South African Reserve Bank

Lessons from the economics of populism

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> At the end of the road one cannot avoid wondering whether the mistakes of past populist regimes can be internalized by policymakers, politicians, and the population at large and, thus, be avoided in the future. Quite clearly, [history] suggest[s] that, in general, there is very little capacity (or willingness) of learning from other countries' experiences. Indeed, one of the most striking regularities of these episodes is the insistence with which the engineers of the populist programs argue that their circumstances are unique and thus immune from historical lessons from other nations.
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> - Rudiger Dornbusch & Sebastian Edwards

My speech today is about populism, about its appeal and its weaknesses. Populism wins supporters in part because it speaks to ordinary people about real problems – problems other leaders can be too embarrassed or nervous to confront. For instance, when Hugo Chávez attacked corruption and inequality in Venezuela, he wasn't just making trouble. He was confronting some longstanding problems of Venezuelan society.

But populism also has a bad side: it pretends there are easy solutions, even where there are none – where the problems are in fact very difficult. Often the easy solutions have unintended effects, impacts that populists ignore or are unaware of. It is these unintended effects that usually end up hurting the people those easy solutions were meant to help. Populist governments tend to be especially weak on economics, which is a common reason why their projects fail. In my speech today, I will explore what it is about economics that populism get wrong, and what we can learn from that.

The knowledge I will detail is mostly drawn from Latin America, a place where populism has flourished over the past century. This experience is relevant for us because these economies closely resemble ours. In particular, they are middle income countries with high levels of inequality. Of course, every country is different. But the populist experience has been so similar, across so many countries and time periods, that we can pull together a few clear lessons relevant to our times and circumstances.

Economic populism starts with deep dissatisfaction.[1] Too much unemployment, too much inequality, too much poverty. The populist solution is to start spending – push as much demand as possible into the economy, without consideration of constraints. The argument is that more spending will make people better off. More demand encourages more supply, meaning more jobs and more investment. It's supposed to be a virtuous circle. So the government starts spending money – as much as possible. It borrows from people's pension funds. It borrows from the central bank and demands it buys its debt – which means printing money. It spends the foreign exchange reserves.

And at first sight, it works. As scholars of populism have noted, the immediate consequence of these policies tends to be an economic boom. People who warn that populism is a disaster will look foolish. There is more growth and big wage increases and more jobs.

But it doesn't last. Time and time again, the boom turns to bust. Inflation shoots up and growth collapses. Some populists realise their strategy has failed and change course. Others put their countries through even greater pain. During the 1950s, the Argentine president Juan Perón effectively aborted his populist programme when inflation neared 50%.[2] In Peru, Alan García abandoned his stimulus programme in 1988, with inflation well over 1000%.[3] In Venezuela, inflation is expected to reach one million percent this year,[4] and people are fleeing the country to find food, but the policy direction still hasn't changed.

What is it about the populist recipe that goes wrong? The literature focuses on two kinds of constraints: inflation and the balance of payments. Now these are things populists probably don't see coming. They don't understand the causes of inflation very well. And they may not even know what the balance of payments is. But these are powerful forces, and ignoring them doesn't mean they will leave you alone.

The inflation problem is fairly simple. If a government wants to stimulate demand, it will want low interest rates, and it will demand that the central bank print money to buy its bonds. This extra money does a couple of things. It raises demand, and with the economy running hot, firms and workers put up their prices. It causes the exchange rate to depreciate. And because people see the government is printing money, they start to put a lot of time and effort into figuring out where inflation is going, and raising their prices to keep ahead of it. This process then gets worse over time. In the first year, you get a fair amount of growth and a bit more inflation. In the second year, you get even more inflation and less growth. A few years in, inflation is running at very high levels – there are cases of inflation exceeding several thousand per cent a year, including Peru and Brazil, and as Zimbabwe showed us, there are many more zeroes that can be added after that. This is poison to an economy – it destroys people's savings and shuts down longer-term credit markets. It also interferes with the

[1] This discussion of populist macroeconomics draws on the seminal essay by Rudiger Dornbusch and Sebastian Edwards (1990) "The Macroeconomics of Populism" in *The Macroeconomics of Populism in Latin America*, University of Chicago Press

[2] Paul H. Lewis (1990). *The Crisis of Argentine Capitalism,* University of North Carolina Press

[3] John Crabtree (1992) *Peru Under García: An Opportunity Lost,* University of Pittsburgh Press

[4] Alejandro Werner (2018, July 23) "Outlook for the Americas: A tougher recovery" Available at: https://blogs.imf.org/2018/07/23/outlook-for-the-americas-a-tougher-recovery/

everyday business of buying and selling goods and services. So what starts with a nice growth bump ends in a deep depression, and a large increase in poverty.

The other constraint is the balance of payments. When a populist government starts to push up spending, it increases domestic demand. That doesn't change foreign demand so you don't get more exports. In fact, local producers will probably be so worried about policy consistency and rising inflation that exports will stagnate. But the import bill still rises as demand booms, and that import bill needs to be paid somehow. Populists may hope that new demand will all go into domestic production, but they are invariably proved wrong. There are no modern economies that produce everything they need locally, from oil to machinery to food to smartphones. And foreigners like to be paid in hard currency, not an inflation and depreciation-prone currency.

The shortage of forex therefore becomes a constraint – a bottleneck. No matter how much demand you push into the economy, you don't get more supply because you can't finance enough imports. In economic terms, the import-intensity of demand means an economy can overheat even when other factors of production are lying idle, with high unemployment or factories operating below capacity.

The symptoms of this foreign exchange constraint will be a widening current account deficit and strong depreciation pressure on the currency. So long as there are foreign exchange reserves left, or there are people willing to lend you dollars, the boom can go on. But as financing dries up, the government ends up going to the only lender who will still take its calls, the IMF. Of course, the IMF isn't interested in funding an unsustainable spending programme. So this means accepting the kind of spending cuts populists started out rejecting.

There is also a third kind of constraint on populism, which moves a bit slower but may be the most dangerous of all. I'll call it the "know-how" constraint, and it is fundamentally about the sources of wealth. In the populist narrative, that story is simple. They say, our country is rich. If the people are poor, that must be because someone else has hoarded these riches – like foreigners, or elites. The solution, then, is to redistribute the wealth to the people.

In practice, however, although populists reliably point to sources of great wealth that they plan to redistribute – oil, land, gold, or something else – they invariably run into macroeconomic trouble. The wealth doesn't cover the extra spending they want to do. And they don't appreciate that their anti-market rhetoric and policies disrupt production and kill off investment. As a result, they can deliver temporary consumption booms, but not lasting improvements in welfare. Redistributing an existing stock of wealth does not mean that that stock of wealth can be built again.

Perhaps the most profound meditation on why this happens comes from Ricardo Hausmann, a Venezuelan economist and former finance minister currently teaching at Harvard. Professor Hausmann has, of course, had personal experience of a country that seems rich but whose people are nonetheless persistently poor. Accordingly, his analysis emphasises the value of know-how, of expertise.[5] Lasting wealth, by this account, isn't in a country's soil but in its citizen's heads.

Countries get rich because people develop specialised skills, and because they find ways to cooperate so they can do things much too complex for any individual to do alone. To handle all this complexity and specialisation, people gather in firms, and firms interact in markets. The state can help with this whole process, for instance through investing in education, guaranteeing security and providing other public goods. But if the state declares war on market mechanisms and condemns rich people, it starts to break the machine that generates wealth. It kills off investment. It scares skilled people away. In this world, natural resources don't get used effectively, no matter how abundant they are, and the economy doesn't develop other kinds of industries either.

This theory helps explain why resource wealth does not always generate national prosperity. Certainly, there are countries with natural resources that are either very rich, like Norway, or that are reasonably prosperous, like Botswana. But there are also countries with the exact same resources that are poor, like Angola with oil or Sierra Leone with diamonds. And while there are countries that lack extraordinary natural resource endowments and are poor, like Malawi,[6] there are also countries that are resource-poor but highly developed, like South Korea or Germany. Clearly, there is more to wealth than winning the commodity lottery.

This message doesn't appeal to populists. For instance, populists do not want to hear about how a resource like oil is difficult to extract, that it requires highly qualified people and carefully maintained infrastructure and well-organised firms to manage the whole process.

More broadly, populists aren't really interested in the hard work of development, the patient progress whereby you grow incomes by a few per cent a year, until after a generation you've become a developed country. For them, the country is already rich, and because the country is rich, the problem must be that someone is stealing the wealth.

Unfortunately, people fall for 'get rich quick' schemes all the time, and countries can fall for them too. There is abundant evidence that the economic strategy of populism leaves people worse off than they were before. Yet somehow, the same ideas show up time and again, as if no-one ever learned from past mistakes. The disaster playing out in Venezuela at the moment is no surprise to anyone who knows anything about Latin American history. We have seen the same basic story in Argentina, Brazil, Chile, Peru and elsewhere. But all these economic disasters on Venezuela's doorstep couldn't spare that country from doing the same terrible things to itself.

Yet it is perhaps too strong to conclude humans never learn. Venezuela aside, other countries have learned from populist mistakes, and constructed defences against repeating those errors. The fundamental mistake of economic populism is failing to understand constraints. Accordingly, the

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[5] Hausmann, R., (2016). Economic Development and the Accumulation of Know-how. *Welsh Economic Review*. 24, pp.13–16. Available at: http://doi.org/10.18573/j.2016.10049. See also Hausmann (2017, March) "Das Knowhow Kapital" available at: https://www.project-syndicate.org/commentary/south-africa-zuma-knowhow-shortage-by-ricardo-hausmann-2017-03

[6] For a discussion of the Malawian example, see Paul Collier (2007) *The Bottom Billion*, Oxford University Press

fundamental solution countries have adopted is building constraints into their policy framework. Instead of madly insisting there are no limits, no constraints, that everything is possible, policymakers look for what freedom of manoeuvre they enjoy within economic reality. In a sense, they design their macroeconomies to have brakes and airbags, not just accelerators.

Of course, accelerators are still useful. Modern policymakers almost universally acknowledge that there are times and places where policy stimulus is appropriate. But those tools are for smoothing output over the cycle. They can't deliver long-run development, and they won't work in the presence of bottlenecks. If a government is facing rising inflation and a binding balance of payments constraint, stimulus is precisely the wrong strategy – as Turkey's financial crisis is once again reminding us. Denying this reality just makes reality more painful.

So what are the policy frameworks countries use to accommodate reality? Latin American economists like to talk about a policy tripod, comprising inflation targeting, a floating exchange rate, and measures to protect fiscal sustainability.

The first part of the tripod, inflation targeting, directly tackles the problem of the inflation constraint, without sacrificing flexibility. If an economy is struggling and inflation is low, it's an easy call to cut rates. If inflation expectations are well-anchored in line with the target, it's easy to look through temporary supply shocks, such as oil or food price spikes. And if inflation is rising and inflation expectations are getting out of control, the policy framework will tell you it's time to tighten, and an independent central bank will have the means to do so. If twenty years ago Venezuela had embraced inflation targeting and central bank independence, today they would have low and stable inflation, not hyperinflation. And they would be richer for it, even though they would at some point had to raise rates and made themselves unpopular. It is better to have unpopular central bankers from time to time than hyperinflation and expanding poverty.

The second leg of the policy tripod is a floating, market-determined exchange rate. Again, this sends everyone the right signals. If the currency is depreciating, it tells importers to cut back, and it tells exporters to raise production. By contrast, a fixed exchange rate helps everyone hide from economic realities too long – leading an economy to rely too much on imports, and to borrow too much in foreign currency. Fixed exchange rates create the appearance of stability, but they are so brittle that when they fail, they fall apart completely, doing tremendous damage. By contrast, floating exchange rate regimes are volatile, but resilient – they give you bad news immediately and help you deal with it, instead of storing it up for later.

The final leg of the tripod is some kind of fiscal rule, to protect government's solvency even when short-term pressures to spend more and borrow more are very high. Chile, for example, has built systems to save copper income in good times, so when bad times come they don't have to slash spending at the worst possible moment. Brazil has a fiscal responsibility law, which is meant to guarantee a primary budget surplus except in emergencies, so debt levels stabilise over the economic cycle.

Unfortunately, fiscal rules have proven easy to break. The result is that countries can slip back into unsustainable fiscal policies, as has happened in Brazil, even as the other parts of the tripod stay standing. In South Africa, we have implemented a policy of fiscal transparency, so everyone can see what fiscal policy is doing and what we expect it to do. This has prompted a clear message from analysts, investors, the ratings agencies, international organisations and others that South Africa needs to maintain budget responsibility and get State-Owned Enterprise risks under control. This is a priority government has reiterated in successive Budget documents.

This macroeconomic tripod is not perfect. Unfortunately, there is no constitutional autopilot that can be written into law and will then produce national prosperity. That said, a sound macroeconomic framework can prevent a lot of pain. This is important, because the temptation to do the wrong thing is clearly strong. This is evident from all the economic mistakes countries have made in history, and continue to make today. But I also know it is true because I often hear people in South Africa contemplating these temptations. People ask, wouldn't it be worth taking big risks, having more inflation, borrowing as much as we can get away with, if only we could get some growth and some jobs? They even say, in a highly unequal country like South Africa, wouldn't it be politically safer to take macroeconomic risks to try and get poverty and unemployment lower? But this is wrong, for two reasons.

First, this only seems attractive until you've actually tried it. Macroeconomic stability is like oxygen. You don't miss it until you haven't got it, and then it's all you can think about. People who want to engineer a short term boom and ignore the long term costs won't like it when the long-term shows up, which history suggest normally starts after about two years. If you don't think inflation matters, go try some. Or ask all the Zimbabweans or Venezuelans who had to leave their countries when their economies collapsed. Unorthodox policies have totally orthodox consequences, as those people can confirm.

Second, countries with difficult social foundations need to be *more* careful about macroeconomic stability, not more reckless. That's because a macroeconomic crisis is an incredibly wrenching social experience, and you need a very strong society to get through one peacefully. When a country blows up its own macroeconomy, its policy options narrow, to the point where all the choices are bad ones. If you can get anyone to lend to you, it will be the IMF. One way or another, you will end up doing real and brutal austerity. What we have had in South Africa over the past few years isn't anything like this. We have interest rates close to all-time lows – the repo rate is at 6.5% currently – and government spending has been increasing every year, faster than inflation. Real austerity is having interest rates at 65%, as in Argentina at present, and cutting pensions and grants and firing government employees. We should avoid reckless economic policies unless we want to risk putting our society through that pain and stress.

This brings me to end of my speech. In conclusion, I would like to leave you with four principles for confronting populist economic policies, drawn from the ideas I have discussed today.

First, rich countries don't make rich people. If your development strategy is to return the wealth of the country to the people, you don't have a development strategy. Real, lasting wealth is about know-how, not natural resources.

Second, if you hear someone urging stimulus and going for growth, ask how they plan on dealing with the macroeconomic constraints. What's the plan for inflation? How are they going to meet the import bill to avoid a balance of payments crisis? If they don't have a serious answer, they aren't serious. If they do have a serious answer, expect it to include policies like inflation targeting, a floating exchange rate and measures for keeping the fiscus solvent. These things cannot be ignored. South Africa's stimulus and recovery package does take these into account.

Third, acute challenges of inequality, poverty and unemployment are not reasons to gamble on macroeconomic stability. South Africa's social challenges mean we need to be extra careful about managing the system carefully so it doesn't blow up – not that we need to run the system as hot as we can get it and hope for the best.

Finally, don't ignore populists completely. They are very good at tapping into social frustrations – in a way, they are uncannily good instruments for detecting where society is hurting most. They aren't very good at economics, so their ideas routinely end in disaster, but that doesn't mean they are altogether foolish. Rather, they are a reminder to better informed, more responsible people that things have to change. We cannot just say the populist path will end in disaster. It will. But we still have to point out another path.

You cannot just be against populism – you need to be for something too. We need to talk about how we are going to get back to real and sustainable growth in South Africa.

Thank you.