Stabilization Tactics in Latin America:

Menem, Cardoso, and the Politics of Low Inflation

In the 1990s, presidents Carlos Menem of Argentina and Fernando Cardoso of Brazil both accomplished something of a macroeconomic miracle, reducing their countries' chronic inflation rates to close to zero. Not since 1944 in Argentina and 1937 in Brazil had inflation been so low for so long. How did these political leaders succeed in this where so many before had failed? I argue that existing theories of the political economy of reform—which focus on crisis, the electoral calendar, social "wars of attrition", party control of veto points, or the enhanced credibility of left-wing converts to neoliberalism—do not add up to a convincing explanation. Success depended on particular tactical choices not captured by theory. In each country, I identify stakeholders that benefited from inflationary policies and had the political or economic leverage to impede reform. I analyze the tactics Cardoso and Menem used to marginalize some stakeholders while coopting others with less inflationary benefits, and contrast these with the tactical failures that accompanied previous attempts.

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1 Introduction

In the 1990s, presidents Carlos Menem of Argentina and Fernando Henrique Cardoso of Brazil both accomplished something of a macroeconomic miracle. Each managed to bring down his country's chronically high inflation rate to close to zero and to keep it very low for more than five years. This followed decades of price instability and repeated unsuccessful attempts to stabilize.

Some of the shine has come off both achievements since then. Brazil struggled through a currency crisis in 1998, which forced a sharp devaluation of the *real* and led to two years of stagnant output before a strong rebound in 2000. In Argentina, Menem's hapless successor, Fernando De la Rúa, struggled in vain for two years to generate growth and fend off a debt default, currency crisis, and run on the banks. He left office in late 2001, amid deadly street violence. As of early 2002, the peso was plummeting again.

So it is worth emphasizing, these crises notwithstanding, just how historically unusual the reemergence of stable money in Brazil and Argentina in the 1990s was. As of late 2001, Brazil's inflation rate had been under 20 percent for five years and Argentina's had for eight. In each country, this was the first time in 40 years that inflation had stayed this low for more than *one* year. There had been no equivalent eight-year spell of low inflation in Argentina since before 1944. Brazil had not had a five-year period with such stable prices since before 1937, when the IMF's statistics begin. Argentina's new commitment to stable money was so entrenched by the late 1990s that it survived the severe, four-year recession that left 18 percent of the population unemployed at the turn of the decade. It took a major political crisis—and three presidents—to break the dollar peg. Even taking into account this recession, Argentine growth in the 1990s was higher than in any decade since the 1950s.

How did these political leaders succeed in macroeconomic stabilization where so many before them had failed? Political economists have developed a number of theories that might account for this. Some emphasize the role of crisis, the playing out of social "wars of attrition", or the electoral cycle. Others argue that Menem's left-wing credentials as head of the Peronist party gave him greater credibility when demanding sacrifice from the working class. I argue in this article that although these theories may contribute to an answer they do not add up to a convincing explanation. In each case, success rested on a particularly effective political strategy that demobilized key beneficiaries of inflationary policies and gave investors confidence in the durability of the stabilization package.

While the specific tactics used in each case were dictated by the existing pattern of stakeholders—actors with an interest in inflationary policies and the economic or political leverage to impede reform—the strategies were quite similar.[1] Both leaders split the labor movement, coopting parts in order to isolate and demobilize the rest. Both used similar tactics against business, coopting the strongest with tariff protection or privatization benefits. Both protected domestic banks in the short run, and bailed out their depositors when necessary, but weakened them relative to their foreign competitors in the longer run. Both provided provincial governors with short-run pork or cash in return for institutional changes—the closure or privatization of state banks and tax reform. Parliamentary politicians were wooed with perks, pork, and policy concessions on individual bills. Each assembled a motley legislative coalition of left-wing deputies elected on his coattails, free-market ideologues, and clientelistic political bosses from the poorer regions.

The reform packages they designed, although often labeled "neoliberal," were far from orthodox. Both leaders compromised their commitment to liberalization and fiscal balance—and to some extent their reputations—in order to create rents and buy the support of previous opponents. The markets proved happy to forgive such departures from orthodoxy in return for the political crediblity that they generated. Leaders that tried much harder to balance the budget (Collor, De la Rúa) ended up panicking investors, who saw that their commitments were not politically sustainable.

To be clear about the paper's goals, I do not pretend to develop a new theory or to test existing ones. I hope to show that theories developed to date are insufficient to explain these two

[1] For a similar use of the term "stakeholders", see Shleifer and Treisman (2000).

important cases, and I set out to examine the puzzles they present. The goal is to illuminate the logic at play in the way that a chess critic might review and compare several famous games. I identify parallels and tactical combinations. But I do not here seek causal laws sufficiently general to be detached from context.

The next section describes the struggles of post-authoritarian governments in Brazil and Argentina to reduce inflation in the 1980s and 1990s. Section 3 discusses five theories of the political economy of reform and argues that by themselves they cannot explain why Menem and Cardoso succeeded where previous presidents had failed. Section 4 identifies the stakeholders in inflationary policy in Brazil and Argentina, and explains why previous attempts at stabilization were undercut by their actions. It then describes the tactics used by Cardoso and Menem to neutralize and coopt a coalition of stakeholders that was sufficient in each case to bring inflation down for an extended period. Section 5 concludes by comparing the particular techniques and "cooptation currencies" used.

2 Inflation and Stabilization

2.1 Brazil

In the seven years before Cardoso was appointed finance minister in 1993, Brazil's leaders tried to stabilize the macroeconomy five times and adopted four new currencies. In 1985, when the military handed power to the elected president, Tancredo Neves, inflation was more than 200 percent a year. The Cruzado Plan (1986-7), Bresser Plan (June 1987), Summer Plan (January 1989), Collor I Plan (March 1990), and Collor II Plan (1991) followed each other in quick succession (Cardoso 2000). None of these drove inflation below 100 percent a year (Figure 1). A series of presidents—Sarney, Collor, Franco—saw their political credibility sapped by their macroeconomic failures (and, in Collor's case, by charges of corruption). When finally the *Plano Real* introduced by Cardoso in late 1993 reduced inflation to a manageable level, this won him the presidency in the 1994 election.

Much is still debatable about Brazil's inflation, but a few facts seem relatively clear. From early on, governments resorted to issuing highly liquid government bonds to finance their deficits. Total federal debt grew from 23.5 percent of GDP in 1984 to 107.9 percent in 1989 (Coes 1995, p.91). The growth of government securities increased M2, changes of which closely foreshadowed subsequent inflation during the decade from 1985 to 1995 (see Figure 1).[2] As the increase in liquid assets drove up inflation, nominal interest rates on government bonds soared, forcing governments to issue ever more of them to roll over the debt (Filho 1998). At the same time, many wages and prices had been indexed, giving inflation a strong inertial component (Bresser Pereira 1993).

Under the Real Plan, inflation fell from more than 2,000 percent in 1994 to 66 percent in 1995 and 16 percent in 1996—a level which has not been topped since then. The conventional wisdom has it that stabilization attempts almost always fail unless the government manages to bring down its deficit to a low level.[3] This was not the case under the Real Plan. In fact, the operational public sector borrowing requirement (that is, the PSBR corrected for the effect of inflation on the state debt) averaged 4.25 percent of GDP in 1995-2000, compared to 0.3 percent of GDP in 1990-94. The most dramatic fiscal adjustment came under the failed Collor Plans, 1990-91, when the budget even managed a surplus. Nor was the stabilization period one of strict adherence to monetary growth targets, many of which were missed and "quietly abandoned later" (Filho 1998, p.6). In 1996-2000, M2 grew more than seven times as fast as prices.[4] Since GDP grew rapidly during this period, this resulted in a gradual increase in the ratio of M2 to GDP, from a depressed 17 percent in 1995 to 37 percent in 2000, comparable to that in other developing countries with moderate inflation.

[Figures 1 and 2 Here]

[2] In the definition of Brazilian monetary authorities, M2 included M1 (currency outside banks and demand deposits), several types of liquid investment accounts, and federal, state, and municipal securities.
[3] For instance, see Jeffrey Sachs (1997, p.244): "The most important step in macroeconomic stabilization is fiscal consolidation, that is, the elimination of the underlying fiscal and quasi-fiscal deficits that are the cause of the high inflation."
[4] The IPCA consumer price index grew by 43 percent between 1995 and 2000, while nominal M2 grew by 311 percent.

2.2 Argentina

Argentina's experience with inflation since the return to civilian rule in 1983 looks rather similar to that of Brazil. In 1983, the military handed over an economy with inflation at 337 percent. For the next seven years, Presidents Alfonsín and then Menem tried repeatedly to reduce the rate to double digits. The Austral, Primavera, and BB plans—along with a number of less notable attempts—all achieved temporary drops, but prices quickly rebounded. Only in 1991, with the Convertibility Plan introduced by finance minister Domingo Cavallo, was a more lasting fall in inflation accomplished (see Figure 3).

Unlike in Brazil, the failures and ultimate success in controlling inflation follow closely the failures and success in fiscal adjustment (Dillinger and Webb 1998, p.14; Murphy and Sturzenegger, p.352). The first civilian government inherited a nonfinancial public sector deficit of close to 10 percent of GDP (World Bank 1996b). Attempts to coordinate on lower price expectations by removing indexation and establishing nominal anchors were relatively successful at deflating inertial inflation. Price increases did slow temporarily after the Austral, Primavera and BB plans. However, until the government succeeded in dramatically reducing the public sector deficit, such successes never lasted more than a few months. Figure 4 shows the sum of the consolidated central government deficit and the quasi-fiscal deficit of the Central Bank. The sum of these deficits ranged from 2.9 to 8.6 percent of GDP between 1982 and 1989; only in 1990 did the total come down to 1.2 percent, with the balance turning slightly positive in 1992. Although the deficit rose in the late 1990s, it did not exceed 2.5 percent of GDP Inflation remained—until 2002—below 15 percent a year.

[Figures 3 and 4 Here]

3 Theories of Reform

How did Cardoso and Menem succeed where so many before them had failed? How did Menem manage to reduce—and hold down—the budget deficit for so long?[5] How did Cardoso decrease inflation despite large and rising fiscal deficits? In this section I discuss several theories developed to account for these and other cases of macroeconomic stabilization.

Some have argued that a necessary condition for stabilization is a widespread sense of crisis, which motivates social actors to accept the temporary costs of adjustment. Soaring inflation may reach a "critical level where ever-rising, collectively shared costs and zero long-run benefits force interest groups to coalesce and to demand the implementation of monetary restraint" (Havrilesky 1990). In a number of past cases, according to Drazen and Grilli (1993), "the heavy costs of extremely high inflation and the situation of emergency associated with it were necessary to force the adoption of stabilization programs." According to this view, success in Argentina and Brazil should have come when inflation reached some critical threshold.

A second approach links the timing of stabilization programs to the electoral calendar. If—as usually assumed—stabilizations have short-run costs but long-run benefits, governments should be more likely to initiate them early in their electoral term, and less likely to do so as elections approach (Haggard and Webb 1993; Remmer 1993). If, on the other hand, stabilization attempts are successful in the short run (because they coordinate lower price expectations) but break down in the medium run, one might expect stabilization attempts shortly *before* scheduled elections.

Third, an influential article by Alesina and Drazen (1991) argued that stabilizations are delayed because social groups engage in a game of chicken, trying to avoid bearing the temporary costs. Reform occurs when the group that is more sensitive to the rising costs of waiting chooses to concede. "In the war of attrition, passage of time and the accumulation of costs lead one group to give in and make a previously rejected program economically and politically feasible." In this view, stabilizations should follow the political capitulation of one group that previously opposed the government's proposals. Labán and Sturzenegger (1994) argue that the capitulating group is most

[5] Some attention has focused since stabilization on provincial budget deficits. However, these appear not to have exceeded 1.6 percent of GDP up until at least 2000 (IMF 2001, p.29).

likely to be the poor, who have restricted access to the financial sector and therefore a lower ability to protect themselves from the costs of high inflation by keeping their assets offshore.

Fourth, Menem—and perhaps also Cardoso—may have benefited from his left-wing political credentials. As Cukierman and Tommasi (1998) argue, in macroeconomic stabilization "politicians coming from the left of the spectrum… had a comparative advantage in convincing people of the long-run necessity of … changes, even if they hurt now." If it took a Nixon to go to China, perhaps it took a Peronist like Menem to stabilize prices. Murphy and Sturzenegger (1998) present a model in which left-wing politicians are better able to signal credibly that market reforms are necessary than right-wing politicians, who are known to prefer neoliberal policies and so have a motive to dissemble.

Fifth, several scholars have argued that major policy changes are more difficult to enact in federal systems, which tend to have a larger number of veto players (Tsebelis 2001, Lohmann 1998). Lohmann (1998) argues that the independence of the German central bank was enhanced by the way control over it was divided between different federal veto players. In such systems, major changes in monetary policy should occur only when all relevant veto points—both houses of parliament and probably also a majority of state governments—are captured by the same party. Both Argentina and Brazil are relatively decentralized federal states. Menem or Cardoso might have succeeded because their parties had captured all the veto points.

How well do these five arguments account for the pattern of failure and success in Argentine and Brazilian macroeconomic outcomes? Elements of some arguments do fit the facts and probably contribute to an explanation. However, they do not by themselves amount to a convincing account, and those arguments that seem partially persuasive raise additional puzzles.

To begin with the crisis theory, it may be true that extremely high levels of inflation increase the odds that governments will try to stabilize. That does not explain why some attempts succeed while others fail. A perception that inflation was getting out of control prompted each of the 11 major stabilization attempts in Argentina and Brazil: only two lasted for more than a few months. Nor did the successful stabilizations (1991 in Argentina, 1995 in Brazil) come right after an all-time high in the inflation rate. In Argentina, inflation peaked in 1989 at 3,103 percent, prompting Menem's first—unsuccessful—attempt to stabilize. It was not until two years later that a plan was successfully implemented. In Brazil, inflation peaked at 2,952 percent in 1990, prompting Collor's attempted stabilization. Again, this failed. Inflation was back up to 2,076 by 1994, at which point the Real Plan was introduced.

Similarly, the electoral cycle theory suggests only why central policymakers might *try* to stabilize at particular times. It also cannot explain why some attempts succeed while others fail. There is, in any case, at best only weak evidence that stabilization attempts in either country were linked systematically to the electoral calendar. In Brazil in the 1980s-90s, stabilization attempts were introduced in the first, second, third, fourth, and fifth years of the five-year presidential term (see Figure 5). In Argentina, attempts were made in the first, third (twice), fifth, and sixth years of the six-year presidential term. Considering legislative elections, in Argentina four of the five stabilization attempts occurred in election years (which alternate with non-election years). This might suggest that incumbents try to bring down inflation temporarily before voters mark their congressional ballots, but it is hardly definitive. In Brazil, congressional elections are held every four years. Stabilization attempts occurred (twice each) in the first, second, and fourth years of the cycle.[6]

Did successful stabilizations in Argentina and Brazil follow capitulation by one previously-opposed social group? The explanation I offer does focus on the competing interests of economic groups. The opposition of some of these did weaken at key points, facilitating implementation of reforms. However, these changes were not simple capitulation in the face of rising costs. Rather, specific government policies helped to change the interests of some previous reform opponents,

[6] Remmer (1993) studied whether inflation tended to be higher at particular points of the electoral cycle in Latin American countries in the years 1980-91. She found that in Brazil inflation was significantly higher both right before and right after presidential elections, contradicting both versions of the political business cycle logic (which imply stabilization attempts *either* right before *or* right after). In Argentina, inflation was greater during and after a presidential election, but was not significantly lower before. As for congressional elections, Remmer did not find significant pre-election falls in inflation, but she did find that the exchange rate depreciated significantly less in the pre-electoral quarter in Argentina and during the electoral quarter in Brazil. Since Remmer's period (1980-91) included only one successful stabilization in Argentina and none in Brazil, it cannot offer much insight into what distinguishes successful from unsuccessful attempts.

compensating them for temporary costs or giving them new ways to benefit from stable prices. Other opponents were not persuaded to concede by rising inflation: they were isolated and weakened by deliberate government action. These were not cases of self-interested concession as inflation reached very high levels—if so, the same groups should have given up in earlier years when inflation rose even higher. They were cases of political manipulation by intelligent and sometimes ruthless incumbents.

[Figure 5 Here]

Did stabilization succeed under Menem because as a Peronist he was better able to convince left-wing constituencies of its necessity? If this was the key, it is hard to see why his first attempt to stabilize (the Menem I plan of 1989) collapsed.[7] One way to judge the response of Menem's traditional left-wing base is to examine whether the frequency and extent of strikes declined after he came to power and began trying to stabilize. The extent of strikes did decline over the Menem years as a whole. But it did not do so immediately after he took office, as one would expect if his political identity alone were the reason.[8] In fact, strike activity "rose by certain measures during Menem's initial period in office" (McGuire 1996, p.145). The number of workers on strike increased from 1.7 million in the third quarter of 1989, when Menem took office, to 4.2 million a year later (see Table 1). It was only in the fourth quarter of 1990 that a sustained drop in strike activity began. This suggests that the fall in strikes did not have much to do with the trust Menem inspired among workers—more than four million out of a total workforce of about 11 million were not willing to give his stabilization plans the benefit of the doubt. The decline in strike activity from late 1990—*before* the Cavallo plan succeeded in bringing down inflation—probably reflects not trust but intimidation. It occurred right

[7] Menem certainly did not *think* that traditional left-wing constituencies would support him if he advocated neoliberal policies, and so deliberately dissembled about his plans before the 1989 election (Stokes 1999).

[8] Several data sources on Argentine strike activity exist, but one researcher who has compared them argues that those compiled by the Consejo Técnico de Inversiones (CTI) are the most reliable (McGuire 1996). McGuire compared the CTI statistics to those collected by the Centro de Investigaciones sobre el Estado y la Administracíon and those of the Unión para la Nueva Mayoría, and contends that the first were more detailed and easier to disaggregate. If one used the Unión para la Nueva Mayoría data, the decline in strike activity would come even later, supporting my argument more strongly.

after Menem's tough response to a strike by Buenos Aires telephone workers, who were protesting the privatization of the state telephone company Entel (Ibid). Menem fired several hundred of them (Epstein 1992, p.152).[9]

Menem was not even able to get all in his own party or in the Peronist union leadership to follow as he reversed his campaign platform and introduced tough stabilization measures. In fact, eight of the most ideologically left-wing Peronist deputies defected to form a separate opposition bloc, the *Grupo de los Ocho,* and three more left to form *Afirmación Peronista*. The Peronist union movement split, with Saúl Ubaldini leading the more statist, anti-reform unions into opposition, joined initially by Lorenzo Miguel and the Metal Workers Union (Ibid, p.145). Peronist deputies in congress repeatedly watered down their leader's reform proposals. In 1990, as other Peronist politicians jockeyed for position before the anticipated collapse of his stabilization attempts, Menem complained of "canibalistic" struggles for power within the movement.[10] When he visited Tierra del Fuego in late 1990, state workers "shouted insults until he gave up trying to speak".[11] All in all, this looks less like the mass conversion of left-wing activists and voters or a loyal rallying behind their leader than a perilous struggle by Menem to survive as the policy underpinnings for stability were levered into place. Menem did not receive a honeymoon from those on the left. He was able to intimidate some militants by firing workers and to win back support from others *after* inflation came down.[12]

In Brazil, Cardoso was a centrist politician who had started out as a socialist intellectual. His early neo-Marxist publications did not shield him from fierce left-wing opposition when he attempted

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[9] On the other hand, the number of *general* strikes did decline from early in Menem's first term. This might suggest that he was more credible in persuading top union leaders that his switch to neoliberalism was necessary. But it might also reflect the effectiveness of his tactical maneuvers to divide and coopt the union movement.

[10] His own vice-president, Eduardo Duhalde, "was seen as joining the manoeuvring to engineer Menem's departure from the presidency" in early 1991 (*Latin American Weekly Report*, 21 February 1991, p.1).

[11] *New York Times*, October 14, 1990, p.17.

[12] Peronist constituencies might have resisted even harder against a Radical leader introducing the same policies. Nevertheless, the "Nixon" effect does not seem sufficient to explain how Menem built support for stabilization.

Table 1: Strikes in Argentina and Brazil

Argentina			
Year	**Number of Strikes**	**Number of Strikers (mns)**	**Number of days lost (mns)**
1984	495	8.5	16.5
1985	333	4.2	8.3
1986	582	11.2	23.2
1987	470	6.0	13.4
1988	443	7.4	33.6
1989	418	7.7	24.4
1990	326	10.0	32.8
1991	119	3.5	10.2
1992	99	4.7	7.2
1993	116	1.6	6.0
Mean per quarter, Alfonsín presidency	115	2.0	4.9
1989 Q3	110	1.7	6.0
1989 Q4	92	2.8	5.9
1990 Q1	108	2.4	12.0
1990 Q2	89	2.6	6.0
1990 Q3	97	4.2	12.5
1990 Q4	32	.8	2.3
1991 Q1	29	1.0	4.9
1991 Q2	20	.4	1.0
1991 Q3	40	1.1	2.3
1991 Q4	30	1.0	2.1
Brazil			
Year	**Number of Strikes**	**Number of Strikers (mns)**	**Number of days lost (mns)**
1992	557	2.56	n.a.
1993	653	3.60	n.a.
1994	1034	2.76	n.a.
1995	1056	2.28	n.a.
1996	1258	2.80	n.a.
1997	630	.81	n.a.

Sources: Argentina from CTI, as in McGuire (1996). Brazil from "O Movimento Grevista Dos Anos 90," *Boletim DIEESE*, September 1998, No.208, São Paulo: Departamento Intersindical de Estatística e Estudos Sócio-Economicos, www.dieese.org.br, and Anuário dos Trabalhadores 2000-2001.

Table 2: Party Control of Key Political Institutions, Argentina and Brazil

Brazil					
	1985-86	*1986-90*	*1990-94*	*1994-98*	*1998-2001*
President	PFL	PFL	PRN/none	PSDB	PSDB
Chamber of Deputies plurality; majority in bold; as of election.	PDS	**PMDB**	PMDB	PMDB	PFL
Senate plurality; majority in bold; As of election.	**PDS**	**PMDB**	PMDB	PMDB	PMDB
State governorships majority	**PDS**	**PMDB**	PFL	PMDB	PMDB/PSDB

Argentina									
	1983-85	*1985-87*	*1987-89*	*1989-91*	*1991-93*	*1993-95*	*1995-97*	*1997-99*	*1999-2001*
President	UCR	UCR	UCR	PJ	PJ	PJ	PJ	PJ	UCR (Alianza)
Chamber of Deputies plurality; majority in bold; as of election.	**UCR**	**UCR**	UCR	PJ	PJ	PJ	**PJ**	PJ	UCR (Alianza)
Senate plurality; majority in bold; as of election.	PJ	PJ	PJ	**PJ**	**PJ**	**PJ**	**PJ**	**PJ**	**PJ**
State governorships majority	**PJ**	**PJ**	**PJ**	**PJ**	**PJ**	**PJ**	**PJ**	**PJ**	**PJ**

Argentina Sources: Jones (1997); *Political Reference Almanac*, Polisci.com (Dec 2001). Llanos (1999). UCR: Unión Cívica Radical; PJ: Partido Justicialista (Peronist); Alianza: alliance of PJ and Frepaso. **Brazil** Source: Mainwaring (1999); Fleischer (1999). PMDB: Partido do Movimento Democrático Brasileiro; PSDB: Partido da Social Democracia Brasileiro (founded 1988); PSD: Partido Social Democratico; PFL: Partido da Frente Liberal. PRN: Partido de Reconstrução Nacional.

to stabilize. Some of his own ministers threatened to resign, and the labor minister, who was from Cardoso's own PSDB, publicly criticized the Real Plan (Resende-Santos 1997, p.185). The number of strikes increased in the early years of the Real Plan, and the number of strikers—although peaking in 1993, before the Real Plan—remained high until 1997. In May 1995, relations with labor deteriorated to the point where Cardoso used military troops against oil industry strikers (ibid, p.187). In 1996, public sector strikers trapped the Finance Minister, Pedro Malan, in his office (Kingstone 1999, p.217).

Was Menem or Cardoso successful because his party had captured the key federal veto points? If this was the key, it is hard to understand why the military regimes in both countries also failed to stabilize. Even under conditions of political repression, in which there was little danger of opposition from parliament or the state-houses, serious attempts at macroeconomic stabilization failed. The most notable Argentine attempt was under economy minister Martínez de Hoz in the late 1970s. Even if we focus on just the democratic period, the argument seems weak. Table 2 shows the distribution of party strength in each country's presidency, chamber of deputies, senate, and state governorships. In Brazil in 1994-8, Cardoso's party, the PSDB, controlled none of the key institutions besides the presidency. He relied upon a coalition with the PMDB, which had a plurality in the two houses and a majority of state governorships.[13] Others had governed with more powerful coalitions—for instance, Sarney, whose Partido da Frente Liberal (PFL) in 1986-90 also joined with the PMDB, which then had an absolute majority in both houses. Yet Cardoso succeeded in stabilization, whereas Sarney failed repeatedly.

The argument might seem more plausible in Argentina. Alfonsín was certainly constrained by the hostile Peronist plurality in the Senate and among the governors. From 1990 until 1995 (and then in 1997-9), Menem had a Justicialista plurality in the Chamber of Deputies and a majority in the

[13] Given the weakness of party discipline in Brazil and the large number of parties in the parliament, coalitions have to be painstakingly constructed. See, for instance, Ames (2001).

Senate and among provincial governors. From 1995-7, he even had an absolute majority in the Chamber.

However, the argument cannot by itself explain the Argentine case. Although it probably helps, it is neither necessary nor sufficient for the president's party to control all veto points for the president to stabilize successfully. It is not sufficient because even members of the president's party may vote against his proposals, albeit at some cost. This was the case for Menem. Key legislation—for instance, the convertibility law itself—were passed with help from right-wing parties in the Chamber of Deputies, with a number of Justicialista Party members voting *against*. As already noted, Menem faced serious challenges from within the Peronist camp—from labor unions whose members' jobs and wages were being cut, from governors worried by fiscal austerity, from leadership rivals who hoped to benefit from his failure. Menem's minister of the economy, Domingo Cavallo, faced the greatest opposition to tax increases from Peronists in the parliament (Acuna 1995, p.36). Resistance to Menem's reforms also came from some of the country's Peronist governors (Manzetti 1993, p.72).

Regardless who controlled the key institutional veto points, other actors had ways to block implementation. The strength of Menem's support in parliament mattered little if financial speculators chose to bid against a weakened central bank. Early attempts to stabilize under both Alfonsín and Menem failed when major exporters staged a *golpe de mercado*, or "market coup", dumping australs on the market to drive down the exchange rate. Real coup attempts by the military—or major labor unrest—could undermine confidence in the currency and scare away investors, whatever laws the parliament passed.

Control by the president's party of all major veto points is not necessary for the passage of reforms since other parties may support a stabilization program—as, in fact, occurred in both Argentina and Brazil. Menem's first major laws—the Economic Emergency Law and the State Reform Law of 1989—were passed with the tacit cooperation of the major opposition party, the UCR, which agreed not to oppose Menem's economic initiatives for six months in return for his agreement to take office early. Later laws often required the votes of small regional parties and the liberal Unión del Centro Democrático. In Brazil, Cardoso's PSDB never had more than 20 percent of the seats in either house of parliament, and he was forced to rely on a coalition of five parties (Kingstone 1999, p.199).

Although aspects of these arguments contribute to an explanation, Menem and Cardoso's victories over inflation remain quite puzzling. To understand how they succeeded, one needs to consider their strategies in more detail.

4 Stakeholders and Stabilization Tactics

The outcomes of most games are not completely determined by the nature of the rules or the goals of the players. They depend also on what strategies are chosen at key points. The task that faced Menem and Cardoso was to identify which actors had the power and the motive to impede macroeconomic stabilization and to find ways to neutralize some while coopting others.

4.1 Brazil

Brazil's institutional structure and economic history created four major groups of stakeholders with an interest in inflation or the deficit spending that fueled it and the ability to obstruct change. First, public sector employees (along with pensioners, and certain narrow interest groups) were guaranteed expensive entitlements by the 1988 constitution.[14] They were prepared to defend these by voting, demonstrating, striking, and lobbying via their unions. Second, politicians in the Chamber of Deputies and Senate wanted to continue receiving the perks of office. Some also hoped later to seek election in their states. They could block attempts to cut pork from the federal budget or to reform fiscal or banking laws. Third, the constitution greatly decentralized government revenues (Weyland 2000, p.42). State governors wanted to retain these revenues and extract additional funds, often by

[14] The constitution confers tenure on public employees after five years. It requires that pensions be paid on the basis of service not age (35 years for men, 30 for women). Mothers are entitled to four months of paid maternity leave (Fleischer 1998).

means of the state banks, whose loans were later bailed out by the federal government. Given the weakness of party discipline, governors were needed to deliver the state congressional delegations. They could also provoke crises by refusing to remit federal taxes or accept a restructuring of their state banks.[15] A fourth influential group—the business community—mostly suffered from inflation, but at the same time feared the high real interest rates needed to cure it. Big businesss could decline to buy federal government bonds and lobby against an opening to foreign capital.

All these groups were prepared to use their political leverage to block spending cuts or other anti-inflationary measures costly to them. In this context, reducing inflation temporarily was not too difficult. A wage-and-price freeze or unilateral reduction in state debt could do the trick.[16] Such measures were key to the stabilization attempts of 1986, 1990, and 1991. But to keep inflation low required getting investors to buy government bonds at moderate rates, and restraining the distributive pressures of groups eager to grab a larger share of national income via price increases.

Previous presidents had failed in opposite ways. Sarney, starting out politically weak, sacrificed reform in order to please its potential opponents. He increased nontax transfers to states and municipalities, raised central spending, and lavished patronage on parliament, all while trying to enforce a price freeze (Coes 1995, Montero 2000, p.64). The plan collapsed amid bursts of repressed inflation, soaring deficits, and business opposition to the uneven effects of the freeze. By contrast, Collor managed to unite all social forces against him by attacking all of them simultaneously. He froze 80 percent of the country's savings for 18 months; eliminated various business tax breaks; increased taxes; reduced trade protection; canceled about half the federal government's debt; fired 360,000 federal employees; prohibited state governments from rolling over their central bank debt;

[15] On the one major occasion when a state governor, Itamar Franco of Minas Geraís, did refuse to pay the state's debt to the federal budget in 1989, this triggered the devaluation that Cardoso had until then avoided.
[16] The Collor Plan of 1990 cancelled almost half of Brazil's domestic Treasury debt, amounting to about 10 percent of GDP (Bresser 1993, p.11).

and tried to recentralize some state revenues.[17] This alienated business, the governors, parliamentary deputies, and the public. Collor was impeached for corruption in September 1992.

What made the Real Plan different was not a more effective fiscal adjustment or stricter monetary policy, but a more credible *political* strategy to create the confidence necessary for non-inflationary deficit financing and channel distributive competition away from the monetary system.[18] This strategy involved tactics for coopting or neutralizing each of the main stakeholders. Repeatedly, Cardoso played their "short-term interests off against their long-term goals," offering "patronage now in order to persuade politicians to accept state-building reforms that [sought] to limit patronage in the future" (Weyland 2000, p.50).

Cardoso's approach to public employees was characteristic. He appeased them with short-term spending and higher salaries, while privatizing many of the enterprises that provided their jobs. In late 1994, public sector salaries were raised, resulting in a 22 percent increase in federal personnel spending in 1995 and major additional payroll costs for the state governments (IMF 2001b, p.155; Weyland 2000, p.54). The next year, Cardoso set out to sell off state monopolies in electricity and gasoline. When the oil workers' union went on strike in May 1995, the government denounced the strikers as "enemies of the people" and sent the military to secure the petroleum refineries (Kingstone 1999, p.205). Privatizations in petrochemicals, railroads, electricity, and telecommunications raised US $33.4 billion for the federal budget in 1994-8 (Pinheiro 2000, p.17).

Appeasing parliament required helping the politicians to please their local constituencies and not complaining too much about their perquisites.[19] One of his first acts in office was to approve a 100-percent increase in legislative and executive salaries (Kingstone 1999, p.202). When attempts to

[17] See Weyland (2000). For an excellent summary of Collor's tactics, see Kingstone (1999, ch.5).
[18] Of course, the Real Plan also included a sophisticated method for coordinating expectations around a common index of value, the *unidade real de valor*, thus avoiding the need for a price freeze.
[19] Cardoso did often denounce congress's preoccupation with extracting patronage, but he was perfectly willing to provide such patronage when necessary.

limit the number of state pensions a single public employee could draw ran into opposition, he did not push the issue. This would have threatened the financial interests of many in parliament itself.[20]

Respecting the corporate interests of congressmen was supplemented by a strategy to build a legislative coalition that would pass reform legislation. Logically enough, Cardoso started with parties ideologically committed to fiscal retrenchment and liberalization. This implied some odd bedfellows for a social democrat—notably, Sarney's PFL, a party of economic conservatives, clientelistic bosses, and former supporters of military rule. To seal the deal, Cardoso even chose a PFL running-mate and backed away from a proposal to increase corporate income tax (Resende-Santos 1997). In office, he allied with the centrist PMDB and several smaller conservative parties. The strength of the PFL and PMDB in the country's poorer, more clientelistic, but legislatively over-represented North, North-East, and Center-West regions helped push legislation through. [21] North-Eastern deputies and senators were "strategically positioned on the key congressional committees" dealing with fiscal and infrastructure issues (Selcher 1998, pp.32-6; Power 1998). To woo rural deputies, Cardoso deferred some $1.8-5 billion in landowners' debt payments to the Banco do Brasil (Mainwaring 1999, p.317)

Helping legislators satisfy their local interests dovetailed with measures to coopt the state governors, whose fiscal profligacy, channeled upward for bailouts via the state banks, was a major source of inflationary pressure. Cardoso's strategy was to offer governors large financial benefits in return for an end to their most inflationary practices—in essence, another trade of money (in this case credit) for institutional changes. The key challenge was to deal with the massively endebted state

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[20] For instance, José Sarney could draw separate state pensions as a former president, governor, senator, and deputy (Flesicher 1998, p.131).

[21] This alliance of Cardoso's social democratic party with the clientelistic, right-wing parties of political bosses from the poorer provinces is reminiscent of the "metropolitan" and "peripheral" subcoalitions in the Peronist movement under Menem and Perón himself, and a similar cross-linkage in the Mexican PRI. The "peripheral" coalition, in each case, enabled what was thought of as a "left-wing" party to engage in neoliberal reform without damaging its electoral prospects (Gibson 1997).

banks.[22] Their failure would threaten the entire financial system; as of 1996, they held about half of all banking sector assets (Dobson and Jacquet 1998). But the state governments had little incentive to restructure or service their debts, since the Senate permitted them instead to keep capitalizing the interest payments (Dillinger and Webb 1998).

Cardoso offered a simple trade. First, in late 1995-96, states received R$2.5 billion in emergency funds in return for signing agreements promising fiscal adjustment (IMF 2001b, p.156). These promises were not all kept. Then, starting in December 1997, the government signed bilateral agreements with individual states in which the states agreed to close or restructure their insolvent banks and implement specific fiscal reforms. In return, the federal government assumed a large proportion of the debt, exchanging federal for state bonds.[23] The total value of federal bonds issued under this program up to August 2000 was $Rs 91.9 billion, or almost 10 percent of 1999 GDP (ibid, p.167). One circumstance simplified the negotiation of these deals. Three of the states with the largest debt—São Paulo, Rio de Janeiro, and Minas Geraís—had PSDB governors, elected on Cardoso's coattails in 1994. Their future prospects depended on Cardoso's good will and on the continued success of his macroeconomic projects. This made it hard for states to organize resistance to the terms of the refinancing scheme. The state bank of Rio de Janeiro was successfully privatized in June 1997 and that of Minas Geraís was sold in September 1998 (Baer 2001, p.313).

Collor's final mistake had been to alienate the business community.[24] From the start, Cardoso was more careful, meeting regularly with business leaders, and sending his ministers to consult them (Kingstone 2000, p.200). Two business sectors had reason to dislike the Real Plan's stabilization strategy. First, the high real interest rates needed for deficit financing attracted in foreign capital,

[22] The constitutional decentralization of revenues appeared impossible then to reverse; Cardoso concentrated instead on devolving matching spending responsibilities.
[23] In part, the states' debts were written off; in part, states were to repay the federal government at subsidized interest rates. For instance, under the agreement signed with São Paulo State in 1997, 7.5 percent of the debt was forgiven, 12.5 percent was to be amortized immediately by transfer of stock in state enterprises to the federal government, and 80 percent was refinanced as a 30-year loan at a low real interest rate of 6 percent (Dillinger and Webb 1998, p.30). The state's debt service was capped at 13 percent of net current revenues.
[24] It was also his first: he had never even consulted the most powerful business association, the FIESP, when drafting the 1990 stabilization plan (Weyland 2000, p.45).

driving up the exchange rate. While this suited importers, it hurt exporters and domestic producers, who faced competition from cheap imports. Cardoso responded to protests from these groups with a variety of concessions. He increased import tariffs in the automobile, consumer electronics, and electrical appliances sectors. Tariffs on cars rose to 70 percent (Kingstone 2000, p.197). The government also reduced export taxes, and provided credit lines to hard-hit sectors via the federal state development bank. Stabilization and liberalization initiated a process of mergers and foreign investment that left many firms closely linked to foreign capital, and therefore dependent on continued liberal policies (Kingstone 1999). By late 1996, business opposition to the Real Plan had subsided.

The second business sector feeling the pinch was private banking. Commercial banks had profited richly from inflation by delaying clearances on accounts with low interest rates and investing the funds in high-yield overnight government bonds. Profits on this "inflationary float" were estimated at about four percent of GDP in 1990-3, or more than one third of banks' total revenues (Baer 2001, pp.306-7). The large increase in required reserves—and the fall in inflation—under the Real Plan ended this.[25] Banks' seignorage revenues fell from about 4 percent of GDP in 1993 to about 2 percent in 1994, and close to zero in 1995 (IBGE estimates, from Cardoso 1998, p.633). Their earnings fell from US$10.4 billion in 1994 to $500 million in 1995 (Dobson and Jacquet 1998).

While drying up the banks' traditional money-maker, Cardoso's policies created another. To finance its deficit, the federal government issued an increasing volume of treasury securities at high real interest rates. The more agile banks switched from exploiting the inflationary float to borrowing abroad and buying domestic government bonds. As one observer noted, Brazilian banks could borrow at 12 percent abroad and earn about 30 percent on government bonds; even after paying taxes and hedging costs, the profits were enormous (Filho 1998, p.14-15). The volume of federal government securities outside the Central Bank grew from 17 percent of GDP in 1994 to 47 percent in 2000.

[25] Required reserves rose from an average 26 percent of deposits in early 1994 to 64 percent in early 1995 (Cardoso 1998, p.632).

This profit opportunity compensated the private banks somewhat for the loss of inflationary revenues, and the large dollar debt to foreign banks they accumulated turned them into a constituency for currency stability. Had inflation eroded the real's exchange rate, these debts would have been harder to repay.[26] Various regulations limited the direct involvement of foreign banks in the Brazilian market (for instance, while they could buy privatized Brazilian banks, foreign banks were not allowed to open new branches), and so their competition did not quickly drive down bond prices (Baer 2001, p.315). Meanwhile, the federal government preempted major failures by rescuing troubled banks; by March 1997, federal loans under the relevant program (PROER) totaled $20 billion (Filho 1998, p.13).

Overall, the Cardoso administration is remarkable more for what it did not do than for what it did. It did not cut spending; spending increased. Between 1994 and 1996, discretionary expenditures on health, education, and land reform grew by almost 50 percent, the minimum wage rose 54 percent, and federal salaries grew by 23 percent (De Souza 1999). The government did not balance the budget; operational deficits rose.[27] While denouncing the over-generous constitutional social security provisions, it did not make the mistake of winning their repeal too soon. Stabilization relied on tight reserve requirements, high interest rates, import competition (except on protected goods), reform of state banks to restore investor confidence, privatization to raise cash and attract foreign capital, and a variety of fiscal and political payoffs to those threatened by aspects of this strategy. The relative political calm and high interest rates encouraged foreign investors to overlook the large budget deficits and keep supplying the funds on which the strategy depended. By contrast, the Collor administration had achieved a decisive fiscal adjustment and a budget surplus—scoring high marks for political will and neoliberalism—but had failed to create confidence that these changes would be politically sustainable.

[26] Treisman (1998) makes a similar argument about the role of high-interest-rate government bonds in reconciling the Russian commercial banking sector to the end of high inflation in the mid-1990s.
[27] As Kingstone (1999, p.196) correctly notes, there was a significant fiscal adjustment in 1993-4. But it proved short-lived. In 1995 the operational public sector borrowing requirement jumped from –1.1 to 5.0 percent of GDP (Pinheiro et al. 2000, p.19).

One should not exaggerate the coherence of Cardoso's strategy or the clairvoyance of its designer. In many ways it was improvised, and it could easily have collapsed. Credibility was won gradually, and at moments seemed to be eroding—as in late 1996, when many feared the real was seriously overvalued and S&P rated Brazil's banking system the riskiest in Latin America (Kingstone 1999, p.218). The rapid accumulation of foreign debt alarmed many. Brazil's strategy—like that followed simultaneously by Russia's economic reformers—depended on the confidence of international financial markets. When that failed, so too did the currency, which was devalued in January 1999. However, as in Russia, devaluation did not prompt more than a temporary burst of inflation. The coalitions and institutional changes that underlay the Real Plan's political credibility proved more important in the end than any particular parity of the currency.

4.2 Argentina

Argentina's macroeconomic stakeholders resembled those in Brazil. First, urban workers—especially public employees—aimed to protect their jobs and wages, and had militant unions to coordinate strikes (Murillo 2000). Second, two business subgroups could torpedo stabilization. A set of domestically-oriented businessmen, the *capitanes de la industria*, benefited from state subsidies, contracts, or protection. Budget cuts, tax increases, or external liberalization would threaten their profits. At the same time, the relatively small internationally-oriented sector, centered around agro-exports and banking, would lose from real exchange rate appreciation. As in Brazil, domestic banks were profiting from the inflationary float. Both business sectors had representatives in parliament and among provincial governors. Internationally-oriented business had additional leverage: given large fiscal deficits and low central bank reserves, its dollars were vital to sustain the currency and government bond markets. Third, despite Argentina's more centralized party system, provincial governors had influence over their provinces' congressional delegations. They hoped to retain a high share of tax revenues and to receive continued central bailouts of their state banks. Fourth, parliamentary deputies sought to survive and prosper in office.[28] To navigate this obstacle course required crafting a sufficient coalition of stakeholders behind large tax increases and/or expenditure cuts, while avoiding an attack by currency speculators. In this, Alfonsín failed and Menem ultimately succeeded.

The Alfonsín years fall into three periods. The first, from 1983 to 1985, witnessed a vigorous attempt by the new government to undermine its own support by attacking all interest groups simultaneously in a manner reminiscent of Collor. Alfonsín alienated agriculture by increasing its fiscal burden; business by ignoring its main confederations; labor leaders by seeking to democratize the unions; and the army by prosecuting officers for human rights violations while sharply cutting the military budget.[29] While attacking virtually all elites, the government sought popular support by means of salary increases, low interest rates, and increased credit. The result was runaway inflation. In the second phase, which began in June 1985 with the Austral Plan, Alfonsín tried repeatedly to stabilize—but he did so over the heads of the main labor and business organizations, with no clear strategy to neutralize their opposition.[30] Attempts to freeze prices and wages provoked militant protests. The unions staged six general strikes within two years. Firms withheld products from market to drive up prices and postponed investments. Agricultural exporters and large industrial firms speculated against the currency, forcing the government to raise interest rates and abandon the wage and price freezes.[31]

From late 1987, the government set out to build a coalition combining some of the domestically-oriented businessmen with some of the more conservative unionists. It began to negotiate informally with a number of the *capitanes*, though not with the main business

[28] The military might be considered a fifth stakeholder. It wanted continued funding, and could threaten coups.
[29] See Manzetti (1992), Smith (1992), Pion-Berlin and López (1992). My point is not that these measures were undesirable, just that pursuing them simultaneously was bound to fail.
[30] He did make some minor attempts at cooptation, appointing a secretary of agriculture from the main agricultural association and meeting with some more moderate unionists. But these steps were too insignificant to be effective.
[31] Increasing tensions with the army further complicated things. Fearing they would be tried as well as the junta leaders, junior officers rebelled on three occasions. Alfonsín essentially gave in, raising military wages and passing a law that required the presumption of innocence for those who had committed crimes while following orders.

confederations. In the hope of dividing the Peronist labor movement, Alfonsín appointed one unionist, Carlos Alderete, minister of labor. Finally, in August 1988, the government invited the business confederations to participate in making policy, and negotiated a "price truce" with two of them. However, with a presidential election looming, these concessions proved insufficient and self-defeating. Alderete refused to settle for just a ministerial armchair, insisting instead on inflationary wage increases. Very sharp spending cuts failed to balance the budget, since revenues dropped too. The two groups crucial to sustaining the exchange rate—the domestic banking and agro-export sectors—were not part of Alfonsín's cooptation strategy, and felt little desire to help him. Fear of exhaustion of the bank's reserves and a Peronist victory in the presidential election led to a run on the currency in February 1989. Once again, the plan collapsed in a burst of hyperinflation. In May 1989, urban food riots erupted (Epstein 1992, p.3).

The collapse of Alfonsín's stabilization attempts suggests two points. First, unless a credible political coalition could be lined up behind government policies, temporary budget cuts and drops in inflation would be viewed as just that—temporary. Inflationary expectations would stay high, and the distributive free-for-all would continue. A credible political coalition required the permanent weakening of some groups alongside the cooptation of others. Second, given the difficulty of reducing deficits, the agro-export sector had to be part of the coalition, at least initially. The concentration of exports, the low level of foreign investment, and the central bank's meager reserves meant that a few major exporters could determine the exchange rate and thus whether deficits could be financed.

From his inauguration in July 1989, Menem's economic strategy looked designed to avoid Alfonsín's mistakes. Like his predecessor, he sought to coopt the *capitanes* and to unite with mainstream labor leaders against the more militant unionists. But he also set out to neutralize the military, and—most importantly—he made the agro-export sector the centerpiece of his coalition. For legislative and electoral support, he relied on one of the two main sub-constituencies of Peronism—

political bosses from poorer, interior provinces that were over-represented in congress; this made it possible to marginalize the second key constituency—the urban working class (Gibson 1997).

The currencies he used to reward his partners were carefully chosen to minimize the inflationary impact. First, Menem appeased the army with non-financial concessions—issuing a sweeping pardon of soldiers accused or convicted of human rights abuses—while, like Alfonsín, reducing the military budget.[32] Second, he split the union movement, appointing some leaders to high positions (including his labor minister, Jorge Triaca), and driving the more militant unions under Ubaldini into opposition. When workers in the telephone, steel, and oil industries went on strike, Menem fired the ringleaders and threatened to call out the military (Corrales 1998, p.26). To woo the agro-export sector, Menem appointed two successive economy ministers from the agro-business multinational Bunge & Born,[33] and gave them a relatively free hand in designing the "BB" stabilization plan of 1989. He increased import duties for agrochemicals (a key line of B&B's business), while decreasing tariffs for other industrial products (Peralta-Ramos 1992, p.110). In return, the major grain companies promised to lend the Central Bank $2.5 billion in emergency aid.

Despite all this, the plan collapsed in December under the pressure of yet another *golpe de mercado*. Hoping to force the government to lower export taxes, major agro-businesses withheld an estimated $2 billion dollars from the exchange market (Acuna 1995, p.30). As other speculators dumped the currency, bond rates soared. Late in the year, the government gave in, devaluing by 53 percent and unilaterally rescheduling its bonds. The general uproar from virtually all economic groups forced the economy minister to resign. Why the failure? Certain vital members of the coalition had not yet been coopted. Those that had—most importantly, the agro-business sector—were given mostly symbolic rather than material benefits. However gratified the agro-export tycoons might feel to see a colleague in the economics ministry, that did not persuade them to withdraw demands for tax

[32] Consolidated public sector spending on defense and security dropped from 2.4 percent of GDP in 1988 to 2.1 percent in 1993 (IMF 1998, p.30). Menem also made several cabinet and military appointments that pleased the military dissidents. The day after his inauguration, the full cabinet attended a 5-hour-long military parade, and Menem often visited military units (Starr 1997, p.105).
[33] The first died after less than a week in office.

breaks.[34] Since a bargain with agro-exporters to support the currency would not, in any case, be enforceable, tactics were required to give holders of dollars a direct interest in currency stability. This was a key ingredient of the successful Menem strategy of 1990-2.

The centerpiece of this political strategy was privatization. In just a few months, gas and electric companies, the national water and sewage companies, petrochemical, iron and steel firms, the post office, ports, and two public tv channels were all put up for sale. Privatization had a direct fiscal purpose. It raised cash for financing the deficit—a total of more than $10 billion in 1990-4[35]—as well as retiring some $5 billion worth of debt papers, which made possible a Brady deal in 1992 and a return to international money markets. It also reduced the need to finance insolvent public firms; in 1989, the total losses of the 13 biggest came to almost $4 billion (Pastor and Wise 1999, p.487). The political effect of privatization was to change the pattern of stakeholders in two ways.

First, privatization was used to coopt leading *capitanes de la industria* and agro-export tycoons (Corrales 1998). Early in Menem's term, the *capitanes* bitterly opposed privatization, which threatened their access to overpriced public works contracts.[36] Within two years, Menem had managed to coopt their leaders by giving them preference in public sales, and sweetening the deals with debt cancelations, monopoly protections, or low prices (Peralta-Ramos 1992, p.110). The *Wall Street Journal* accused Menem of selling the state telephone company Entel and the airline Aerolíneas Argentinas "for a fraction of their net worth."[37] Such sugar-coating helped avoid the business opposition that had blocked Alfonsín's attempts to privatize the same companies (Peralta-Ramos 1992, pp.118-9). Some of the leading agro-export conglomerates, such as Bunge & Born, also acquired stakes in privatized firms (Bambacci et al. 2001, p.35; Alexander and Corti 1993).

[34] In fact, they did not even make good on formal agreements: of the $2.5 billion loan promised by the grain companies, only $370 million was actually delivered (Peralta-Ramos 1992, p.153).
[35] This is calculated from Marina Ongaro, Mariano Cena, Juan Francisco Carluccio, and Jorge Rodríguez (2000, Annex 2).
[36] According to Corrales (1998, p.34), in 1989 private businesses overcharged the government by about $2.5 billion and received an additional $2.2 billion in tax breaks.
[37] *Wall Street Journal*, August 31, 1990, quoted in Peralta Ramos 1992, p.117.

By getting the titans of Argentine business to buy state enterprises, Menem changed their interests. Such entrepreneurs now needed currency stability in order to sell their shares to foreign investors at a handsome profit. Since many of the privatized firms produced non-tradables (telephone calls, airline flights, gas transportation), depreciation would lower the relative price of their output, and the implicit dollar value of their assets.[38] An agro-exporter whose grain would be more competitive if the austral's value fell would, if persuaded to buy a large stake in a domestic gas distributor, suddenly have a lot to *lose* in a devaluation. Firms accused of speculating against the currency in past crises would have reason to fear future market coups.[39]

A revealing moment came in 1995 as Mexico's crisis sparked fears in Argentina of yet another market coup. Depositors withdrew some $8 billion from Argentine banks, threatening many with insolvency and draining currency reserves. Had Argentine big business bet determinedly against the peso at this time, it could easily have collapsed. But times had changed. Though it is hard to verify, one close observer claims that the country's largest businesses in fact *bought* $1 billion worth of pesos to support the currency in March 1995 (Luis Majul, quoted in Manzetti 1999, pp.83-4). Along with an IMF announcement of additional aid, this helped turn the tide.

Privatization's second effect was to create a new stakeholder—foreign capital. Contest rules often required foreign involvement, and the foreign direct investment stock rose from $9 billion to $73 billion during the 1990s (UNCTAD 2001, p.302). This inflow helped to finance the balance of payments (Llanos 2001, p.78). But it also had political effects. Foreign investors, interested in the dollar value of their Argentine assets, had motive either to support the peso themselves, to hedge risk with other investors (giving them reason to support it), or to lobby their governments to provide

[38] This was not true in the case of some electricity companies, whose privatization contracts pegged prices to the dollar. But the demand for electricity would have declined as the price rose in peso terms, squeezing profits.
[39] In December 1989, one Peronist congressman accused the engineering conglomerate Techint of being among the leading speculators (*Latin American Weekly Report*, WR-89-48, 7 December, 1989, p.9). The next year, Techint became deeply involved in privatization, acquiring stakes in a railway line, a national road concession, an oil pipeline, an electricity company, and a gas transportation company, as well as participating in the consortium that bought the southern zone of Entel. The same Peronist congressman also accused Banco General de Negocios of having helped undermine the austral in late 1989. Banco General de Negocios was among three banks the government chose in 1991 to manage the sale of the state electricity company SEGBA (Petrazzini 1993, pp.74-5).

financial aid at critical moments.[40] For instance, Spanish companies played a major role in Argentine privatization, investing more than $30 billion in the country. By 2000, Spain's two largest banks, BBVA and SCH, controlled 20 percent of the Argentine banking system. Each invested heavily in Argentine government bonds, and stood to lose billions in a devaluation.[41] In November 2001, as crisis loomed and most investors were racing for the exits, SCH readied an additional $670 million to add to its Argentine investments.[42] Earlier that year, the Spanish government had pledged $170 million in aid to Argentina, and was reportedly considering extending up to $1 billion.[43] Later, a former Spanish prime minister, Felipe Gonzalez, flew to Buenos Aires to lobby against devaluation (*The Economist*, January 5, 2002, p.64). Although ineffective against a total meltdown, such external efforts and pressures probably helped in smaller crises. A second effect of the influx of foreign dollars, many of which ended up in the central bank's reserves, was to broaden the currency market and dilute the influence of Argentine exporters and banks, making it harder to stage the traditional market coup. By creating a new stakeholder, Menem weakened an existing one.[44]

Financial liberalization—in particular, the increasing dollarization of bank lending—also helped to coopt the middle class and business community behind currency stability (Díaz Bonilla and Schamis 1999). Although Menem facilitated this, there is no clear evidence it was part of a deliberate strategy. The proportion of loans to the Argentine non-financial private sector made in foreign currency increased from 41 percent in 1985 to 62 percent in 2000.[45] A home owner whose mortgage payments were in dollars, or a small businessman with a dollar-denominated loan, would have been

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[40] This is not to suggest that investors would throw money away betting on a falling currency, or even that major investors engaged directly in currency trading operations. But their deep involvement in the market and interest in stability helped to create confidence among other investors. In late 1996, international banks extended a $6.1 billion contingent repurchase facility to the Argentine central bank to provide banking system liquidity in case of crisis (IMF 1998, p.6).

[41] In late 2001, each held about $2 billion worth of Argentine government debt. Argentina's default in late 2001 was believed likely to cost SCH $4.6 billion and BBVA $3.6 billion (*The Economist*, January 5, 2002, p.64).

[42] *Wall Street Journal*, November 8, 2001, p.A16.

[43] Morgan Stanley, *Global Economic Forum Briefing*, August 8, 2001. Even this was not sufficient to reverse investor panic at this point, given the IMF's reluctance to provide additional credit.

[44] Menem initially coopted the domestic banking sector with continued protections; he shifted to a more extreme financial liberalization after the Tequila crisis of 1994-5.

[45] World Bank (1996b, Vol. II, Table 6.1) and information from Argentine Ministry of Economy.

devastated by a major devaluation—indeed, they were in 2002. Even large businesses that borrowed abroad to finance investments or banks that did so to purchase government bonds stood to lose if the peso's value fell.

Long term fiscal adjustment required major reforms of the tax system, provincial state banks, and social security—changes that directly threatened the provincial governments. Menem could not even rely on his own party members for support. Justicialista members of the Senate budget committee watered down efforts to eliminate tax exemptions for four underdeveloped provinces, and tried to increase automatic transfers to the provinces (Eaton 2000, pp.427-8). Despite such opposition, Menem managed to broaden the base of VAT, increasing federal tax revenues by three percent of GDP between 1989 and 1993.[46] State banks were gradually shut down or privatized. Many provinces also accepted a federal takeover of their troubled pension systems, and agreed in 1992 to let 15 percent of their coparticipation transfers be diverted to shore up social security.

How did Menem do it? To get fiscal legislation passed, Menem relied on a coalition of the over-represented poorer provinces plus Buenos Aires Province (Dillinger and Webb 1998).[47] The poorer provinces stood to gain from larger federal collections, since a majority—17 of 24 provinces in 1996—received more in estimated federal transfers and federal spending than their residents paid in federal taxes (see Figure 6).[48] Where necessary, Menem bought support retail with targeted concessions. The interior provinces objected to VAT on services as this would increase costs of long-distance shipping; Menem exempted freight transport (Eaton 2000). A new fund to "finance provincial fiscal disequilibria" was used to reward poorer provinces; a *Fondo Conurbano*, to finance social services in the capital's outskirts won over Buenos Aires Province. Earmarked funds for water, electricity, highways and housing were transferred to provincial control. Discretionary transfers (ATN) to the poorer provinces rose from $68 million in 1990 to $600 million in 1995 (World Bank

[46] Figures are from the IMF's *Government Finance Statistics Yearbooks*, various years.
[47] The poor provinces, with 20 percent of the popuation, had 58 percent of seats in the senate. These provinces, along with Buenos Aires Province, had a majority in the lower house (Bambaci et al. 2000).
[48] The data are estimates from World Bank (1998, pp.53, 57).

1996a, p.ii). Formosa received a free trade zone and public works projects. A debt impasse with Chaco province was resolved (Schwartz and Liuksila 1997). Reforms of industrial subsidies to interior provinces were "pushed onto the back burner" until late 1992 (Sawers and Massacane 2001, p.127).

[Figure 6 here]

To wean provinces from central bank bailouts, Menem let them borrow privately using their future federal transfers as collateral. This provided credit, but made default costly. The government offered cash incentives—partly funded by the World Bank—to provinces that surrendered their state banks. By mid-1998, 20 of the 26 provincial state banks had been closed or privatized (Nicolini et al. 2000, p.8). Once again, the government traded money for institutional changes that enhanced the system's credibility. In a similar trade, the government assumed responsibility for provincial pension systems (11 by 1996), at a cost that reached $1.5 billion in 1998 alone (Ibid, p.13).

To recap, privatization helped finance the budget deficit and attract foreign dollars to balance the current account. Giving major domestic businesses stakes in privatized companies weakened their resistance to stabilization. By including major *foreign* companies and banks, the government created a new stakeholder with access to dollars and an interest in stability, diluting the agro-export sector's influence over the currency market. Financial liberalization increasingly dollarized lending to businesses and middle class home-owners, rendering them vulnerable to devaluation. Targeted concessions helped secure a coalition behind tax reforms that reduced the deficit. And major cash payments won provinces' acquiescence to reforms of danger points in the country's financial architecture. Unions were part coopted, part neutralized, and the armed forces were appeased with criminal immunity. Together, these measures created unprecedented confidence in the currency, at least for a while.

Menem's tactics were so successful at forging consensus behind the fixed exchange rate that, in a perverse twist, they helped prepare the economic and political crisis of late 2001. Any talk of devaluation became taboo, even after the economy sanks into recession in 1998. A controlled devaluation then or earlier would have made Argentine exports more competitive, stimulating output.[49] The experience of Russia and Brazil suggests that such devaluations need not restart high inflation. But Menem's tactical engineering entrenched currency stability politically, even after its economic value had been exhausted. Even as state finances collapsed in 2001, Menem's successor, Fernando De la Rúa, imposed capital controls and fiscal austerity rather than devalue. After violent protests drove him from power, his temporary successor, Adolfo Saá, again insisted that the peso's peg to the dollar would remain. It was only the third president, Eduardo Duhalde, who finally devalued in early 2002.

5 Concluding remarks

Argentina and Brazil's struggles against inflation in the 1980s and 1990s are hard to understand without examining the tactics of reformers. Each country's failures and achievements cannot be traced straightforwardly to the extent of crisis, the electoral calendar, or the pattern of party control over political veto points (although the last was probably important). Nor do the details of these cases fit interpretations of stabilization as the climax of a "war of attrition" or the result of left-wing leaders' greater credibility with labor.

From a purely economic standpoint, the two cases seem strange. Although labeled "neoliberal", the strategies of both Cardoso and Menem contained much that was unorthodox. Most economists agree that stabilization requires a low public sector deficit, which usually means cutting spending. In Brazil, public sector deficits rose under the Real Plan, and in both countries spending increased sharply before and during stabilization.[50] Brazil's burgeoning deficits help explain why it

[49] Exports were actually quite stable during the first years of the recession, and in any case constituted only a small share of GDP. Nevertheless, a more competitive exchange rate would certainly have helped.

[50] In Argentina, public sector spending rose from 17.7 percent of GDP in 1989 to 26.7 percent in 1998; in Brazil, it rose from 32.7 percent of GDP in 1994 to 38.2 percent in 1998.

ran into difficulty in 1998, prompting a more serious fiscal adjustment; but this adjustment followed the victory over inflation rather than causing it. Neoliberals generally aim to enhance competition and eliminate rents. However, both leaders went to pains to create or preserve rents, writing monopoly powers and protections into their privatization and trade policies. Critics accused them of clientelistic deals and sometimes corruption.

Yet the markets smiled. Capital flooded in, financing the deficits and stimulating growth. From a tactical perspective, such sins against economic orthodoxy are understandable and even rational. Investors seem to have recognized this, and they declined to punish Menem and Cardoso for their political compromises. What pleased the markets most—at least in the short run—was not economic orthodoxy but political credibility. This, in turn, depended on a political strategy that could overcome resistance to reform. It was when politicians refused to make such compromises that the worst problems arose. The fiscally responsible budget cuts of Collor were not politically sustainable, and the markets saw this. Fernando De la Rúa's fiscally prudent but tactically inept struggle to balance the Argentine budget month by month in late 2001 provoked political showdowns that terrified investors and drove bond prices to levels comparable to those of Nigeria.

Obviously, governments cannot run large deficits indefinitely. And other things equal, fiscal balance is certainly preferable. But in developing countries, other things are rarely equal. At times, the only feasible path to low inflation may be to deliberately incur temporary deficits in order to buy political support. Paradoxically, fiscal policies that are unsustainable in the long run sometimes constitute a country's best hope of making a tight monetary policy politically sustainable in the short run.[51] Sometimes, this can lead to a virtuous cycle as low inflation stimulates investment and growth,

[51] Some observers write as though it were the laws themselves—e.g., the Argentine convertibility law, or the new central bank charter of 1992, which banned it from lending to domestic borrowers—that entrenched the commitment to low inflation. However, parliament can repeal laws as easily as it can pass them. In fact, the central bank's charter was amended in 1995 to permit it to provide "advances to financial institutions to deal with temprorary situations of liquidity," on terms left to the central bank's discretion—precisely what the 1992 version had sought to rule out. Even before this, the state-owned Banco de la Nación had been called upon to purchase some 982 million pesos worth of bad loans from illiquid banks (Calcagno 1997, p.80). The convertibility law was, itself, far less absolute than many realized. Most of the money supply (e.g., bank

which increases revenues and returns fiscal policy to balance. But even if such policies lead eventually to a second fiscal crisis, this may be preferable to the only alternative—giving in from the start to hyperinflation, stagnation, and political conflict.

Menem and Cardoso's successes suggest several notes about the art of tactics. When confronted by a blocking coalition of opponents, reformers have two options. They can seek to split the opponents by coopting some. The challenge then is to drive a hard bargain, appeasing only as many stakeholders as are vital and paying as little as possible in currencies that compromise efficiency.[52] Or they can seek to introduce a new player into the game who will either divide the opposition or dilute its power. Both Menem and Cardoso managed to split and weaken the domestic business community by opening the economy to large foreign investors, who became key allies in the struggle for currency stability.

In coopting allies, two methods can be distinguished. The first involves a direct bargain: the reformer promises to provide some benefit if the stakeholder withdraws his opposition. The problem with such *quid pro quo*'s is that enforcement is often not credible. For instance, had Menem promised the Argentine export conglomerates some benefit if they declined to dump australs, this would have been unenforceable given the anonymity of (black market) currency trades. The second method is to provide the stakeholder with an opportunity or asset whose value increases with success of the proposed reform: to create vested interests. The advantage of this technique is that it is self-enforcing. One example is the sale of enterprises producing nontradeables to the Argentine conglomerates, giving them a stake in currency stability. The difficulty is how to vest such interests: the

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demand deposits, including those in dollars) was not covered by the hard currency reserve requirement, which meant "convertibility" offered no defense against a run on the banks. And up to 20 percent of the peso's hard currency backing could consist of the Argentine government's own bonds (Calcagno 1997, p.66).

[52] Sarney failed in this, making too many compromises that were not strategically useful. Menem can also perhaps be criticized on this score. The extent of benefits he provided to allies during privatization may have exceeded those strictly needed to secure their participation. Expecting tax revenues to grow sharply after stabilization, he might have struck better deals with provincial governors over revenue distribution earlier on. And, though few anticipated the strength of the dollar in the 1990s, had Cavallo chosen to peg to some weaker basket of currencies the peso's real appreciation would have been slower. I am grateful to Daniel Artana and Ricardo Lopez-Murphy for suggesting these points.

conglomerates could sell the privatized companies to other investors, restoring their freedom of action.

The payoffs to coopt allies can be made in any of three *cooptation currencies*. First, the government might offer money as part of a *quid pro quo*. Cardoso's federal assumption of state debts in return for the privatization of state banks or utilities is an example. In this case, the bargain was overt and easily enforceable. Second, the government might coopt stakeholders by giving or selling them property—for example, Menem's sale of state enterprises to the *capitanes*. Since reselling these properties at a profit required macroeconomic stability, this created a vested interest at least in the short run. The third cooptation currency is state-created market restrictions that generate rents. Cardoso's decision to slap 70 percent tariffs on imported cars is an example.

From the standpoint of efficiency, transferring property and cash are superior to introducing market distortions. Thus, to evaluate reform tactics one must consider whether reformers used the least distortionary cooptation currency. In the case of Brazilian car producers, a lump sum transfer might have worked as well (though it might have been harder to administer and justify). In the Argentine privatizations, lowering the price and discriminating in favor of bids from key stakeholders would have been less distortionary than guaranteeing monopoly power. Ironically, the more efficient options would probably have appeared more corrupt. They would also have cost the government more cash up front, at a time when such cash was vitally needed for the anti-inflation crusade.

Finally, it is important to recall that tactics are neutral. They can be used to pursue good or bad objectives, and objectives may change over time. In Argentina, Menem's skill became President De la Rúa's misfortune. The former had entrenched support for dollar-peso parity so effectively that it would have required far more tactical skill than De la Rúa could muster to build a coalition for changing it. Menem's tactics created vested interests not just in low inflation but in a particular value of the exchange rate. Delinking the two remained extremely hard even after most economists came to think a measured devaluation would help restore growth. Menem's less politically adept successor was swept away before he found a solution.

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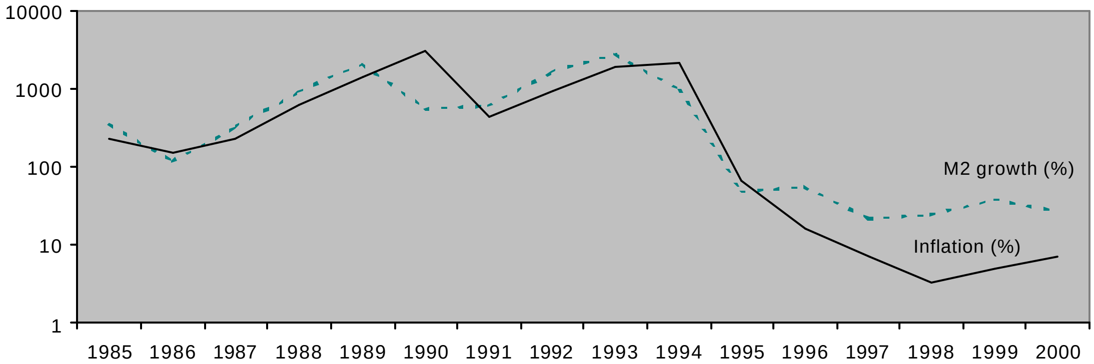
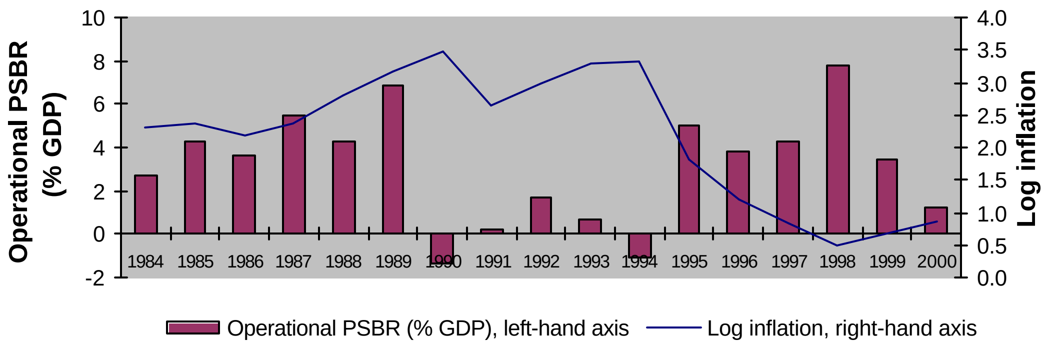
Figure 1: M2 Growth and Inflation in Brazil



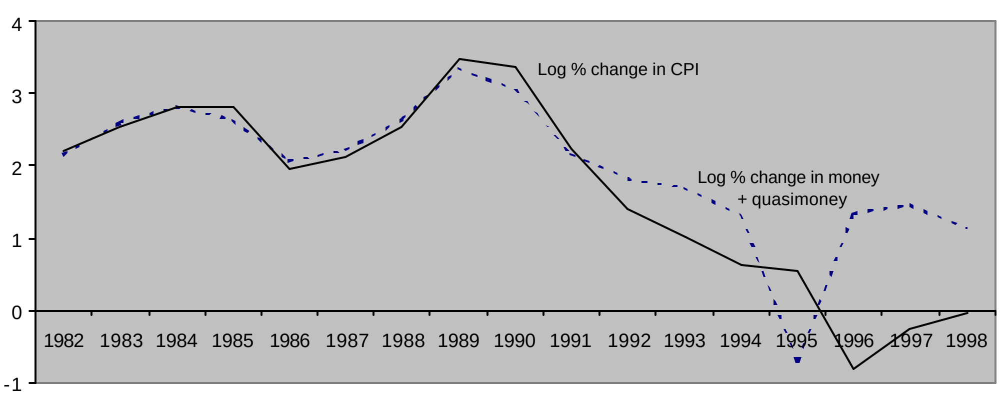
Sources: IMF, *International Financial Statistics Yearbook* 1999;
Boletim do Banco Central do Brasil May 2001. Inflation is IPCA period average.

Figure 2: Operational Public Sector Borrowing Requirement and Inflation, Brazil



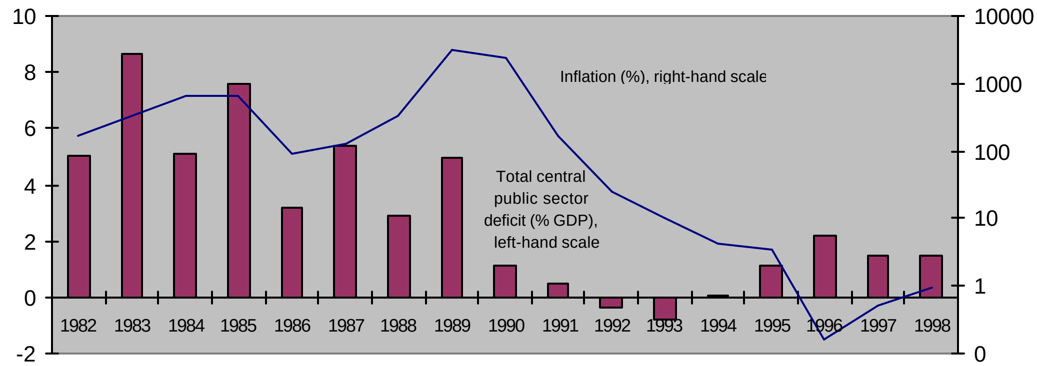
Sources: 1983-90 from Coes (p.68); 1991-98 from Pinheiro et al. (2000, p.19); 1999-2000 from *Boletim do Banco Central do Brasil* , May 2001

Figure 3: Money Growth and Inflation, Argentina



Sources: IMF *International Financial Statistics Yearbook* 1999; 3 has been added to % change in money + quasimoney before taking logs, since one observation was -2.81; Inflation is % change in CPI

Figure 4: Central Public Sector Deficit and Inflation, Argentina



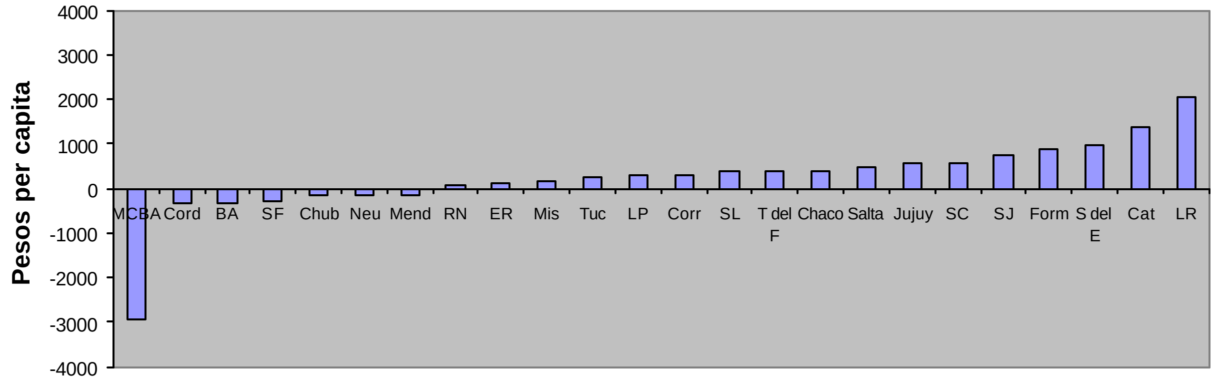
Source: IMF, *Government Finance Statistics Yearbook,* various years, for consolidated central government deficit; World Bank 1996b for quasi-fiscal deficit of central bank; IMF, International Financial Statistics Yearbook, 1999, for inflation of CPI. Total central public sector deficit = consolidated central government deficit + quasi-fiscal deficit of the Central Bank.

Figure 5: Elections and Stabilization Attempts in Argentina and Brazil

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Argentina																		
Presidential election																		
Legislative election																		
Stabilization attempt			1		2	3	4		**5**									
Brazil																		
Presidential election																		
Legislative election																		
Stabilization attempt				6	7		8	9	10		**11**							

Notes: 1 = Austral; 2 = Australito; 3 = Primavera; 4 = BB; 5 = Convertibility; 6 = Cruzado; 7 = Bresser; 8 = Summer; 9 = Collor I; 10 = Collor II; 11 = Real. Successful stabilizations in bold.

Figure 6: Estimated net central transfers to Argentine provinces, 1996



Transfers (automatic and ATN) and federal direct expenditures (Social Development, Ministry of Education and Culture, Ministry of Labor, National Universities, Federal Services in MCBA, Ministry of Health and Social Action, Ex-fund for Rural Development, Subsidy for Gas Consumption, Provincial Pensions, Pensions) per capita minus federal tax collections in province per capita (VAT, excise, personal and corporate income tax, personal assets tax, fuels tax, external trade, payroll taxes, and others).

Source: World Bank, *Argentina: The Fiscal Dimension of the Convertibility Plan, A Background Report,* I, 1998, pp.53, 57.