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# Disinflation and fiscal reform: a neoclassical perspective

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**Abstract**

Many Latin American countries engaged in disinflation programs based on both exchange rate management and fiscal reforms. In most of the cases, part of the fiscal reform was not implemented and the program had to be abandoned. The aftermath of these programs is not encouraging. In this paper we show that, if the reform process is uncertain and inflation has welfare costs, the optimal exchange rate policy indeed implies the initiation of a disinflation program at the announcement of the fiscal reform, even if it implies the possibility of a balance of payments crisis. Finally, we show that it is optimal to engage in a sequence of stabilization programs until one of them is successful.


*Keywords:* Stabilization programs; Exchange rate management; Disinflation; Reform; Speculative attacks

*JEL classification:* F31; F32; E13; E4

## 1. Introduction

During the last two decades, many Latin American countries engaged in disinflation programs based on both exchange rate management and fiscal reforms. However, in most instances, part of the fiscal reform was delayed or not implemented completely, so the fiscal deficit increased and the program had to be

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abandoned. The aftermath of these programs is not encouraging: since most of these policies turned out to be failures, lowering reserves and causing higher inflation rates. Given this record, it is worth asking why governments start a disinflation program even though the fiscal equilibrium is not guaranteed. A more sensible strategy would be to stabilize the fiscal accounts first, and then reduce inflation.

The literature has explained this behavior based on four alternative theories: the Olivera–Tanzi effect, optimal tax composition, exchange rate management as a disciplinary device, and political economy issues. First, if the economy is working in the wrong side of the Laffer curve, there exists another equilibrium with lower inflation. The idea is that the lag that exists between the realization of income and the time income tax is paid reduces real revenue. A stabilization moves the economy to the left hand side of the Laffer curve and no fiscal effort is required. This is the Olivera–Tanzi effect (see Olivera, 1967; Tanzi, 1978). Second, the disinflation program might be the result of an optimal tax choice problem. For example, consider an economy that has a high inflation tax and a low income tax. Moving toward the optimal tax portfolio implies a reduction in inflation and an increase in income tax. This kind of tax recomposition are common in the Latin American experience, and are an important component of their reform processes. Third, the disinflation program can be thought as a commitment or disciplinary device to encourage fiscal responsibility. If there is a conflict between the central bank and the government, and the central bank is the stronger one, then the monetary authority initiates a managed exchange rate to force the fiscal authority to reduce expenditure.[1] Fourth, there are models that concentrates on how the incentive structure of the government interacts with the choice of exchange rate regime (see Tornell and Velasco, 1995, 1998, 2000)

These theories capture important aspects of the disinflation programs in Latin America. They fail, however, to explain several of the issues in those processes. The first two theories cannot justify why disinflation programs usually end with a balance of payments crisis. Both predict that no need for extra financing is required during the disinflation. The third explanation does not seem to capture the institutional arrangements that prevail in Latin America; central bank independence is a relatively new concept for the continent, and, in general, we observe that the monetary authority abandons the policy, and not the converse. Finally, the fourth hypothesis depends on political economy institutions that are not necessarily common across the region. These are undoubtedly important components of the story, however, here we abstract from them and emphasize an alternative explanation.

[1] The European disinflation experiences of the 1980s can be classified as examples of the use of monetary policy as a commitment device.