3. Populism and Inflation in Latin America

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Past populist governments generally implemented unsustainable macroeconomic policies (large fiscal deficit, high inflation, and ultimately recessions) as argued by Dornbusch and Edwards, 1991. Also, recent populist governments increased fiscal deficits with disappointing growth, but inflation generally remains subdued. We speculate that this is due to a world-wide trend toward low inflation, the commodity super-cycle (which helps financing the deficit), and some learning.[2]

What macroeconomic policies do populist governments pursue? What are the consequences of these policies? To answer these questions, we examine the experience of Latin America, a region with a long history of populist regimes. And we focus on inflation, which was the hallmark of macroeconomic mismanagement.

A challenge is that the concept of populism itself is elusive. How to define what is populism given that different authors have used different definitions (see Mudde and Rovira Kaltwasser, 2017)? We take the definition by Dornbusch and Edwards (1991; DE henceforth) for past episodes and the database of Team Populism for the modern episodes. Based on these authors our sample consists of the ten classical cases as identified by DE (1991) plus five recent cases.[3] Table 1 lists the episodes we consider.[4]

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1 International Monetary Fund.

2 We are grateful to Kirk Hawkins for sharing with us his Team Populism dataset on populist parties in Latin America, populist presidents, and prime ministers in power. Ana María Trujillo and Diego Wachs provided superb research assistance. The views expressed in this study are the sole responsibility of the authors and should not be attributed to the International Monetary Fund, its Executive Board, or its Management. This paper is based on our on-going research on the broader macroeconomic effect of populism (Magud, Spilimbergo and Werner, 2020)

3 Note that we exclude some cases like Menem or Fujimori which sometimes political scientists identify as 'neoliberal populist', i.e. governments which had a populist rhetoric and neoliberal policies. Other authors (Edwards, 2019, and Filkenstein, 2017) also include the Kirchner government (2007-2015.) The conclusions do not change if we include this government in the new wave of populist governments.

4 Our data goes through 2017.

Table 1. Populist events

Event	Country	Period	Source
Past wave of populist governments			
Perón	Argentina	1973-76	Dornbush-Edwards
Vargas	Brazil	1951-54	Dornbush-Edwards
Goulart	Brazil	1961-64	Dornbush-Edwards
Sarney	Brazil	1985-90	Dornbush-Edwards
Allende	Chile	1970-73	Dornbush-Edwards
Echeverría	Mexico	1970-76	Dornbush-Edwards
Velasco	Peru	1968-75	Dornbush-Edwards
Belaúnde	Peru	1963-68	Dornbush-Edwards
García	Peru	1985-90	Dornbush-Edwards
Pérez	Venezuela	1974-78	Dornbush-Edwards
Modern wave of populist governments			
Morales	Bolivia	2006-17	Team Populism
Correa	Ecuador	2007-17	Team Populism
Ortega	Nicaragua	2007-13	Team Populism
Chávez-Maduro	Venezuela	1999-2017	Team Populism

Dornbusch and Edwards (1991; DE henceforth) analyzed the economic effects of populism in Latin America in the countries listed above during the 1970s and 1980s. Their conclusion was that, even though rhetoric and economic conditions differed, populist governments ended up implementing a remarkably similar set of policies. Populist objectives clash with the constraints imposed by macroeconomic realities and face the economic consequences of these inconsistencies. They describe five phases:

Phase 0. Initial conditions. People are dissatisfied with current economic policies. Preceding stabilizations have often provided some room in the budget. Populist politicians reject the policies of austerity. Reactivation of the economy and redistribution of income are usually done through increasing wages and the use of the fiscal space.

Phase I. For a while, populist policymakers are fully vindicated. Real wages grow and inflation is kept at bay via price controls. Shortages are avoided through imports, which are still financed by reserves. Moreover, given fixed exchange rates under the Bretton Woods' international monetary system in place during the early episodes, and the continued use of different varieties of rigid exchange rate arrangements as a tool to contain inflationary pressures thereafter, higher inflation eventually strengthens the domestic currency's real (effective) exchange rate.

Phase II. Bottlenecks start appearing and low levels of inventories become a problem. Inflation increases, and wages try to keep up with it. An underground economy emerges.

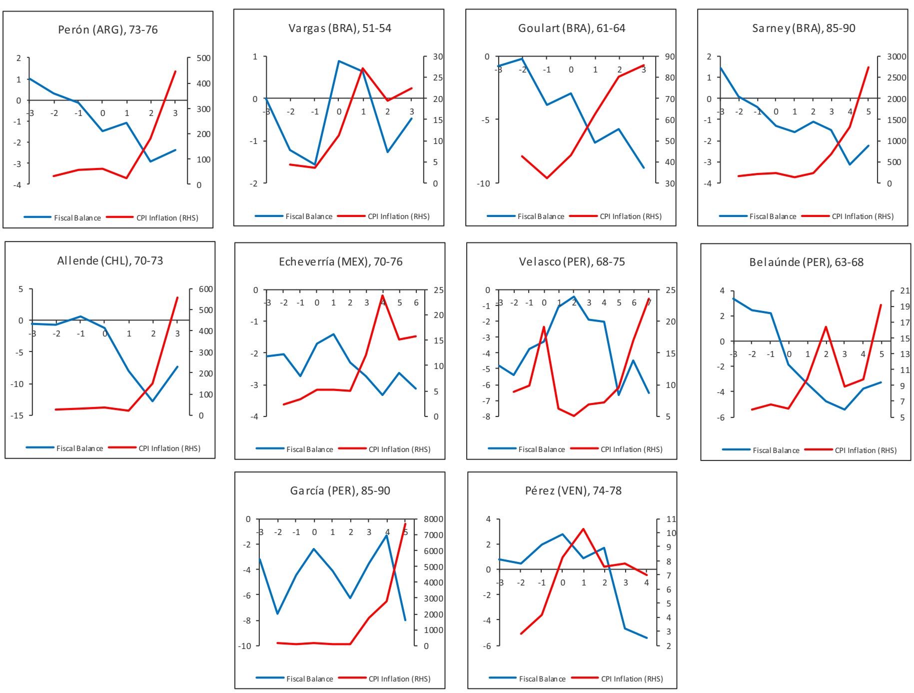
Phase III. Pervasive shortages and accelerating inflation become the norm. Capital flight accelerates, and the economy slows. The budget deficit deteriorates and real wages collapse. As the economy implodes, there is increasing disillusionment with populist policies.

Phase IV. Orthodox stabilization policies are implemented under a new government. At the end of the cycle, real wages stabilize at a level lower than at the beginning.

Magud, Spilimbergo, and Werner (2020) document the deterioration of economic activity during all these episodes and the deterioration of institutional indicators during recent episodes and argue that also the modern episodes follow as similar patterns as in DE (1991). Here we focus on the behavior of inflation.

During these phases the central banks play a central role and provide monetary financing to the government. Figure 1 shows the fiscal balance and inflation in the ten cases discussed by DE (1991). Zero on the x-axis represents the year when a populist government took over as indicated in Table 1.

Figure 1. Fiscal expansion and inflation. Past episodes (percent of GDP and percent)

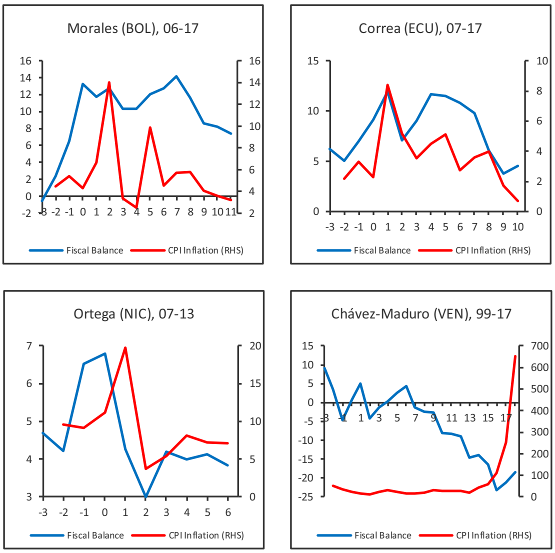


Source: IMF's World Economic Outlook.

In all cases fiscal balances worsened and inflation picked up. Moreover, inflation surged to become hyper-inflation in most cases. Central banks accommodated and financed the increasing fiscal deficit.[5]

Figure 2 shows fiscal expansion and inflation in recent episodes of populist government. In all these episodes there was a clear worsening of fiscal balances. Notice that the fiscal deterioration happened despite the fact the commodity super-cycle' windfall resulted in higher tax revenues, pointing to unsustainable government spending (see below). However, differently from the previous cases only one case, Venezuela, ended up in hyperinflation. In other words, inflation was remarkably stable when compared with the past experience.[6]

Figure 2. Fiscal expansion and inflation. Recent episodes (percent of GDP and percent)



Source: IMF's World Economic Outlook.

What explains the difference? Basically, four factors. The commodity super-cycle which started at the beginning of the 2000s helped financing the deficit and so loosened the budget constraint. The commodity super-cycle also appreciated the real exchange rate boosting consumption, and through that channel boosting revenues. And the large trade balance surpluses helped finance the external accounts and accumulate reserves. Additionally, massive expansionary monetary policies in advanced economies in response to the global financial crisis reduced

5 Edwards (2019) makes the point that modern populism follows the same patter as old populisms.
6 However, inflation in countries with populist governments is still higher on average than in countries with no populist governments.

the cost of international financing; capital flows to emerging markets, including to Latin America, further eased hard-currency financing and strengthen domestic currencies. Second, the entire world had a secular slowdown in inflation dynamics. Third, even populist politicians learned that monetary financing could be dangerous, leading to hyper-inflation. Fourth, modern populists found alternative ways to finance the increasing deficits through nationalization (see Bolivia, Ecuador, and Venezuela), freezing of tariffs for energy, or raising import and export taxes.

In conclusion, even though the basic economic and political mechanisms remain the same, the recent episodes of populism were associated to less inflation than in the past, though still larger than in most non-populist regimes. One of the hallmarks of classical economic populism has changed but the long effects on the economy may remain.

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