

Political conditions for successful inflation stabilization: comparing Brazil and Argentina

Condições políticas para estabilização bem-sucedida da inflação: comparando Brasil e Argentina

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Introduction

Chronic inflation has been one of the most distinguishing macroeconomic characteristics of Latin American countries since the end of the Second World War. This study looks at two chronic inflation cases in Latin America—Argentina and Brazil—to examine how stabilization of prices was finally accomplished in early 1990s after a series of repeated failures. Although inflation seems to be an old economic problem which was largely resolved by the developing countries by now, the ways in which these countries secured low inflation rates is still an important issue. Disinflation requires politically challenging economic policies and reforms which are similarly required to resolve other macroeconomic problems.

Most studies on Latin American inflation focus on economic features of the stabilization programs and try to link the success or failure of stabilization to these technical specifics. This study presumes that economic strategies that reduce inflation are widely known and recently have become quite standardized. Yet, similar programs may produce different outcomes under different political conditions. Thus, political factors are as critical as economic ones for successful price stabilization. However, there is no consensus in the literature regarding the political conditions necessary for successful stabilization. Some political economy theories, such as the “war of attrition model,” (Alesina and Drazen 1991; Drazen and Grilli 1993) try to explain the political impediments to stabilization. There are also many comparative political studies on the issue. Some argue that autonomous decision-making is necessary for stabilization (Geddes 1994; Haggard and Kaufman

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1992, 1995; Gasiorowski 2000), while others emphasize political unity (Shugart and Haggard 2001). This study rests on the studies which highlight the importance of political negotiation and coalition-building efforts that accompany stabilization (e.g. Waterbury 1989; Haggard and Webb 1993; Etchemendy 2001; Armijo and Faucher 2002) and refuses the argument that state autonomy or political unity is necessary for successful stabilization. Instead, it suggests that, although these factors may contribute to successful price stabilization, reconciling the interests of different stakeholders and thereby raising widespread political support is more important for successful stabilization. The way governments raise political support may differ from case to case. Broadly speaking it is argued that the more a government is fragmented and fragile, the more there is a need for a skillful leader to reconcile the interests of different stakeholders. Additionally, political support has to remain intact beyond the short-term for stabilization to succeed and this can be achieved by a stabilization plan which gives immediate positive results.

In particular the Brazilian case shows that a strong and unified government is not a necessary condition for successful stabilization. The key in the Brazilian case was to generate wide political support for stabilization through skillful leadership. Yet, even in Argentina where politics was more unified, the government had to work to gain wide political support for stabilization. Therefore, in none of these cases stabilization was simply a top-down process where autonomous policymakers implemented the disinflationary programs without any or much political consultation.

The following section includes a review of the literature on political economy of stabilization and states the main arguments of this study. Next section presents a detailed analysis of how successful stabilization occurred in Brazil and in Argentina with particular focus on the political factors, especially how broad political support was built for stabilization. The last section summarizes the findings of the study and concludes with the implications.

How do stabilizations become successful?

According to Pazos (1972), chronic inflation is high and persistent inflation which may last for decades. It may exist because of some public expenditures that benefit the society or just some sections of the society, such as welfare benefits, subsidized products, support for certain sectors, high wages, and payments for client relationships. Those expenditures can cause serious fiscal strains. Raising funds through taxation is usually politically difficult, so governments may simply print more money, and thus raise inflation, to meet the demands of the constituents and clients.

There are many economic and political studies which try to explain why inflation stabilization does or does not occur. However, there is no agreement on the necessary political conditions for successful stabilization. A common view in the

political economy literature is that politicians are responsive to popular pressures, and thus, use inflation for more spending and redistribution. This relationship is supposed to be stronger in democratic regimes (O'Donnell 1973; Skidmore 1977; Thorp and Whitehead 1979; Nelson 1984; Kaufman 1985; Remmer 1986; Haggard and Kaufman 1992). The argument follows that policymakers may use monetary policy and inflation to stimulate economic growth and for redistribution, so they delay stabilization (Dornbusch and Edwards 1991; Haggard and Kaufman 1992). Disinflationary policies may decrease growth and increase unemployment before any positive economic effect can be felt (Oatley 2004). Also, fiscal adjustment necessary for stabilization usually means drastic cuts in public services and subsidies. Usually costs occur up-front, while benefits only accrue with time (Williamson 1994). Therefore, governments which implement stabilization policies may bear huge political losses in the short-term, even though these policies may bring about better macroeconomic performance in longer run (Bresser Pereira, Maravall, and Przeworski 1993; Williamson 1994). This study suggests that there are ways to overcome these handicaps. In fact, as Tommasi and Velasco (1996) suggest, stabilizations can be both more popular and more lasting than many have predicted.

Some scholars argue that opposition to stabilization may be overcome through authoritarian governments as they are not as accountable and sensitive to social and political pressures (Olson 1982; O'Donnell, Schmitter, and Whitehead 1986; Whitehead 1989; Haggard and Kaufman 1992, Oatley 2004). However, although successful disinflation by authoritarian regimes had some examples in the 1970s and 1980s (e.g. Chile and Mexico), by the mid-1990s prices were stabilized even under democratic regimes (e.g. Argentina and Brazil). The "war of attrition model" tries to explain why authoritarian regimes may be as unsuccessful in inflation stabilization as the democratic ones, or how some democratic regimes can successfully stabilize. This model sees inflation stabilization as a distributional conflict between different conflicting parties (Alesina and Drazen 1991; Drazen and Grilli 1993; Sturzenegger and Tommasi 1998). The burden of the necessary economic adjustments, which involve spending cuts and tax increases, may fall on different social groups. This creates a prisoner's dilemma where every interest group wants the others to pay the price and postpone inflation stabilization. Stabilization is delayed until one group concedes and is forced to assume the heavier cost of stabilization. Hence, some scholars argue that only technocratic, politically insulated policymakers can manage successful stabilization (Geddes 1994; Haggard and Kaufman 1995; Gasiorowski 2000). This study concedes that inflation can create a prisoner's dilemma, but disagrees that autonomous decision-making is essential for stabilization.

Some scholars have pointed out that the characteristics of the democratic system may matter when it comes to implementing stabilization plans successfully. For instance, it is argued that political unity, referred as "unity of purpose" by Shugart and Haggard (2001), positively affects price stabilization. Political unity

indicates a situation where both the executive and legislature have the same political mandate, and thus share the same policy goals. It exists when the executive and the legislature are under the control of the same party, the legislators and the president have similar interests, and the executive is supported by a legislative majority (Shugart and Haggard 2001). Political unity is hard to attain especially if the party system is fragmented, undisciplined, weak, and particularistic. However, despite its extremely fragmented political system, Brazil was able to eliminate high inflation.

This study argues that a strong unified government is neither a sufficient nor a necessary condition for successful stabilization. No matter how unified and strong a government is, it still needs to work on raising wide political support for stabilization and reconciling different interests in the society. Stabilization plans become successful when they secure support from considerably broad sections of the society and that political opposition to stabilization is low. In that respect, stabilization efforts should be accompanied by negotiation and coalition-building efforts, as previously argued by some scholars (Waterbury 1989; Haggard and Webb 1993; Gibson 1997; Corrales 1998; Kessler 1998; Etchemendy 2001; Armijo and Faucher 2002). In other words, building constituencies for stabilization is crucial, because successful stabilization is possible if the government is responsive to the social groups who are affected by the reforms and make bargains with them and sometimes makes concessions in order to create support. This suggestion also directly contradicts with the argument that state autonomy is essential for successful stabilization.

Especially the backing of the lower echelons of the society is crucial, because one cannot build a broad support base if they are excluded from the process. Coopting working classes to stabilization would limit economic populism that would cause stabilization to falter. Although lower echelons of the society suffer from inflation more than the others, they are usually distrustful of and resistant to stabilization plans. Uncertainty about the future costs and benefits discourages people to support stabilization, even though they may eventually benefit from stabilization (Fernandez and Rodrik 1991; Rodrik 1996). Under these conditions they need to be persuaded to support stabilization. This is possible if they are convinced that all major stakeholders will somehow share the costs and benefits of stabilization. Some scholars argue that left wing or popular governments are more advantageous in forming broadly based social coalitions (Rodrik 1996; Cukierman and Tommasi 1998). Commitment to working classes are seen as a guarantee that the cost of the stabilization plan adopted will not fall entirely on the shoulders of the working classes; or even if heavier costs are assumed by these groups, they would be compensated in future.

Political support for stabilization also depends on whether the losers of stabilization are somehow compensated in the plan or with other policies that accompany the plan (Cornia, Jolly, and Stewart 1987). As Przeworski (1993) suggests, if stabilization is not accompanied by social or other compensatory

policies, it may not be maintained in the longer term. The disadvantaged groups should at least partially be compensated for their losses to continue to support the plan. This contradicts with the general belief that stabilization means strict austerity.

This study argues that in some cases skillful political leaders may determine the fate of stabilization, because they can help persuasion, cooptation and coordination of different stakeholders, and thus successful implementation of even the most difficult economic policies. By using her charisma, the leader can secure wide political support from the population and also help bring interest groups together to negotiate on a stabilization plan. In some political contexts, these may prove to be impossible tasks if a skillful leader does not exist. It also helps if the political leader is mainly supported by the lower classes as she can give more confidence to those people in terms of compensating for their potential losses. That is why economic reforms may be implemented with less difficulty by governments least expected to implement them (Cukierman and Tommasi 1998). In fact, in many Latin American countries, such as Argentina, Brazil, and Peru, important economic reforms were led by “neopopulist” leaders who made use of their broad political support while implementing unpopular economic policies (Weyland 2000, 2003).

Moreover, this paper suggests that political support needs to remain intact for a while in order for the stabilization plan to succeed in the long term. Normally stabilization policies hurt many groups in the short-term because of the cuts in the budget, high interest rates, and the resultant unemployment. Political opposition to stabilization tends to increase as the honeymoon period ends and the structural reforms get underway (Nelson 1994). However, if the stabilization plan soon starts to show improvements in the economy, political risks of stabilization decrease, credibility of the plan rises, and political benefits for the implementing government increases. All these enhance the support for the stabilization plan in the longer term. Therefore, rapid disinflation and economic recovery are also essential for successful stabilization. Yet, the speed of positive economic results may eventually depend on the type of the stabilization strategy chosen.

There are two main strategies to stabilize prices. *Heterodox programs* include some fiscal correction, an exchange-rate freeze or a preannounced exchange-rate path, and an income policy in the form of either explicit wage-price controls or a “social contract.” *Orthodox programs*, which have been more common lately, include fiscal adjustment and either a money-based or an exchange rate based anchor. There are primarily two kinds of orthodox programs depending on the anchor chosen. *Money-based orthodox programs* rely on restrictions on the rate of monetary expansion to provide a nominal anchor, while *exchange rate based orthodox programs* rely on exchange-rate pegging to provide the nominal anchor (Agénor and Montiel 2008). However, despite these technical differences, disinflationary programs are actually more or less similar, because they all involve tight monetary and fiscal policies, as well known by the policymakers. Therefore, the critical issue is not much which economic policies to follow for stabilization, but rather how

these policies will become politically acceptable. In fact, technically very similar stabilization plans may end up very differently in different political settings. Having said that, there is a key difference between the effects of a money-based plan versus effects of an exchange-rate-based plan. The conventional view was that disinflation would always cause economic contraction (Samuelson and Solow 1960; Fischer 1986). However, later it was revealed that exchange rate-based stabilization typically creates an immediate consumption boom, while money-based stabilization creates a recession in the beginning (Calvo and Végh 1999). Hence, the economic and thus the political costs of a money-based stabilization would be paid up front, whereas those costs would be postponed until a later period under an exchange-rate based stabilization. Therefore, the experiences with the exchange rate-based plans have shown that it is possible to stabilize without a recession, at least in the early phases of stabilization, and this makes exchange rate-based stabilization politically more feasible, at least in the short-term. Therefore, it is not surprising that exchange rate-based orthodox plans have become the most common strategy for stabilization.

Case analyses

Brazil and Argentina are high middle income Latin American countries which are classified as emerging markets. They both struggled with inflation long years. Argentina had high inflation all through the 1970s and 1980s and Brazil from the second half of the 1970s until the second half of the 1990s (see Table 1 below).

Table 1. CPI inflation rates in Argentina and Brazil (1970–2008).

| Year | Argentina | Brazil | Year | Argentina | Brazil |
|------|-----------|---------|------|-----------|---------|
| 1970 | 13.5 | 22.3 | 1990 | 2,314.0 | 2,947.7 |
| 1971 | 34.8 | 20.1 | 1991 | 171.7 | 432.8 |
| 1972 | 58.4 | 16.5 | 1992 | 24.9 | 951.6 |
| 1973 | 61.2 | 12.6 | 1993 | 10.6 | 1928.0 |
| 1974 | 23.5 | 27.6 | 1994 | 4.2 | 2075.9 |
| 1975 | 182.9 | 28.9 | 1995 | 3.4 | 66.0 |
| 1976 | 444.0 | 42.0 | 1996 | 0.2 | 15.8 |
| 1977 | 176.0 | 43.7 | 1997 | 0.5 | 6.9 |
| 1978 | 175.5 | 38.7 | 1998 | 0.9 | 3.2 |
| 1979 | 159.5 | 53.9 | 1999 | -1.2 | 4.9 |
| 1980 | 100.8 | 132.6 | 2000 | -0.9 | 7.0 |
| 1981 | 104.5 | 101.7 | 2001 | -1.1 | 6.8 |
| 1982 | 164.8 | 100.5 | 2002 | 25.9 | 8.5 |
| 1983 | 343.8 | 135.0 | 2003 | 13.4 | 14.7 |
| 1984 | 626.7 | 192.1 | 2004 | 4.4 | 6.6 |
| 1985 | 672.2 | 226.0 | 2005 | 9.6 | 6.9 |
| 1986 | 90.1 | 147.1 | 2006 | 10.9 | 4.2 |
| 1987 | 131.3 | 228.3 | 2007 | 8.8 | 3.6 |
| 1988 | 343.0 | 629.1 | 2008 | 8.6 | 5.7 |
| 1989 | 3,079.5 | 1,430.7 | 2009 | 6.3 | 4.9 |

Source: International Financial Statistics, International Monetary Fund (2010).

Argentina and Brazil both have had major shifts between democracy and authoritarianism, but there are political factors that differentiate one from the other. Brazil is a perfect example of low political unity with its extremely fragmented multi-party system (Mainwaring 1997). On the contrary, Argentina is an example of relatively disciplined party system (Jones 1997). By looking at the Brazilian case, one can see that political unity is not necessary for successful stabilization. Yet, for both cases, broad political support was raised before and during the implementation of the stabilization plan. This is especially true for Brazil, where politics has been notoriously fragmented, but it was also the case for Argentina, where it seemed like stabilization was performed through an autonomous government in a top-down manner.

Brazil: stabilization through a skillful leader

According to the argument that successful inflation stabilization necessitates a strong unified government, it would have been impossible to eliminate inflation in Brazil because of its extremely fragmented political system. In fact, until 1994 Brazil struggled with chronic and even hyperinflation. Many stabilization plans were tried and failed in Brazil prior to 1994.¹ Finally, the Real Plan (*Plano Real*) decreased inflation indefinitely. The key to the success of the Real Plan was securing a broad base of support; something which Cardoso managed, but his predecessors had failed to do.

Brazil is an extreme case of multipartism and it has the most fragmented and undisciplined party system (Mainwaring 1997). It had a significant and almost continuous increase in legislative fractionalization from 1975 until 1994.² In 1988 Brazil had adopted a new constitution which instituted proportional representation in large districts, an open-list electoral rule, an undisciplined multi-party system, two legislative houses with extensive powers, and strong local government autonomy (Lamounier 1994; Mainwaring 1999; Power 2000). This kind of a system made it more difficult, if not impossible, to create political unity or stable government majorities in Brazil. Moreover, parties are personalized in Brazil, and party organization and party discipline are weak. Party switching is also very common, so the presidents cannot even rely on their own parties (Mainwaring 1995). Because of the lack of unity in its political system, we would have expected Brazil to fail in stabilization. Yet, although these conditions might have delayed stabilization, they did not prevent stabilization. In fact, when the Brazilian government initiated the Real Plan in 1994, the political fragmentation was at its peak.

1 The Cruzado Plan (1986–1987), Bresser Plan (June 1987), Summer Plan (January 1989), Collor I Plan (March 1990), and Collor II (1991) are only the most important of those failed stabilization attempts.

2 According to the *Database of Political Institutions* of the World Bank, the effective number of legislative parties in Brazil increased from 1.9 in 1975 to 8.5 in 1994.

Fernando Henrique Cardoso, the architect of the Real Plan, was an internationally known leftist intellectual before becoming the Finance Minister of the Itamar Franco government in May 1993. He was an unusual suspect for orthodox stabilization and reform, and probably his left wing credentials helped him to gather support from diverse social groups, including both the elites and the masses. Although Real Plan was resisted by some leftwing people, it received broad support from Brazilian public, because Cardoso was an ideal consensus leader (Flynn 1996).

The Real Plan was adopted in mid-1994 without any IMF arrangement.³ It was clearly an exchange-rate based plan. It combined orthodox and heterodox elements which simultaneously aimed disinflation and sustained growth. It included de-indexation of the economy, a fixed currency, high interest rates, tight reserve requirements, privatization (especially state banks), and some wage and price controls through creation of a new unit of account URV⁴. According to da Fonseca (1998), despite the rise in federal taxes and 15% reduction in the funds transferred from the federal government to states and local governments, the Real Plan did not involve a considerable fiscal austerity. Even wages were increased before they were frozen. It was a comprehensive plan which included neoliberal structural reforms, like privatization and trade liberalization, but also social reforms to deal with their effects.

Also Cardoso's more open and democratic approach to economic policy may have increased his political support. "The Real Plan's implementation process—and to some extent even its design, details of which were altered in the process—was transparent, bargained, and ultimately democratic... Cardoso's Real Plan was preannounced by the executive, debated in Congress, and minutely negotiated with powerful societal interests" (Armijo, Faucher and Dembinska 2006, 774). In February 1994 the first stage of the three-stage Real Plan was announced. Yet, in April, even before the third stage of the Real Plan was announced, Cardoso resigned from his post to run for presidency. Before the October 1994 elections, he made an electoral alliance between his party PSDB and two other smaller parties: Liberal Front Party (PFL) and Brazilian Labor Party (PTB). He won the presidential elections in the first round by 54.3%. His rapidly rising popularity was largely due to decreasing rates of inflation from July to October 1994, thanks to the Real Plan (da Souza 1999). The heaviest burden of inflation was on the underprivileged segments of the society, and thus, the immediate effects of decreasing inflation were increased expenditure on food and consumer durables (da Silva and Kinzo 1999). As a result, the majority of the Brazilian people voted for Cardoso.

3 Only in November 1998 IMF financially started to support the Real Plan upon the request of the Brazilian government which was struggling to defend the Plan against the pressures created by the Mexican *tequila crisis* and the 1997 Asian crisis (Mussa and Savastano 1999).

4 URV was abolished in July 1994 and converted to a new currency, *real*, set at par to the US dollar. When the 1997 Asian crisis sparked a financial crisis in Brazil in 1999, the slow crawling peg system was replaced with a floating exchange rate system and inflation targeting.

Cardoso assumed office with strong electoral endorsement of his Plan. His victory in elections provided continuity to stabilization, allowed him to complete the economic reforms, and prepared the conditions for Real Plan's enduring success. Nonetheless, his economic policies still had to be implemented and sustained politically (Panizza 2000). This proved to be a challenging task, especially when it came to handling the legislature. Despite Cardoso's sweeping victory in the elections, his party PSDB could only control the presidency. PSDB did not win more than 20% of the seats in the Congress or Senate and the combined seats of the three allied parties were only 36%. The Party of the Brazilian Democratic Movement (PMDB) controlled both houses of the legislature and held the majority of state governorships and Cardoso relied on a very heterogeneous five party coalition of PSDB, PMDB, PFL, PTB and the Brazilian Progressive Party (PPB) in order to have a comfortable majority in the legislature. Not to mention the lack of party discipline in Brazil that makes legislators unreliable. Therefore, Cardoso's political support among political elites seemed quite fragile. Moreover, for the constitutional changes that were needed for economic reform, Brazilian government had to get 60% vote of both the Congress and Senate. That was almost an impossible mission. Although Cardoso relied on decrees on some urgent reforms,⁵ he still had to work hard to build the needed 60% majorities in the legislature (Mainwaring 1997; da Souza 1999). Consequently, Cardoso used his position of presidency as a base from which to raise a broad political coalition (Panizza 2000).

Notwithstanding the weakness of his party, Cardoso was able to build a large political coalition which helped him carry on stabilization and even increase his popularity. He constantly worked to guarantee the support of social groups and political elites.⁶ Thus, in order to neutralize opposition and co-opt different sections of the society, Cardoso's policies were a mixture of orthodox policies, heterodox measures, democratic tools of persuasion and negotiation, and traditional pork-barrel policies (Mainwaring 1999; Panizza 2000). That proved to be costly in terms of public finances, because he basically had to pay off to various interest groups.⁷ Therefore, especially with respect to fiscal standards, Real Plan was far from being orthodox. Yet, when Cardoso was using state spending in order to gain support of certain groups, he was also implementing structural reforms to restrict such pork and patronage in the future.

In September 1994, Cardoso proposed a \$ 115 billion pending package for social issues and infrastructure. Immediately after becoming the president,

5 Article 62 of the Brazilian Constitution gives the president the authority to issue "provisional measures with force of law" in cases of "urgency and relevance." For the Real Plan Cardoso made frequent use of presidential decrees to get around the legislature (Maxwell 1999).

6 This was very different from Collor's style of economic decision-making which neglected consultations with different social and political groups (Weyland 2000).

7 In fact, public expenditure in Brazil increased from 32.7 percent of GDP in 1994 to 38.2 percent in 1998, and Brazil continued to run budget deficits during Cardoso's first term (Treisman 2004, 409).

he initiated the “Solidarity Community” program which involved various social projects to combat poverty and hunger. He also started the “Wake up Brazil” education program (Flynn 1996). Not only during election campaigns but also while governing, he emphasized the urgency of tackling the problems of inequality and poverty and the importance of state intervention in the problems that markets cannot resolve (Kingstone 1999). In 1995 Cardoso created the National Secretary of Social Assistance (SNAS) and emphasized the social program PRODEA to provide basic necessities for poor families (Hall 2006; Fenwick 2009). Moreover, he created a new system of unemployment insurance which helped millions of unemployed Brazilians (Schwartzman 2000). Later, Cardoso also introduced some social welfare payments (conditional cash transfers) to alleviate poverty, such as *Bolsa Escola*. As a result, social assistance spending increased rapidly under Cardoso and reached to 5.6% of total social spending as of 2002 (Hall 2006). Even redistribution of land to landless farmers increased significantly under Cardoso’s presidency. In a way, agrarian reform became another mechanism to raise support for the government’s economic policies (Pereira 2003). It was clear that he was trying to build social consensus over stabilization and reform by relieving the hardships they posed on the lower classes.

Cardoso also proved quite successful in defusing the legislative opposition. In the beginning of 1995, the legislature was still reluctant to pass his reforms. Therefore, Cardoso began bargaining by using traditional political methods of pork and patronage (Flynn 1996; de Souza 1999; Armijo 2005). For instance, he doubled legislative and executive salaries. He also helped politicians to appease local constituents by providing them with extra funds. In order to make an alliance with conservative PFL, he pleased its electorate by deferring billions of landowner debt payments to state banks (Mainwaring 1999). This was particularly important for passing certain laws, because small states which PFL controlled were overrepresented in the legislature. Cardoso also offered credit benefits and emergency funds for state governors in return for their support for structural reforms. Where these strategies did not work, he signed agreements with individual governors to force them to fiscal adjustment by partially or fully writing off their debt. Therefore, Cardoso sacrificed short-term orthodoxy to boost political support.

Even support of the business class for stabilization was not warranted. Cardoso’s economic team, which was composed of a number of skillful and experienced economists,⁸ raised business confidence (Flynn 1996). His and his ministers’ regular meetings with business leaders facilitated business support, but he also used some carrot and stick tactics. In order to compensate domestic industrialists for rising interest rates and appreciating currency, he increased import tariffs on certain durable goods (e.g., automobiles and consumer electronics). He also reduced export taxes and provided credit help to suffering industries

8 Cardoso’s team included distinguished Brazilian economists, such as Edmar Bacha, Persio Arida, Andre Lara Rezende, Winston Fritch, and Gustavo Franco.

(Kingstone 1999). The financial sector was automatically pleased with the new ability to hedge between international and domestic interest rate differences by borrowing abroad to finance government's fiscal deficits (Filho 1998). These tactics neutralized the potential business opposition to structural reforms needed for long term stabilization.

Quick stabilization was also instrumental in maintaining support for the Real Plan and for Cardoso's economic policies in general. Inflation dropped from more than 3,000% in 1994 to single digits by the end of 1996. Because it was an exchange-rate-based stabilization, disinflation was accompanied by an economic boom which helped sustain political support. The first nine month growth rate after the beginning of the Real Plan was 9% (Flynn 1996). After a 0.5% economic decline in 1992, the growth rates in 1993, 1994, and 1995 were 4.2%, 5.3%, and 4.4% respectively.⁹ With the improved economic conditions and increased purchasing power, there was a consumption boom among middle classes. Even income distribution got better (Neri and Considera 1996; Mostajo 2000). Especially the lower income groups benefited from disinflation as minimum salaries and wages used to lag behind inflation (Armijo 2005). These definitely helped increase political support for Cardoso and his economic policies and, despite worsened economic conditions, he was reelected in the October 1998 elections at the first round of voting which allowed continuation of economic stabilization and reforms. Therefore, political skills of Cardoso compensated for the lack of unity in the political system and eventually made stabilization successful. Even the 1999 crisis did not cause Brazil to return to the inflationary spiral.

Argentina: unusual suspect and the unity of government

Throughout the 1970s and 1980s the Argentine economy was mostly known for its chronic and hyperinflation. Prior to 1991 various stabilization plans were adopted—Austral Plan in 1985, Primavera Plan in 1988, Bunge and Born (BB) Plans in 1989, and the BONEX Plan in 1990 to name some—but they all ended with failure. In 1989 inflation rate had reached to 3,080% (see Table 1). Finally the 1991 Convertibility Plan succeeded in disinflation. The Plan was successful in part due to the unity of government at that time, but also President Menem's popularity and his ability to raise political support for stabilization was critical.

It is argued that, more than its technical traits, Convertibility Plan's success was the social consensus it created (Szusterman 2000). Having a presidential system with a two-party system and adequate party discipline, an executive with strong legislative support seemed to be sufficient to initiate and implement stabilization in Argentina. However, what was critical for the success of Argentine stabilization was Menem's high popularity which secured political support across different

9 *World Development Indicators*, World Bank, retrieved on July 19, 2010 at <http://databank.worldbank.org/ddp/home.do?Step=12&id=4&CNO=2>.

social groups and his skills in using traditional pork-barrel policies to appease the opposition. While his precedent Alfonsín alienated important stakeholders of stabilization, Menem managed to co-opt them successfully and effectively implemented stabilization.

There were several factors which helped Menem. One factor was that Argentina has been an exceptional case in terms of presidential decree powers, because presidents did not need prior consent of the legislature and they were not exposed to other checks by the Congress or judiciary. That is why Argentina has been called a “delegative democracy” (O’Donnell 1994). President Menem frequently used decrees of “necessity and urgency” during his term, particularly regarding his economic stabilization and liberalization program (Rubio and Goretti 1998; Bambaci, Saront, and Tommasi 2002).¹⁰ However, similar to Cardoso, Menem still had to build broad support base for his stabilization plan.

Both Cardoso and Menem had significant decree powers when they initiated their respective stabilization plans. However, Menem enjoyed the legislative majority and party discipline that Cardoso lacked. In the 1989 elections Menem was elected by the 47.5% of the popular vote and could control the majority of the seats in both houses of the legislature. Even the majority of the governors were from his party. Considering also the strong party discipline, Argentina had a rather “unified government” at that time. That significantly helped Menem to pass the necessary laws and legislation to implement the 1991 stabilization plan, but that was not sufficient. In fact, even some of his party members were against his policies. Like Cardoso in the Brazilian case, Menem’s success depended on his ability to build a broad social and political support and his efforts not to alienate any group.

The Convertibility Plan announced in April 1991 was an orthodox plan. It included fiscal adjustment, a large-scale privatization program, and a “currency board.” The currency board fixed Argentine peso one-to-one with US dollars, so the Plan was exchange rate-based.¹¹ Despite its orthodox characteristics, the Convertibility Plan included some compensatory policies which helped to reconcile different interests. In fact, Menem’s “anti-inflation coalition” was composed of very different groups of people who had to be kept content: organized labor, domestically-oriented small and medium size businessman, internationally-oriented businessmen, middle-classes, and even the military (Starr 1997). The expansionary and compensatory policies were instrumental in building a wide political coalition. It is even argued that the Plan involved “moderate populism” (Palermo 1998). It combined orthodox monetary policies with only

10 President Menem issued more decrees than all previous Argentine presidents since 1816 and he also dominated the judiciary to make sure that his decrees were not reversed (Rubio and Goretti 1998; Jones 1997).

11 The decision to adopt “currency board” was taken by the Argentine government in early 1991. IMF was not very supportive of the idea in the beginning and it started to give financial support only in July 1991. Yet, when the *tequila crisis* of Mexico began to disrupt Argentine economy in 1995, IMF actively helped sustain the currency board through a generous loan package (Mussa and Savatino 1999).

moderately strict fiscal policy. As a result, even inequality and poverty fell between 1990 and 1993 (Palermo 1998).¹²

Menem was a populist and he gathered widespread popular support in Argentina during his rule (1989–1999). Before coming to power, he had promised a huge wage increase and a “productive revolution.” He argued that the wage increase would come automatically with the elimination of inflation and pegging peso to dollar, and the productive revolution would be achieved through structural adjustment, privatization and liberalization. Yet, regardless of his neoliberal agenda, Menem did not completely commit himself to neoliberalism. As a populist, he had to maintain his mass support, so he deviated from neoliberal policies at his political convenience (Weyland 2001).

Menem chose an economic team headed by Domingo Cavallo, who not only was a very credible economist but also had strong ties with local and international economic circles. The appointment of this team helped Menem receive support of the business sector which he badly needed. However, having a very technocratic economic team was not by itself sufficient to guarantee the support of the business sector. He appointed two businessmen from the exporting agricultural sector to his cabinet and got them involved in the creation of the stabilization plan. Menem also made favors to major domestic industrialists (*capitanes*) in privatization sales of major state owned enterprises. Those privatizations were an important tool for Menem to gain economic elites’ support for his economic reforms (Weyland 2000; Schamis 2006).

Menem was elected from the Peronist party, which had strong links with the major labor unions. Thus, he was an unlikely suspect for hurting labor interests (Cukierman and Tommasi 1998; Murphy and Sturzenegger 1998). That is probably one of the reasons that he was able to gather an unusual popular support for initiating stabilization policies. Menem’s Peronist identity increased his ability to demand sacrifice from the working classes (Treisman 2004). Still, labor was not willing to give him unconditional support for all his neoliberal policies. Yet, Menem was successful at exploiting the divisions among the organized labor for his political benefit and neutralize the labor opposition (Starr 1997).

Military was also an important potential opposition to Menem’s stabilization due to sharp decreases in military budget and privatization of military-owned industries that stabilization required. However, Menem was also able to appease military opposition through skillful political tactics. Unlike his predecessor Alfonsín, he helped military to restore its honor and dignity within Argentine society and granted pardons to the vast majority of military members who had been involved in human rights violations during the military regime (Starr 1997).

12 According to *Standardized Income Distribution Database*, GINI coefficient of Argentina decreased from 48 in 1989 to 46 in 1994. (<http://salvatorebabones.com/wp-content/uploads/2006SIDD-1-Aug21.xls>).

Menem, like Cardoso, got engaged with traditional pork-barrel politics as well. He especially paid off political bosses from interior poorer states which were overrepresented in the legislature. By transferring them more federal funds and other cash and credit incentives, he persuaded them to accept federal takeover of their pension systems and privatization of provincial banks (Weyland 2000). This was necessary to control future fiscal deficits to end inflation for good.

What helped Menem to secure and even strengthen political support for the Plan was also his skill in assigning costs of the Plan and the accompanying structural reforms, such as privatization, tax reform, and deregulation of the economy, which would have normally created strong opposition from different sections of the society. As mentioned above, the Plan had an orthodox character but it was also expansionary so that Menem was able to neutralize opposition. For instance, despite the IMF opposition, the Plan involved some tax cuts, such as elimination of export taxes and the reduction of payroll tax rates (Cavallo 2004). In the end, with the Convertibility Plan, Argentina started to achieve economic growth, increased investment, zero inflation, falling poverty, and increased real earnings for all sections of the society (Szusterman 2000). Workers were happy that more jobs were created and their purchasing power increased; middle classes were happy to consume more; business sector was kept happy by tariff protections, cheap credits, and privatization benefits; and political clients (especially local bosses) were appeased by traditional pork policies. Therefore, all major groups were somehow coopted. Menem also guaranteed political support for his long term economic reforms in a similar manner. This was needed especially for the structural reforms which would ensure the continuity of stabilization by legally controlling economic policy-making.

Inflation was reduced from more than 700% at the beginning of to 25% in 1992 and then to 4% by 1994. As it was an exchange rate-based stabilization, the Convertibility Plan created an immediate economic boom. The GDP growth rates were 11.9% in 1992 and 5.9% in 1993.¹³ Once the plan began to show its positive effects, both Plan's and Menem's credibility increased. Especially the lower and middle class people who suffered most during the hyperinflationary era gave Menem a broad base of electoral support due to success in disinflation (Starr 1997). As real purchasing power rose and credit markets revived, people began to buy durable goods and industrial sector also began to recover. Increased economic growth raised more tax revenues. With these fiscal surpluses and the revenues received from privatization, the state was not only able to run positive external balances but also could increase public spending that relieved social costs of the plan and helped strengthening the consensus.

Some of the public spending was used to pay off political clients but part of it was used for social projects like improving infrastructure (Palermo 1998).

¹³ *World Development Indicators*.

Menem used targeted social programs to win the votes of the informal poor (Weyland 1996).

Certain policies directed toward alleviating the social costs of the reforms had an important impact, among them were the social programs developed in the Buenos Aires metropolitan area. The majority of these funds were distributed along clientelist lines and spent on urban infrastructure in one of the areas of greatest concentration of poor households. (Palermo 1998, 50-51)

Under Menem, the Peronist party transformed itself into a mass patronage party which distributes benefits to the poor through clientelist links. With such links, he was able to maintain the support of the masses and prevent political discontent and antireform feelings (Levitsky 2003). Social spending increased especially before the elections to maintain political support. In fact, in the next elections in 1995, Menem won the presidency again comfortably with about 45% of the votes and his economic policies had continuity.

Winning the support of working classes, business groups, and political elites was important to guarantee a long lasting success with stabilization. The shortcoming was that, as the economic growth slowed down and external deficits reappeared because of overvalued currency in late 1990s, Argentina sunk into its worst economic crisis in 2001 since the 1930s. Yet, it is important to note that, even such a huge crisis did not bring back the hyper inflationary spiral in Argentina.

Conclusion and implications

The purpose of this paper was to understand how chronic inflation ended in Brazil and Argentina after battling with it for long years. Assuming that the economic strategies to deal with inflation have been standardized and widely known, this paper focused on the political conditions that facilitate successful stabilization. It is argued that, if there is already an adequately designed disinflationary program at hand, political support from broad sections of the society is the most important factor for successful stabilization. Thus, this paper agrees with Nelson (1994, 61) that authoritarian, executive-dominated style of economic stabilization and reform is damaging for democratic institutions and that “fuller consultation and coordination between state and society” is much more preferable for the sake of lasting stabilization and reform.

By comparing the case of Brazil and Argentina, this study demonstrates that even the unified governments need to reconcile the interests of different stakeholders and secure a wide political support to implement stabilization successfully. A unified government can make the stabilization process easier, but it does not guarantee its success. Neither authoritarianism nor an autonomous state is necessary or sufficient for successful stabilization. What is important is building a wide political coalition

for stabilization. On the other hand, the difficulty of establishing such a coalition differs depending on the political context of each country.

Where political unity is weak, there is more need for a skillful political leader and compensatory policies. In the case of Brazil, the need for a wide political support was most crucial as the other political conditions were quite unfavorable because of highly fragmented politics. Yet, President Cardoso's political skills helped overcome the political barriers to stabilization and reconcile different interests and gain their support. In both Brazil and Argentina stabilization policies were accompanied by some social policies to raise political support. This was necessary at least for the working class support. This contradicts with the assumption that successful disinflationary programs are strictly orthodox in nature. Actually both in Brazil and Argentina, contradicting with the general neoliberal prescriptions, lots of spending had to be done to create a pro-stabilization political coalition. Yet, also business circles and political elites had to be coopted to the process. Argentina's two-party system created a more unified government, but still political skills of President Menem and his Peronist credentials were critical in raising political support.

For both cases, continuity of political support was essential for a lasting stabilization and this was enhanced by rapid improvements in the economy with stabilization. In that respect using an exchange rate-based plan was critical since such plans create an immediate economic boom. Therefore, the immediate positive economic results of stabilization are also critical for maintaining political support that is essential for sustainable stabilization.

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Abstract

This study tries to understand how Brazil and Argentina, two countries with chronically high inflation, achieved permanent stabilization by looking at political factors necessary for stabilization. It suggests that, although state autonomy or political unity may contribute to successful price stabilization, reconciling the interests of different stakeholders and thereby building a broad political support base is more essential for stabilization to succeed. Political skills of the leaders and compensatory policies may help raise such support and they are more crucial where other political conditions are less favorable. Also, rapid improvement in the economy is important for sustained political support, and thus, for successful stabilization.

Keywords: chronic inflation; disinflationary programs; political coalition-building; stabilization.

Resumo

Este estudo tenta entender como o Brasil e a Argentina, dois países com inflação cronicamente alta, atingiram a estabilização permanente olhando para os fatores políticos necessários para a estabilização. Sugere-se que, embora a autonomia estatal ou a unidade política possam contribuir para a estabilização bem-sucedida dos preços, reconciliar os interesses de diferentes agentes envolvidos e, assim, construir uma ampla base de apoio político, é mais essencial para a estabilização obter êxito. As habilidades políticas dos líderes e as políticas compensatórias podem ajudar a angariar esse apoio e elas são mais cruciais onde outras condições políticas são menos favoráveis. Além do mais, a melhora rápida na economia é importante para sustentar o apoio político e, assim, para a estabilização bem-sucedida.

Palavras-chave: inflação crônica; programas desinflacionários; construção de coalizão política; estabilização.