

# CEPAL

## Review

*Executive Secretary of ECLAC*  
Gert Rosenthal

*Deputy Executive Secretary*  
Carlos Massad

*Director of the Review*  
Anibal Pinto

*Technical Secretary*  
Eugenio Lahera



UNITED NATIONS  
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN

SANTIAGO, CHILE, DECEMBER 1990

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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.

LC/G. 1642 - P
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December 1990
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UNITED NATIONS PUBLICATION
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ISSN 0251-2920
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ISBN 92-1-121168-9
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Printed in Chile

# CEPAL

## Review

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Santiago, Chile

Number 42

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## Structural elements of spiralling inflation

Héctor Assael\*

This paper reviews some of Prebisch's ideas on inflation and comments on the article by Felipe Pazos which appears in this number of the *Review*.

It is pointed out that inflation and stabilization policies were not among the subjects most frequently dealt with by Prebisch. Nevertheless, in the earliest ECLAC documents, when Prebisch became the Executive Secretary, a "structural" interpretation was developed of the phenomenon of inflation in Latin America.

The paper also reviews the causes put forward by Pazos of the present period of spiralling inflation. It emphasizes the significance of "imported inflation" and of recessive adjustment policies as causes of inflation. It goes on to analyse the responsibility of the fiscal deficit for inflation and warns that this does not justify conclusions about adjusting the size of the public sector, given the form in which the external debt service was transferred to it.

Finally, the paper analyses various anti-inflationary measures. An integral stabilization policy should make a joint and coordinated attack on both the structural factors of inflation and the ways in which it spreads. From another point of view, orthodox fiscal and monetary measures should be coordinated with unconventional measures, such as controlling a set of key prices and wages. In cases where inflation is accompanied by significant disequilibria in the balance of payments, the situation of external strangulation must be attacked. Finally, an effective and rapid anti-inflationary programme needs broad public support.

\*Director of the International Trade and Development Division (ECLAC).

### I

One of the reasons it is particularly important for me to participate in this seminar is that it gives me the opportunity to comment on the spiralling inflation in Latin America. I shall, therefore, look at some of the subjects which were given special attention by distinguished Latin American economists such as Raúl Prebisch, Felipe Pazos, Aníbal Pinto, Juan Noyola, and Osvaldo Sunkel, who have had an extensive and profound influence on economic and social thought in the region.

I will then make separate brief comments on some points, to facilitate a subsequent interchange of ideas.

### II

It can be stated that inflation and stabilization policies were not among the subjects most frequently dealt with by Prebisch, especially when its small relative weight in the enormous intellectual legacy he left us is taken into account. However, it can also be claimed that it was present in the earliest ECLAC documents, dating from the beginning of his work as Executive Secretary, and that these documents put forward a "structural" interpretation of the inflation phenomenon in Latin America. This was the beginning of a school of thought which was later perfected by other economists of the region.

A preliminary stage in Prebisch's thinking on inflation appeared at the end of the 1940s when he wrote the original version of the introduction to the *Economic Survey of Latin America, 1948*, in a section called "Capital formation and the inflationary process".<sup>1</sup> By way of illustration, the following paragraph from this section is quoted:

"The considerable pressure of those individual and collective needs on a relatively scarce supply of resources, is usually accompanied by inflation phenomena, such as those which so rightly worry governments at this time. Simultaneously, a school of thought has been developing not only among the more privileged, but also among those, concerned only with the general good, who consider inflation an unavoidable means of forced capitalization in situations where spontaneous saving is notoriously insufficient."

<sup>1</sup> See, *La obra de Prebisch en la CEPAL*. Selection by Adolfo Gurrieri (1982). Mexico, D.F., Fondo de Cultura Económica, pp. 99-155.

At this stage which, in my opinion, culminated in 1961 with the publication of his work, "Economic development or monetary stability: the false dilemma",<sup>2</sup> Prebisch seems to put forward three essential ideas on the subject of inflation: a) the set of relationships generated between Latin American economic and social growth and the corresponding changes in both the level of prices and the pricing system in the various countries; b) the role inflation can play in correcting imbalances in the development process, i.e., its incidental "effect"; and c) the relationships existing between the external strangulation of the regional economies and their propensity to inflation.

There was a final stage based on all his work on "peripheral capitalism" carried out over most of the 1970s and continuing to his death in 1986. As a means of recalling this different and novel concept of structural inflation, it is useful to quote a paragraph of his article "Socio-economic structure and crisis of peripheral capitalism",<sup>3</sup> which originally appeared in the *CEPAL Review*, 1978:

"Thus we approach the system's critical limit. In order to understand what happens when this is reached, it is worthwhile to recall an indispensable requirement of the dynamics of the system. If the consumer society is to operate smoothly, it is essential that the growth rate of the surplus should be at least the same as that of the global product. Otherwise, if the pressure of the middle strata through the various forms of participation which have just been described, and the incidence of the tax burden on the surplus, were to prevent the fulfilment of this requisite, the attenuation of the surplus would reduce the rate of accumulation, and that would bring down the growth rate of the product and would correspondingly reduce the part of the surplus earmarked for the consumption of the upper strata. In this case, enterprises would endeavour to retrieve the surplus by raising prices in order to restore the dynamics of the system."

Prebisch later continued developing and perfecting these ideas.

### III

Dr. Felipe Pazos has presented an excellent paper which shows clearly that he is an expert on the subject of inflation and stabilization policies and he has made valuable contributions to the study of the numerous aspects of this problem. In this respect, it should be remembered that as early as 1969 Dr. Pazos made an in-depth analysis of what he called the "chronic inflation" of Argentina, Brazil, Chile, and Uruguay, in his book called *Medidas para detener la inflación crónica en América Latina*, published by the Centre for Latin American Monetary Studies (CEMLA).

On this occasion, Dr. Pazos's paper is aimed essentially at clarifying the causes of spiralling inflation in Latin America over the last two decades, as well as at reviewing appropriate measures to contain it. He also examines briefly the recent stabilization plans of four countries in the region (Argentina, Bolivia, Brazil, and Mexico).

Dr. Pazos puts forward the following as the main causes of spiralling inflation in the region: a) in the 1960s, the vertical rise in oil prices, the much lesser but substantial increase in the price of other primary products, and the considerable increase in the price of exports from the industrialized countries; b) the attempts of Latin American Governments in the 1980s to cushion the domestic effects of the steep decline in foreign exchange returns, complicated by the foreign debt crisis and the reduction in prices of primary products. To factors a) and b) which had a general impact, he adds others which affected only some of the countries: c) monetary expansion which was not aimed at cushioning the fall in foreign exchange returns; d) rises in the exchange rate resulting from the lifting of earlier controls or from predictions that there would be an imbalance in international payments; e) the guerillas; and f) the automatic spiralling of inflation which occurs when a specific point is reached.

It is easy to comment on a diagnosis which is correct; however, I would like to make two comments.

In the first place, in the 1960s as in the 1980s, "imported inflation" was of basic significance as a

<sup>2</sup> See, Raúl Prebisch, "Economic development or monetary stability: the false dilemma", *Economic Bulletin for Latin America*, vol. VI, No. 1, Santiago, Chile, March 1961.

<sup>3</sup> Raúl Prebisch, "Socio-economic structure and crisis of peripheral capitalism", *CEPAL Review*, Second half of 1978. United Nations Publication, sales No. S.78.II.G.4, Santiago, Chile.

structural factor in destabilizing internal prices in many Latin American countries.

Later, with the appearance of this structural phenomenon, various propagating mechanisms began to operate. Naturally, they became much more active in the 1980s, particularly in some economies of the region. The recessive adjustment policies followed in Latin America contained, themselves, a very significant inflationary element, since they were aimed persistently at bringing about a thorough change in relative prices, favouring tradeable products over non-tradeable products. Thus, flexible exchange rate policies were largely used to achieve a stable and considerable undervaluation of the domestic currencies of many of the countries in the region.

In the second place, as I see it, there has not been sufficient academic study of the spiralling inflation of the 1980s to support claims that public deficits and their effect on monetary expansion have exerted a significant impact on the growth of inflation.

This observation does not directly lead to conclusions about the enormous size and inefficiency of the Latin American public sector. This is because it is always forgotten that before the debt crisis, Governments in the region often took on respon-

sibility for the private sector foreign debt without having sufficient access to the corresponding funds in domestic currency required for this service.

In other words, the Governments, in "guaranteeing" the private sector foreign debt, made the situation twice as bad: on the one hand, they needed access to the foreign exchange indispensable for servicing the debt and, on the other, they had some how to obtain, largely through monetary emissions favouring the public sector, funds in domestic currency equivalent to these foreign payments.

For example, in Brazil in recent years, the Government has received from the private sector, according to a rough estimate, the equivalent of some US\$5 billion less in domestic currency (5% of the foreign debt) per year, when it is taken into account that about 50% of the total debt was "transferred" from the private to the public sector and assuming, as well, an average annual interest rate on the debt of 10%. Because of its magnitude, this sum, approximately 2% of the gross domestic product and a very high proportion of the money available in the country, has undoubtedly great inflationary potential.

#### IV

A complete section of Dr. Pazos's paper examines what measures can be taken to contain inflation. He tackles the question directly without specifying whether these measures could be differently defined and ordered according to the essential characteristics of specific inflationary processes. For example, in the case of purely monetary inflation of a primarily structural nature or with a predominant inertial element, there could be various alternative stabilization strategies each with relatively differentiated policies and measures with respect to the inclusion or exclusion of each component and in the various combinations of anti-inflationary measures that could be feasibly conceived.

In the final analysis, Dr. Pazos places the necessary components of a stabilization policy in three groups: a) measures for ending the over-adjustment of contracted or officially regulated prices; b) measures to cushion, as far as possible, the effects of variations in export prices and capital movements; and c) an economic policy for re-establishing equilibrium between aggregate demand and total supply.

This classification of the major components of anti-inflationary policy might seem, at first glance, to be somewhat generalized. However, this impression disappears on further reading since throughout the paper appropriate descriptions are given of the different actions to be included in each of the three groups.

The special case of hyperinflation is dealt with in the paper and is defined as inflation where the rate of price increase is higher than 50% per month, or 13 000% per year.

Curiously, Dr. Pazos has a somewhat optimistic view of hyperinflation since, in his opinion, when price increases have reached this level, there is no need for temporary controls to stop the process of delays and overadjustments, since the shortening of the intervals between increases has already done this. He adds, however, that when the overadjustment mechanism is discontinued, hyperinflation can only be contained by establishing financial equilibrium in the fiscal as well as in the monetary and exchange rate areas. Confidence is restored when equilibrium has been reached.

Although Dr. Pazos quotes some historical cases of the sudden halt of hyperinflation, particularly in Europe in the 1920s and 1940s, and more recently in Bolivia, there remains some doubt about the implications of his argument.

This doubt is especially valid considering that in some countries inflation can remain at relatively high levels (for instance, between 20% and 50% per

month) over long periods of time, without the process getting out of control and without the hyperinflationary limit being soon reached. In these cases, the automatic corrections of overadjusted prices would not occur, but conversely, could aggravate serious distortions among the various elements of the pricing system.

## V

To conclude these comments on Dr. Pazos's paper, I would like to try to describe what he feels should be the essential characteristics of a reasonable, integral anti-inflationary policy with a good chance of success in achieving a substantial and stable slowdown of price increases in various specific situations.

The first condition of this integral stabilization policy is that it should make a joint and coordinated attack on both the structural elements of inflation and those propagating it. The structuralist interpretation of inflation does not try to ignore the importance of monetary policy in controlling inflation, but it does emphasize that monetary imbalances are usually deeply rooted in the economic system (for instance, production maladjustments or social problems) and that these must also be eliminated.

Second, to combat inflation, a combination of orthodox and unconventional measures are necessary, particularly in cases of inertial inflation involving prolonged price increases. In this kind of situation, it is very costly to eliminate it only by orthodox fiscal and monetary measures. We must apply unconventional complementary and temporary measures, such as controlling a set of key prices and wages and/or setting price and wage guidelines, in order to break inflationary inertia without excessive costs to economic activity.

Third, if this inflationary process is accompanied by a significant disruption in the balance of payments,

the formulation and management of the necessary stabilization policy is highly complicated. Here we must usually combine anti-inflationary policies with strategies for structural change to combat as quickly as possible the foreign strangulation which is affecting the economy. The tactics resulting from this approach should have a simultaneous effect on the current and capital accounts of the balance of payments.

Fourth, an effective anti-inflation programme needs a wide social consensus. As is well known, when inflation is high, extensive and sharp fluctuations occur in prices and relative incomes. The result is social unrest and acute rivalries among the factors of production. In this situation, the struggle against inflation requires wide social acceptance or agreement among the various economic partners (above all, government, workers, enterprises and consumers) in order to promote concerted action without serious and permanent disputes.

Lastly, a reasonable stabilization policy must quickly bring down prices and re-establish the necessary conditions for renewing economic growth and social development. Otherwise, the policy may be politically unviable and short-lived, since various social and economic interests will soon combine to oppose it and finally put an end to it.