

# MACROECONOMIC MANAGEMENT FOR SUSTAINABLE DEVELOPMENT: EXPERIENCES FROM LATIN AMERICA

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Latin America has been a laboratory of macroeconomic management... and mismanagement. The region shows all kinds of disruptive economic and political events: institutional instability, military coups, populist dictatorships, hyperinflation, debt defaults, bank runs, and a few successes as well.

These experiences, therefore, allow us to evaluate the different crises and the policies that eventually succeeded in solving them. The present paper will focus on hyperinflationary crises, commenting briefly on the different cases in Latin America during the last decades of the XXth Century. We will also emphasize how those crises had not only economic consequences but political and institutional as well, many of them to regret. Then, we will focus on the lessons coming out of the difficult task of defeating hyperinflation in Argentina. We will conclude relating the episodes with institutional weakness, presenting an indicator of institutional quality and how does LA perform in it, and showing the relationship between institutional quality and inflation.

## Hyperinflation in Latin America

Although the most intense episodes of hyperinflation took place in Germany 1923-24, Greece and Hungary after the Second World War and China during the communist revolution, Latin America had somewhat less intense in terms of prices, though as deep in terms of the economic depressions hyperinflations bring with it.

What is inflation and what hyperinflation is harder to define but is clear when one sees it. Some economists define inflation when the price index grows more than 50% a year. But that is a rather arbitrary definition. Leijonhufvud (1990) says inflation is when one considers annual rates in order to make decisions, while in hyperinflation prices bring no useful information and the horizon falls to monthly figures and even less. It depends on the perception of economic agents. Not a more precise but a more

descriptive definition, since such perception has an important impact in the demand for money.

Inflation affects economic growth: prices are no longer reliable, relative prices become distorted and entrepreneurs cannot perform economic calculation with regard to future revenue flow. When in hyperinflation the economy plunges into a depression, the whole chain of trade collapses since goods are more valued than any currency that may be offered in exchange and there is no accurate forecast of the prices to be paid in order to replenish stocks. Therefore, production collapses as well.

People run from the currency, desperately trying to change it for any goods or services, or for another currency. Interest rates skyrocket and even then they are not able to stop the run. Commercial credit disappears, savings evaporate. Paradoxically, currency bills become scarce, the monetary authority does not print them fast enough, they were printed on one side in Germany or stamped with a new value in Argentina.

The inflationary tax falls heavily on people with cash balances, particularly the poor, shoppers resist selling products, riots usually follow.

In the meantime, governments fall prey to what is called the “Olivera-Tanzi” effect, occurring in hyperinflation when government expenditures grow faster than government revenues, increasing the fiscal deficit and the need to cover it with new monetary issuing. There is no budget anymore.

Barro (1997) finds a negative relation between inflation and growth, when it reaches a level over 20% annually. Dabús et al (1998), considering the hyperinflation experiences in Latin America, additionally find much lower and even negative growth when inflation is higher and particularly in hyperinflation. According to Leijonhufvud’s definition they classify countries according to whether they experienced moderate, high or extremely high inflation. With moderate inflation agents consider annual rates to make their decisions, while with high inflation consider monthly rates and with extremely high less than monthly. The following are the cases in Latin America since 1950 (see also Figure 1):

<b>Inflation in Latin America</b>			
	<i>Moderate</i>	<i>High</i>	<i>Extreme</i>
Argentina	1960-1970 1992-1997	1971-1974 1977-1981	1982-1983 1988-1990

		1986-1987	
		1991-1991	
Bolivia	1971-1972 1975-1979 1987-1996	1973-1974 1980-1983	1984-1986
Brasil	1971-1973	1974-1983	1992-1993
Chile	1981-1996	1972-1972 1977-1980	1973-1976
Nicaragua	1971-1978 1981-1982 1992-1996	1979-1980 1983-1989	1985-1991
Perú	1971-1975 1994-1996	1976-1987 1992-1993	1988-1991
Colombia	1971-1987 1993-1996	1988-1992	
México	1971-1979 1989-1996	1980-1988	
Uruguay		1970-1996	
Venezuela	1971-1986	1987-1996	

Years of high inflation, and particularly hyperinflation meant depressions and economic decline. Argentina's GDP growth was -2.1% in the 1980-90 decade, Brazil's was -0,4% during the same time, Chile's GDP fell -5.8% during 1974-75, Nicaragua's -5.7% during 1985-90, Peru's -3.8% in the same period.

The crises also show that hyperinflation has a dramatic impact in the institutional structure of the countries, showing two main results: governments in charge at the time of runaway inflation were either removed or defeated in elections; also, those who were able to stop hyperinflation had political success in the future:

- The hyperinflation of Argentina in 1982-83 ended up in a military coup, the one in 89-90 with the resignation of a democratically elected president six months before the end of his mandate.
- In Bolivia 1984-86 it was stopped after a dramatic change of policies and direction by a populist president (Paz Estenssoro) who reversed his policies

interventionist policies from his own previous mandate, and the minister in charge of the program was later elected president (Sánchez de Lozada).

- In Brazil, the minister in charge of defeating hyperinflation (Fernando Henrique Cardoso) was later elected two times as president.
- In Chile, it is associated with the fall of the Salvador Allende regime and Pinochet's bloody military coup.
- Perú is the exception, in the sense that Alan García's term 1985-90 was continued by the democratically elected Alberto Fujimori, and the successful fight against inflation gave this one the chance to get reelected.

### The way out of hyperinflation

What the experiences in Latin America show is that defeating hyperinflation is no easy task, with regular attempts that fail, with successive moves towards the solution. In all cases the source of the problem was the monetization of fiscal deficits, and the solution came when the deficit was controlled and a "shock of confidence" was able to recreate the demand for money. In this particular case, the fiscal problem had been building for years. The three main sources of fiscal deficit were the state companies most of which had been incorporated into government since the 1940s, the pension system also becoming under the government sphere at that time, and the provinces, depending on the federal government revenue collection since the 1930s.

In the meantime, different governments implemented all sorts of policies aimed at the effects (prices increases) and not the causes (monetization of the fiscal deficit). In the case of Argentina they included:

- Price controls, either as maximum prices or "frozen" prices as they stood at a certain time.

Price controls faced always two insurmountable problems: the first was to set prices for all prices of consumer goods, intermediate goods and raw materials in the economy; the second was to adjust them to scarcities and surpluses. Since the first problem made the goal of controlling "all" prices impossible, government usually set prices for a basket of consumer goods. But that created

another set of problems since producers of these products had their prices controlled but not their inputs. Profits margins disappeared and, sooner or later, the products themselves.

Price “freezes” were even more difficult to implement. As different from price controls, a price “freeze” just tries to keep prices as they are at a particular time. How could these be controlled? Usually it requires every shop to submit lists of prices at that date, but think about supermarkets filling up form with the price of every product in stock.

Both policies, also, demand an army of inspectors, and multiply corruption.

Some policymakers argue that price controls or freezes are needed in order to cool down expectations, but it does not take much time for people to learn and to become cynical with regard to their success.

- Attempts to fix the exchange rate with the main reserve currency (in Argentina’s case the US dollar), what creates a “parallel” market for foreign exchange. The price of the dollar in this market became the reference price for the indexation of all prices in the economy
- Different exchange rates for services, travel, capital inflows and outflows, exports and imports and combinations of official and “parallel” rates for access to foreign exchange. The exchange rate control and the usual gap between the official rates and the market rate promotes under-invoicing of exports and over-invoicing of imports.
- Increased debt to limit growth monetary aggregates (quasi-fiscal deficit) and to limit the growth of the “parallel” dollar, at increasing interest rates and shorter terms for bonds, even reaching a point when most debt was at 7 days. The battle “interest rates vs. parallel dollar” only allowed to slow down one at the expense of skyrocketing the other.
- Monetary “reforms” that pretended to revalue the currency by taking away different number of zeros, but with no change on fiscal and monetary policy this was only a change in the unit of account of prices but not in inflation as such.

None of these worked, or they did it for a short span of time. Inflationary acceleration and the rise of interest rates increased government expenditures, deepened

the “Olivera-Tanzi” effect, to the point that it became cheaper to stop paying taxes, regardless of punitive interest charges.

In 1989 annual inflation in Argentina reached 4,900% with a monthly accelerating path as follows:

<b>Hyperinflation in Argentina in 1989</b>		
<i>Month</i>	<i>Consumer price index</i>	<i>Wholesale price index</i>
January	8.92	6.94
February	9.59	8.41
March	17.01	18.90
April	33.37	57.99
May	78.47	104.46
June	114.47	133.48
July	196.63	209.11

A new government had been elected in May but the inauguration was scheduled to take place in December. In July, though, president Raúl Alfonsín resigned six months in advance to the end of his term and Congress appointed the recently elected president, Carlos Menem. The new president started giving signs that deep reforms might be coming, although he started his term with price controls and timid measures to control the fiscal deficit, which now was 8% of GDP.

Nevertheless, there was no lack of gestures. The new president appointed as minister of the Economy representatives of one of the largest private conglomerates in the country, which was a message in itself, particularly coming from a populist peronist candidate. He also appointed as advisor a pro-free-market politician who had taken the third place in the elections. Other gestures included a show of willingness to solve the pending foreign debt default problem and an alignment with the western powers, particularly the US and an improvement of relations with the UK.

There was a new economic team and new round of hyperinflation with prices growing 79.21% in January, 61.57% in February and 95.53% in March of 1990. Each peak came with a new package of measures, each time bolder and more drastic than the one before. The last was in February 1991 with an increase of 26.99% in the CPI and 37.89% in the WPI

What eventually stopped hyperinflation in Argentina, and what lessons can we learn from it?

1. Inflation is a monetary phenomena expressing itself in an increase in prices, a distortion of relative prices and high growth of the indexes. This is important to understand since, even though price indexes may affect inflationary expectations, we must not lose sight that not all prices increase at the same speed and all sorts of distortions arise in the structure of production.
2. The main reason for monetary growth is to cover the fiscal deficit. Until this one has become under control economic agents are not going to trust any promise of a reduced monetary expansion.

<b>Fiscal Deficit as a Percentage of GDP<sup>1</sup></b>	
1979	3.90
1980	4.99
1981	8.73
1982	10.05
1983	15.14
1984	11.44
1985	6.57
1986	6.02
1987	10.45
1988	10.75

3. Hyperinflation is not only the result of increased monetary supply but of a drastic reduction in the demand for money. This one in turn is related to the expectations people may have with regard to the future purchasing power of the currency.
4. There is a need to engineer a dramatic “shock of confidence”, which may enable people to trust the currency again, and increase their demand. This usually comes when there is a signal clear enough that there will be no more monetary

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<sup>1</sup> Fundación de Investigaciones Económicas Latinoamericanas y Consejo Empresario Argentino (1989), “El Gasto Público en la Argentina 1960-1988”, Buenos Aires.

debasement and, therefore, that there will be no need for it since the cause has been eliminated (the fiscal deficit).

5. The first step to eliminate the fiscal deficit is to secure genuine government revenues. Expenditures are usually reduced in two stages: the first and most immediate one comes from not adjusting them to the latest price increases, which usually happens with salaries of government employees, pensions and payments to suppliers; the second, more extended in time and more difficult, comes from a cut in expenditures through the elimination of subsidies, administrative reform and privatizations.
6. The “shock of confidence” usually includes the freeing up of all economic variables that are supposedly controlled by government but are, in fact, running away of control, creating a distortion of prices and impairing productive activities. This important step has the goal of turning the productive capacity to work again. It will start to remove scarcities, eliminate all kinds of “parallel” prices and informal markets, goods will flow again and the economy will start recovering. The most important price to be liberated is, of course, the exchange rate, the control of which creates all kinds of distortion of relative prices in the economy and channels the efforts of economic agents towards unproductive activities

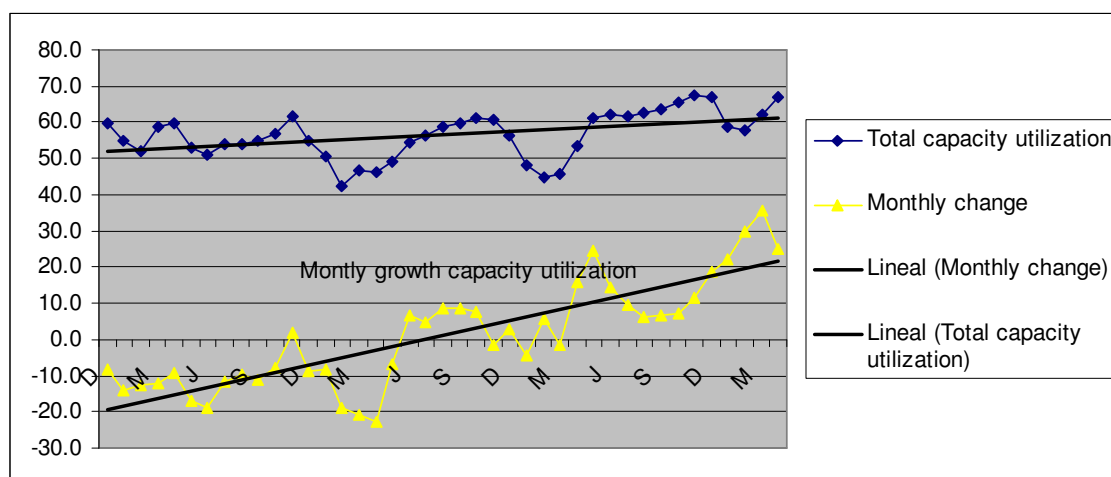
In the case of Argentina the shock of confidence was produced by a newly elected government which raised the expectations of people through the announcement of drastic measures of reform which included administrative reform, the elimination of subsidies and the privatization of most state companies, through the approval in Congress of two bills allowing the government to cut those expenditures and to privatize. Nevertheless, the problem here is that these reforms usually take time, and there is a need to sustain credibility with a dramatic show from power of the willingness to implement those changes, no matter the political cost.

In this particular case, the “shock of confidence” came not at once, but in different stages, starting with the inauguration of a new government and its first announcements, the elimination of price controls and exchange rate controls, the approval of the abovementioned bills, and was completed when the government announced the introduction of a “currency board-like” monetary system, implemented by law. According to it the Central Bank, which would now become an independent agency,

would not be able to issue money for the Treasury or any other purpose and would have limited its monetary policy capacity to keep high powered money (or monetary base) at the same level of reserves in foreign currency. Not only that, the “Convertibility Law” as it was called, allowed contracts to be written in any currency the parts would agree on, although it stayed short of extending this to all prices in the economy and, particularly, salaries. Started in April 1, 1991, prices evolved consequently as follows:

<i>Month</i>	<i>Consumer price index</i>	<i>Wholesale price index</i>
April	5.51	1.39
May	2.80	1.03
June	3.12	1.07
July	2.59	0.35
August	1.30	-0.39
September	1.77	0.42
October	1.35	0.73
November	0.39	-0.85
December	0.65	-0.99

This monetary regime was able to stop inflation in its track. The Olivera-Tanzi effect started working in reverse, now revenues were increasing faster than expenditures, which added to the confidence shock. Economic activity picked up again, as seen in the following graph showing the percentage use of industrial capacity in 1989-1991:



A decade later, though, coupled with returning fiscal deficits and increased debt, the model exploded into a devaluation and debt default.

### Macroeconomic management and inflation

The specific recipe to stop hyperinflation will certainly vary from country to country, although the need for a confidence shock based on fiscal and monetary reforms will always be present. How deep the reforms should go has also to do with how much trust in the government currency has been lost. In the case of Argentina, for example, just proposing the independence of the Central Bank was clearly not enough since an independent monetary authority would have no power to change the fiscal situation. Something more was needed and it came in the form of preventing the government, by law, to increase the money supply without backing reserves. All monetary discretion had to be eliminated and the main sources of the fiscal deficit were to be tackled. In this case they consisted of the public debt, and the deficits of state companies, the state pension system and provinces.

Nothing much was done with the provinces that benefited from a revenue sharing scheme allowing them to spend and not to collect revenues, and the debt was eventually defaulted, creating a traumatic situation for many savers.

Companies were privatized but in a hurry and the lack of adequate controls opened the door for corruption and the sale of public monopolies into private ones. The angst and pressure to get the revenues pressed for the sale even though some basic checks and controls from a republican regime were left aside. This may have been desperately needed at that time but proved quite damaging afterwards.

The state pension system was privatized in 1994, although the weak fiscal performance of the government did not allow it to cover the costs of the loss of revenue and the government started placing its own debt with the newly privatized pension funds, a debt that eventually defaulted.

All these experiences show that, although a sound currency is a basic component of macroeconomic management it is not the only one. Fiscal prudence is as much important and usually the reason why countries do not get the first. The third is to

relieve people from the burdens that stop their efforts and creativity to be productive. Altogether, that means having a set of institutions that will prevent mismanagement from happening.

## Macroeconomics and institutions

We call “institutions” the rules that allow us to coordinate the actions of individuals in society, the compliance of which give us reliability with respect to the actions of others. Customs and practices give birth to expectations that guide people, and the practices people follow are usually recognized as law. The authority of a legal system comes ultimately from a feeling that it is “correct” since it verifies expectations. From such a perspective on authority it comes clear that reciprocal agreements are the basic source of recognition to the duty to obey the law. (Benson, 1989)

From this perspective social institutions are the result of regular non-planned conducts of individuals in order to face their problems. Institutions, or norms, or conventions, can be of two kinds: formal and informal. Informal are those which we usually associate with “culture” or “ethics”, transmitted from generation to generation through teaching and learning. The difference between them is just a matter of degree. We could imagine a continuum of taboos, customs and traditions in one side and written constitutions on the other. Societies have moved from less to more complex organization along such a path, associated with the more extended specialization and division of labor in more complex societies. (North, 1993)

Their function, in the end, is to save on information costs with regard to the actions of others. In order for social relations to be ordered, actors must form expectations over the actions of others with a certain probability of being correct. In this sense, institutions are communication tools through which an individual, adjusting her conduct to a certain rule or institutions, sends information to others so they can guide their actions related to the emitter.

Macroeconomic rules and macroeconomic institutions are of fundamental importance for a proper functioning of the economy. They are the “rules of the game” that allow the coordination of actions that eventually lead to prosperity. Fiscal and monetary rules are a basic ingredient of them, but they are, at the same time, the result of values and formal and informal rules, of checks and balances on power and the abuse of it. All those countries that suffered hyperinflation also showed weak institutions.

That was clearly the case of the German Weimar Republic and the other cases related to wars and revolutions. In the case of Latin America such weakness was not related to such kind of events, but the thing is that they have been unable to build strong institutional frameworks and, therefore, have fallen into repeated macroeconomic crises.

What are those institutional frameworks and how does Latin America fare in each case? It is certainly difficult to measure “institutional quality” in a country since it is more of a “qualitative” concept, determined by very different variables. Nevertheless, there are a number of comparative indicators that allow us to have an idea of what we are talking about, aggregating a large number of variables.

A recently presented Index of Institutional Quality (Krause, 2007), attempts to do that by aggregating the relative positions of countries in different indexes which cover different aspects related to “institutional quality”. They include the Indexes of the Rule of Law and Voice and Accountability by the World Bank, Freedom of the Press by Freedom House, Perception of Corruption by Transparency International, Doing Business by the World Bank, Global Competitiveness by the World Economic Forum and the indexes of Economic Freedom by the Heritage Foundation/Wall Street Journal and the Fraser Institute.

The more important aspects considered in these indexes that relate to institutional quality are: the independence of the judiciary, respect for the law, respect for human rights and political rights, accountability of government officials, freedom of opinion, abuse of power and corruption, enforcement of contracts, burden of regulations, respect for property rights, economic freedom and open trade.

The report, showing the performance of 185 countries, shows that Latin American countries do not perform well. The results for the region in 2006, including the Caribbean, are:

<b>Country</b>	<b>Relative Qualification</b>	<b>General Position</b>
Chile	84.05	22
Bahamas	83.39	23
St. Lucia	82.19	25
St. Vincent and the Grenadines	80.92	29
Barbados	78.88	32
Dominica	72.91	44
St. Kitts and Nevis	69.79	47
Uruguay	68.57	50
Antigua & Barbuda	68.31	51

Costa Rica	67.61	54
Belize	65.99	56
Jamaica	64.94	58
Grenada	64.80	59
Trinidad & Tobago	62.31	63
El Salvador	60.85	65
Panama	59.15	68
Mexico	56.98	75
Peru	52.44	80
Brazil	47.66	90
Argentina	45.23	93
Nicaragua	44.66	95
Suriname	43.97	97
Colombia	43.10	100
Guatemala	38.59	109
Guyana	38.47	111
Honduras	38.37	113
Dominican Republic	37.98	114
Bolivia	37.30	118
Paraguay	33.03	128
Ecuador	31.50	133
Venezuela	15.76	161
Cuba	15.17	164
Haiti	15.00	165

Venezuela, Cuba and Haiti are comfortably in the last places in the region. The three largest countries in the region (Mexico, Brazil and Argentina) show a poor performance, even though Mexico seems to move away of the pack.

The smallest countries occupy interesting positions, not only the Caribbean ones but also Uruguay, Costa Rica, Panama and El Salvador, the first two with a long democratic tradition and “moderate” political environments; the other two have gone through quite traumatic periods in their recent history but they have been able to order themselves and strengthen their institutions. And in this last group the best example is, of course, that of Chile, showing continuous signs of institutional strength to the point of positioning itself among the first in the world. No wonder Chile shows the more stable macroeconomic environment in the region during the last two decades, taking into account that it moved from a military dictatorship towards a democratic government run by an opposition that, essentially, did not alter the macroeconomic course.

This prevailing institutional “weakness” is the basic source of “macroeconomic mismanagement” in the region. The situation, though, is not different in the rest of the developing and underdeveloped world. There is a clear link between the quality of

institutions and economic performance, particularly affecting investment and, therefore, growth.

There even seems to be one clear link relating institution to inflation. If we look at the IMF inflation projections for 2007 and we correlate them with the position the countries have with the Index of Institutional Quality we see that countries with the highest inflation (and in this case the projection with regard to Zimbabwe has already been surpassed) have also weak institutions as comes out from their position in such a ranking of 185 countries.

Country	Inflation 2007	Institutional quality	
		<i>Position</i>	<i>% ranking</i>
Zimbabwe	?	179	7.13
Myanmar	37.5	184	2.34
Guinea	34.1	160	15.87
Eritrea	22.7	162	15.50
Venezuela	21.6	161	15.76
Yemen	21.1	146	24.21
Azerbaijan	21.1	141	29.05
Iran	17.8	149	23.53
Congo	17.4	166	14.60
Ethiopia	17.0	152	22.74
Libya	16.2	167	14.37
Sri Lanka	14.0	98	43.73
Egypt	12.3	124	33.99
Belarus	11.4	172	11.24
Tajikistan	11.4	155	21.00
Ukraine	11.3	132	32.38
Uzbekistan	10.04	177	9.41
Argentina	10.3	93	45.23

Countries with the lowest inflation are also positioned at the top of the institutional index: Japan (18), Switzerland (1), Norway (14), Israel (34), Finland (3), Singapur (27).

### Institutional competition

Institutional quality is important nowadays, not only because it creates an environment for prosperity and a higher quality of life, but also because of what is now called “institutional competition”, a process accelerated by the accelerated move of factors of production throughout the world.

What we now call “globalization” is the result of a wider mobility of resources as a result of technological advances and the removal of regulatory barriers limiting it.

Since 1987 exports have grown from 16 to 27% of the world economy, foreign direct investments have tripled and financial investment quintupled. The number of tourists has more than doubled in the last two decades. International communications have exploded: phone international traffic has grown from 40 billion minutes in 1991 to 140 billion in 2004, users of Internet almost nonexistent at that time were 900 million in 2005.

Consumers now have more options, learn about other possibilities, increasing competition between producers which, in time, encourages creativity, innovation and an productivity. Such competition forces producers to search for places offering the best conditions for production.

Globalization, then, submits countries to competition, offering “institutional frameworks” to attract resources that now have an accelerated mobility. Countries that can offer these conditions receive resources, those who not, expel them (people, capital, ideas, innovations, technologies).

This process also limits the power of governments to implement policies that would eventually create incentives for the resources to leave the country or for foreign ones not to come in. Governments may not like this but it is a fact of life, and with regard to macroeconomic management, the globalization process enforces a discipline that was not present before. If such a discipline does not come from within it is imposed by the world markets that work beyond anyone’s control.

## Conclusions: Gradualism or shock therapy?

As mentioned, there are two main problems to consider with regard to macroeconomic management, particularly under a hyperinflationary environment: the first is how to stop hyperinflation; the second is how to prevent such mismanagement from happening again.

Considering the first one, there is usually a debate related to different kinds of macroeconomic reforms whether a gradual path should be followed, introducing changes through a certain time frame, with the supposed goal not to kill the patient with the surgery. The problem with hyperinflation though, is that the patient is already at the surgery room with the chest open and delaying the operation will only make matters worst.

Asserting that in order to stop hyperinflation a “shock of confidence” is needed, basically leaves out the option for gradualism. Bringing such a level of confidence back into the currency means introducing a set of policies that certainly “shocks” economic agents into accepting that the inflationary policies are a thing of the past. In Argentina, stopping hyperinflation took a new government almost two years, but that does not mean they followed “gradualism”; it only means that successive announcements did not produce enough of a shock of confidence until a new monetary regime was introduced by law.

There is a clear need to reassure people that the currency that lost value on a daily basis will no longer do so in the coming future. Many times, this entails introducing a new (and fully backed by solid reserves) currency plus the reliable independence of the Central Bank and a verifiable elimination of the fiscal deficit. In order to come out of hyperinflation, though, this may not even be enough, and it arises the need to eliminate the capacity of the monetary authorities to implement monetary policy, either through the adoption of some other country’s currency, a currency board or the legalization of competition in currencies.

A credible monetary reform, as mentioned, must be accompanied by a no less credible fiscal effort to eliminate the deficit. This will most probably include drastic cuts in spending (expenditures in public employees salaries are reduced by the high level of inflation itself) and subsidies, as steps of immediate impact. These measures are usually resisted by governments, considering that different sectors of society could not

be left without the support they get from government, but hyperinflation is a dramatic crisis, and it must be understood that those sectors are hurt much more by the loss of value of a currency than by the elimination of a subsidy.

Hyperinflationary crises usually bring riots with them, people storming into supermarkets, even fighting among themselves for the few goods that are found in the markets. The problem in this case is that trade channels have been shut down by the impossibility of calculating prices and the value of the currency in the immediate future. Hunger is not a matter to be solved by subsidies, since such spending is precisely one of the sources of the problem. What is needed is opening up those trade channels again, something only the shock of confidence will bring about.

In order to close the deficit the government needs to secure revenues. In times of a crisis some taxes are introduced that, in normal times, would be distorting and damaging for the economy. But at times like this what counts is how easily those taxes can be collected. In Argentina the usual victim in these situations were exports, and the government introduced taxes over the FOB prices of exports, collecting the tax in hard currency, taxing the competitive sales of agricultural commodities or oil products. Doing this at the same time that it frees up the exchange rate may not hurt exports so much since they momentarily benefit from being able to get the market rate for the foreign currency. Of course, a tax on exports is clearly damaging if it stays beyond the crisis.

The elimination of all kinds of controls over prices was very important in the case of Argentina, it allowed the productive economy to start working again, and it was also part of the psychological impact of the “shock of confidence”. This one also included another very important and bold step: the elimination of exchange controls and the unification of all exchange rates into the market price of foreign currencies.

Finally, the shock has political content as an outstanding component as well. In the case of Argentina and other Latin American countries it was usually composed of symbolic signals that economic policies would go in a completely different direction and credible announcements of reforms to be implemented in the future. In this last case, this was inevitable since some reforms will take quite some time, but the announcement usually came with a signal of the political commitment to change such as the introduction in Congress of bills and their rapid consideration and approval.

Preventing hyperinflation from happening again and assuring sound macroeconomic management for sustainable development is more a question of

strengthening institutions. People is usually receptive, supportive and demanding on those institutional changes after the crisis; governments, though, must accept that such strengthening means more controls on power, more the “rule of law” than the “rule of leaders”, checks and balances.

Although change in institutions is essentially slow and the result of a process of evolution, particularly in the case of informal rules; crises bring a possibility of change in formal ones. This change usually has two components:

- An internal consensus accepting a certain change in rules at the constitutional level or at the political system. Such would be the case of the Moncloa Pact in Spain after Franco’s regime and, although not so formal, the also in Ireland and Estonia
- A move that may eventually mean the “import” of institutions, or a check against unstable changes in the future. In this second case, a country, unable to reach a consensus with regard to a set of institutions, at least agrees, for example, to join a larger institutional framework and, therefore, “imports” the institutions from it. That would be the case of some countries joining the European Union as those mentioned above. Or it could also be the case of Chile, a country that first made the reforms, reached an internal consensus and then locked them in through a large number of free trade and investment protection agreements with countries like the US, the European Union, Japan, China and many others.

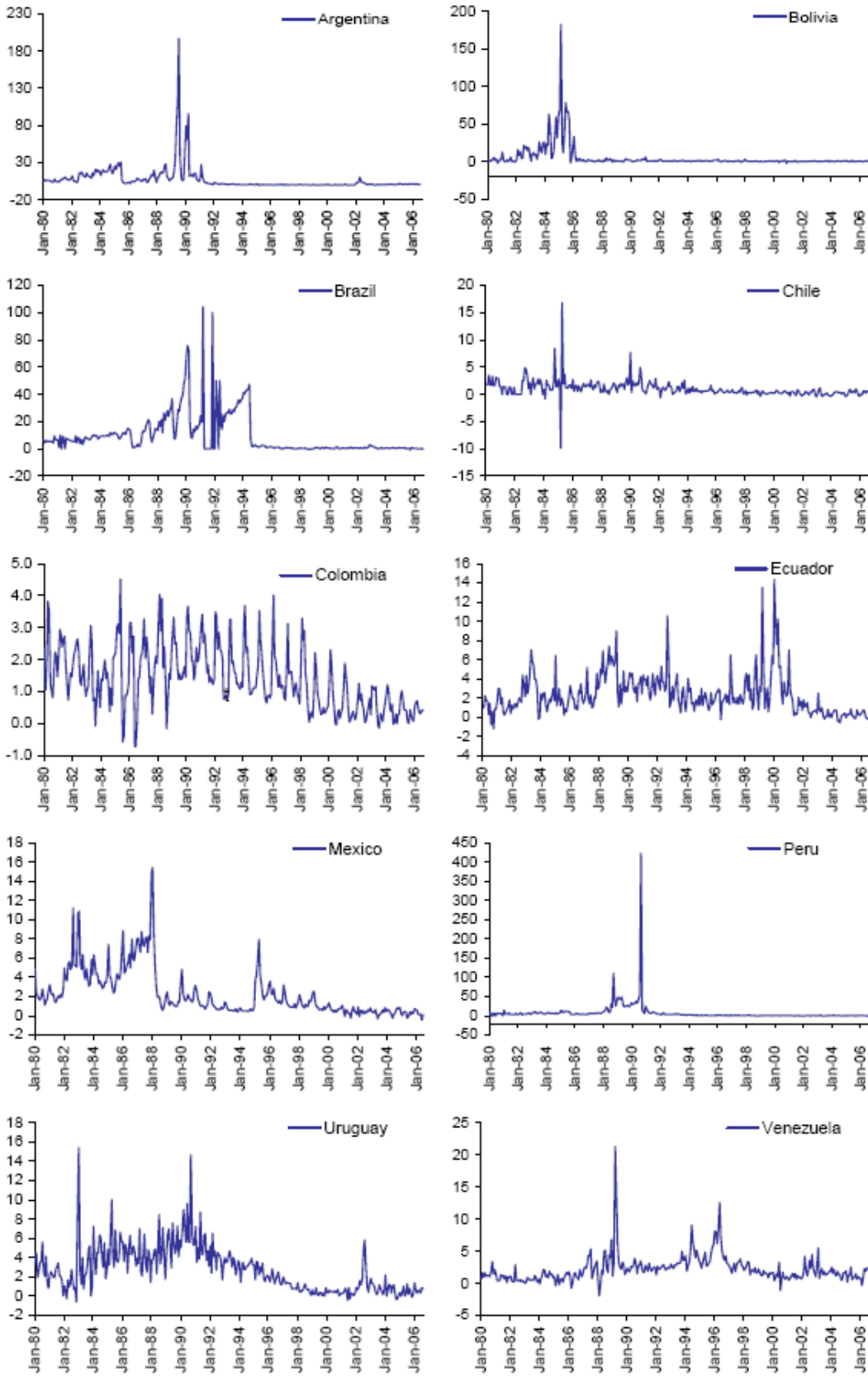
The second option may also help the first, in case it is not possible to reach an internal consensus with regard to what kind of reforms should be implemented. Ireland, Estonia and Spain eventually imported different institutions from the EU framework including, of course, its currency.

Latin America has not been able to do the same, except the already mentioned case of Chile. The Mercosur has proved no equivalent to the UE for its member countries, there is no unified currency, no Maastricht Treaty limiting government debts and deficits, no decision to have unified and competing markets.

Latin American countries have learnt about the benefits of good macroeconomic management the hard way. It took some of them to fall into hyperinflation to learn about the importance of a sound currency; it others to fall into debt defaults in order to learn

about fiscal prudence. Most of them are now enjoying the upswing of the world economy and the high prices of commodities. They should also be looking at improving their institutions for the future when economic conditions may not be that good.

Figure 1. CPI (Monthly % Change)



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