Foreword

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Milton Friedman argues that inflation, always and everywhere, is a monetary phenomenon—too much money chasing too few goods, money burning holes in peoples' pockets. This fine book by Bresser Pereira and Nakano defends a very different view of the inflation process. The authors argue persuasively that Brazilian-style inflation must be explained mostly from the supply side. Inflation perpetuates itself as a consequence of past inflation, transmitted through formal and informal indexation of wages, public sector prices, and the exchange rate into cost and price increases today. Inflation is the result of *inertia*, not of excess demand at current prices.

That is decidedly not the theory espoused by "Chicago boys" brought up on the quantity of money and on perfect competition. It is a line of thinking developed in the setting of high inflation, indexation, and fights about income shares in Latin America in the postwar period, but especially in the past fifteen years. It is tempting to write off this approach as unsound in that it gives little room to excess demand as a central explanation for inflation. But that would be going much too far. The inertia approach does capture an extraordinarily important fact of high inflation economies, and ignoring this characteristic would lead to dramatically wrong policy advice. Where monetarists see the cure for inflation in budget tightening and monetary restraint, the inertia approach recommends incomes policy in the form of wage-price controls. The economists' scissor normally has two blades, supply and demand. But in questions of stabilization policy, that often is not the case. Monetarists want to stop inflation from the demand side only, and inertialists concentrate

their attention on the control of costs and prices. There could not be a sharper contrast.

The recognition of inflation inertia is not new to some readers. The Brookings panel on economic activity has long been a forum of this approach. Students of Arthur Okun and James Tobin will remember those two's insistence that the Phillips curve is "very flat," meaning that it takes massive increases in unemployment through demand contraction to bring about even a minor reduction in the inflation rate.[1] Indeed, in 1980, under the almost Latin American title, "Inertia, Expectations and Structural Inflationary Bias," Tobin argues that it would take a decade of high unemployment to bring down U.S. inflation from its double-digit levels. As it turned out the job was done much faster and at much lower cost.

The inertia hypothesis makes for powerful politics, Roberto Campos has said that incomes policy is the aphrodisiac of politicians, and he may have understated his point. For more than a quarter of a century Latin American policy makers have been fighting inflation halfheartedly, mostly from the demand side, sometimes from the supply side. Suddenly, in the 1980s a new generation of economists proposes a coherent program of "heterodoxy": correction of fiscal deficits to pay attention to demand side problems, combined with incomes policy to stop inflation dead in its tracks. The attraction of the approach is twofold: first, incomes policy has always made for good populist politics. Second, it offers immediate results, since an inflation of 200 or 300 percent will stop from one day to the next. And there is a bonus: the heterodox approach predicts that inflation not only can be stropped, it also can be stopped with out recession.

The heterodox hypothesis has been tested in Argentina, Brazil, and Israel. The Israeli experience, after more than two years, can be pronounced a full success. Inflation has been reduced to European levels, and growth has continued throughout. The insistence in this book that heterodoxy is better than monetarism is fully vindicated by this experience. But the case of Brazil dramatizes that the demand side does matter. When incomes policy was combined with election politics that led to a massive fiscal deficit, the predictable consequence was a collapse of the Cruzado Plan. Argentina's experience has been more favorable. Inflation has been sharply reduced, but the remaining rate of 100 percent points to the need for further budget control before the next attack is staged.

What lessons are to be drawn? Should Mexico go the way of heterodoxy, or should inflation be attacked by tight monetary and fiscal policy, without incomes policy. The analysis presented in this

book and the experience of Argentina and Israel clearly suggest that incomes policy should be a central pillar of stabilization. But the Brazilian experience indicates that the political euphoria of inflation stabilization removes the danger signals and hence makes overexpanding all too attractive.

Since this book was completed, the 1986 Cruzado Plan has literally blown up. Inflation in Brazil reached unprecedented levels of 20 percent per month and more in early 1987. The authors took over Brazilian economic policy in May 1987, when Bresser Pereira was nominated finance minister and Nakano joined him as chief economic advisor. Predictably, they have tried to stabilize the economy using incomes policy. The results are not in, but this valuable book offers their thinking. Much of what they will implement is already written here, but with one difference: the extra year of experience with the first Cruzado Plan has shown that, although demand side policies may not be everything, neglect them at your peril.

NOTE

1. *See* James Tobin, "Stabilization Policy Ten Years After," *Brookings Papers in Economic Activity* 1 (1980); and Arthur Okun, *Prices and Quantitites: A Macroeconomic Analysis* (Washington: Brookings, 1981).