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Review

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Notes and explanation of symbols

The following symbols are used in tables in the *Review*:

Three dots (...) indicate that data are not available or are not separately reported.

A dash (—) indicates that the amount is nil or negligible.

A blank space in a table means that the item in question is not applicable.

A minus sign (-) indicates a deficit or decrease, unless otherwise specified.

A point (.) is used to indicate decimals.

A slash (/) indicates a crop year or fiscal year, e.g., 1970/1971.

Use of a hyphen (-) between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.

Reference to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated.

Unless otherwise stated, references to annual rates of growth or variation signify compound annual rates.

Individual figures and percentages in tables do not necessarily add up to corresponding totals, because of rounding.

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Runaway inflation: experiences and options

*Felipe Pazos**

Inflation was a major concern for Prebisch from his time in central banking up to the end of his career, when he stressed the need for new thinking by Latin American economists about stabilization policy. The topic is of vital importance, not only for Latin America, but also for the world in general, for specialists in industrialized countries have also been unable to elaborate policy recommendations for their governments that will resolve the dilemma between inflation and monetary restriction.

Economists have searched arduously for a theory of inflation that corresponds with the facts, but have not achieved a consensus. On the contrary, strong disagreement persists as to why inflation behaves in ways so different from those described in established theory. Consequently, there are also differences in policies designed to halt or slow the process.

Given this lack of a policy that can stop it, inflation presents serious obstacles to economic growth throughout the world and causes very serious social problems in many countries. For fear of accelerating inflation, industrial nations are limiting economic activity to levels below productive capacity and, due to the lack of politically feasible stabilization programmes, a number of developing countries (especially in Latin America) are undergoing inflationary processes that cause severe damage to their economic, social and political structures. Therefore, today, the control of inflation constitutes the highest priority for economic science.

*Economic Adviser to the Central Bank of Venezuela.

"We have not offered governments a set of coherent and attainable principles that will allow them to escape the dilemma between inflation and monetary orthodoxy. We Latin American economists are in debt to the politicians of our countries."

RAUL PREBISCH

El falso dilema entre desarrollo económico y estabilidad monetaria, March 1961.

"... I am convinced that we must renew our thinking about stabilization and capital accumulation policy."

RAUL PREBISCH

Statement at the twenty-first session of ECLAC, 24 April 1986.

I

Price trends in Latin America: 1961-1990

Table 1 presents average retail price increases in 19 Latin American countries during the 1960s and 1970s and the annual figures for the 1980s. During these three decades, inflation was constant and generalized. The only exceptions were Guatemala in 1982 and Panama in 1986, 1988 and 1989, years in which real economic activity experienced strong contractions in those countries. It is also possible that there are errors in the figures because, during the years in question, prices rose in the United States, the main supplier of both countries. Examination of the table reveals, first of all, that inflation was a persistent phenomenon in all Latin American countries during the last three decades. This is an entirely expected conclusion and cannot surprise either economists or lay persons in the era of global inflation. However, its causes must be investigated in depth.

Further analysis of the table leads to the second observation that inflation has accelerated during the period, at a moderate rate during the 1970s and explosively in the 1980s. In the 1960s, four countries experienced annual inflation rates of 20% to 50%, another four, from 5% to 20%, while the rest registered rates the same or lower than that of the United States, yielding an average of 21% for the region, as a whole. In the 1970s, inflation rose more rapidly: two countries registered annual rates of more than 100%, 13 registered increases of between 10% and 50%, while the remaining figures are above 5%, yielding an annual average of 39% for all of Latin America. In the 1980s, inflation went out of control: five countries had annual rates of more than 1 000%,

Table 1
RETAIL PRICES: 1961-1989

(For 1961-1970 and 1971-1980: annual average change; for 1981-1989: percentage increases over previous year)

Countries	1961-1970	1971-1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Latin America	21	39	57	85	130	185	274	64	198	758	994
Argentina	21	136	104	165	344	627	672	90	131	343	3 731
Bolivia	6	20	32	127	276	1 281	11 743	276	15	16	16
Brazil	45	37	106	98	142	197	227	146	230	497	1 476
Colombia	12	21	27	24	20	16	24	19	23	28	27
Costa Rica	2	11	37	90	33	12	15	15	16	25	14
Chile	27	174	20	10	27	20	31	19	20	15	21
Ecuador	5	12	13	16	48	31	28	31	29	86	59
El Salvador	1	11	15	12	13	11	22	22	13	4	21
Guatemala	1	10	11	-	15	10	25	38	13	10	14
Haiti	3	11	11	7	10	6	7	11	17	4	6
Honduras	2	9	10	10	9	5	3	4	3	4	11
Mexico	3	15	28	59	102	65	58	86	132	114	18
Nicaragua	-	18	24	25	31	36	219	681	912	10 205	3 452
Panama	2	7	7	4	2	2	1	-	1	-	-
Paraguay	3	13	14	7	13	20	26	32	22	23	29
Peru	10	32	75	64	111	110	163	78	86	150	2 949
Dominican Republic	2	10	7	8	5	27	42	10	16	34	43
Uruguay	48	62	34	19	49	55	72	76	63	62	82
Venezuela	1	8	16	10	6	12	12	11	40	35	90

Source: International Monetary Fund, *Yearbook of International Financial Statistics*, 1985 and ECLAC, *Preliminary overview of the Latin American and Caribbean economy*.

and three reached or, at times, surpassed monthly rates of 50% (13 000% annually), which Philip Cagan considers to be definitive of hyperinflation.¹ To complete the scene, it must be noted that two of the five countries with annual rates higher than 1 000% managed to lower those rates to below 20%. Inflation in Bolivia fell abruptly from an annual rate of 21 000% in August 1985 to -25% the following month. It fluctuated erratically until January 1986 and, since then, has remained below 20%. Mexico, for its part, managed to lower inflation from an annual rate of 214% in January 1988 to 16% in July, a level it has maintained since then. In Argentina, inflation registered very marked fluctuations in the 1980s: in the first half of the decade, it rose rapidly to an annual rate of 2 500% in July 1985 and fell to an average annual rate of 30% in the second half of that year, although it began to rise again the following

year, rising constantly and rapidly for four consecutive years to reach an annual rate of 400 000% towards the end of July 1989. Then, it fell during several months but again shot up to its current hyperinflationary levels (March 1990).

The third fact to be observed from the table is that, in spite of a clear tendency to rise, the tempo of price increases fell on occasion, at times considerably. There are few examples of successful stabilization policies, but the table shows pronounced declines in Chile from 1974 to 1982, in Bolivia from 1985 to 1987 and in Mexico from 1987 to 1989; and less spectacular declines in Argentina and Brazil from 1985 to 1986; and in Ecuador and Nicaragua between 1988 and 1989. In periods prior to those reported in the table or hidden in the 10-year averages there were considerable reductions in inflation in Paraguay in 1953-1954; Bolivia 1956-1958; Argentina 1959-1960 and 1967-1969; Chile 1960-1961; Brazil 1964-1969; and Uruguay 1968-1970. Reducing inflation is a very difficult task but it has been achieved on many occasions. For that reason, we should analyse how it was achieved in each case. We must study the successes of the past and learn from them.

¹Philip Cagan, "The monetary dynamics of hyperinflation", *Studies in the Quantity Theory of Money*, Milton Freidman (ed.), Chicago, University of Chicago Press, 1956

A further finding, as important as those cited above, as becomes clear in the analysis of table 2, is that in each of the last four decades inflation in Latin America has been considerably higher than that of other developing countries and very much higher than in industrial countries. Equally serious is the fact that this greater inflationary intensity has become gradually more pronounced: in the 1950s, it was a little more than double that of other developing countries and nearly four times higher than in industrial nations; in the 1980s it was seven times higher than in the Middle East, 20 times higher than in Asia and nearly 30 times higher than in the industrial countries.

Table 2
RETAIL PRICES IN FOUR GROUPS OF COUNTRIES: 1951-1989
(Percentage increases over previous year)

Regions	1951-60	1961-70	1971-80	1981-89
Industrial countries	2.1	3.3	8.7	4.9
Asia	3.3	5.8	9.1	7.4
Middle East	3.6	3.8	19.6	19.0
Latin America	7.9	21.2	39.4	149.0
World	2.4	4.4	11.0	12.7

Source: International Monetary Fund, *Yearbook of International Financial Statistics*.

II

The persistence of inflation

1. *The great enigma of contemporary economics*

In order to analyse the problem of prices in recent years, we first must ask why inflation has continued, since accelerated price hikes have occurred within a pre-existent process. And, more importantly, in order to elaborate and implement an effective anti-inflationary policy, we must understand the mechanism that sustains the phenomenon. The persistence of inflation is the great enigma of contemporary economics.

Economic theory clearly identifies the pressures which give rise to inflation but not the factors or mechanisms that maintain it. Economic literature contains extensive and intensive analyses of the origins and nature of increases in aggregate demand beyond available supply, of cost increases and of the partial supply deficiencies that disorganize the economy, all of which cause prices to rise; but the reasons for the persistence of inflation have not been studied in depth. Unfortunately, economists of industrial countries have resigned themselves to a constant annual inflation rate of from 3% to 4%. They consider it to be a consequence of the power of labour organizations, of imperfect competition in the goods and services market, and of expectations.

We specialists in developing countries, especially Latin Americans, have accepted much higher inflation with the same passivity, as long as it did not

surpass 40% or 50% annually. We considered it to be the nearly inevitable result of the instability of our foreign trade. This resignation has meant a tacit renunciation of in-depth investigation into the causes of the persistence of the phenomenon. It has had the severely negative effect of inducing industrial nations to apply very restrictive policies and to impede the design of effective anti-inflationary programmes in Latin America. Therefore, we must study in depth, the causes of the persistence of inflation both of the slow rates of inflation in industrial nations and of the intermediate rates of inflation in Latin America.

Current imperfections in the markets for labour, goods and services are a necessary condition for the persistence of inflation because the power of labour organizations together with unemployment insurance allow workers to obtain pay hikes even in times of unemployment; nevertheless, these factors are not its cause. This lies rather in the deterioration of real wages arising from the use of annual or multi-year labour contracts, which freeze wages while general price levels rise. Monopolistic price-fixing among producers is also a necessary condition for the persistence of inflation because it allows companies to reduce production while continuing to raise prices when the Government applies restrictive fiscal and monetary policies; but this is not a cause of price increases either. These result from wage hikes that occur in the renewal of work contracts.

Expectations tend more to intensify short-term price rises, than long-term increases. In the short term, they exacerbate inflation, encouraging hoarding, with the consequent drop in supply; but this accumulation produces a deflationary effect over time. As long as they last, inflationary expectations lead to hoarding; nevertheless, this cannot continue indefinitely due to limits on storage space and the costs involved. When the process ends, inflationary expectations take on a deflationary role.

Expectations of persistent price hikes raise the costs of longer-term projects and affect labour and rent contract negotiations. Nevertheless, the main objective of the workers in contract renewal has more to do with recovering their real wage losses derived from past price hikes than with protecting themselves in advance from those they expect to occur in the future; and the same can be said with respect to landlords and the rent they charge. In practice, contract adjustments serve both to replace losses occasioned by past inflation and to cover losses expected from future inflation; but the first objective is the most important, since these wage and rent hikes would have to take place even if there existed absolute security that inflation would stop. Failure to make these adjustments would undercut wages and rents in real terms.

2. Temporary lag and periodic over-adjustment of wages, rent, exchange rates and public service charges

The imperfect nature of competition in the markets for labour, goods and services creates conditions for the persistence of inflation. Inflationary expectations help maintain it, but the fundamental cause of its persistence is the temporary lag and periodic overadjustment of those prices subject to fixed-term contracts, such as wages and rent or subject to official regulation, such as exchange rates and public service charges.

Work and rent contracts are usually signed for periods of one year, or, at times, for two years or more, which means that wages and rent are kept stable for those periods and gradually lose value with respect to general price levels, which means that the incomes of workers and landlords lose buying power during that time. When it is time to renew contracts, workers and landlords demand increases that will

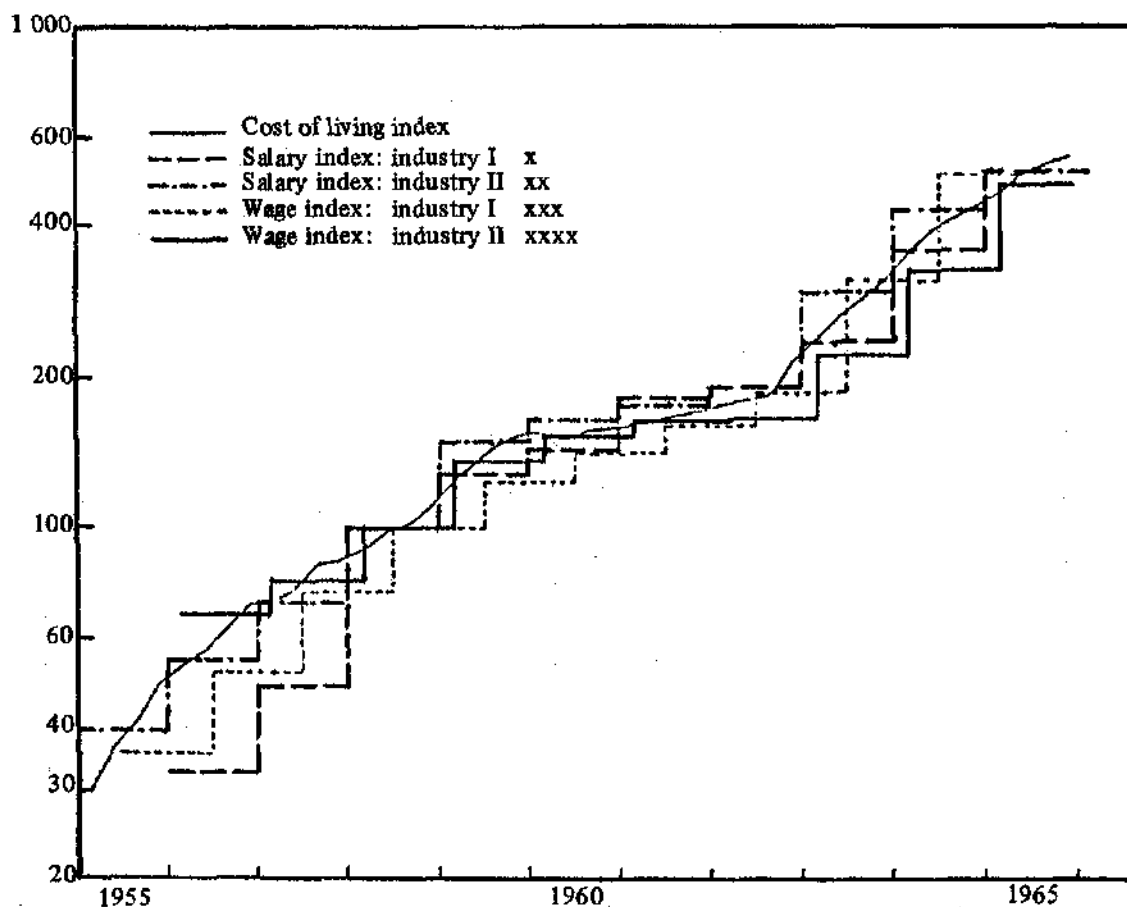
restore their real incomes and, in the case of workers, take into account increased productivity arising from technological progress and, in the case of landlords, changes in the property market. These increases occur in stages that intercross the annual price curve (figure 1). The data used in the figure are 35 years old but they are used here because labour contract structures have not changed. Consequently, the search for recent information would have entailed unnecessary effort.

Wage hikes periodically surpass price index increases, pushing these into new increases (figure 2). The increases are, therefore, overadjustments and not simply the re-establishment of equilibrium. This seems to surpass the goal of the workers to recover their real wages, together with the companies' policy of maintaining real wages, without paying very much greater amounts. Therefore, it is necessary to investigate the causes of these overadjustments in circumstances in which the increases could be limited to the amount necessary to bring wages into equilibrium that would not put pressure on prices. In order to clarify this problem, it will be convenient to divide the question into two: i) Why are equilibrium wages not re-established in the first adjustments that occur during the early phases of inflation? and ii) Once inflation is under way, why do overadjustments occur?

In the first rounds of contract renewal that occur in the early phases of inflation, the workers demand and obtain increases necessary to restore their wages to pre-inflationary levels, probably apart from small additional percentages due to productivity increments. However, the prior real level is no longer a real equilibrium wage because it has been reduced by inflation. The recovery of the prior real level involves an overadjustment that puts upward pressure on prices. In subsequent renewals, efforts to recover real income prior to inflation and incorporate productivity increases will continue to raise wages above equilibrium levels. Once inflation is under way, the mechanism that will maintain it is installed, i.e., the temporal lag and periodic overadjustment of wages and other prices subject to fixed term contracts or official regulation.

The mechanism for the transmission of inflationary pressures expounded here is not a theory accepted in academic circles but is rather an explanation put forward in a conference sponsored by

Figure 1
CHILE: WAGES AND SALARIES IN TWO INDUSTRIES: 1955-1965
 (1958 = 100)



Source: Personal archives of author and *Boletín Mensual*, Central Bank of Chile.

Symbols: x Area supervisor: Rayonhill, Industria Nacional de Rayón, S.A.
 xx Area supervisor: Fábrica Victoria, Puente Alto, S.A.
 xxx Average daily wage: Rayonhill, Industria Nacional de Rayón, S.A.
 xxxx Average daily wage: Fábrica Victoria, Puente Alto, S.A.

the Central Bank of Chile in August 1965² and developed in a book published in Spanish in 1969³ and translated into English in 1972.⁴ This explanation was not refuted but neither was it accepted until Dornbusch endorsed it in 1984, in a conference of the Institute of International Economics,⁵ and repeating it subsequently in a number of papers.⁶

² Central Bank of Chile, *Boletín Mensual*, No. 451, Santiago, Chile, September 1965.

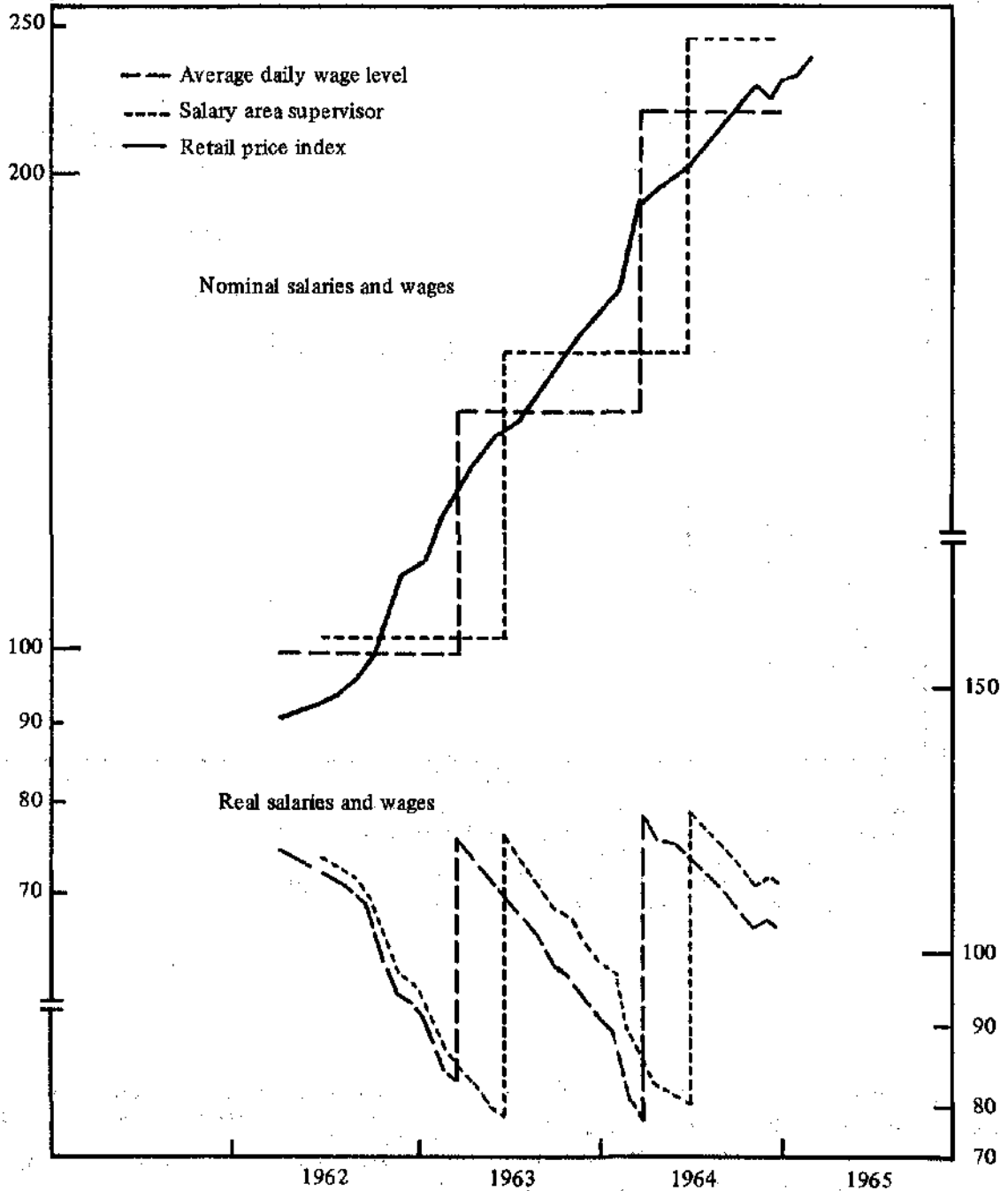
³ Centre for Latin American Monetary Studies (CEMLA), *Medidas para detener la inflación crónica en América Latina*, Mexico City, 1969.

⁴ *Chronic Inflation in Latin America*, New York, Praeger Publishers, 1972.

⁵ Institute for International Economics, *Inflation and Indexation*, Washington, D.C., 1965.

⁶ Rudiger Dornbusch, *Inflation, Exchange Rates and Stabilization*, Essays in International Finance, No. 165, Princeton, N.J., 1986; Rudiger Dornbusch and Juan Carlos de Pablo, *Deuda externa e inestabilidad macroeconómica en Argentina*, Buenos Aires, Editorial Sudamericana, 1988.

Figure 2
CHILE: ANNUAL SALARY ADJUSTMENTS IN ONE COMPANY^a
 (April 1962-March 1963 = 100)



Source: Personal archives of author and *Boletín Mensual*, Central Bank of Chile.
^aIndustria Nacional de Rayón, S.A., Rayonhill.

3. Diversity in productivity rate increases

Another cause of the persistence of inflation lies in the fact that industries that increase productivity more rapidly do not lower the prices they charge consumers but, rather, raise wages, thus establishing the norm for wage levels to be based on economic activities with lower productivity increases. In those areas less favoured by technological progress, the fact that wages rise more than productivity forces increases in their prices, with the consequent impact on the general cost of living index. In the United States, since the end of the Second World War, average merchandise prices have risen at an annual rate of 3.8%, while those of services have risen at an annual rate of 5.3%, giving an annual average increase of 4.4% in the general consumer price index (table 3).

The persistence of inflation due to cost increases in activities of lower productivity accounts for only 1% or 2% annually. This is not important in annual

inflation rates of 30% or 40% but is significant in annual inflation rates of 3% or 4%, as is commonly the case in industrial nations.

Table 3
UNITED STATES: PRICE INCREASES OF
DIFFERENT TYPES OF PRODUCTS
(1982-1984 = 100.0)

	1946	1988	Annual rate of exchange
Merchandise	22.9	111.1	3.8
Food	19.8	117.8	4.3
Durable goods	29.2	110.2	3.2
Non-durable goods	23.6	105.5	3.6
Services	14.1	125.5	5.3
Medical service	10.4	137.9	6.4
Other services	13.1	124.1	5.5
General index	19.5	118.0	4.4

Source: *Economic Report of the President*, Washington, D.C., 1989.

III

Inflationary acceleration in the last two decades

1. The causes of acceleration

The acceleration of price increases in Latin America in the last two decades was caused by a number of factors, some general in character and others specific to certain countries. In the 1970s, the sharp rise in oil prices, the much lower, yet substantial, increases in the prices of other primary products, and the considerable rise in prices of exports from industrial nations accelerated inflation which, however, was moderate in comparison with that of the 1980s. Then, the surge in prices was caused mainly by: a) the efforts of Latin American Governments to soften the domestic effects of the sharp decline in the acquisition of foreign resources resulting from the debt crisis and b) the drop in primary product prices. To these factors, a) and b), others must be added which affected only certain countries; c) monetary expansion not geared to absorb a decrease in foreign resources; d) the increase in the exchange rate resulting from the liberalization of previous controls

or arising from expectations of international payment disequilibria; e) guerrilla wars; and f) the automatic acceleration of inflation when the process surpasses certain levels.

As we will see, factor c) has been the cause of acceleration, at one time or another, in nearly all the countries of the region but especially in Argentina, Bolivia, Brazil, Chile, Mexico, Peru and Uruguay; factor d) has accelerated inflation in Chile, Mexico and Venezuela; factor e) in El Salvador and Nicaragua; and factor f) in Argentina, Bolivia, Brazil, Nicaragua and Peru.

Two of the six factors mentioned, a) and b), are of foreign origin and are not, therefore, attributable to domestic policies, although these could have been more effective. For their part, guerrilla wars constitute a serious non-economic national problem. The other three factors are directly and immediately related to economic and financial policy and, therefore, must be studied with care in order to avoid them in the future.

2. Increases in the prices of oil, other primary products and imported manufactured goods

Oil prices rose sharply in 1973-1974 and again in 1979 and 1980, with the result that average fuel prices in the 1970s were eight times higher than in the 1960s (table 4). Also in 1973-1974, the prices of other primary products began a trend of increases that continued until 1980, raising their average value to double that of the 1960s; a similar trend occurred in the prices of exports from industrialized nations or in the prices of imported manufactured goods, which is the same thing. Given this increase in oil and other primary product prices, which led to considerable income and cost increases in producer countries, raising prices from the demand side and pushing them up from the cost side; and, given, moreover, the higher value of imported manufactured goods, it is no wonder that Latin American inflation rose from an average annual rate of 21% in the 1960s to 39% in the 1970s and to around 50% by the end of that decade.

Table 4
LATIN AMERICA: IN BASIC PRODUCT PRICES
AND RATES OF INFLATION: 1961-1980
(1961-1970 = 100)

	Index 1971-1980	Increase (%)
Price of oil	828.5	728.5
Price of basic products	212.1	112.1
Price of industrial country exports	211.6	111.6
Average industrial country rate of inflation ^a	263.0	163.0
Average rate of inflation ^b	185.7	85.7

Source: International Monetary Fund, *Yearbooks of International Financial Statistics*.

^a 3.3% in the period 1961-1970 and 8.7% in 1971-1980.

^b 21.2% in the period 1961-1970 and 39.1% in 1971-1980.

3. Policy to offset the decline in assets and foreign loans

As can be seen in table 5, during the 1960s, net financial transfers (new loans and direct investment less amortization, dividend and interest payments) left a negative average annual balance of US\$700 million.

Positive annual averages of US\$12.6 billion were achieved in 1971-1975 and US\$23.4 billion in 1976-1981 in the following six years, 1982-1987, they became negative again, with an average annual

loss of US\$22 billion, i.e., a decline of US\$45.4 billion in the annual average of net financial transfers between one period and another (computed, as all the other figures in constant 1986 buying-power dollars).

Table 5
NET FINANCIAL TRANSFERS: 1961-1987
(Annual averages in billions of 1986 dollars)

	1961- 1970	1971- 1975	1976- 1981	1982- 1987
Direct investment	2.6	3.9	5.5	3.3
Loans	4.1	17.3	41.9	9.7
Acquisition of capital	6.7	21.2	47.4	13.0
Interest and dividend payments	-7.4	-8.6	-24.0	-35.0
Net financial transfers	-0.7	12.6	23.4	-22.0

Source: International Monetary Fund, *International Financial Statistics*; International Bank for Reconstruction and Development, *World Debt Tables*; and Economic Commission for Latin America and the Caribbean, *Preliminary overview of the economy of Latin America and the Caribbean*.

Latin American exports attained their maximum value of US\$108.2 billion in 1981, fluctuating below that amount during the following years and averaging US\$94.8 billion during the 1982-1987 period. That average was higher than that of the preceding five years, even if computed in terms of 1986 prices; however, as table 6 shows, total acquisition of foreign resources (exports plus net financial transfers) fell from an annual average of US\$103.2 billion in 1976-1981 to US\$72.8 billion in 1982-1987, i.e., a decline of US\$30.4 billion. This figure is equivalent to 3.6% of regional GDP, 22.7% of exports and 17.3% of fiscal income.

Table 6
NET FOREIGN RESOURCE ACQUISITION:
1961-1987
(Annual averages in billions of 1986 dollars)

	1961- 1970	1971- 1975	1976- 1981	1982- 1987
Exports	28.8	52.4	79.8	94.8
Net financial transfers	-0.7	12.6	23.4	-22.0
Net foreign resource acquisitions	28.1	65.0	103.2	72.8

Source: International Monetary Fund, *International Financial Statistics* and table 3.

The drastic decline in foreign income presented governments with the dilemma either of allowing this phenomenon to provoke a violent contraction of economic activity and employment or of applying compensatory policies which would inevitably accelerate inflation. Governments chose the second alternative but, even so, could not avoid GDP contractions of 1.4% in 1982 and 2.9% in 1983, with a very slow rate of growth in the following years, which was less than population growth. For its part, the average Latin American inflation rate rose from 57% in 1981 to 85%, 130%, 185% and 274% in the following years (table 1).

In the process described, inflationary acceleration was caused by economic policy aimed at absorbing a sharp drop in the acquisition of foreign resources. This outlines the situation which gave rise to the structuralist theory of inflation, first articulated by Juan F. Noyola and later reformulated in more systematic form by Osvaldo Sunkel, Anibal Pinto and Raúl Prebisch. This theory argued that Latin American inflation was not due to lack of foresight or extravagance but to imperfections in the productive apparatus and instability in foreign trade. These factors forced governments to implement compensatory policies which generated inflationary trends.⁷

⁷Juan F. Noyola Vázquez, "El desarrollo económico y la inflación en México y otros países latinoamericanos", *Investigación económica*, vol. 15, No. 4, Mexico City, National School of Economy, 1956; Osvaldo Sunkel, "La inflación chilena: un enfoque heterodoxo", *El trimestre económico*, vol. 25, No. 4, Fondo de Cultura Económica, October-December, 1958; Anibal Pinto, *Ni estabilidad ni desarrollo: la política del Fondo Monetario*, Santiago, Chile, Centre for Research and Social Action, 1960; Raúl Prebisch, "Economic development or monetary stability: The false dilemma", *Economic Bulletin for Latin America*, vol. 6, No. 1, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), March 1961; Dudley Seers, "A theory of inflation and growth in underdeveloped countries", *Oxford Economic Papers*, vol. 14, London, Oxford University Press, 1962; Aldo Ferrer, "Reflexiones acerca de la política de estabilización en la Argentina", *El trimestre económico*, vol. 30, No. 4, Mexico City, Fondo de Cultura Económica, October-December, 1963; Eduardo García, "Inflation in Chile, a quantitative analysis", 1964, mimeo; Héctor Malavé Mata, "Metodología del análisis estructural de la inflación", *El trimestre económico*, vol. 35, No. 3, Mexico City, Fondo de Cultura Económica, July-September 1968; and Camilo Dagum, "Un modelo econométrico sobre la inflación estructural", *El trimestre económico*, vol. 37, No. 1, Mexico City, Fondo de Cultura Económica, January-March 1970.

4. Monetary expansion not aimed at absorbing the drop in foreign assets

The direct and immediate cause of inflation is obviously monetary expansion. As explained above, such expansion can be used to finance compensatory policies, or can originate from the idea that monetary expansion does not raise prices in situations of unemployment and unused productive capacity, or can result from irresponsible financial policies. The first cause has been analysed in the previous section and the third cannot be justified, but the second is little understood and, therefore, merits explanation.

The belief that, in situations of unemployment and unused productive capacity, monetary expansion does not generate inflation is based on an erroneous application of Keynesian theory which forgets that this will be true in closed but not in open economies and in countries with low gold reserves and affected by a lack of funds. When a country with an open economy and unused productive capacity possesses international reserves, the expansion of demand can, for a time, increase production without provoking inflation, because accumulated funds will finance the increased imports resulting from greater domestic activity. However, when the reserves are spent, inflation takes off, the economy becomes disorganized, production contracts and unemployment increases.

Expansion of demand as an instrument of development policy has been applied, at one time or another, in many of our countries. To illustrate its effects, it is sufficient to study the figures (table 7) for the main macroeconomic variables of Chile in 1970-1973 and Peru in 1985-1988, when this policy was applied. In Chile, the deliberate expansion of demand was successful during the first two years, when the real product rose and the inflation rate was stable, but it began to have negative effects during the third year and became critical during the fourth year, in which inflation took off, economic activity contracted sharply and real salaries plummeted. In Peru, the favourable effects lasted three years but the crisis that began in the fourth year was even more serious than that suffered by Chile.

In spite of these arguments and the facts themselves, we economists have frequently maintained the illusion that, when labour and infrastructure are available, monetary expansion will increase production and not prices. On the basis of this illusion, we have had recourse to monetary expansion, although it is difficult to discern when this has been motivated by the hope of increasing

Table 7
CHILE AND PERU: EFFECTS OF DELIBERATE EXPANSION OF DEMAND AS DEVELOPMENT POLICY

	Chile				Peru			
	1970	1971	1972	1973	1985	1986	1987	1988
Rate of increase in public spending (%)	47	76	88	378	158	80	87	395
Inflation rate (%)	35	35	217	606	158	63	11.5	1 722
Rate of real growth (%)	2.1	9.0	-1.2	-5.6	2.5	9.5	6.9	-8.4
Commercial balance (millions of dollars)	246	73	-161	-13	1 173	-67	-463	-84
International reserves (millions of dollars)	320	129	95	36	1 842	1 407	646	518
Real wages (first year = 100)	100	112	108	89	100	114	124	95

Source: Rudiger Dornbusch and Sebastian Edwards, "Economic crises and the macroeconomics of populism in Latin America: lesson from Chile and Peru", *mimeo*, March 1989.

production or when it was merely irresponsibility. Be that as it may, inflationary acceleration, in many cases, has been the consequence of monetary expansion that should not have occurred.

5. Increases in exchange rates due to liberalization of controls or unfavourable expectations

During 1971-1973, while a policy involving the deliberate expansion of demand was being applied in Chile, inflation was partially contained through the overvaluation of the exchange rate. Table 8 shows that, between 1969 and the third trimester of 1973, the exchange rate rose nearly 250%, more than three times retail prices (860%). The liberalization of the exchange rate decreed by the new authorities caused it to rise more than 2 300% in the following 15 months, a period in which retail prices rose little more than 1 000%. In 1975, the exchange rate rose 490% and prices 375%. This inflationary acceleration was basically a consequence of the liberation of pressures restrained by the overvalued exchange rate of the previous three years but it also had its own momentum. In fact, a devaluation to equilibrium would have meant an increase of from 25 to 90 pesos per dollar in December 1973, and not to 360 pesos per dollar, which is what happened in the free market. Such a devaluation would perhaps have been able to contain the increase of the dollar from 90 to only 200 pesos, or less, in the following 12 months, in contrast to the 1 870 pesos of December 1974.⁸ The extremely

⁸ This figures does not coincide with that of table 8 because the latter reports annual averages and not end-of-year values.

high rate of inflation in Chile in 1974, 1975 and 1976 was a consequence not only of the liberation of previously contained pressures but of the multiplication of these pressures in the exchange rate-prices-wages spiral.

Table 8
CHILE: EXCHANGE RATE AND RETAIL PRICE INCREASES: 1970-1976
(Percentages)

Year	Exchange rate increase	Retail price increase
1970	20.3	33.0
1971	8.3	35.0
1972	38.5	77.3
1973 ^a	38.5	170.3
1974 ^b	2 328.0	1 014.4
1975	490.3	374.7
1976	165.8	211.8

Source: International Monetary Fund, *International Financial Statistics*.

^a First three quarters.

^b Last quarter of 1973 and all of 1974.

Inflationary acceleration stimulated by autonomous rises of the exchange rate took place in Mexico in 1982-1988 and in Venezuela in 1989. The strong increase in the rate of inflation in Mexico, from 28% in 1981 to 59% in 1982 and to figures that fluctuated around 100% for six years, was basically, though not exclusively, due to capital flight provoked by the debt crisis. The effects of inflation themselves caused the exchange rate to rise rapidly, which, in turn, accelerated price hikes. In Venezuela, inflation increases, from an average rate of 35% in 1988 to 90% the following year, were due to the exchange

unification decreed in February 1989, which caused the average import exchange rate to rise from 18.1 bolivars per dollar that month to a free and unified rate which fluctuated between 36.9 and 34.7 bolivars between March and December, a 120% real exchange rate increase. Table 10 presents variations in the real exchange rate and the monthly and annual inflation rates for 1989 and the first three months of 1990.

Table 9
MEXICO: EXCHANGE RATE AND RETAIL PRICE INCREASES: 1982-1989
 (Percentages)

	Exchange rate increase	Retail price increase
1982	130	59
1983	114	102
1984	40	65
1985	53	58
1986	138	86
1987	125	132
1988	65	114
1989	8	18

Source: International Monetary Fund, *International Financial Statistics*.

Table 10
VENEZUELA: EXCHANGE RATE AND RETAIL PRICE INCREASES: 1989-1990

Year and month	Exchange rate variation (%) (with respect to previous month)	Retail prices	
		Monthly variation in annual terms (%)	12-month change (%)
1989			
January	0.2	14.0	36.4
February	117.1	45.9	43.5
March	-5.9	884.9	74.3
April	2.7	357.0	93.8
May	2.1	110.5	103.3
June	-1.9	45.9	99.8
July	-0.21	34.5	94.9
August	3.2	29.8	94.5
September	0.8	42.9	97.6
October	8.6	42.6	95.0
November	4.5	16.8	90.0
December	-1.7	22.4	80.9
1990			
January	0.9	32.9	83.2
February	-0.7	25.3	91.1
March	2.1	23.9	51.9

Source: International Monetary Fund, *International Financial Statistics*.

6. Guerrilla movements

In Latin America, guerrilla movements have become strong enough to increase inflation in El Salvador and Nicaragua. El Salvador went from an average rate of 1% in the 1960s to 11% in the 1970s and to rates slightly higher than 20% in 1985, 1986 and 1989. In Nicaragua, the tempo of price hikes rose from 1% in the 1960s to 18% in the 1970s and to rapidly rising annual rates in the 1980s, reaching levels of hyperinflation. Probably in Peru, the guerrilla movement has contributed to inflation, although the determinant factor clearly was the policy of deliberate expansion of demand.

Given the great difference between the intensity of inflation in El Salvador and Nicaragua, it would be worth while to investigate the cause. This would require obtaining information on the damage caused by the guerrilla movement in each country. Without such information, it can be assumed that the lower inflation observed in El Salvador was due to the much greater foreign aid received by that country, which allowed it to maintain a much more stable exchange rate and to apply more conservative fiscal and monetary policies.

7. Automatic acceleration of inflation when certain levels are surpassed

When the rate of inflation rises above tolerance levels, more and more worker organizations demand and obtain wage increases before their contracts expire. These increases further stimulate inflation and provoke a further reduction of the adjustment interval, which is initially cut to six months and, then, to three months, one month, one week, one day. At first, the adjustment is based on the cost of living index but, since today it is published after one or two months have passed, it is replaced by another price hike indicator: the best known and most up-to-date is the current price of some foreign currency, generally the dollar. As adjustment periods become shorter, the persistence mechanism grows progressively weaker, until it disappears completely. This is why there comes a time when hyperinflation loses its momentum and suddenly stops, with the cessation of exogenous pressures of demand and costs, or of the partial deficiency of supply which affected the economy.

This mechanism has been the cause of the acceleration of price hikes to hyperinflationary levels in Argentina, Bolivia, Brazil, Nicaragua and Peru and

has conferred specific characteristics on the processes of those countries, which must be taken into account in the design of policies designed to stop them.

Table 11
HYPERINFLATION
(Monthly percentage price increases for the last five months of hyperinflation and the following five months)

Months	Germany ^a	Austria ^b	Hungary ^c	Poland ^d	Greece ^e
1	205	41	6	38	305
2	1 276	33	8	275	349
3	4 126	92	25	148	1 909
4	3 773	134	29	109	8 894
5	35 875	82	79	70	85 507 000
6	-10	-8	13	6	63
7	-7	-6	3	-1	-8
8	-3	-2	6	-	5
9	1	1	-3	-1	7
10	2	2	4	-1	2

Source: Felipe Pazos, *Chronic inflation in Latin America*, Praeger Publishers, New York, 1972.

^a July 1923-April 1924.

^b May 1923-February 1924.

^c October 1923-July 1924.

^d September 1923-June 1924.

^e July 1944-April 1945.

IV

Measures for stopping inflation

1. Successful policies in the past

The information in table 12 demonstrates that, in the last decades, some Latin American countries have managed to reduce their inflation rates substantially, for shorter or longer periods of time. Since the author of this article is not fully familiar with the policies applied in Paraguay in 1953-1954 and in Bolivia in 1956-1958, they will not be considered in the following analysis. In the other cases, eight countries took measures especially designed to disconnect the mechanism of overadjustment; two began a drastic deceleration of the depreciation of the exchange rate; and the last country adopted an orthodox programme which brought about a sharp drop in its hyperinflation, in a way similar to that which ended hyperinflation in Central Europe after the World Wars.

Policies for ending the overadjustment process have assumed three different modalities over the years. In the 1950s and the first half of the 1960s, the procedure consisted in limiting the wage hikes

established in contract renewals to the equivalent of half the inflation rate of the adjustment period, plus a small percentage for increased productivity. Towards the end of the 1960s, a formula of scaled wage increases tended to prevail, by virtue of which greater increases benefited those workers who had gone longer without an adjustment. Finally, in the 1980s, the choice was made to create a new monetary unit and to regulate the conversion of work contracts signed in terms of the previous monetary unit into contracts using the new money.

The first procedure allowed for the reduction of inflation in Chile, from 76% in 1955 to 29% in 1958 and from 39% in 1959 to 8% in 1961; in Argentina, from 114% in 1959 to 27% in 1960; and in Brazil, from 91% in 1964 to 22% in 1968, making an average growth rate of 9.4% possible for the following eight years.

The second method was applied in Argentina during the 1967-1969 period and brought about a decrease in inflation from 29% to 8%; and in Uruguay from 125% to 17% in 1968-1970. Finally,

the third formula was used in the Austral and Cruzado Plans implemented by the Governments of Argentina and Brazil respectively, both in 1985-1986. The Austral Plan lowered inflation from an annual rate of 2 554% in July 1985, to an average annual rate of 33% in the following seven months, although prices were soon to rise sharply again. In Brazil, the Cruzado Plan caused inflation to fall from an annual rate of 535% in February, 1986 to an average rate of 14.6% in the following seven months, a period at the end of which, however, prices rose again exponentially.

We will now deal with programmes designed not to disconnect the overadjustment mechanism but to decelerate the exchange rate depreciation. For example, Chile reduced inflation from slightly more than 1 000% in 1974 to 20% in 1981 through a stabilization plan whose essential element was the deceleration of the rise in the dollar exchange rate from 2 328% in 1974 to zero in 1981, followed by low incremental increases in the following years.

Mexico reduced inflation from an annual rate of 214% in January 1988 to 18% in the following September, by applying a policy designed mainly to freeze the exchange rate for that year, limiting depreciation to 1.3% monthly (16.8% annually) beginning in January 1989.

The halt in exchange rate depreciation is an effective anti-inflationary policy because it slows price increases for internationally tradeable goods, whose weight in the cost of living index is less than 30%. By containing increases in that area, this policy leads to moderation in wage hikes, as the annual contracts of different worker groups come up for renewal. In the absence of other inflationary pressures, the deceleration of exchange rate depreciation can halt the inflation process in one or two years and in even briefer periods, if the interval between wage adjustments has been shortened due to the intensity of price hikes. However, this method achieves its objective at the cost of overvaluing the currency and discouraging exports which, after a short time, provokes an exchange crisis that sparks inflation once again.

Both in Chile and Mexico, policies of exchange overvaluation were implemented after a period of rapid depreciation, which stimulated inflation but which was, in fact, more rapid (tables 8 and 9). The exchange rate was obviously undervalued, which gave room for revaluating it without letting it go too high. However, those were exceptional circumstances, since exchange revaluation is a highly risky policy, by no means advisable as a means of detaining inflation.

Table 12

LATIN AMERICA: CASES IN WHICH INFLATION HAS BEEN REDUCED

Country	Period	Annual inflation rate		Duration of "stability"
		Initial	At end of programme	
Paraguay	1953-1954	62	21	23 years
Chile	1955-1958	76	29	2 years
Bolivia	1956-1958	115	20	12 years
Argentina	1959-1960	114	27	5 years
Chile	1959-1961	39	8	2 years
Brazil	1964-1967	91	22	8 years
Argentina	1967-1969	29	8	2 years
Uruguay	1968-1970	125	17	2 years
Chile	1974-1981	504	20	to present
Argentina	1985-1986	2 554	27	7 months
Brazil	1985-1986	535	17	8 months
Bolivia	1985-1986	11 743	16	to present
Mexico	1987-1989	214	18	to present

Source: International Monetary Fund, *International Financial Statistics*

The third effective anti-inflationary plan was that of Bolivia, the first Latin American country to which levels defined by Cagan as hyperinflation and, until the recent price explosions in Argentina, Brazil and Peru, the only country in the world in which this process had not been caused by war or revolution. Hyperinflation in Bolivia was the result of systematic fiscal disequilibria, freely financed by foreign banks between 1975 and 1980 and by the Central Bank during the first half of the 1980s. Prices rose from an annual average rate of 20% in the 1970s to 32% in 1981 and accelerated in the following years, to 127% in 1982, 276% in 1983 and 1 281% in 1984, reaching 11 743% in 1985. This last figure is the equivalent of a monthly average of 49%, which rose to 56% in the last week of August, before falling sharply to a negative rate of 2.9% in the first week of September. Hyperinflation ended in the same sudden fashion in Central Europe at the end of the World Wars and, as in those cases, its end can be attributed to the loss of inertial persistence, more than to the measures taken to stop it, which had been implemented only days before.

The stabilization plan of Bolivia consisted in an orthodox programme of public expense reductions, tax and public service tariff hikes, privatization of State companies and general economic liberalization. Credit cannot be given to the programme for the end of hyperinflation, since it did not have time to achieve that goal, although it did halt pressures in the following months and maintained inflation below an annual rate of 20% in subsequent years.

2. Characteristics and lessons of successful plans

The study of Latin American plans which have been successful in substantially reducing inflation reveals that all of them ended the process of overadjustment, applying wage and price controls, or decelerated the process, slowing exchange rate depreciation.

It is also clear that none of the plans was based exclusively or mainly on restriction of aggregate demand.

Controls applied to end the process of overadjustment have been transitory and have not affected market operations nor have they distorted the structure of relative prices. Neither has deceleration of the exchange rate brought about negative effects, due to the special circumstances in the countries which had recourse to that policy.

It is also clear that plans which have not implemented adequate measures for the restoration of financial equilibrium have been effective for only brief periods, after which inflation reappeared with great force; on the other hand, countries which took such measures have maintained relative stability for longer periods.

The substantial reduction in price increases achieved by these plans shows that inflation is controllable. This is a very important conclusion because one of the obstacles which the struggle against inflation in Latin America faces is the belief that it is an unavoidable evil, due to the instability of foreign trade and imperfections in the economic structures of our countries, according to some, or to deficient government administration, according to others.

3. The need to end the process of overadjustment and re-establish basic economic equilibria

Analysis of the causes of inflation and of the plans which have managed to contain it shows that it is necessary to end the process of overadjustment. It also demonstrates that the more advisable of the two formulae available for this purpose consists in establishing transitory wage and price controls because the deceleration of the process through gradual revaluation of the exchange rate implies the risk of overvaluation and, therefore, of discouraging growth of exports.

In their book on Argentina,⁹ Dornbusch and De Pablo clearly and convincingly explain that temporary wage and price controls do not seek to replace the mechanism of the market and consumer freedom but seek rather to re-establish the normal functioning of that mechanism and allow economic agents to obtain undistorted information for their decisions. Temporary control can be effective when it is not prolonged beyond a couple of months because, in that short time, the structure of relative prices is not distorted by that control.

⁹ Rudiger Dornbusch and J.C. De Pablo, *op. cit.*

It is necessary to understand clearly how and why temporary controls designed to break inflationary inertia do not replace the mechanism of the market but rather perfect it. Failure to understand this phenomenon prejudices many economists against an indispensable policy for halting inflation or for reducing its intensity to bearable rates.

The temporary wage and price controls necessary to break inflationary inertia are not an alternative to the adoption of financial policy that would balance aggregate demand and total supply. Measures to rationalize the budget and halt monetary expansion must be taken simultaneously. If financial equilibrium is not restored, excessive demand will make prices rise and reactivate inflation.

When formulating policies for fiscal correction, financial authorities must be aware that, measured in real terms, government assets fall when inflation accelerates and rise again when inflation falls. This can be attributed to the Oliveira-Tanzi effect, i.e., to the fact that government assets lose real value between the date when taxes are computed and that on which they are collected, losses being greater in conditions of higher inflation. It is foreseeable, then, that income will increase in real terms when inflation decreases, although not to the extent necessary to balance the budget. Consequently, it is necessary to raise taxes and public service charges or reduce expenses to cover the budget deficit which will probably remain, in spite of increased real income due to decelerated inflation.

Financial authorities must also be aware that economic agents reduce their monetary balances to painfully low levels during periods of rapid inflation and restore them to normal levels when inflation slackens. For this reason, it is possible to expand monetary supply in this phase, without provoking inflationary effects, up to the amount required to restore normal liquid balances. Nevertheless, this does not mean that stabilization can be achieved with a lax monetary policy: for the positive effects of breaking inflationary inertia to become firmly established, fiscal policy and monetary policy must achieve and maintain strict macroeconomic equilibrium.

4. Equilibrium in international payments

The fiscal and monetary policies designed to balance domestic accounts, also balance international payments on regular accounts, although it does so at a low level of economic activity. Therefore, strategy for stabilization must be accompanied by policies

designed to promote a high level of exports, taking into account the possibility that this high level of activity may lead to foreign deficits, which would require financing with international reserves or by postponing foreign debt service. Consequently, maintaining foreign equilibrium and high production and employment levels simultaneously requires: i) application of conservative financial policy; ii) establishment of an exchange rate that stimulates exports; iii) implementation of an anticyclic policy with respect to international reserves and foreign debt service.

These are the three classic prescriptions in this matter, except the third recommends anticyclic policies, not with respect to acquiring new foreign loans, but to interest and amortization payments on previously contracted loans. In the circumstances in which Latin American countries currently operate, with a debt many times greater than their capacity to pay, an increase of that debt cannot be recommended. Rather, they must try to lower the rate of growth of that debt as much as possible.

5. The special case of hyperinflation

When price hikes have reached hyperinflationary levels, it is no longer necessary to install temporary controls to end the process of lags and overadjustments, since the shortening of intervals between increases has already performed that task. This explains why hyperinflation ended from one month to the next in Germany, Austria, Hungary and Poland after the First World War; and in Greece, after the Second. And it explains the abrupt end of the recent hyperinflation in Bolivia.

Given the rapid disappearance of the phenomenon in the countries of Central Europe after the World Wars and the more recent experience of Bolivia, it was reasonable to expect that the same process would occur in Argentina and Brazil, overwhelmed by explosive inflation. But this has not happened. More than half a year after the implementation of rigorous stabilization programmes in these two countries, in July 1990, retail prices were rising at an annual rate of more than 340% in Argentina and around 430% in Brazil. Why has the hyperinflation of these two countries not behaved in ways similar to those observed in other countries in the past? This is a question to which we must dedicate our best efforts.

VI Conclusions

In Latin America, as in the rest of the world, inflation is maintained by lags and subsequent overadjustments of prices subject to contract or official regulation and is accelerated or decelerated by deficits or positive balances in the country's foreign or domestic accounts. Consequently, anti-inflationary programmes must attack both factors, with measures to reduce overadjustments to normal levels and policies that will balance domestic assets and debits and international payments. The reduction of overadjustments to normal levels requires the application of simple controls for brief periods, which need not distort the structure of relative prices nor affect the efficient allocation of resources which will continue to occur through the mechanism of the market. Domestic financial balance must be re-established through higher taxes and public service charges or reduced public expenses, or through a combination of both measures; and foreign equilibrium must be achieved and maintained through the application of i) a policy of domestic financial balance; ii) an exchange rate that stimulates exports; iii) an anticyclic foreign debt service plan which will lower payments when the country's export income falls and raise them when exports rise.

In situations of hyperinflation, wage and price controls are not necessary to put an end to the process of lag and overadjustment. With daily adjustments, wages no longer lose ground with respect to average prices. However, it is still absolutely necessary to re-establish domestic and foreign financial equilibrium and create confidence that it will be maintained.

The spectacular worsening of inflation in Latin America in recent years could facilitate the struggle against this social and economic scourge and reduce its intensity to the levels found in industrial countries, because it has obliged us to scrutinize the measures necessary to achieve this goal and because it ought to give us the resolve to apply these measures.

It is perhaps justified, then, to repeat that control of inflation constitutes the most urgent task for economic science and the central problem that we Latin American economists must solve in order to alleviate the suffering of millions of persons, renew the development of our countries and rescue the prestige of our profession.