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Latin America's Inflation Success

Better monetary, fiscal, and structural policies are paying off for Latin America.

BY JERRY HAAR

With Asia having overtaken Latin American in attracting foreign direct investment, multilateral and regional trade liberalization at a standstill, and intractable problems of poverty and income inequality contributing to social and political tensions across the region, it would seem that Latin America has little to celebrate. However, in one policy sphere the Americas has performed marvelously—combating inflation.

From 1945 until the 1990s, the Latin American region had been the worst performer with regard to inflation. Government intervention in the economy, including the provision of subsidies to firms and heavy protection and regulation of industry through high cost import substitution together with relatively narrow tax bases and inefficient tax collection, led to chronic fiscal deficits and pervasive economic inefficiency in the protected industries.

These domestic polices, compounded by a high volatility of external conditions resulted in a sharp increase in prices, to almost 500 percent in 1990. Indeed, high inflation morphed into hyperinflation--conventionally defined as inflation exceeding 50 percent per month in a number of Latin countries during the latter part of the 1980s and in the early 1990s. Brazil's inflation rate, for example, exceeded 1,000 percent per year in four of the five years between 1989 and 1993; although the most notorious case of hyperinflation was Bolivia that posted a 25,000 annual percent rate in 1984.

The last half decade has witnessed stellar progress by Latin American nations in quelling inflation and pursuing consistently prudent monetary policies. The remarkable success of more market-oriented development strategies, notably the examples of the "Asian Tigers" and of Chile captured the attention of Latin American policymakers. In addition to restructuring external debts and restoring access to international financial markets, countries necessarily faced outside pressure to improve their policies, both from multilateral institutions and from the discipline of market forces.

Different countries have successfully implemented inflation targeting as their main policy mechanism, most notably Chile, Colombia, Peru and Brazil. Although Mexico has not introduced inflation targeting as an explicit monetary policy, in practice it follows that approach.

As Ben Bernanke, chairman of the US Federal Reserve Board has noted, inflation has declined in Latin America because new ideas and new political realities have fostered the development of economic institutions and policies that promote macroeconomic stability more generally.

These include sound fiscal policies, privatization, the reduction of marginal tax rates, the addition of new revenue sources such as value-added taxes, and the passage of laws that restrict the use of public funds for certain purposes. Modernization of the banking system and the improvement of bank regulation and supervision are also essential for promoting stable monetary policy and low inflation, as is an independent central bank.

The near-term outlook for Latin America suggests that better monetary, fiscal, and structural policies are paying off (although Venezuela, Argentina, Bolivia and possibly

Ecuador seem to be moving in the opposite direction.)

Unfortunately, Latin American economies have grown at rates below their potential in recent years, in part due to the financial crises of the 1990s. Much still needs to be done to alleviate income inequality and poverty. The next few years will be an interesting test of the efficacy and sustainability of economic reform in Latin America.

A key factor will be winning the inflation battle on a permanent basis. Small businesses, export-oriented companies, and investors require low inflation and economic stability to flourish in an increasingly global economy. However, it is the poor who will benefit most from currency strength and price stability. A conservative monetary policy, regardless of a nation’s politics, is no longer a choice but an indispensable course of action.

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