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1 The Macroeconomics of Populism

Rudiger Dornbusch and Sebastian Edwards

Latin America's economic history seems to repeat itself endlessly, following irregular and dramatic cycles. This sense of circularity is particularly striking with respect to the use of populist macroeconomic policies for distributive purposes. Again and again, and in country after country, policymakers have embraced economic programs that rely heavily on the use of expansive fiscal and credit policies and overvalued currency to accelerate growth and redistribute income. In implementing these policies, there has usually been no concern for the existence of fiscal and foreign exchange constraints. After a short period of economic growth and recovery, bottlenecks develop provoking unsustainable macroeconomic pressures that, at the end, result in the plummeting of real wages and severe balance of payment difficulties. The final outcome of these experiments has generally been galloping inflation, crisis, and the collapse of the economic system. In the aftermath of these experiments there is no other alternative left but to implement, typically with the help of the International Monetary Fund (IMF), a drastically restrictive and costly stabilization program. The self-destructive feature of populism is particularly apparent from the stark decline in per capita income and real wages in the final days of these experiences.

Accounts of these populist episodes by sympathizers often highlight politics and, especially, external factors as central to the demise. We do not pretend to belittle these factors. There is no question in our minds that external destabilization can be an important part of the unraveling of an economic program. But we want to emphasize that the extreme vulnerability that makes destabilization possible is, by and large, the result of unsustainable policies.

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This is one more reason to focus sharply on the *macro*economics of populist programs.

How can we explain this recurrence of mistakes and ill-conceived development strategies that span so many countries at different points in time? Is it just the lack of "memory" of policymakers, or is it, perhaps, a deeply rooted ignorance of the mechanics of economic populism? An alternative interpretation, based on the new political economy approach to economic policymaking, is that the engineers of these populist episodes have some kind of (dynamic) strategic considerations in mind.

Our purpose in organizing this conference was to bring together a group of experts on Latin America to analyze general systemic features of macroeconomic populism in Latin America and to document the regularities, and peculiarities, of a large number of populist episodes. The case studies collected in this volume show the striking similarity of populist policies in a score of Latin American countries. Policymakers in Argentina, Brazil, Chile, Mexico, Peru, and Nicaragua had comparable views on the objective conditions of their economies, on how they proposed that strongly expansionary policies should and could be carried out, and how they rationalized that constraints could be dealt with. More impressive perhaps, is the fact, so clearly illustrated throughout the volume, that in the end, foreign exchange constraints and extreme inflation forced, in every country, a program of violent real wage cuts that ended, in many instances, in massive political instability, coups, and violence. There is no doubt in our minds about the sincerity of the policymakers who embarked on these programs, and we share their concern for income distribution and poverty alleviation. It is, however, the very sincerity of these policymakers that makes the necessity of laying out exactly how and why the programs go wrong particularly urgent.

In this first chapter we present what we consider to be the most salient features of the populist paradigm, and we discuss the circumstances that lead policymakers to repeatedly undertake these type of policies in spite of abundant historical evidence on their harmful consequences.[1] Our emphasis is on the macroeconomics of populism, not because we think that other aspects of the phenomenon are uninteresting, but because we believe that it is in the macroeconomic sphere that populist experiences have been particularly weak. An earlier version of this paper was distributed to the different participants in this project and was used by most of them as a general framework in preparing their own contributions to the conference. In that regard, then, this chapter provides a somewhat unifying framework used by the majority of the authors.

1.1 The Populist Paradigm

Populism is, in many ways, a controversial concept. In fact, for many years political scientists have struggled to provide a meaningful and precise defini-

1. Parts of this chapter draw on our paper on the populist experiences of Peru and Chile. See Dornbusch and Edwards (1990).

tion. Drake (1982), for example, has emphasized three elements of a tentative definition: populism uses "political mobilization, recurrent rhetoric and symbols designed to inspire the people," it draws on a heterogeneous coalition aimed primarily at the working class, but including and led by significant sectors from the middle and upper strata, and, third, populism "has connoted a reformist set of policies tailored to promote development without explosive class conflict." He notes that the programs "normally respond to the problems of underdevelopment by expanding state activism to incorporate the workers in a process of accelerated industrialization through ameliorative redistributive measures" (p. 218).

Conniff (1982, p. 5) has argued that "populist programs frequently overlapped with those of socialism." We emphasize that the redistributive objective is the central part of the paradigm. Whether they are motivated by a strategy of massive social reform is important and consequential, but it is not central to our discussion.

For us "economic populism" is an approach to *economics* that emphasizes growth and income redistribution and deemphasizes the risks of inflation and deficit finance, external constraints, and the reaction of economic agents to aggressive nonmarket policies.[2] The purpose in setting out this paradigm is not a righteous assertion of conservative economics, but rather a warning that populist policies do ultimately fail; and when they fail it is always at a frightening cost to the very groups that were supposed to be favored. A central thesis we advance is that the *macro*economics of various experiences is very much the same, even if the politics differed greatly.

The most important features of the populist paradigm can be summarized as follows:

1. *Initial conditions.*—The populist policymakers—and the population at large—are deeply dissatisfied with the economy's performance; there is a strong feeling that things can be better. Typically, the country has experienced very moderate growth, stagnation, or outright depression as a result of previous stabilization attempts. This previous stabilization experience often, though not necessarily always, has been implemented under an IMF program and has resulted in reduced growth and lower living standards. In addition, a highly uneven income distribution usually presents a serious political and economic problem, providing the appeal for a radically different economic program. The preceding stabilization would generally have improved the budget and the external balance (through the accumulation of international reserves) sufficiently to provide the room for, though perhaps not the wisdom of, a highly expansionary program.

2. *No constraints.*—Policymakers explicitly reject the conservative paradigm and ignore the existence of any type of constraints on macroeconomic policy. Idle capacity is seen as providing the leeway for expansion. Existing international reserves and the ability to ration foreign exchange create addi-

2. See Sachs (1989) for a discussion of some aspects of populism in Latin America.

tional room for expansive policies without the risk of running into external constraints. The risks of deficit finance emphasized in traditional thinking are portrayed as exaggerated or altogether unfounded. According to populist policymakers, expansion is not inflationary (if there is no devaluation) because spare capacity and decreasing long-run costs contain cost pressures and there is always room to squeeze profit margins by price controls.

For example, the script for Peru's populism, *El Peru Heterodoxo: Un Modelo Economico* (Carbonetto et al. 1987, p. 82) notes: "An examination of the Peruvian record reveals that periods of moderate inflation are associated with expansionary fiscal policies. And periods of major inflation are associated with fiscal restraint. Thus, the record shows exactly the opposite of what is predicted by a theory which explains inflation by fiscal deficits." And:

> If it were necessary to summarize in two words the economic strategy adopted by the government starting in August 1985 they are *control* (meaning control of prices and costs and recognizing that this could be done only temporarily for the first twelve months) and *spend*, transferring resources to the poorest so that they increase consumption and create a demand for increased output, thus "justifying" that idle capacity be put to use.
>
> It is necessary to spend, even at the cost of a fiscal deficit, because, if this deficit transfers public resources to increased consumption of the poorest they demand more goods and it will bring about a reduction in unit costs, thus the deficit is not inflationary, on the contrary!

3. *Policy prescriptions.*—In light of the initial conditions described above, the populist programs emphasize three elements: reactivation, redistribution of income, and restructuring of the economy. The common thread here is "reactivation with redistribution." The recommended policy is to actively use macroeconomic policy to redistribute income, typically by large real-wage increases that are not to be passed on into higher prices. However, even if inflationary pressures do develop, the populist policymaker rejects devaluation because of a conviction that it reduces living standards and because it will have further inflationary impact without positively affecting the external sector. The economy is to be restructured to save on foreign exchange and support higher levels of real wages and higher growth. In Allende's Chile, Vuskovic (1973, p. 50) argued:

> The urgent need to achieve rapid recovery of the economy, and to extend the benefits to the mass of the working population, cannot be undertaken in isolation from the structural changes; they are all necessarily interdependent. It is not possible to make deeper changes without broadening the Government's political support, and economic reactivation and income redistribution will provide an impulse to these fundamental changes.

In Garcia's Peru, a strikingly similar program was articulated in the *Plan Nacional de Desarrollo, 1989–90:*

> The new economic policy seeks to pass from an economy of conflict and speculation to one of production and consensus. In this economy it is pos-

sible to make compatible stability, growth, distribution, and development in a context of national planning which finds concrete expression in dialogue and social and economic agreement. We need to reconcile economic efficiency with social equity in a productive system which is fundamentally sustained by domestic resources. (Presidencia de la Republica 1986, p. 63).

1.2 The Phases of Populist Economics

Once in power, and armed with the above paradigm, populist policymakers rapidly move to implement ambitious economic programs aimed at redistributing income, generating employment, and accelerating growth. Although each historical populist episode exhibits some unique features, it is still possible to distinguish four phases common to the vast majority of experiences.[3]

Phase 1.—In the first phase, the policymakers are fully vindicated in their diagnosis and prescription: growth of output, real wages, and employment are high, and the *macro*economic policies are nothing short of successful. Controls assure that inflation is not a problem, and shortages are alleviated by imports. The run-down of inventories and the availability of imports (financed by reserve decumulation or suspension of external payments) accommodate the demand expansion with little impact on inflation.

Phase 2.—The economy runs into bottlenecks, partly as a result of a strong expansion in demand for domestic goods, and partly because of a growing lack of foreign exchange. Whereas inventory decumulation was an essential feature of the first phase, the low levels of inventories and inventory building are now a source of problems. Price realignments and devaluation, exchange control, or protection become necessary. Inflation increases significantly, but wages keep up. The budget deficit worsens tremendously as a result of pervasive subsidies on wage goods and foreign exchange.

Bitar (1986, chap. 5) portrays very clearly the Chilean government's inability to control events, to shift from redistribution to accumulation: "It turned out to be very difficult to contain the forces unleashed in 1971. The sequential conception of redistribution followed by accumulation assumed that basic political and social conduct could be altered and popular expectations changed virtually instantaneously. In the next few months [early 1972] it proved impossible to apply this thinking with the facility that had been hoped for."

Phase 3.—Pervasive shortages, extreme acceleration of inflation, and an obvious foreign exchange gap lead to capital flight and demonetization of the economy. The budget deficit deteriorates violently because of a steep decline in tax collection and increasing subsidy costs. The government attempts to stabilize by cutting subsidies and by a real depreciation. Real wages fall massively, and policies become unstable. It becomes clear that the government is in a desperate situation.

3. Sturzenegger (1990) develops a dynamic intertemporal model that traces out the dynamics of populism described in this section.

Phase 4.—Orthodox stabilization takes over under a new government. More often than not, an IMF program will be enacted; and, when everything is said and done, the real wage will have declined massively, to a level significantly lower than when the whole episode began. Moreover, that decline will be very persistent, because the politics and economics of the experience will have depressed investment and promoted capital flight. The extremity of real wage declines is due to a simple fact: capital is mobile across borders, but labor is not. Capital can flee from poor policies, labor is trapped.

The ultimate dismantling is often accompanied by major political change, including violent overthrow of the government. The middle-class sanctions these developments because of the economic threat of populism. Rosenstein-Rodan (1974, p. 7) has captured this middle-class "legitimization" of the coup in the crass expression, "Salvador Allende died not because he was a socialist, but because he was an incompetent."

1.3 Policy Mistakes, History and Memory

With the exception of Colombia—where populist macroeconomic policies have been largely absent during the last four decades—the episodes with populist economics in Argentina, Brazil, Chile, Peru, Mexico, and Nicaragua, analyzed in this book, have followed quite closely the four phases we identify above. Although the final outcome of these experiments was not always the total collapse and destruction of the economy (as in Chile, Peru, and Nicaragua, for example), in all cases there were disastrous effects for those groups who were supposed to be the beneficiaries of the policies.

At the end of the road one cannot avoid wondering whether the mistakes of past populist regimes can be internalized by policymakers, politicians, and the population at large and, thus, be avoided in the future. Quite clearly, the detailed case studies collected here suggest that, in general, there is very little capacity (or willingness) of learning from other countries' experiences. Indeed, one of the most striking regularities of these episodes is the insistence with which the engineers of the populist programs argue that their circumstances are *unique* and thus immune from historical lessons from other nations.

A slightly different question, however, is whether countries have an economic and political *memory* that allows them to learn from their *own* mistakes. Recent developments in Chile, where the new democratic government that took power in March 1990 faced urgent and immediate pressures to improve the social conditions of the poor, provide some new light on this subject. Both the writings of the economic team of the new Chilean government, as well as the economic program of the governing coalition—which includes many of the parties in Allende's Unidad Popular, suggest that some of the more important lessons regarding the design of economic policy have indeed been absorbed in that country. The new authorities have, in fact, emphasized repeatedly the need to maintain fiscal balance and to pursue redistributional goals through focussed microeconomic policies.

The central question is whether populist policies are outright unsustainable, or whether there is a variant that, properly executed, can in fact succeed. We leave to further research the elaboration of the thesis that (short-term) expansionary policies can succeed provided they stay far clear of foreign exchange constraints, emphasize reactivation only for a brief initial period, and then shift to growth policies. Most important for success, expansionary policies need to be aware of capacity constraints and for their financing must rely on an extremely orthodox fiscal policy and rigorous tax administration.

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