

Discussion of the History of Paraguay 1

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Let me start by confessing that, before reading this chapter, I knew virtually nothing about Paraguay. Happily, that has now changed: after studying this chapter, I am now familiar with several interesting facts and issues about Paraguay's macrodevelopments since 1960. In this sense, I find the chapter rewarding and instructive. We should thank the authors for producing their work, which should become a reference for students of the region.

The chapter examines a time span of more than half a century, breaking that long period into four smaller subperiods. Focusing on the subperiods helps the analysis of short- and medium-term phenomena. One cost, however, is that it prevents a discussion of longer-term issues, which I would have enjoyed. I was surprised, for example, to learn that Paraguay's average growth rate during the whole period was 2.4 percent on average. This performance ranks in the middle of the Latin American pack, which I had not expected, having heard over the years that Paraguay's economy was a stagnating one because of political events combined with being landlocked. Perhaps those factors may have played a much smaller role than I would have guessed. On the other hand, as the authors remark at the end of the chapter, Paraguay's per capita income level remains significantly below the average level for the region: no Paraguayan growth miracle has occurred in the half century under study. This raises the question of the determinants of Paraguay's growth rate and, in particular, whether access to the sea has or has not been a significant obstacle.

Instead of exploring such long-run issues, the chapter's main focus is on how short-run macroaggregates, especially inflation, may be linked to fiscal imbalances and the way those imbalances have been financed. Figure 2 in the chapter shows how Paraguay's inflation rate, which averaged very small levels in the 1960s, exhibited two acute but short-lived bursts in the 1970s. Inflation became more of a chronic problem in the 1980s, settling in the 30–40 percent per year range. The beginning of the 1990s saw a drastic correction, to the 10–20 percent range; since then, inflation has fallen slowly but steadily, and now it is in the single digits.

Table 1 is suggestive of a link between the evolution of inflation and the financing of the budget. The table shows that the government's financing needs were about the same

(2.7–2.8 percent of GDP per year) during the 1960–80 and 1981–90 subperiods. There is a noticeable difference between the subperiods, however, in that seigniorage revenue increased from 1.6 percent per year in 1960–80 to 2.4 percent per year in 1981–90. A plausible conjecture, then, is that one should be able to find some econometric evidence of a connection between increases in seigniorage and inflation. Likewise, government finances have been roughly balanced since 1990, allowing seigniorage to fall to 1 percent of GDP. Again, this suggests searching for some correlation between the fall in seigniorage and the fall in inflation in the data for the subperiods after 1990.

As we review these statistics, we should note that the magnitudes are quite small. The increase in seigniorage revenue in the 1980s relative to the previous two decades is less than 1 percent of GDP. One wonders what kind of mechanism can amplify the increase in seigniorage so that it translates into 40 percent inflation. This is perhaps why the chapter offers only a few results in terms of formal statistical tests of the correlation between inflation and fiscal imbalances. One of them is a zero correlation between inflation and the total fiscal deficit in the 1980s and a 0.22 correlation between inflation and the deficit of public companies. These results indicate that the link between fiscal imbalances and inflation is quite weak, in spite of the less formal evidence in Figure 2 and Table 1.

In fact, the evolution of inflation in Figure 2 suggests that there may be other, more empirically important, factors underlying the increases in inflation before 1990. The first one is the behavior of oil prices. The two inflationary spikes in Paraguay in the 1970s coincide tightly with the first and second OPEC oil shocks, which also caused inflation to increase in the United States and elsewhere. The second factor was the Latin American debt crisis that started with the 1982 Mexican default. As we know, the 1980s was a lost decade for many Latin American countries, some of which experienced hyperinflationary episodes. It is hard to believe that Paraguay would have been immune to contagion effects during this period, even if its fiscal deficit had been in perfect balance.

All in all, the Paraguayan experience between 1960 and 1990 remains somewhat of a puzzle. But to me, in fact, the puzzle is not whether fiscal imbalances can explain the increase in inflation in the 1980s but, rather, how it was that Paraguay did *not* have triple-digit inflation and could limit seigniorage to *only* 2.4 percent. In this regard, I think that future research may benefit from a comparison of Paraguay's experience against others in the region.

The chapter's discussion of Paraguay after 1990 is dominated by policy reforms, especially those regarding the central bank's legal status, and by the impact of financial liberalization and crises. The 1992 constitution placed strict limits on the central bank's ability to finance government deficits. In 1995, a new central bank charter established "maintaining the value of the currency" as the single objective of the bank. More recently, starting in 2004, an inflation-targeting regime has been gradually implemented.

In view of the steady fall in inflation since the early 1990s, one is tempted to conclude that these reforms were instrumental in lowering inflation. Nevertheless, such a conclusion, while plausible, warrants more scrutiny, at least in view of two facts. First, Figure 2 shows that inflation already started a steep fall in 1991—that is, before the 1992 constitution—hence raising the question of whether the timing of the constitution and

other legal reforms is consistent with the view that those reforms were the main drivers of the reduction in inflation. Second, inflation fell after 1990 in many Latin American countries, of which some did not reform their central bank frameworks. Here, once more, a comparative perspective may prove useful in future research.

The chapter stresses that a key development after 1990 was the growth of financial intermediation, made possible by deregulation aimed at overcoming financial repression. Starting in 1995 and until 2003, the financial system was hit by a sequence of runs and attacks, which according to one estimate resulted in the loss of more than 15 percent of GDP. The discussion in the chapter suggests that financial fragility and crises during this period mostly reflected policy errors following financial liberalization, including an inadequate deposit insurance policy and weak supervision and regulation. But this perspective by and large ignores that the period was characterized by financial instability in virtually all emerging markets, including Argentina, Brazil, and Uruguay, Paraguay's main economic partners. One then wonders to what extent the financial crisis in Paraguay was driven by contagion and the general retrenchment of capital flows from the region rather than by policy mistakes.

At the end, this chapter left me convinced that Paraguay has been surprisingly tranquil in macroeconomic terms since 1960, with the exception perhaps of the financial liberalization–growth–crash episode of 1995–2003. There were some fiscal and monetary imbalances, yes, but they seem to have been quite small, especially when compared with neighboring countries. And the outcomes, especially in terms of inflation, were correspondingly tame for Latin American standards. True, inflation rates rose to 40 percent in the eighties, but at that time Paraguay's neighbors were dealing with rates in the triple digits or worse.

From that viewpoint, I find somewhat strained the authors' conclusion that the evidence shows that Paraguay "follows the conceptual framework of 'A Framework for Studying the Monetary and Fiscal History of Latin America' reasonably well, in that the high and volatile inflation that ensued since the mid-1970s to the late 1980s coincided with the period of large fiscal deficits that were partially financed by the central bank . . . [and that] the permanent reduction in inflation that started in the early 1990s coincides with a change in the institutional framework that made the central bank independent and with a more conservative fiscal policy." To convince us that these are more than rough coincidences, future research should center on developing more formal evidence establishing the hypotheses that the authors maintain in this chapter and assessing their importance relative to other, natural alternatives.