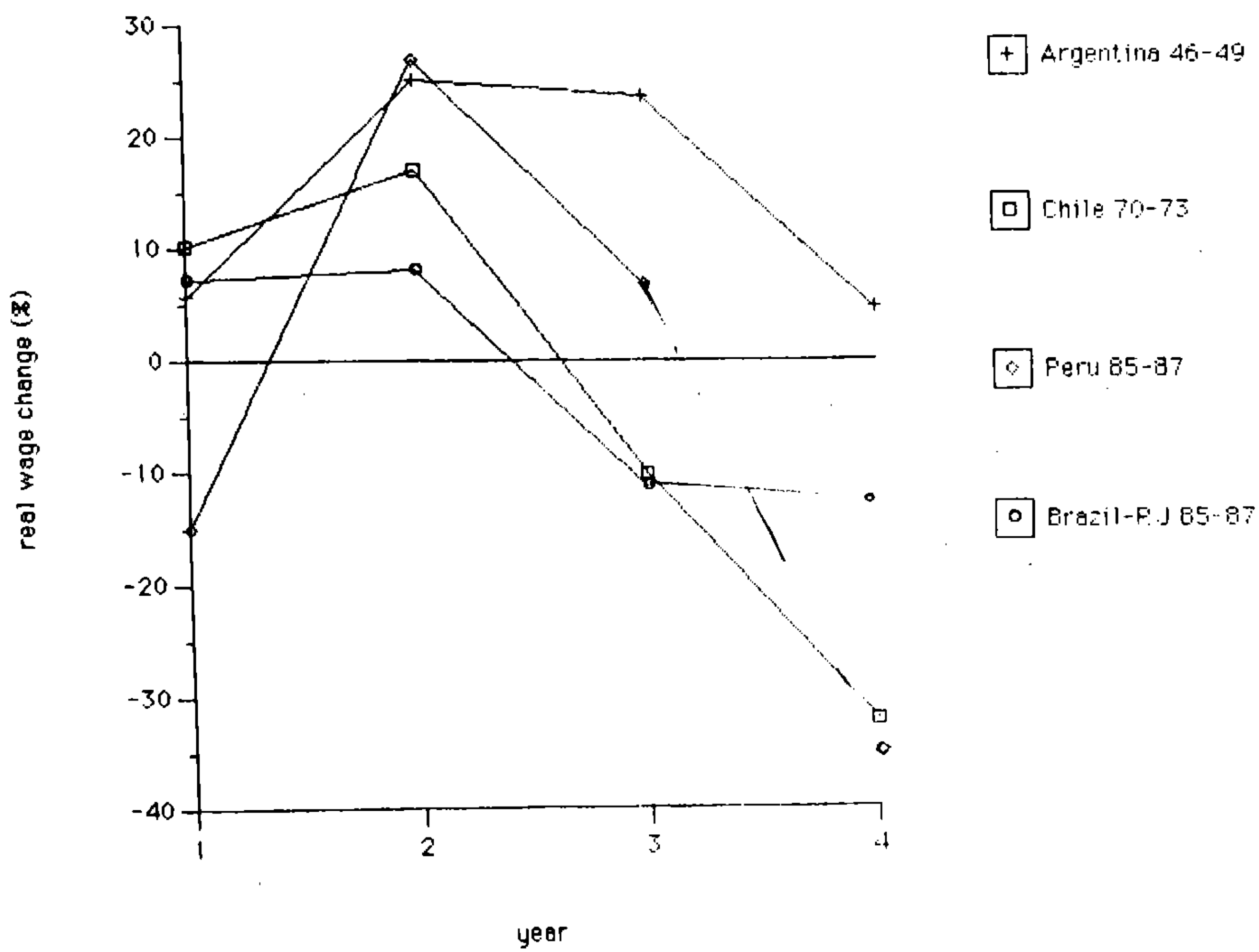

Figure 4

Index of Exp.volume/Index of GDP

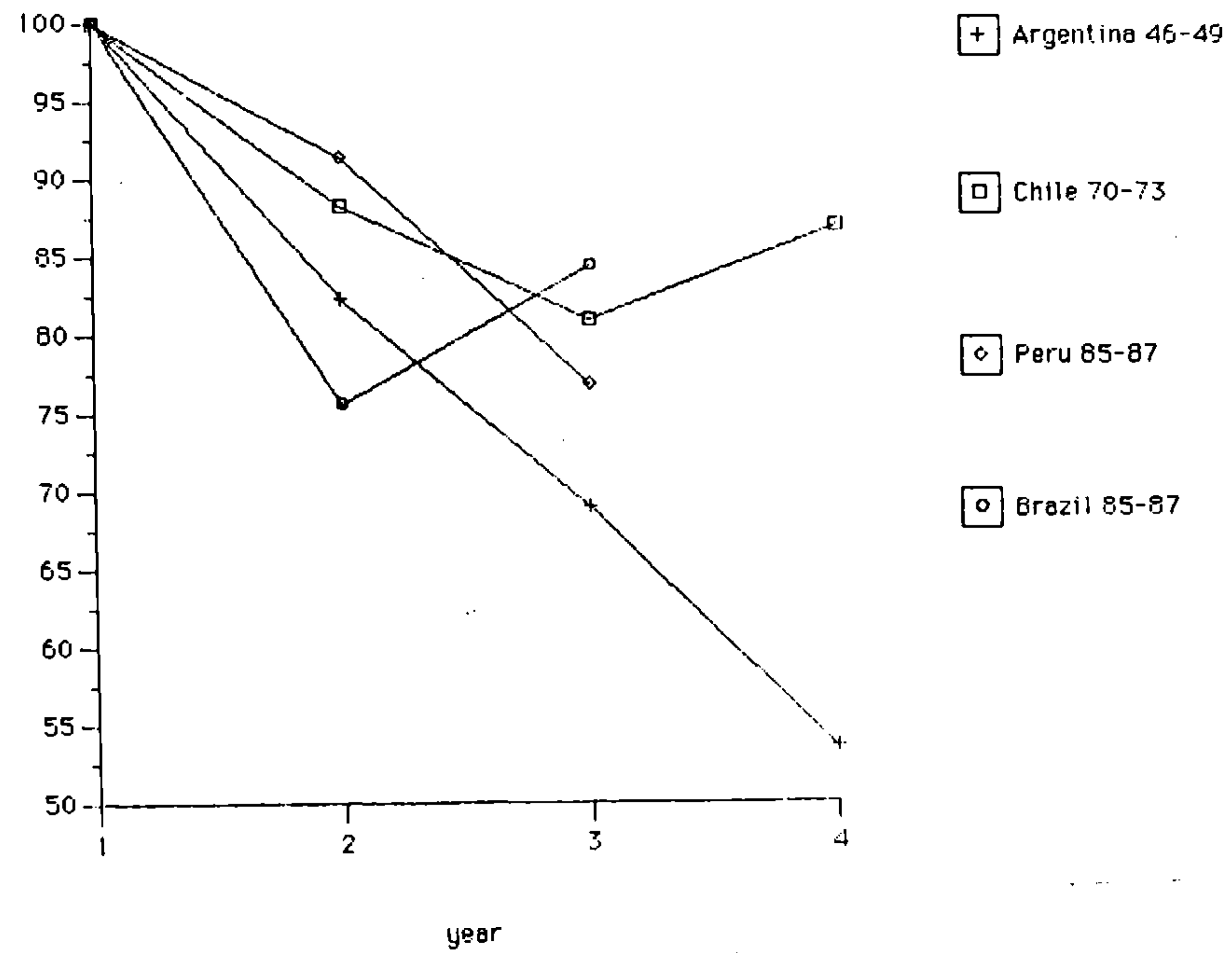

Figure 5

Int.Reserves/Imports

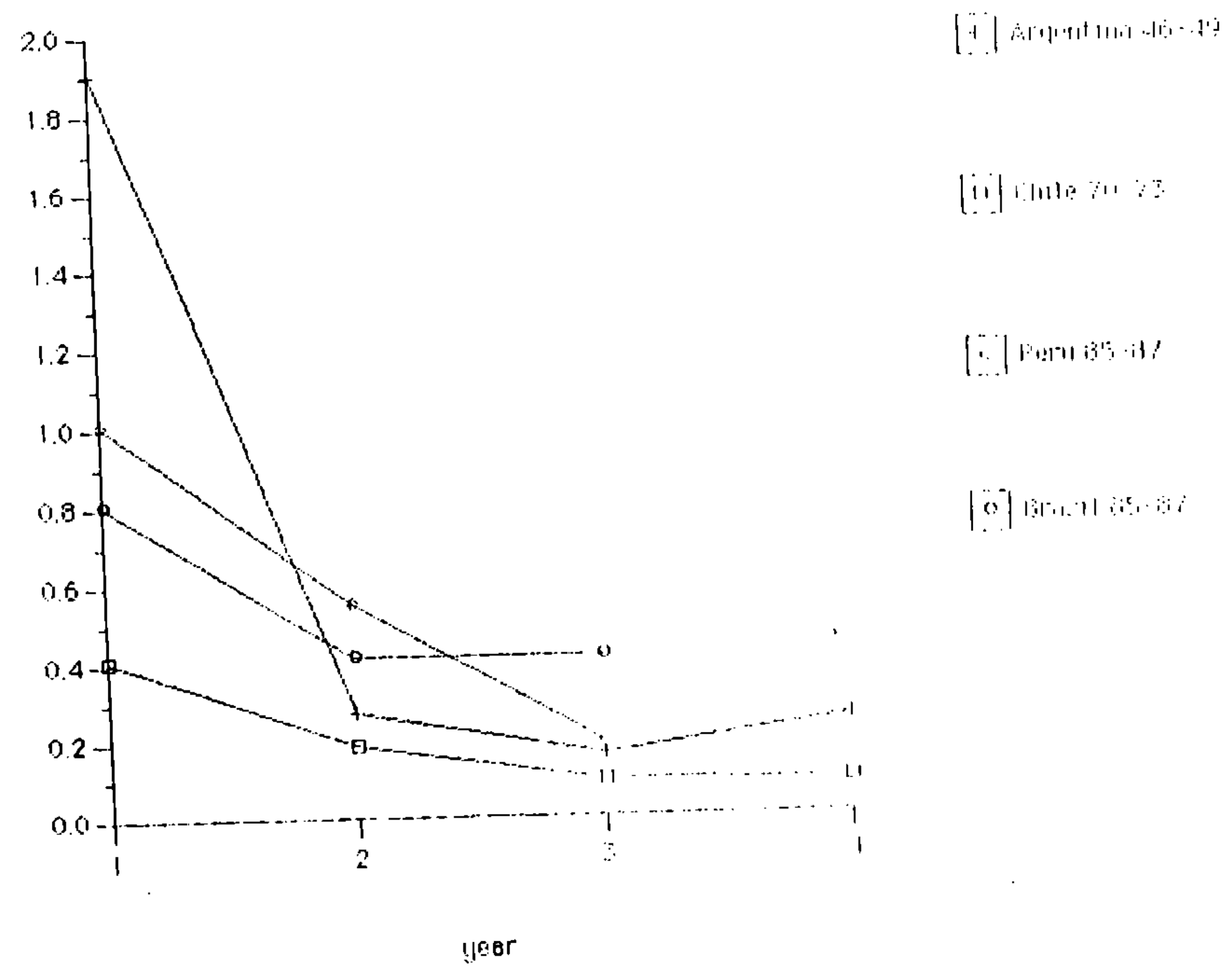

Figure 6

REAL EXCHANGE RATE INDEX
(average of each period)

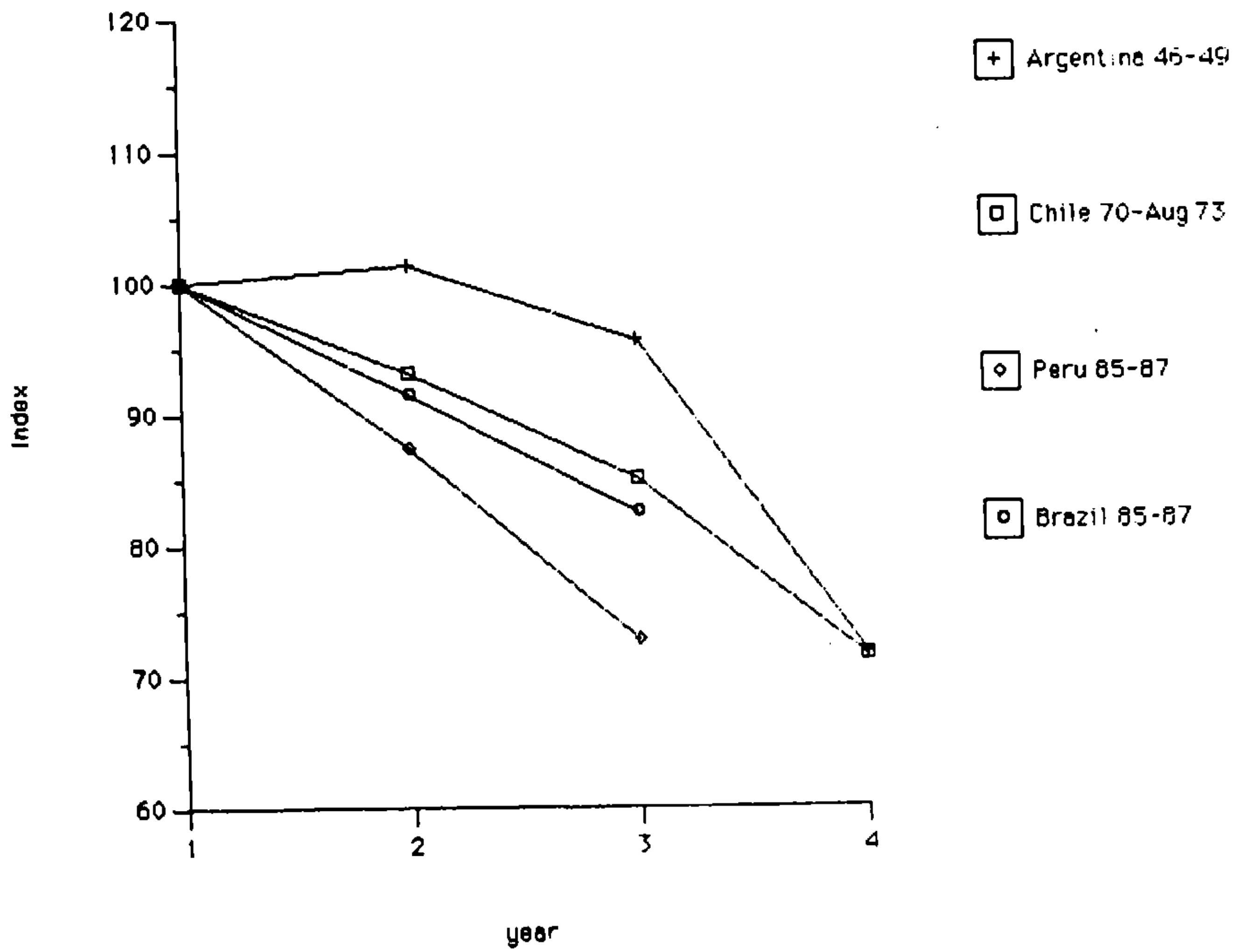

Figure 3 focuses on a crucial target of the populist policies: the real wage. The chart shows the percentage change in the wage each year of the policy. Real wage growth is strong at the beginning of the program, through the first two years, and then slows down in the third year, and finally collapses as the balance of payments crisis hits the economy. In Chile in 1973, real wages fell by 32 percent; in Peru in 1988, real wages fell by 34.5 percent; and in Brazil in 1988, real wages in Rio de Janeiro fell by 12.8 percent, following a decline of 16 percent in 1987.[11]

Figures 4 through 6 demonstrate the Achilles' heel of all of the experiments: the external sector. As shown in Figure 4, export volumes fall relative to GNP in all of the countries, and in Figure 4 we see that the ratio of international reserves to imports plummets in the second year of the program in each of the countries. One major reason for this collapse is shown in Figure 5: the steady and significant appreciation of the real exchange rate, where the real exchange rate is defined in this figure as the nominal exchange rate vis-a-vis the dollar, divided by the ratio of the consumer price index of the home country to the consumer price index of the U.S. In all of the countries the real exchange rate appreciates sharply in the course of the program, by as much as 25 to 30 percent in real terms by the third and fourth years. We have already noted that this appreciation helps to explain the initial rise in the

[11]The 1988 data for Peru, and the 1987 and 1988 data for Rio de Janeiro are from CEPAL (1988). The 1988 data are provisional. Note that in Brazil, there is a big discrepancy between the sharp fall of real wages in Rio de Janeiro, and the much more moderate decline in Sao Paolo (where wages fell only by about 2 percent between

real wage, as well as the decline in net exports and international reserves.

III. Conclusions and Extensions

A great many of Latin America's economic problems in the 1980s are due to external factors. World real interest rates reached unexpected and unprecedented levels in the 1980s, resulting in an enormous drain of resources from Latin American debtor countries to the creditor world. Commodities prices for Latin America's leading exports collapsed, often falling in real terms to the lowest levels in half a century or more. And in many countries, fragile democratic governments had to try to pick of the pieces from the rubble -- in human, political, and economic terms -- left by earlier military regimes.

Nonetheless, Latin America cannot fully escape the responsibility for the current crisis. The debt crisis has hit hardest in countries with a long tradition of fiscal laxity. In many cases, that laxity has hit shocking proportions, particularly when governments have used drastic fiscal expansions in order to try to solve deep-seated problems of economic inequality and poverty. We have seen in this paper the evidence that these populist measures tend to collapse in a remarkable burst of inflation and falling real wages, at the moment when the fiscal expansion hits the balance of payments constraint.

We have suggested that the impulse for populist measures follows from several factors, including: an enviroment of deep economic conflict, rooted in a highly unequal distribution of income; political instability, leading to governments with short expected tenure and equally short time horizons; and a deep perceived cleavage in sectoral interests, with the urban working class sharply opposed to the exporters of primary commodities.

And yet, a major puzzle remains. The populist episodes we have reviewed ended in collapse, sometimes even in tragedy. Peron was forced into exile, leaving a weakened economy and a society both politicized and deeply divided; Allende died in a military coup that destroyed democracy in Chile for the next fifteen years; Sarney and Garcia now preside over failed regimes, each now facing the real danger of a hyperinflation and economic collapse. Why did these leaders opt for such a dangerous strategy? At least Brazil and Peru should have had the benefit of the lessons of the other two experiences.

Perhaps the most accurate, and also simplest, answer is that these leaders, and even more their followers, did not understand the riskiness of the course that they selected. Populist policies look remarkably good at the beginning of the populist cycle. It is only the hopeless pessimist that raises doubts in the midst of a boom that causes real wages to rise sharply while keeping inflation under control (or even cutting inflation, as in Brazil and Peru)! Presidents Peron, Sarney, and Garcia reached remarkable levels of popularity in the early stages of their programs. The problem of falling foreign exchange reserves looks like a technical nuisance at this stage. Something will come up, each of the leader reasoned: new loans, a cut in world interest rates, a surge of exports (<u>deus ex machina</u>), even a debt moratorium or exchange controls if necessary. After all, what is a little inconvenience in foreign trade if the benefits are a real wage boom and rapid growth?!

In truth, the situation may be difficult even when the leader understands the difficulties, if his followers (in congress, in the unions, and on the streets) do not. The pressures for redistribution may be too much to resist, if the congress is pushing hard for more spending, and siding with important constituencies towards that end. In Brazil, the finance ministers in 1987 and 1988 understood well the dangers of the fiscal expansion, but were powerless to resist a President that in turn was bowing to populist pressures in the Brazilian Congress.

The lack of perspective is not limited to politicians. Various schools of "structuralist" thought in economics continue to advocate measures along populist lines. There is no better evidence of this than the self-congratulatory volume El Peru Heterodoxo: Un Modelo Economico (D. Carbonetto, ed.), published in 1987 by the technical analysts that designed the ill-fated Peruvian program. Just on the eve of the collapse of the program (as liquid foreign exchange reserves were finally depleted), the book appeared, with the following pronouncement.

> At the moment of sending this book to print we close the first year and a half of the application of the reactivation policies in Peru. The [economic] data obtained corroborate on the whole the thesis that it is possible to reactivate an economy (when one has excess capacity) and at the same time to reduce the level of inflation.
>
> In this year and a half, Peru reduced its inflation from 250 percent annual to around 65 percent annually, and raised its GNP by more than 8 percent per year.
>
> Nonetheless, the same success obtained in this process of reactivation open unknowns which could be called the second stage of development of the Peruvian economic model. These unknowns refer to the extent of savings-investment and of exports capacity of the Peruvian economy in the immediate future. (p. 16, translation mine).

Unfortunately, the authors failed to recognize that the failure of the second stage (to develop adequate savings and exports) is the logical result of the "success" of the first stage. Sadly, by September 1988, Peruvian exports had collapsed and the economy had entered into a hyperinflation! As of September 1988, the government was attempting to make an emergency turn towards fiscal stabilization.

This problem of understanding is undoubtedly complicated by the absence of adequate "institutional memory" in most of the governments in Latin America. With every change of government there is a complete overhaul in public-sector personnel, extending far down into the bureacracy. In modern Japan, by contrast, one man per ministry is subject to change when the government changes -- the minister himself (all other positions are based on internal promotion within the ministries)! The result in Latin America is the absence of normal bureaucratic restraint in the design of major initiatives. The President and his immediate advisors can launch a fundamental change in direction, subject of course to his maintaining office.

In closing, it is important to stress a point of view also expressed at the beginning. The political and moral impulses underlying the populist policies are understandable and indeed often noble. The income distribution in Latin America is a reason for moral concern and a provocation to action. Moroever, many actions of populist governments (such as the debt moratoria of Peru and Brazil in the 1980s, or the "heterodox" shocks that attempted to control inertial inflation), may be meritorious even though they are highly controversial and a part of an otherwise ill-designed program.[12]

Finally, the populist excesses do not prove the merit of extreme orthodox policies that often follow the populist collapse. Too many opponents of populism dismiss real problems over income distribution, and are content to balance budgets without concern for the distributional consequences. The failures of Latin American populism should prompt a search for a middle path, rather than being read as an endorsement of unfettered orthodoxy.

This paper has naturally raised more questions than it has answered. Do the social and political factors described in the paper not only explain the Latin American temptation towards populism, but also the relative absence of populist policies in East Asia? Do the "pacted democracies" of Colombia and Venezuela provide a model for achieving political stability in other countries in the region, and do the experiences of those two countries support the hypothesis that political stability contributes to fiscal responsibility? What are the most effective ways for Latin America to address the long-standing crisis in income inequality, and at the same time to encourage price stability, private investment and accumulation? These great issues provide an agenda for future study of the political economy of the region, an agenda that would have benefitted greatly from the attention and insights of Ezio Tarantelli.

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[12] Alan Garcia's declaration in 1985 that Peru needed debt relief, and that the choice for Peru was "debt or democracy", was accurate. Given the collapsed state of the Peruvian economy and society as of 1985, the possiblity of servicing debt on the terms of the international community was negligible. Thus, the debt moratorium need not be dismissed as wrong simply because it was accompa

Data Appendix

ARGENTINA

YEAR	(1) GDP growth	(2) Real Wages Change	(3) Inflation(CPI) (a)	(4) Reserves/ Imports	(5) Quantum Index Exp/GDP index 1946=100	(6) Quantum Index Imp/GDP index 1946=100	(7) Real Exchange Rate Index 1946=100
1946	8.3%	5.7%	17.7%	1.90	100.0	100.0	100.0
1947	13.8%	25.0%	13.5%	0.28	82.4	177.0	101.3
1948	1.1%	23.6%	13.1%	0.17	69.1	179.7	95.8
1949	-4.5%	4.6%	31.1%	0.25	53.6	129.7	71.8

(a) It represents Buenos Aires change in cost of living (year average)

Sources:
(1),(2),(3),(4),(5),(6) : Diaz Alejandro, Carlos :" Essays in the Economic History of the Argentine Republic" Yale University, 1970.
(7) : Diaz Alejandro, Carlos :" Essays in the Economic History of the Argentine Republic" Yale University, 1970 & Economic Report of the President, USA.

CHILE

YEAR	(1) GDP growth	(2) Real Wages Change	(3) Inflation(CPI) (dec-dec)	(4) Reserves/ Imports	(5) Quantum Index Exp/GDP index 1970=100	(6) Quantum Index Imp/GDP index 1970=100	(7) Real Exchange Rate Index 1970=100
1970	2.1%	10.2%	34.9%	0.41	100.0	100.0	100.0
1971	9.0%	17.0%	22.1%	0.19	88.3	94.3	93.2
1972	-1.2%	-10.1%	163.4%	0.10	81.1	85.8	85.2
1973	-5.6%	-32.1%	508.1%	0.09	87.1	86.9	71.7

* As of August

Sources:
(1),(2),(3), & (7): Central Bank of Chile
(4) IMF and ECLA
(5) & (6) ECLA and Central Bank of Chile.

PERU

YEAR	(1) GDP growth	(2) Real Wages Change	(3) Inflation(CPI) (dec-dec)	(4) Reserves/ Imports	(5) Quantum Index Exp/GDP index 1985=100	(6) Quantum Index Imp/GDP index 1985=100	(7) Real Exchange Rate Index 1985=100
1985	1.9%	-15.0%	158.3%	1.01	100.0	100.0	100.0
1986	8.5%	26.7%	62.9%	0.55	91.4	127.0	87.5
1987 (a)	6.9%	6.7%	114.5%	0.19	76.9	130.7	72.9
1988 (b)	-4.0%	- 34.5%	500.0%	n.a.	n.a.	n.a.	n.a.

(a) Preliminary figures
(b) Estimation

Sources:
(1) & (7): Apoyo SA.
(2) ECLA
(3),(5)&(6) Apoyo SA and ECLA.
(4) IMF and Apoyo SA.

BRAZIL

YEAR	(1) GDP growth	(2) Real Wages Change (R.Janeiro)	(3) Inflation(CPI) (dec-dec)	(4) Reserves/ Imports	(5) Quantum Index Exp/GDP index 1985=100	(6) Quantum Index Imp/GDP index 1985=100	(7) Real Exchange Rate Index 1985=100
1985	8.3%	7.2%	248.5%	0.81	100.0	100.0	100.0
1986	8.2%	8.1%	63.5%	0.41	75.6	106.4	91.5
1987 (a)	3.0%	-16.0%	432.0%	0.42	84.5	106.1	82.6
1988 (b)	-1.0%	~~[illegible]~~ -12.8%	700.0%	n.a.	n.a.	n.a.	n.a.

(a) Preliminary figures
(b) Estimation

Sources:
(1),(2),(5) & (6): ECLA
(3) &(7): IMF
(4): IMF and ECLA

ARGENTINA

	1945	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955
Money(M1) growth*	20.3%	30.8%	21.2%	34.3%	27.7%	25.4%	21.3%	13.8%	24.0%	16.3%	17.6%
Fiscal Deficit (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	1.5%	0.5%	-0.1%	0.8%	2.5%	2.0%

* End of year to end of year
Source: Diaz Alejandro, C.

CHILE

	1969	1970	1971	1972	1973
Money(M1) growth*	35.2%	66.2%	113.4%	151.8%	362.9%
Fiscal Deficit (% of GDP)	0.4%	2.7%	10.7%	13.0%	24.7%

Source: Central Bank of Chile

PERU

	1984	1985	1986	1987	1988-Est
Money(M1) growth*	116.0%	285.5%	85.7%	86.7% (a)	n.a
Fiscal Deficit (% of GDP)	8.0%	4.4%	7.9%	10.9%	9.0%

(a) As of November
Source: Apoyo SA and IMF.

BRAZIL

	1984	1985	1986	1987
Money(M1) growth**	201.9%	304.3%	303.8%	5.3% (a)
Fiscal Deficit (% of GDP):				
Nominal	22.2%	27.1%	9.9% (b)	n.a.
Operational	1.6%	3.5%	4.1% (b)	n.a.

(a) As of June
(b) Estimate
** December - December
Source: Central Bank of Brazil & Dornbusch, R. and Cardoso, E. NBER, Working Paper # 2142.

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