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Economic populism versus Keynes: reinterpreting budget deficit in Latin America

Budget deficit is once again at the center of the economic adjustment debate on Latin America. The failure of the successive heterodox programs adopted and pursued in the last decade has resulted in a renewed emphasis on the primacy of fiscal orthodoxy and sound money as preconditions for the success of economic stabilization. Countries as diverse as Brazil, Argentina, Mexico, Costa Rica, and Nicaragua have felt compelled to make dramatic fiscal adjustments the cornerstone of stabilization programs, overriding the traditional use of budget deficit as a cyclical stabilization device.

The swing from the heterodox to the orthodox approach has been matched by a body of literature that links Latin America's economic ills to a populist type of policy making.[1] On the other hand, it is very common in Latin America to legitimate budget deficits with Keynesian economic policy. In this paper we will try to clear up these two questions, arguing first that Keynes' views on economic policy do not support fiscal laxity, and second that macroeconomic populism is not the only explanation for the fiscal crisis in Latin America.

We will analyze macroeconomic populism in Latin America, with emphasis on fiscal policy aspects. There is no question, in our view, that populist policies can be a significant factor in the unraveling of stabilization programs. But it should be noted that the fiscal imbalance that has made stabilization difficult in Latin America during the 1980s is, or was not, by and large, the result of populist policies.

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[1] See, among others, Canitrot (1975); Dornbusch and Edwards (1989); Sachs (1988); and Bresser Pereira (1988).

We shall argue that the continuing inability of many Latin American governments to make sound fiscal policy choices is also closely associated with the developmentalist policies implemented mainly in the 1970s, with the strong support of foreign borrowing—policies that should not be confused with economic populism. In this sense, the recent emphasis on populism, while partially correct, may divert attention from the fundamental causes of the ongoing fiscal crisis and the more urgent needs of the debtor countries in Latin America.

Economic populism versus Keynes

An emerging literature has focused on the continuing problem of large budget deficits in Latin America as a result of populist macroeconomic policy making. This particular type of approach to economics has been defined by overly expansionist policies focusing on growth and income distribution, with little concern about the risks of inflation, budget deficit, and external constraints.

The search for ways to cut inflation while minimizing output loss often motivates the implementation of policies in which monetary and fiscal disciplines are not pursued, on the assumption that demand pressure on prices arising from an excess of absorption is not a crucial determinant of inflation. Idle capacity and existing reserves are seen as providing necessary room for noninflationary expansion, without the risk of running into external constraints.

Indeed, there are several well-defined experiences in Latin America where budget deficit was significantly increased to meet growth and distributive goals, with disastrous effects on economic performance. The list of recent historical episodes that illustrate some kind of populist experience includes Brazil under João Figueiredo (1979–80) and under José Sarney (1985–86); Chile under Salvador Allende (1971–73); Peru under Alan Garcia (1985–88); and Bolivia under Herman Suazo (1982–84).

This economic populism has usually been legitimated by a certain type of "Keynesianism" that gives exclusive emphasis to effective demand, reversing Say's law,[2] and advocates the indiscriminate use of fiscal policy and budgetary deficits as a means for cyclical stabilization. The extreme example of this view is the attempt to legitimate wage increases as a way to promote consumption and sustain aggregate demand.

[2] According to this kind of "Keynesianism," demand creates supply. In order to promote growth, it is enough to promote investment or consumption demand.

The appropriation of the standard Keynesian analysis to support the fiscal laxity of the adjustment programs in Latin American economies is spurious for many reasons. Indeed, there is within the Keynesian tradition an emphasis on fiscal policy and budget deficit as components of aggregate demand. In that view, the objective of a balanced budget could be suspended for a while during periods of recession.[3] Governments should fall back on budget deficit to re-create the full employment lost due to insufficient aggregate demand caused by the reduction of foreign demand for exports or by a fall in private investments.

This does not mean, however, that Keynes favored budget deficits. On the contrary, he was very reticent on the subject. As Kregel explains, "the stabilization of investment was Keynes's primary policy goal" (1985, p. 33). To achieve such stabilization, a capital budget would be necessary, but this should not be confused with deficit financing. Keynes is very clear on this subject:

> The capital budget will be a necessary ingredient in this exposition of the prospects of investment . . . .This is a very major change in the presentation of our affairs . . . one which I greatly hope we shall adopt. It has nothing whatever to do with deficit financing. Quite apart from this is the proposal that if, for one reason or another, the volume of planned investment fails to produce equilibrium, the lack of balance would be met by unbalancing one way or the other the current Budget. Admittedly this would be a last resort, only to come into play if the machinery of capital budgeting has broken down. [1943, p. 352]

In the Keynesian framework, wage and price trends are assumed to be sufficiently stable. Thus, changes in aggregate demand result in variations in production, employment, and capacity utilization. In these circumstances, no crowding-out would occur as a result of a temporary deficit, since labor and other productive resources would be available to meet the increased demand of the government without displacing other demands. That is, new public borrowing could be financed by savings generated from income associated with the expansion of production and employment. In sum, budgetary deficit is seen as a cyclical stabilization device to be shortly applied during periods of recession, and eliminated during times of economic prosperity.

[3] Actually, Keynes emphasized that in case of "a decline in income due to a decline in the level of employment, if it goes far . . . [g]overnment . . . will be liable, willingly or unwillingly, to run into a budgetary deficit" (1936, p. 98). Thus, in case of recession, budget deficit will tend to increase anyway.

According to Kregel:

> Keynes himself did not ever directly recommended government deficits as a tool of stabilisation policy—this came rather in Lerner's functional finance—and when he did consider them as temporary measures he showed a net preference for investment over consumption spending. [1985, p. 32]

Keynes considered capital budgeting "a fundamental idea," whereas deficit financing was a "desperate expedient" (1943, pp. 353–354). Budget deficits are only acceptable as a short-run fiscal policy. The basic assumption is that the economy exhibits unemployment and spare capacity on the supply side, so that any demand stimulus will be met by an increase in production, even if real wages and unit markups remain stable. Thus, significant excess capacity provides the theoretical base for the belief that fiscal deficit can sustain a noninflationary recovery.

If fiscal policy is used in this form, it will have minor inflationary consequences.[4] But Keynes was very aware that fiscal expansion might raise inflation, as supply prices increase, as markups widen, as financial assets accumulate in private hands (Taylor, 1988, p. 127). Keynes warned that, as output increases, bottlenecks would cause the acceleration of inflation. In his words:

> It is probable that the general level of prices will not rise very much as output increases, so long as there are available efficient unemployed resources. But as soon as output has increased sufficiently to reach the "bottle-necks," there is likely to be a sharp rise in prices of certain commodities. [1936, p. 300]

Ignoring or paying little attention to the fact that Keynesian analysis is useful only for short periods, populist macroeconomics conceives fiscal policy as a key tool in a sustained growth strategy. Public deficits have not been used as a cyclical stabilization device, but rather as a central policy in achieving rapid economic growth and income distribution goals. A fundamental element of this macroeconomic strategy is the belief that, if adequately channeled and accompanied by appropriate kinds of administrative controls, an increase in budget deficit can

[4] A Keynesian economist, Robert Eisner, after a careful econometric analysis of inflation and budget deficit in the United States, concluded that "the true story is apparently that major inflation of the 1970s and the beginning of the 1980s stemmed not from budget deficits or excess demand but from the major supply shocks" (1989, pp. 88–89).

stimulate a sustained process of economic growth engendered by greater income equality.

Needless to say, this view of fiscal policy ignores some of the key principles of Keynesian theory. This is not only reflected by the greatly increased role given to fiscal policy, but also by the presumed facility of the transition from a short-run recovery to a sustained growth path. This dynamic conception of the role of fiscal policy fails to recognize that public expectations and economic and social conduct cannot be instantaneously changed to sustain a rapid and simultaneous expansion of productive capacity and demand without running into inflationary pressures and external constraints.

A second limitation has to do with the Keynesian assumption that changes in the flows, such as government borrowing and monetarization, do not significantly affect the outstanding stocks, such as government debt, of high-powered money over the period under consideration, and, so, they can be ignored. This assumption is consistent with Keynes' proposal that deficit financing, when adopted, should be very temporary in nature. Because outstanding stocks are assumed unchanged in the very short run, the consequences of the means by which the budget deficit may be financed are not deeply pursued in the Keynesian model. Monetary policy is seen as a truly discriminatory variable, such that the short-run impact of public deficit on output and price, on the one hand, rather than on real interest rate, on the other, depends simply on the degree of accommodation built into the money supply by the Central Bank. In accordance with this view, populist macroeconomic programs have paid very little attention to monetary and financial management when implementing short-run expansionary fiscal policy.

Assuredly, this assumption does not apply for most Latin American countries, where the size of the outstanding public deficit is enormous. Under this circumstance, the management of fiscal policy raises difficulties that were not anticipated by Keynesian analysis. When the public sector is highly indebted, the sustainability of the government's fiscal policy will depend more strongly on alternative methods of financing the public deficit, enhancing a greatly increased role not only for monetary and financial policies but also for the exchange rate as a key variable in determining macroeconomic equilibrium.

A reliance on domestic borrowing to finance budget deficit can be thought to restrain pressures on prices arising from expectation or excess of absorption. Meanwhile, it will be self-defeating to the extent that higher interest rates will also increase the fiscal burden, and, conse-

quently, the needs of public sector financing, perhaps causing a deficit–debt spiral and/or debt monetarization (seignorage), which sooner or later will mean more inflation. Also, when the largest part of the government debt is owed to foreign creditors—which is the case in several Latin American countries—the foreign debt service is a large part of the fiscal burden. Under these conditions, fiscal policy becomes very sensitive to the attempts to improve the country's net external asset position. Policies to promote exports, such as real devaluation of the exchange rate, will relieve external debt constraints just as they will worsen the state of public finances.

Populism versus developmentalism

While the populist interpretation of Keynes' theory is inadequate, the focus on populism as the basic reason for the historical fiscal laxity in Latin America may also be dangerous in that it reinforces the myth that the Latin American governments can work their economies out of the actual crisis if the correct policies are followed—in other words, that theoretical wisdom might solve the economic crisis in Latin America, no matter how severe the situation might be in each country. In this sense, the emergent emphasis on populism may distract attention from the central causes of this crisis, thus overloading the political circuits in these economies and misdirecting focus on the role of the international financial community.

In this context, one should note that the ongoing fiscal crisis in Latin America cannot be explained exclusively by successive experiments of fiscal policies modeled on a populist approach. Developmentalist policies have also played an important role. In particular, in Latin American authoritarian regimes in the 1970s government budgets were generally maintained unbalanced, often with large deficits, as a response to the strong internal pressures of entrepreneurs and bureaucrats for an economic model that ensured a rapid rate of capital accumulation. Under this model, several Latin American countries witnessed a substantial expansion in government expenditure, not financed by tax collection, associated with a rapid increase in public investment, subsidies, and other fiscal incentives. This set of policies aimed to promote particular sectors of the economy, or to offset reductions in general export profitability that might arise from an overevaluation of the nominal exchange rate.

During the developmentalist cycle, Latin American governments heavily financed the budget deficit through increased foreign borrow-

ing. Brazil, Argentina, and Bolivia are classic examples of countries running chronic budget deficits that were easily financed with external loans during the 1970s.

The existence of easy foreign finance made it easier for Latin American countries practically to ignore budget deficits. In Brazil, for instance, during the 1970s, while the country and particularly the state-owned enterprises were involved in heavy foreign borrowing, budget deficits were usually denied. The concept of budget deficit was limited to the deficit of the central government, which formally was balanced. The larger concept of Public Sector Borrowing Requirements (PSBR) was first used in Brazil in 1983, when an IMF adjustment program was adopted. Although budget deficits were certainly high during the 1970s, there are no disposable figures about it.

By increasing foreign borrowing, instead of printing money, governments could mitigate the inflationary effect of fiscal disequilibrium. This policy slowed appreciation of the exchange rate relative to the level it would otherwise have assumed, alleviating inflationary pressures on the economy. The policy of delaying exchange depreciations to slow down inflation could not be maintained with external credit rationing at the beginning of the 1980s. Most of the Latin American countries that faced debt-service difficulties were then running excessively large budget deficits with limited possibilities of financing in the domestic capital market. When the debt crisis erupted early in the decade, for example, the nominal budget deficit (PSBR in nominal terms) reached a record of more than 15 percent in Mexico, Argentina, Bolivia, and Brazil. Thus, reduction of the availability of external financing imposed on these countries the need to reinstate economic fundamentals rapidly—namely, the rehabilitation of fiscal policy, to make it compatible with a low inflation rate. Looking at the other side of the coin, strong fiscal adjustment was needed to improve the current account of balance of payments, since there were no more external savings to buffer trade deficits.

Legacy of developmentalism

The developmentalist cycle has left a strong legacy that makes it difficult to undertake fiscal adjustment in several Latin American countries. Expected long-term effects on economic growth play a critical role in the design of the economic model implemented during this cycle. Long-term effects on income distribution, if explicitly considered, are

usually assessed on the basis of a capital-investment-led growth model. Such a model implies that cuts in consumption are necessary to assure improved consumption levels in the future, and that shifts in income distribution in favor of the higher-income groups will increase savings and, therefore, productive investment. In other words, the need for a rapid increase in economic growth will initially worsen the relative distribution of income. In this sense, the developmentalist cycle witnessed a bitter harvest of social conflicts caused by a development strategy that deepened the income inequalities among social classes, regions, sectors and ethnic groups.

During the 1980s, these serious economic inequalities activated economic and political forces that favored a radically different economic policy—emphasizing growth and income distribution objectives. However, economic policy making was simultaneously limited by debt constraints arising from past foreign borrowing and from social pressures for less inequality. Public overspending during the developmentalist cycle has left an enormous foreign debt. The cessation of new lending to Latin American countries in 1982 suddenly left them unable to finance budget deficit with foreign borrowing. While government lost a major source of deficit financing, debt service rapidly became a large part of the fiscal burden, which inhibited the governments from playing a redistributing role as a response to social demands.

In sum, the situation of public finances in Latin America today is seriously compromised by the need to service foreign debt and by pressures to increase expenditures to alleviate social conflicts. Under the economic and social circumstances we have just described, even in an increasingly inflationary context, fiscal austerity has too often been rejected because of the difficulties in reducing interest payments associated with a huge public debt and the fear that cuts in social expenditures will provoke widespread social conflict and political unrest. As a result, Latin American governments have failed to adopt decisive fiscal correction measures, and large budget deficits have become a major obstacle to stabilization.

Past budget deficits were not necessarily the cause of inflation but they certainly validated it through the money supply. Other causes, particularly the inertial character of inflation combined with supply shocks, may have a larger role in accelerating inflation, but, given the impossibility of financing the resulting budget deficits, there is no doubt that its elimination is a condition for controlling inflation in most Latin American countries.[5]

Conclusion

Whatever its social and political motivations might be, populism should not be seen as the only, or even the main, reason for the failure of adjustment programs in Latin America. The combination of huge public debts and income inequalities with an inflation that, particularly in Brazil and Argentina, is chronic or inertial,[6] has made the nature of economic policy management much more complicated, contributing to policy decisions of nonpopulist governments that have led to—or have failed to avoid—poor economic performance in the countries of the region.

Meanwhile, fiscal adjustment remains as the most pressing problem in the implementation of a macroeconomic stabilization program in Latin America. Cutting social expenditures or raising taxes to service the debt are difficult measures to sell in the political arena, especially in economies where social conflicts bring strong pressures to bear on the redistributing role of the public sector. Thus, today, fiscal adjustment means not only the will to adopt painful fiscal actions, but also the amelioration of the foreign debt service through the cancellation of the part of the debt that is not consistent with growth and price stability. This will provide Latin America's governments with enough room to stabilize their economies and resume growth.

[5] It should be noted that we reject the linear or symmetrical type of reasoning that says, if the elimination of budget deficit is a necessary condition for controlling inflation, then the cause of inflation is the budget deficit.

[6] The neostructuralist theory of inertial inflation was developed in Latin America in the early 1980s. See Bresser Pereira and Nakano (1987) for a general presentation of the theory, and Bresser Pereira (1990) for the perverse macroeconomics of deficit and debt in a country like Brazil, where inertial inflation prevails.

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