The Theory of INERTIAL INFLATION

The Foundation of Economic Reform in Brazil & Argentina

LUIZ BRESSER PEREIRA
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FOREWORD BY RUDIGER DORNBUSCH

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Contents

Tables

Tables

Figures

Foreword

RUDIGER DORNBUSCH

Milton Friedman argues that inflation, always and everywhere, is a monetary phenomenon—too much money chasing too few goods, money burning holes in peoples' pockets. This fine book by Bresser Pereira and Nakano defends a very different view of the inflation process. The authors argue persuasively that Brazilian-style inflation must be explained mostly from the supply side. Inflation perpetuates itself as a consequence of past inflation, transmitted through formal and informal indexation of wages, public sector prices, and the exchange rate into cost and price increases today. Inflation is the result of *inertia*, not of excess demand at current prices.

That is decidedly not the theory espoused by "Chicago boys" brought up on the quantity of money and on perfect competition. It is a line of thinking developed in the setting of high inflation, indexation, and fights about income shares in Latin America in the postwar period, but especially in the past fifteen years. It is tempting to write off this approach as unsound in that it gives little room to excess demand as a central explanation for inflation. But that would be going much too far. The inertia approach does capture an extraordinarily important fact of high inflation economies, and ignoring this characteristic would lead to dramatically wrong policy advice. Where monetarists see the cure for inflation in budget tightening and monetary restraint, the inertia approach recommends incomes policy in the form of wage-price controls. The economists' scissor normally has two blades, supply and demand. But in questions of stabilization policy, that often is not the case. Monetarists want to stop inflation from the demand side only, and inertialists concentrate their attention on the control of costs and prices. There could not be a sharper contrast.

The recognition of inflation inertia is not new to some readers. The Brookings panel on economic activity has long been a forum of this approach. Students of Arthur Okun and James Tobin will remember those two's insistence that the Phillips curve is "very flat," meaning that it takes massive increases in unemployment through demand contraction to bring about even a minor reduction in the inflation rate.[1] Indeed, in 1980, under the almost Latin American title, "Inertia, Expectations and Structural Inflationary Bias," Tobin argues that it would take a decade of high unemployment to bring down U.S. inflation from its double-digit levels. As it turned out the job was done much faster and at much lower cost.

The inertia hypothesis makes for powerful politics, Roberto Campos has said that incomes policy is the aphrodisiac of politicians, and he may have understated his point. For more than a quarter of a century Latin American policy makers have been fighting inflation halfheartedly, mostly from the demand side, sometimes from the supply side. Suddenly, in the 1980s a new generation of economists proposes a coherent program of "heterodoxy": correction of fiscal deficits to pay attention to demand side problems, combined with incomes policy to stop inflation dead in its tracks. The attraction of the approach is twofold: first, incomes policy has always made for good populist politics. Second, it offers immediate results, since an inflation of 200 or 300 percent will stop from one day to the next. And there is a bonus: the heterodox approach predicts that inflation not only can be stropped, it also can be stopped with out recession.

The heterodox hypothesis has been tested in Argentina, Brazil, and Israel. The Israeli experience, after more than two years, can be pronounced a full success. Inflation has been reduced to European levels, and growth has continued throughout. The insistence in this book that heterodoxy is better than monetarism is fully vindicated by this experience. But the case of Brazil dramatizes that the demand side does matter. When incomes policy was combined with election politics that led to a massive fiscal deficit, the predictable consequence was a collapse of the Cruzado Plan. Argentina's experience has been more favorable. Inflation has been sharply reduced, but the remaining rate of 100 percent points to the need for further budget control before the next attack is staged.

What lessons are to be drawn? Should Mexico go the way of heterodoxy, or should inflation be attacked by tight monetary and fiscal policy, without incomes policy. The analysis presented in this book and the experience of Argentina and Israel clearly suggest that incomes policy should be a central pillar of stabilization. But the Brazilian experience indicates that the political euphoria of inflation stabilization removes the danger signals and hence makes overexpanding all too attractive.

Since this book was completed, the 1986 Cruzado Plan has literally blown up. Inflation in Brazil reached unprecedented levels of 20 percent per month and more in early 1987. The authors took over Brazilian economic policy in May 1987, when Bresser Pereira was nominated finance minister and Nakano joined him as chief economic advisor. Predictably, they have tried to stabilize the economy using incomes policy. The results are not in, but this valuable book offers their thinking. Much of what they will implement is already written here, but with one difference: the extra year of experience with the first Cruzado Plan has shown that, although demand side policies may not be everything, neglect them at your peril.

NOTE

1. *See* James Tobin, "Stabilization Policy Ten Years After," *Brookings Papers in Economic Activity* 1 (1980); and Arthur Okun, *Prices and Quantitites: A Macroeconomic Analysis* (Washington: Brookings, 1981).

Preface

Inflation became a central problem for the capitalist economies in the second half of the twentieth century. In the days of the gold standard and competitive capitalism, inflation was a passing phenomenon that characterized either the periods of expansion and the peaks of the economic cycle or the extraordinary upheaval of the economic system caused by catastrophies such as wars. Inflation generally alternated with periods of deflation during recessions.

However, once we entered the phase of oligopolistic and technobureaucratic capitalism, beginning after World War II and especially since the 1970s when the world economy entered a period of deceleration and crisis typical of a long Kondratieff cycle, inflation began to change. It became chronic all over the world. In some countries, principally the central countries, the rates were still moderate, although they sometimes reached levels of over 10 percent a year. Beginning in 1982, they were reduced at the cost of severe recessive policies coupled with high rates of productivity increase; however, price stability definitely no longer exists.

In many of the underdeveloped countries, the rates rose and established themselves at much higher levels, often above 100 percent. They had to be accompanied by indexation systems that moderated the distortive effects of inflation but, at the same time, accentuated its autonomous or inertial nature, thus making it more difficult to reduce. In the central capitalist countries, as well as in the periphery, the periods of deflation completely disappeared. Now we only have periods in which inflation accelerates or decelerates. Based on this broad evidence and being faced in Brazil with a permanent and accelerating inflation, we started studying inflation and writing some papers on the subject. When our ideas about autonomous or inertial inflation matured, we decided to publish this book, first in Portuguese and now in English.

During the first half of the 1980s, while Brazilian inflation rose from around 50 percent to 350 percent, to be finally stopped by a heterodox shock in February 1986, the theoretical analysis of inflation advanced significantly. Based on the Latin American structuralist theory of the 1950s and on the administered or cost push theory of the 1960s, a group of Brazilian economists criticized the monetarist and rational expectations theories and developed the theory of inertial or autonomous inflation.

The acceleration of inflation in Brazil between 1979 and 1986 did not happen gradually and linearly, but by jumps. In the second semester of 1979, inflation jumped from the 50 percent to the 100 percent level; in 1983, from the 100 percent to the 200 percent level; in the last quarter of 1984, from the 200 percent to the 280 percent level; and finally, on the eve of the shock, from the 280 percent to the 350 to 400 percent level. The theory of inertial inflation was started by making a distinction between the accelerating and the maintaining, or inertial, factors of the level of inflation. The development of the theory of inertial inflation, therefore, was deeply embedded in the Brazilian experience of inflation; however, its application can be much more generalized, including for developed economies. The basic paper, which served as matrix for the theories of this book and which corresponds to its first chapter, dealt with inflation in contemporary—technobureaucratic and oligopolistic—capitalism.

Most of the chapters in this book were first published as essays in *Revista de Economia Política*. When we got together to write Chapter 3 about the accelerating, maintaining, and sanctioning factors of inflation (1983), we decided that we would write additional essays to form a book. Its first edition was published in Brazil in 1984, with the title *Inflação e Recessão*. All chapters were written by both of us, except Chapter 2 (1981) and 6 (1980), written by Luiz Bresser Pereira, and Chapter 7 (1982), written by Yoshiaki Nakano. Chapter 4 (1984a) and Chapter 8 were written for the first Brazilian edition, and Chapter 5 (1986) for the second Brazilian edition. Chapters 1, 9, and 10 were written especially for the English edition between March and September 1986. Dates at the end of each chapter refer to the first publication except for the chapters written especially for this book for which dates refer to the moment they were completed.

The ideas developed in this book were the result of debates with many economists. To Ignácio Rangel, who developed the theory of the endogenous supply of money and gave special importance to administered inflation in Brazil, we owe a special debt. Our friends, Adroaldo Moura da Silva, André Lara Rezende, Edmar Bacha, Francisco Lafayete Lopes, Mário Henrique Simonsen, and Pérsio Arida developed, at the same time, ideas similar to the ones presented in this book. Albert Fishlow was the first economist to propose to us personally, in July 1983, the idea of an unorthodox shock. We both had been discussing this subject since we had written the second chapter of this book (first published in December 1983), and, in the second semester of 1983, we wrote Chapter 3 (first published in July 1984) proposing "the heroic solution to control inflation." We also have a debt to Celso Furtado, André Montoro Filho, Alkimar Moura, Fernando Maida Dall'Acqua, Fernão Botelho Bracher, Geraldo Gardenalli, João Sayad, José Serra, Luiz Gonzaga de Mello Belluzzo, Marcelo Antinori, Marcos Fonseca, Roberto Vellutini, Rudiger Dornbusch, and Werner Baer.

Along the line of thought that was initiated by Ignácio Rangel, we believe that, at certain points, the inverse relation between growth and inflation is more powerful than the direct relation for oligopolized economies like that of Brazil. When there is recession, inflation tends to accelerate rather than diminish because the oligopolistic corporations succeed in increasing their profit margins. At the same time, there is a reduction in the profit margins of the competitive corporations and the agricultural sector, but this reduction does not manage to make up for the increase of the markup in the oligopolist sector. The relationship between inflation and growth is more complex because there are other factors such as the variations in the rate of real wages, in the real exchange rate and in the prices of imported goods, and the measures of "corrective inflation" taken by the economic authorities, which accelerate or decelerate inflation. On the other hand, without underestimating the market, we consider that the administrative factors, derived from the monopoly power of the corporations, the trade unions, and the state, have a decisive importance in the contemporary phenomenon of inflation. In these terms, in this book we try to develop, within the wide boundries of structuralism, a theory of administered inflation that is conditioned by the power of monopoly and of inertial inflation that becomes dominant as inflation reaches high rates, resulting in the appearance of the formal and informal mechanisms of indexation.

Luiz Bresser Pereira
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