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An iron dose of Latin American monetary and fiscal policy — the failure of unrealistic hopes in macroeconomic language

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Timothy J. Kehoe and Juan Pablo Nicolini, (editors)
A Monetary and Fiscal History of Latin America, 1960-2017
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Latin American economic issues lie are quite remote for most Finns. Even so, Africa and the Middle East have become much more familiar with their jobs. The information gap places better than well in this work, measured by Timothy Kehoen of the University of Minnesota and Juan Pablo Nicolin of the Federal Reserve Bank of Minneapolis. The reader is offered an iron dose of Latin American macroeconomics from 1960 to the present day. This is a milestone in a comparative study of economic policy, and its conclusions have implications outside Latin America.

The book is quite a solid work, but the research project behind it is extensive. There is The 10 largest economies in South America, as well as Mexico, whose results are then spread across Latin America. The research project drew more than 40 leading researchers in the field from Latin America, North America and Europe for six years. The theorists of the project are among the leading stars of macroeconomics.

Empire is based on a strong macro theory

The country-specific empirical analysis is based on the macro models developed by Thomas Sargent in the 1970s and 1980s, which are applied to the Latin American context (see Sargent 2013).
He was awarded the 2011 Nobel Prize in Economics for these contributions.
In addition to Sargent, the theoretical side is included

1 The work is available in electronic form at https:// manifold.bfi.uchicago.edu/ projects/ monetary-fiscal history-latin-america-1960-2017.

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Fernando Alvarez and 2013 financialist Lars Peter Hansen (both from the University of Chicago). The theory is really needed in this type of research - it helps to select the most relevant of the country's innumerable facts and to organize them systematically.
This gives a deeper picture of the economy, not just what is happening at the moment.

The main hypothesis in the book is that prolonged inflation (as opposed to hyperinflation) is due to the close link between monetary and fiscal policies - they must therefore be considered together. Uncertainty, expectations and the credibility of economic policy are associated with this dynamic. Government budgets and budgetary policies are dominant: they endogenize the money supply (unlike Friedman's theory of the quantity of money, which was based on the study of hyperinflation). After a detailed examination of the economies of all 11 countries - these country studies are the majority of Kehoe's and Nicolin's books - the authors manage to prove convincingly the applicability of their theory in empirical data. But that’s not all: the most important of the other conclusions below.

The essential elements of the macro-model are thus public expenditure and revenue, ie the budget deficit, government debt, and the *demand for real money.* These variables are not determined independently but are interdependent. As has been said, the budget deficit is the dominant force in Latin American economies (not monetary policy). Debt financing also does not eliminate the interdependence of monetary and fiscal policies. Where a loan is readily available, the budget deficit does not directly determine monetary policy. But when access to credit becomes more difficult when fiscal policy is diminishing, budget deficits are always eventually monetised. The end result is inflation and the many difficulties it brings to ordinary citizens.

Other features relevant to Latin American economies, such as the maturities of government bonds and the currencies in which they were taken out, have also been included in the model. Indeed, changes in exchange rates have been a component of many debt crises. Also included in the model are *defaults* and related expectations; Sudden stops in capital flows made known by Guillermo Calvo *(Sudden stops);* the role of foreign investors; and unequal treatment of different economic actors, especially in crisis situations.

Convergence is waiting for itself

After the Great Depression of the 1930s, the per capita gross domestic product (GDP) of Latin American countries was 21 percent of U.S. GDP. According to neoclassical growth theory, income levels in different countries should converge over time. This is because capital is sought where it is scarce and where it receives a higher return. But there has been no convergence: in the early 1970s, per capita GDP in Latin America was 26% of US GDP. In 2000, it had fallen to 23%. Today we are at the level of the early 1970s.

Robert Barro studied the convergence of economies empirically in the 1980s (Barro 1991). In Latin America, a negative dummy variable was always found that remained negative even when all possible control variables were added to the regression. Indeed, the present book can be summed up in one sentence: It seeks to shed light on the reasons behind the negative dum my variable in Latin America in a macroeconomic analysis.

The 10 largest economies in South America and Mexico

The economic crises in Latin America have largely been caused by poorly designed and implemented monetary and fiscal policies. The 1970s and 1980s are generally described as lost decades. Under social pressure, the state has typically increased spending without a corresponding increase in tax revenue. In the beginning, the deficits have been financed by a loan, much of which has been from abroad. Once the debt-to-GDP ratio has exceeded a certain threshold, lenders have become reluctant to lend - and the crisis is over. Some kind of economic reform has since been implemented sooner or later.

In many countries, this crisis process has been repeated many times over the years and decades. Although causality cannot be demonstrated in the same way as in the empirical field of microeconomics, recurring crises are closely linked to economic stagnation.

Each country study in the book has its own solid information package covering more than half a century of the economic development of each country. Mention should be made, for example, of Argentina, which is a very extreme example of the inflation, budget deficit and debt spiral in Latin America. The failure of politicians to control government spending has meant misery and trouble for its citizens. At the end of March 2022, the International Monetary Fund once again approved a huge financing package - $ 44 billion - for Argentina.

The description of Bolivia's economy had familiar features to me, resembling many of its low-income countries. Venezuela's economy, on the other hand, could grow dramatically in the 1960s — there could even be talk of convergence — but the country experienced at least as dramatic a collapse. over the last decade. The inflation *tax* has been the main source of funding for its budget deficit. And in the situation of the venezue laity, there is little light visible.

Descriptions of the development of macroeconomic institutions and rules are also of interest. As early as the early 1960s, for example, Brazil did not even have a central bank or money market for government debt. Nevertheless, in the 1960s and 1970s, the country changed power — rural society became urbanized. Major public investment in infrastructure and industrialization to replace imports were a strategy that continued with foreign borrowing even after the first oil crisis. The peak of optimism was represented by the new capital Brasília.

But by the early 1980s, inflation was already hovering at more than 100 percent a year, sometimes turning into hyperinflation. The strategy, led by a state-owned company and based on public development banks, had come to an end. Although it has taken years, even decades, macroeconomic institutions have finally been able to curb inflation in Brazil, Chile, Colombia and Paraguay (unlike Argentina and Venezuela).

The research project has produced a unified macroeconomic data bank for the 11 participating Latin American countries - strictly based on theory. Each separate country study systematically analyzes the same variables. They tell the macroeconomic story *(narrati ve)* of each country - its history of inflation, economic crises and economic growth with its underlying factors - and, finally, the whole of Latin America. At the very end of the book, the scope of the analysis is extended, by way of example, to the Asian financial crisis in the late 1990s and the euro crisis in the early 2010s.

Of particular note are the carpet-free diagrams in Luke’s book, which have been carefully systematized. I have never seen such precision anywhere before. For any chart or table, the reader does not have to figure out what its author might have meant. The collected data bank has also been opened to others for use, meaning more weather research is expected.

Some important conclusions

One of the main messages of the book is that curbing budget spending is the way to keep inflation back on track. A fixed exchange rate has proven to be a viable tool in the short term. Together, they are behind many successful stabilization programs. The authors also argue, challenging the widely accepted leadership on the results of the US Federal Reserve's anti-inflationary action in the early 1980s, that stopping inflation will not necessarily lead to unemployment and recession. At least this has not been the case in many episodes in Latin America.

Based on its analysis, the book concludes that the gradual liberalization of foreign trade and capital movements works better than the one-off push recommended by the Washington Consensus. Personally involved in many structural programs, this one reminded me vividly of the debates that took place in the 1990s.

The study also highlights external factors that have had a major impact on these (small) open economies, such as the increase in lending by US banks to the oil market in the 1970s. When bank financing then stalled in the early 1980s, Mexico left its debt in Hoi An default . It was not until the so-called *Brady Plan* (in 1989) that the market situation resolved, but the Mexican economy suffered badly for almost a decade.

The study also analyzes the countries' budgetary constraints as a whole, ie taking into account realized contingent liabilities . More specifically, these liabilities, which are often hidden but fall on the state (referred to in the book as *trans fer) ,* are presented as a residual item of budgetary identity (budget deficit, government debt and amount of money issued). Country-specific surveys are often, but not always, able to identify these realized hidden responsibilities.

The background is often the losses of state-owned companies or the cost of *bail-outs* in the banking sector . In Mexico, for example, such extra-budgetary responsibilities - of which the national parliaments were not even aware when they adopted the budget - averaged almost 6% of GDP in the 1980s. Today, fortunately, they are much smaller.

The editors of the book mention, somewhat in passing, that income disparities and social tensions are greater in Latin America than in most other countries, and that they may explain the dominance of budget deficits. But they leave these themes in favor of other researchers. I still missed politics, like Adam Tooze's, in order to find answers to why bad economic policy is being done year after year. Why endure *Las venas abiertas de América Latina* (loosely translated as the open wounds of Latin America), as Uruguayan Eduardo Galeano once wrote?

Why the bitter disappointment after another and the apeus they bring?

But towards the end, the book's pull together — along with and based on theory and country studies — offered such a brilliant analysis that I no longer longed for policy research in this context. I appreciated the thoroughness of the current macroeconomic research, its high level of expertise and its significant contribution to a better understanding of this important area (and the world as a whole). The book offers its readers a great glimpse into the world of Latin America, *rent seeking* behavior, and the big picture of its economy, and with new knowledge, maybe even hope for better!

Finally, the Becker-Friedman Institute of the University of Chicago, home to the Conservative School of Economic Policy, is the home of the research project. This was by no means a striking trend when reading the book, although public spending played a key role in explaining inflation and macroeconomic imbalances. The economic crises in Latin America have been so long-lasting and serious that there is probably little controversy over the evidence and role of the budget.

As has already been pointed out in terms of conclusions, the Washington Consensus was upheld in the book - something I would not have expected from a group of conservative researchers. ÿ

Literature

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