Political Elites and the Delay in Stabilization

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June 2001

Abstract

In order to add realism to the war of attrition model and explain high inflation experiences of countries such as Turkey, Argentina and Brazil, one needs to consider the crucial role played by political elites. In countries with weak institutions and social interest groups, it is rather difficult to prevent political elites from using government resources for their personal interests. Using the general strike channel repeatedly, powerful Argentinean and Brazilian labor unions were ultimately able to force political elites to bring budget deficits under control. In Turkey, however, unions lack the political and organizational power to force political elites towards finding a permanent solution to the high inflation problem.

JEL Classification: E60, F41.
Keywords: Political economy; Inflation; Stabilization; War of attrition; Turkey.

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1. Introduction

"Once the political incentives and constraints are correctly taken into account, policies that appear to be mistakes are perfectly rational responses to distorted and imperfect political incentives. The political economy approach attempts to explain why apparent mistakes repeatedly occur. This approach underscores that one cannot correct the "mistakes" without addressing the institutional features which make these so-called mistakes likely to occur." Alberto Alesina, "Comment" on Kaufman and Stallings (1991).

After two decades of developing country experience with high and chronic inflation, a consensus has emerged among economists about the major cause of chronic inflation. It is the excessive fiscal deficit, which in the final analysis is financed through money creation. While this consensus was in the works, towards the end of 1980's economists started to show more interest in the analysis of the political and institutional forces in the macroeconomic policy making process. The early research in this area focused on industrial countries and developed rational heterogeneous agent models to analyze the dynamics of macroeconomic policy making. Through time, however, the political economy of stabilization and reform in developing countries has started to receive some attention, and research in this area started to offer both positive and normative studies of policy reform.

Distributional conflict among social groups is one of the obvious political economy explanation of large fiscal deficits, as summarized by Michael Bruno: "A large fiscal deficit often reflects a country's inability to resolve social conflicts over income and wealth distribution" (see Bruno, 1993). Referring to experiences of Israel, Argentina and Brazil, Bruno (1993) emphasizes interest groups' desire to use the government as a lever in their quest to increase their share of the national income. Consequently, any effort to take the government budget under control has to confront formidable opposition. Even though, inflation stems mostly from the fiscal deficit, no interest group would like to see its income reduced to bring inflation under control. The fact that everyone prefers a situation where the others pay for the cost of stabilization leads the society to a non-cooperative equilibrium, with high and chronic inflation. Obviously, the non-cooperative equilibrium is Pareto inferior to the cooperative equilibrium, where the cost of stabilization is distributed among different segments of the society.

There have been several attempts to formally model the inflation stabilization and the role of distributional conflict. One of the important contributions in this area is Alesina and Drazen (1991), where they use a war of attrition model to explain the political dynamics that generated rather long periods of high and chronic inflation.[1] The war of attrition waged among social groups with conflicting interests explain why inflation stabilization is delayed for so long in many countries. In their model, as long as both groups hold out not to carry the burden of stabilization, there is no way for the government to put any stabilization package into practice. Similarly, in a model of war of attrition, Drazen and Grilli (1993) show how a major crisis may increase the chances for a successful stabilization. By increasing the cost of chronic inflation for one or more groups, the emergence of a major crisis makes it rational for these groups to concede and assume the cost of stabilization.

Alesina and Drazen (1991) and Drazen and Grilli (1993) models fit rather well to several chronic and hyperinflation episodes in Europe after the first World War and in Latin America more recently. Turkish experience with inflation since 1970's, however, points to the need for an alternative formulation of the political economy framework. In Turkey, economic policy-making has been under the control of the center-right parties or technocrats since the coup d'état in 1980. Policy makers have successfully undertaken steps to insure external adjustment. Both trade and foreign investment regimes have been liberalized, reducing the risk of emergence of balance of payments crisis of the late 1970's again. However, liberal economic philosophy of the center-right parties has not helped much when serious policy steps had to be undertaken to control fiscal deficits. None of the parties in power was "successful" in reducing government expenditures on a permanent basis. Nor were they able to increase tax revenues, especially direct taxation.

[1] Another important contribution to the theoretical literature is Fernandez and Rodrik (1993), where the uncertainty about the gains and losses individuals may incur in the post-stabilization period can prevent the adoption of reforms, even the ones which may be pareto-superior to status quo. For other theoretical contributions on political economy of reform, see Sturzenegger and Tommasi (1998).

In this paper, we argue that Turkish political elites were not "successful" in controlling budget deficits, because the social and economic dynamics in Turkey had not forced them to do so. The quotation from Alberto Alesina summarizes this paper's approach. As Alesina makes it clear, pointing at past policy mistakes as the main culprit behind failed stabilization attempts does not take us too far. Instead, we should try to understand the major shortcomings of the social and institutional framework that blocks successful stabilization attempts. A study of the history of stabilization efforts in Argentina, Brazil and Israel shows that the role of political institutions and social norms in delaying successful stabilization cannot be ignored. That is why it is crucial to study the repeated "failures" of Turkish stabilization efforts along with "successful" but yet delayed stabilization plans in Argentina and Brazil.

Our analysis is an extension of Alesina and Drazen's (1991) war of attrition model. Alesina-Drazen model implicitly assigns a passive role to political elites. The decision to implement a stabilization plan rests with social interest groups only. Political elites are supposed to implement the policies the society chooses. This implicit assumption does not reflect the reality in many countries. We modify the war of attrition model to incorporate political elites as the key player in the process of delayed stabilization. Political elites can increase their power and economic wealth by making use of privileged access to and discretion over government resources.

Irrespective of differences in political views, political elites have common interests and has the potential to transform themselves into an interest group and act as one. Politicians (or as Barry Ames calls them "political executives") care enormously about retaining their posts and, hence, are willing to use government resources to attain their objectives. "In the turbulent politics of developing nations, leaders can never take tenure for granted. Political survival must be actively pursued, manipulating public policy to construct supporting coalitions. Public expenditures are central to survival coalitions. … Claims on the budget

[2] See the Proceedings of a Conference on "The Macroeconomics of Populism in Latin America" edited by Dornbusch and Edwards, 1991.

come from job-seekers, economic groups, social classes, and regional interests." (Ames, 1987) They would not prefer to see the resources under their command be reduced, because this would have undesired consequences for their personal well-being.

In many developing countries the social, institutional and legal environment lacks the control mechanisms that will prevent political elites from transforming themselves into an interest group. Our extension of the war of attrition model implies that it is not possible to cut deficits and bring inflation down, unless political elites' privileged use of government resources for their self-interest is curtailed. In Argentina, and to some extent in Brazil, well-organized labor unions performed this function and stabilization had become a reality in the first half of 1990's. During the high inflation period Argentinean labor unions organized 13 general strikes against the government's heterodox stabilization programs, which aimed to control inflation without any fiscal adjustment.

Based on our comparative analysis, we conclude that Turkish inflation cannot be brought down to single digits on a permanent basis, unless radical institutional and legal reforms that will ensure society's control over political elites are put into effect. Since Turkey, unlike Israel, Argentina and Brazil, lacks well-organized labor unions and other civic organizations, the high inflation has persisted for more than two decades. Thanks to politically weak labor unions, real wages and salaries are flexible. This flexibility gives the government the power to temporarily cut its expenditures when needed. As a result, the successive Turkish governments have been able to control inflation at 2-digit levels. Turkey has never seen 3-digit inflation rates two years in a row. Once the inflation is kept at politically admissible 2-digit levels, political elites can go on with their business as usual.

In the next section, we summarize the war of attrition model and present various dimensions that must be added to the model to analyze the experiences of Turkey, Argentina and Brazil. In section three, we discuss inflationary experiences of these countries as well as that of Israel. In section four, we use the extended war of attrition model to explain why, unlike other countries, Turkey could not bring inflation down permanently in more than two decades. Section five provides econometric evidence that in Argentina, Brazil and Israel wage increases and general strikes did have significant impact on the inflationary dynamics. Section six concludes the paper.

2. Inflation and Stabilization: The War of Attrition Model

The war of attrition model of Alesina and Drazen (1991) provides an analytic framework that can explain the delay in implementing major policy changes associated with distributional conflict. Alesina and Drazen assume that in every society there are self-interested social groups. The government's only role is to implement the policies agreed upon by these social interest groups. Since each group is composed of individuals with similar objectives, it is sufficient to assume a representative agent making the decisions on behalf of the group.

There is an exogenous shock to the economy at some point in time, which leads to a decline in government tax revenue. Before the exogenous shock taxes were non-distortionary, but from then on government runs a budget deficit, which is financed through issuing external debt. With the rise of the budget deficit, taxes become distortionary, generating disutility through inflation.[3] Because they suffer from distortionary taxation, both groups prefer stabilization. However, stabilization is possible, only if one or both groups decide to pay higher non-distortionary taxes to cut the budget deficit. Obviously, each group expects the other side to "volunteer" first and, hence, none of the two groups volunteer out of goodwill.

The dynamics of the war of attrition is determined by rational calculations of social interest groups. At each instant, the groups decide whether to concede to carry the higher tax burden indefinitely or not. Being rational agents, each group looks at the costs and benefits of waiting one more period before conceding. A group concedes to carry the higher tax burden when the cost of waiting one more period is equal to the expected gains from waiting, assuming that there is a positive chance that the rival group may concede in that period. Once one of the groups concedes, increased tax revenues enables the government to balance the budget and there would be no need to borrow any more.

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[3] This is where the Drazen-Grilli and Alesina-Drazen versions of the model differ. While Alesina-Drazen model takes the additional taxes to cover the budget deficit as distortionary without explicitly incorporating why it is so, Drazen-Grilli model assumes monetization of the deficit. Alhough

The cost of waiting one more period with inflation is known for sure. It is the utility cost of inflation, which stems from increased price uncertainty. In a society of heterogeneous interest groups, the gains from waiting one more period are uncertain. This is so, because when a group decides to postpone concession one more period, one of the two possibilities will take place. If the other group decides to concede and pay the cost of stabilization right away, the group that postponed the concession would gain. Inflation is brought under control with no burden on that group. If the other group does not concede in that period however, then there would be no gains from postponing concession one more period. Since none of the groups can know with certainty when the other group will quit, the gains from waiting one more period would be uncertain. The expected gains can be found as the gains that will accrue if the other side concedes in that period times the probability that the other side will concede given that they had not done so before.

As long as the cost of living with high inflation is lower than the expected benefit of postponing the concession one more period, no one will concede. Instead of cooperating and sharing the burden of stabilization, interest groups behave non-cooperatively and inflation stabilization will be delayed. When the cost of living under high inflation for one of the groups becomes higher than the expected gains from stabilization, then that group will concede to pay for the cost of stabilization. Budget deficit will be cut and inflation will be brought under control.

Social interest groups differ from each other in terms of the intensity of the utility cost of inflation. This assumption fits reality. The utility cost of inflation for fixed-income earners is higher than business or wealthy groups who can protect their real income and/or wealth from the effects of inflation. Consequently, it is quite likely for fixed-income earners to concede earlier than higher income groups and carry the burden of stabilization. The model generates another important result. In a country with an extensive indexation system, stabilization will be delayed for a long time. As the indexation reduces the utility cost of

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explicit modeling of inflation tax makes the model more realistic, this is gained at the expense of the analytical tractability of the model.

inflation on all groups in the society, it will reduce the cost of waiting one more instant. Optimal time of concession of each group would be pushed further into the future.

When we apply the war of attrition model to Turkish experience, we observe that stabilization would likely to take place once fixed-income earners, who are not able to shield themselves from the cost of inflation, concede to carry the burden of stabilization. This prediction of the war of attrition model was actually confirmed during the 1994 crisis. Real manufacturing wages declined by 35% in a matter of one year. What is more important from our perspective is the outcome of this game. In the war of attrition model, it is implicitly expected that once one of the interest groups concedes to carry the extra burden, stabilization will take place automatically. However, this was not the case in Turkey since 1994. Although, the workers and employees did not block the government's stabilization plan that envisaged a large drop in their real incomes, it is not possible to talk about a successful stabilization attempt since 1994. The downward flexibility of nominal wages enabled the government(s) to reduce CPI inflation from 140% in 1994 to approximately 71% by the end of 1998. Yet, all the economic hardship suffered by fixed-income earners was not sufficient to bring inflation further down. Five years after the 1994 crisis, today the real manufacturing wage index is 30% lower than its pre-crisis level.

As it is, Alesina and Drazen's war of attrition model does not really address political and economic dynamics behind the Turkish inflation. However, this does not mean that their approach is completely inadequate to explain the inflationary process in Turkey. The only shortcoming of the Alesina and Drazen model lies in the treatment of social and political actors involved in the game, in particular, the role assigned to political elites. In this model, political elites have no decision-making role. The decision to implement a stabilization plan rests with interest groups. Political elites are implicitly assigned to implement the stabilization plan that is agreed upon by social interest groups. However, it is difficult to reconcile the passive role assigned to political elites with the political culture of many developing countries, including Turkey.

In democratic societies, it is not possible to ignore the potential of the political elites to transform itself into an interest group. This potential can be realized if the existing institutional and social norms leave sufficient room for them to maneuver. In countries with well-developed social and institutional control mechanisms, such as civic social organizations, independent and functional judicial system, internal party democracy, the society can exert control over the political elites. Under such a political system, politicians have to safeguard the interests of the social groups they represent and/or pursue policies that are supported by the majority of the public. When they fail to do so, it will be difficult for them to hold on to power in government, in parliament or in their parties. Social and institutional checks and balances in Western democracies do perform these functions. However, in a country where the only well-functioning control mechanism is the general elections, it is difficult to prevent political elites from becoming a special interest group.

Political elites play a crucial role in generating chronic budget deficits and in delayed stabilization. Because of their proximity to government's economic and political power, political elites differ from other interest groups in the society. In countries with weak control mechanisms, there is nothing preventing political elites from using their privileged position for their self-interest. On the other hand, expenditure cuts required for bringing inflation down would necessarily hurt political elites as well as other interest groups. That is why political elites do not prefer stabilization.

Political elites do not have to form an ideologically homogenous group. Whatever their ideology is, and whoever they claim to represent, the ability to use government funds for their self-interest is a common characteristic of the political elites. Depending on their ideological and political standing, political elites belong to different political parties. In every political party, there is a leader and a hierarchy of members. The main objective is to become the ruling party, produce solutions to major issues and problems of the country, and get re-elected. If the party in government cannot succeed in producing solutions, it will lose the office in the next elections. With the internal party democracy in effect, the leading cadres will take responsibility of the failure and be replaced by other members of the party.

If the institutional and social control mechanisms operate effectively, political elites cannot easily use government funds for their self-interest in one way or the other. In societies with weak institutions that can exert control over political elites, political parties cannot perform their primary functions and become hostage to political elites' interests. Weak social and institutional control over political elites can easily lead to oligarchic leadership.[4] When in power, the leader of the party has to serve to the interests of those political elites who financially supported his party in the elections and when they are in opposition. As long as the leader delivers to his fellow political elites during his/her administration, they will not attempt to replace her or him. An election loss or a move to opposition is viewed as a temporary failure. Preferences and constraints of the political elites in the ruling party are no different from that of the opposing party. As they are all interested in their personal rather than the social well-being, the ruling party or parties will not work hard to solve major problems of the country. Consequently, in the next elections or when the coalition government collapses, the ruling and opposition parties will switch places. Given the rules of the game, the ideological differences among political parties become a matter of label rather than substance. Therefore, from a theoretical perspective it would not be wrong to treat political cadres of all parties as a single interest group, the political elites.

Being dependent on government resources, political elites do not have an incentive to take inflation under control. Inflation control cannot be achieved without reducing government spending, increasing tax revenues and privatizing state owned enterprises. These measures will definitely hurt some social interest groups, such as businesses that pay very little or no taxes, government employees, and farmers who are dependent on government subsidies. Political elites are also expected to suffer from budget cuts. Since tax revenues cannot be raised in a short time period, most of the deficit reduction has to target expenditure cuts and this will hurt political elites the most. With the consolidation of the budget, it will become more difficult for political elites to use government resources at discretion for their self-

[4] Turan (1995) analyzes the evolution and consequences of oligarchic leadership in Turkish political parties. He argues that oligarchic leadership "seems to be an ever-present quality of Turkish

interest. Once these privileges are lost or restricted, the leaders will not be able to protect their seats at the helm of their respective parties. The cadres behind leadership will start to dissolve.

Having understood the political consequences of stabilization measures, political elites have strong incentives not to implement them unless they are forced by other interest groups in the society. We discuss the role of strong labor unions in Argentina and Brazil in a delayed but eventual implementation of stabilization measures in the next section.

3. High Inflation Experiences of Turkey, Argentina, Brazil and Israel

a. Turkey

Between 1977 and September 1980 Turkey had lived through the worst political crisis in its history. The country had almost reached to the point of civil war and political disintegration. Towards the end of 1970's, Turkey was one of those countries that were unable to institute macroeconomic and structural adjustment policies in response to oil price shocks. Despite rapid deterioration in the terms of trade, successive governments had chosen to finance the rapidly increasing current account deficits through foreign borrowing. However, soon after the disagreement with the IMF on economic policies, in 1978 Turkey had become the first country to suffer from the foreign debt crisis. Because of the rising internal and external imbalances, inflation reached to 64 % in 1979.

The first serious attempt to take inflation under control was announced on January 24, 1980. The stabilization package, which contained a 70% devaluation of the Turkish Lira, cut in government expenditures and substantial increase in the government controlled prices, including that of gasoline. The result was a jump in inflation to above 100% as well as a 1.1 % decline in GDP in 1980. However, the political chaos through which the country was suffering in the late 1970's led to a coup d'état in September 1980. After coup d'état, the military government kept the economic policy team in place, providing them with more power to pursue the implementation of the program uninterrupted. These measures formed the cornerstone of the military government's macroeconomic policy.

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party life".

Among the social groups, January 24 measures hurt fixed-income earners the most. In the period from 1974 to 1978, real wages had increased 25 percent. However, the rapid increase in inflation in 1979 wiped out around 20% of the real wages. On top of this, the austerity measures of the January 24 package generated another 30% decline in real wages (see Figure 1). Because the military government banned activities of all political parties and labor unions, there was nothing these social groups can do under the military government to reverse the loss of purchasing power.

Insert Figures 1 and 2 about here

The military regime lasted until the 1983 general elections. However, the restrictions on political and social activities continued until October 1987. With the September 1980 coup d'état the political chaos brought under the heavy handed control of the military and liberal economic policies were given a free hand. A lot had been achieved until 1986. The import-substitution policies of the past were completely scrapped and the government adopted an export-oriented trade regime. Enormous sums of money were spent on infrastructure investments, which had been completely neglected throughout the 1970's. Yet, one thing that was conspicuously lacking was the control over fiscal deficit. Actually, there were some positive signs in the first few years of the decade. Thanks to the pressure on real wages and cuts in politically motivated government expenditures, public sector borrowing requirement was reduced from 10% of GNP in 1980 to 5.4% in 1981. The inflation was brought down, from 107% in 1980, to 37% in 1981 and 25% in 1982. However, the 25% inflation rate has since proven to be the lower limit of Turkish inflation (see Figure 2)

Despite favorable domestic and international circumstances, neither the military government of 1980-83 nor the Ozal government of 1983-87 was able to cut the budget deficit on a permanent basis. Then-prime minister Turgut Ozal, who was known as a reformist politician, did not really push hard for stabilization, either. In the limited democracy period of 1983-87, Ozal was more interested in expanding the political base of his recently founded Motherland party. He wanted to prepare his party for the political competition among the center-right parties once the full-democracy period started. In order to pull members of the banned center-right parties to his own party, Ozal used government resources extensively. He used extra-budgetary funds to move part of the government expenditures outside the parliament's control.

Once the anti-democratic rules of the post-coup period expired and democratic competition started in 1987. Almost all of the pre-coup political leaders went back to political arena. An intense political competition started especially among the center-right parties. Turgut Ozal, who had been critical of populist policies until then, decided to use his incumbency advantage and called for early general elections before opposition could gather force. Thanks to new election law, with 36% of the popular vote Ozal's Motherland Party captured more than 60% of the seats in the parliament.

Although his party was able to hold on to its majority in the parliament, the opposition's strong showing in the elections was an unexpected result for Ozal. A new era had started. All the past promises and efforts to keep inflation under control were forgotten. Public sector borrowing requirement (PSBR) doubled in 1987 and reached to 8.3% of GNP. With increased intensity of political competition, Motherland Party decided to make use of government resources to garner support from workers and government employees. In a matter of five years from 1987 to 1992, the country had early general elections in 1987, municipal and local elections in 1989 and early general elections in 1991. During this period, real wages in the manufacturing sector increased by 120%. The increase in real public sector wages and salaries during this period was even higher, around 200%.

Another reason behind the rapid increase in real wages in the 1988-92 period was the intensified labor union activism. Strike activities, which were banned in 1980, restarted in 1987 and continued to increase until 1992.[5] Although there was an increase in the number of work days lost in strikes in the post-1987 period compared to pre-1980 period, with the restrictions imposed by Constitution and the new labor laws, labor union activism could never recovered from the impact of the military coup. Unions' strike activities have been mostly confined to sector level and they are facing an uphill battle in mobilizing masses in favor of their cause.

The dose of political populism and corresponding budget deficits continued to increase until 1994, when a policy mistake triggered the worst economic and financial crisis in the history of Turkish republic. The crisis hit the Turkish economy in January 1994. However, the government postponed any major stabilization effort until after the local elections. Only a week after the elections, on April 5th, a medium-term stabilization package was announced. As part of the stabilization package, the government officially devalued Turkish lira against US dollar by 28 percent (from 23,000 to 32,000) and announced an average of 30 percent hike in public sector prices. The package also included cuts in the government's current and capital expenditures as well as a one- time tax surcharge on private enterprises.

Once announced, the long awaited stabilization package received a calm reaction from all segments of the society. All social groups were more or less ready to make some sacrifice to put an end to the long-running chronic inflation episode. The IMF and the World Bank welcomed the stabilization package. They urged the government to take advantage of this window of opportunity and turn the stabilization program into a major economic reform. IMF and the World Bank actually urged the government to keep the package in place for more than a year to cut the budget deficit permanently. In May 1994, the government signed a stand-by agreement with the IMF, in exchange for a loan of $720 million. This agreement was crucial for the government to gain some time, because it also insured that Turkey had access to international private capital flows. The domestic financial markets stabilized at once, with a considerable reduction in interest rates.

Yet, no more than four months into the program the first signs of a floundering government became apparent. Once the Ciller government was sure that it was able to control

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[5] There were only 307 and 171 strikes in 1987 and 1989, with 30,000 and 39,000 workers participating. The number of strikes in 1990 and participation increased to 458 and 165,000, respectively.

the runaway inflation, it relaxed the tight grip over the budget deficit and postponed or cancelled any further cuts in government spending.

The government's so-called "success" in controlling inflation, that is, reducing it to double digits in one year, without any real fiscal adjustment was mostly due to the passive reaction from the labor unions. In a matter of a year, real wages declined by more than 35 %. Yet, there was no general strike organized by unions to protect workers' real incomes against 140% inflation. Participation in demonstrations was rather low and not effective.[6] The silence of the labor unions has lasted until this day. Despite some gains, average 2000 real wage was still 20 % lower than the average real wage rate in 1993. It is difficult to imagine a stabilization program in Argentina or Brazil generating more than 35 % decline in real wages in a matter of a year and labor unions do not call for a series of general strikes to pressure the government to increase wages.

The decline in labor unions' influence in the political and social arena was evident in the lack of any serious union reaction to economic measures implemented after the 1994 economic crisis. The unions' passive standing helped Ciller government prevent inflation getting out of control. However, once the political elites in power realized that inflation could be kept around 100% a year, they did not pursue even tougher measures to bring inflation down permanently. Ciller government abandoned the medium-term stabilization plan in the last quarter of 1994. The economic crisis of 1994 and the efforts to bring the inflation down weakened Ciller's coalition government and another early general election was called for December 1995.

Since then, there has been a lot of talk about stabilization, and other stand-by agreements with the IMF were signed, but with the exception of the last these attempts were not significant move in that direction.

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[6] According to the yearbook of Oil Workers Union (Petrol-Is), participation in the largest two protests in 1994 were 50 and 100 thousand, respectively.

b. Argentina and Brazil

Argentina and Brazil used to top the world inflation rankings throughout the 1980's and the early 1990's. Soon after the outbreak of the foreign debt crisis in 1982, they could not manage to control ever-rising inflation. By the late 1980's, they suffered through a hyperinflationary episode. After living with three digit inflation rates more than a decade, both countries managed to reduce the inflation rate to single digits in the nineties (Argentine in 1991, and Brazil in 1994).

Argentine and Brazil's experiences with inflation are rather crucial to develop a solid understanding of the political economy dynamics behind high and chronic inflation. The two countries' inflationary experiences have many common features (see Figures 3 and 4), behind of which lies the similarity in political and institutional frameworks. After being under the military rule for more than two decades, both countries accomplished the transition to democracy in the early 1980's. However, the rapid acceleration of inflation just after the foreign debt crisis of 1982 put the recently re-established democratic regime into a test.

Insert Figure 3 and Figure 4 about here

The social and political conditions at the time were not conducive to take the inflation under control. Political parties that were expected to form the backbone of any democratic regime had lost their institutional autonomy during the military regime. Trapped in this institutional vacuum political elites were assimilated from the society, and had become an interest group that was keen to exploit its proximity to state resources and military power to pursue their self-interest. Under these circumstances, it was almost impossible to realize the social consensus needed to successfully bring the inflation down.

The lack of social consensus reflected in the failed stabilization attempts. In neither of the two countries was it possible to implement fiscal austerity measures. Rather than instituting medium and long- tem structural adjustment and take the fiscal deficit under control, newly elected presidents and their administrations opted for the easy route. They adapted the heterodox measures of 1960's military regimes and froze the prices and wages. Rather than being a policy of social contract between the government and major social groups, the heterodox measures were government dictates.

First serious attempts at stabilization, the Austral Plan of June 1985 in Argentine and the Cruzado Plan of February 1986 in Brazil, received strong popular support. The majority of the population thought that, unlike the past military governments, democratic governments would be successful in their first major stabilization attempts. A period of hopeful waiting started. The heterodox price and wage freezes were instrumental in cutting monthly inflation from 31% to 3% in Argentine and from 22 to –0.5% in Brazil in a matter of two months. The heterodox "incomes policies" were effective in keeping the inflation under control for the longest period of time in the two countries' history (11 months in Argentina and 9 months in Brazil).

The stabilization was achieved mostly thanks to heterodox measures. Although the package included fiscal measures, these measures could not be put into practice. Following the heterodox measures, Argentinean real wages declined by 20 % in 1985. The decline in Brazilian real wages after the Cruzado plan was around 10 percent. Within two months after the implementation of the policy measures, labor unions made an unsuccessful attempt to organize strikes and general strikes to protest and block the measures.[7]

Despite the failure of unions' early attempts, the governments' inability to institute fiscal austerity measures and cut fiscal deficits for good helped turn the tide against the government. Without a fiscal contraction, the aggregate demand continued to expand, putting upward pressure on prices. Being aware of the continued increase in their cost of living, workers and fixed-income earners lost their faith in government policies. In this atmosphere, renewed calls for general strike received strong backing from the public. In the face of general strikes, the governments could not persist in the implementation of anti-inflation programs. Soon after the removal of price and wage freezes, the anti-inflation program collapsed completely and inflationary spiral started.

[7] Detailed chronologies of major economic and political developments in Argentina, Brazil and Israel during the high inflation period are provided in the Tables A1 through A3 in the Appendix.

The failure of the first stabilization efforts led to a rapid decline in the popularity of democratically elected governments and made the public more and more weary about future attempts to fight inflation. Consequently, the inflationary process got out of control and both countries lived through a very costly period of hyperinflation.

Powered with a strong organizational structure to organize strikes and general strikes against government policies, labor unions played a crucial role in the process that led to hyperinflation. Fixed-income earners stood firm against government policies that demanded more sacrifices from them and demonstrated their determination not to carry the burden of inflation stabilization. In Argentina, in the period from the announcement of the Austral plan in June 1985 until the general elections in May 1989 unions had organized 13 general strikes against the Alfonsin government. While the participation in the first general strike attempt after the Austral plan in August 1985 was rather low, five months later with the second general strike, which had a participation rate of 90-95%, unions succeeded in stopping the daily economic activities for one full day (see Table A1). Following the second general strike, the government accepted the unions' demands for wage increases.

During the six years that ran between the Austral plan of June 1985 and the successful Convertibility Plan of 1991, successive Argentinean governments made 6 attempts to implement stabilization measures. Each of these measures was less successful than the one before. Alfonsin governments were not or have not tried hard to implement fiscal austerity measures. Observing the government's inability or unwillingness to institute fiscal deficit cuts, the unions showed their political power through general strikes and each time were able to make the government accept their requests.

The repeated episodes of half-hearted stabilization measures followed by general strikes led to a period of hyperinflation in Argentina after 1989. Even with the indexation system, it was impossible to keep real incomes intact in an environment where prices increase more than 50% a month. Consequently, all segments of the society were affected from hyperinflation. As the Olivera-Tanzi effect eroded real tax revenues of the various levels of the government, the political elites, who were completely dependent on government spending, were also affected. This state of chaos could not be tolerated. Therefore, political elites in the center and periphery were forced to make some serious concessions. However, the real stabilization attempt to bring down the inflation had to wait until 1991, almost two years after the Peronist candidate Carlos Menem was elected as the new president.

Despite the long delay, Argentinean government succeeded in lowering the inflation rate down to single digits. The inflation stabilization was finally possible, thanks to a package that contained not only the fiscal and monetary austerity measures, but medium term structural measures as well. Known as a populist and elected with a populist agenda, Carlos Menem was subject to a rapid transformation soon after he was inaugurated. A politician who used to condemn the IMF for all ills of the Argentinean economy, Menem signed an agreement with the IMF in less than 90 days after he was inaugurated. The first stabilization attempt of his administration included fiscal adjustment and it was successful in lowering monthly inflation to single digits. Good times did not last very long and the economy headed for hyperinflation one more time.[8]

Despite the opposition of his party and unions, Menem took series steps in privatizing the government owned firms. Most of the privatizations were undertaken in 1990, providing a breathing space for the government. Then, in March 1991, finance minister Domingo Cavallo introduced the "Convertibility Plan" which was to consolidate stabilization attempts of the past year and a half. The plan was revolutionary in many aspects. It incorporated the move to a Currency Board system. By transforming the Central Bank into a currency board, the government hoped to take the monetary policy outside the government control. Annual inflation rate was brought down to less than 25 percent in a years time, and to single digits by the second half of 1993. Despite serious pressure on its hard currency peg, Argentina continues to run single digit inflation.

The populist governor Menem and the reformer President Menem were one and the same person. However, as soon as he took the presidential responsibility, the incentives and

[8] As Fernandez (1991) argues this round of hyperinflation was not a result of unsustainable fiscal deficit, but more a result of unsustainable government debt burden and the public's decision to switch to

constraints he faced changed completely. Unless he wanted to share his predecessor Alfonsin's fate, who under great public pressure had to leave office a few months before his term had expired, he had to spent all his political capital in the fight against inflation.

There was a similar process in Brazil. After the death of the popular President Tancredo Neves who was elected by the Congress, vice president Jose Sarney took office. Sarney's term was full of unsuccessful attempts against inflation. It took approximately one year from his inauguration for his government to put together a serious stabilization package. With the announcement of the Cruzado plan in February 1986, the national currency Cruzeiro was replaced with a new currency called Cruzado. The plan included government's intentions to eliminate the indexation system that had been in place until then. Following an initial realignment, wages, prices, interest rates, taxes and rents were all frozen. It was declared that wage readjustment would be allowed only after the cumulative inflation rate reached to 20% level. Thanks to the price and wage freeze, monthly inflation was –0.5% in April, down from 22% in February. For the first time in years the country lived with an uninterrupted 9 months of low inflation (see Figure 4). However, the fiscal and monetary measures crucial for the success of the package was not in place (Kiguel and Liviatan, 1991). This was mainly due to President Sarney's desire to hold back unpopular austerity measures until the elections in November. Indeed, there was a monetary expansion to cover the deficit and buy back domestic debt. These policies led to a 23 percent increase in the aggregate demand in 1986.

Sarney and his governing coalition got what they wanted in the elections: the governing coalition picked up most of the state governor races and a large number of seats in the Congress. As soon as the elections were over, government tried to cut the deficit by imposing extra consumption taxes on luxury items, gasoline and alcohol. However, these measures were too late and too drastic. In response to the increase in gasoline prices, all segments of the society pressured the government to get rid off the price and wage freezes. Labor unions led the opposition against government policies. They organized general strikes

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US dollars. Hyperinflation process could only be controlled by a compulsive conversion of short-term domestic debt to long-term domestic debt, reducing the interest burden on government budget.

on November 27 and 29, and December 12. The strike wave initiated by electricity workers spread throughout the country towards the end of January. Unions demanded that average wages increased from $ 60 to $ 132 a month. Unsuccessfully sought to convince labor unions to soften their wage demands, the government had to abandon one-year old Cruzado plan. Soon after this failure, the ministers of finance and planning and the central bank governor resigned in February 1987 (see Table A2). Monthly inflation, which was brought down to 2-3% a month, increased rapidly to 12 % in February and to more than 25 % by May 1987 (see Figure 4).

In June, a new stabilization package known after the then-new finance minister Bresser Perreira was introduced. Cruzado was devalued by 11 %. Wage and price freezes were introduced again. Expecting a heavy opposition from the unions, the government added a provision that allowed periodic adjustments in wages and prices in every three months. However, the most crucial component of the package originally proposed by the finance minister, fiscal austerity measures, did not receive political support from the government and the Congress. Without crucial fiscal austerity component, the fate of the Bresser plan was no different from the previous one. Inflation was brought down to less than 10 % in July and August. However, this initial success could not repeated in the ensuing months and inflation rose rapidly to surpass 20 % a month by the end of 1987 (See Figure 4).

With the proven failure of Cruzado and Bresser plans, a new plan was introduced in April 1988. Blaming the shock therapy nature of the previous packages for their failure, the government tried a new strategy against inflation. The new plan was called the Gradualist Plan. Its objective was to arrest inflation gradually. Rather than freezing wages and prices, the new plan focused on limiting the wage and price increases. Unlike the previous packages, the Gradualist plan also included tight monetary policy. However, the fiscal austerity component was still missing. The Gradualist Plan was proven a failure as well. Because the Gradualist Plan did not carry any wage and price freezes, it was not even able to lower inflation in the first few months (See figure 4). After staying close to 20 % a month for a few months, inflation continued to rise and reached to 40% a month by the end of 1988.

A similar fate awaited the Summer Plan, the last stabilization package implemented before the presidential elections in 1989. Carrying heterodox features such as price and wage freezes, the Summer Plan lowered the monthly inflation rate from 40% in January 1989 to 6-7 % in the next two months. However, the absence of any fiscal correction is reflected in a rapid increase in monthly inflation back to 40 % in mid-1989 and to 80% by the end of 1989.

Lacking a political support base inside and outside the parliament, Sarney never dared to take on political elites by adopting fiscal austerity measures. The result was a complete failure in economic policy during his presidency. This failure is reflected in an increased public dissatisfaction with political parties and the National Congress. Lacking an institutional past and reputation, public viewed these institutions as serving the interests of political elites and their clientele. One of the presidential candidates, Fernando Collor de Melo was aware of the public disgust with the political system. He built his entire election campaign on a platform against corrupt political elites and parties. Throughout the presidential campaign, he displayed a public image of a young, energetic and modern politician, who was aware of the seriousness of difficulties facing his country. He relayed his messages not only through his campaign speeches or interviews, but through op-ed letters in newspapers as well. He was elected in the popular presidential vote. At the time of his inauguration on March 15, 1990, the majority believed that they had finally found the long-awaited statesman in Collor de Mello.

Endowed with popular support, Collor de Melo could act independently from the Congress. He believed that it was not possible to take the budget deficit under control, unless the political elites' influence over the budget making process was reduced. With this determination, he never shied away from taking on the Congress in his guest to take the reigns in the budget making process. However, despite the public support for his policies President Collor de Melo could not succeed in bringing inflation down.

Collor administration unsuccessfully tried to change the Constitution to bring the fiscal policy completely under the President's control. The government committed a big mistake by confiscating 80% of the saving deposits in commercial banks. One mistake followed the other. A widespread administrative reform program was initiated with a goal to cut government expenditures. Without making any performance review, 120,000 administrative employees were fired haphazardly. Collor's choice for the economic policy making team were dictated rather by loyalty rather than competence.

In the meantime, the Collor Plan, which was initiated immediately after his inauguration, helped bring inflation down from 80 % to 10 % a month. However, the success did not last too long, and inflation started to move up to 20%. The measures adopted in 1991 by the then-new finance minister Moreira did not help to bring the inflation down either. After several policy mistakes and unsuccessful anti-inflationary plans in its first two years, there were signs that Collor administration had learned from its experience to formulate new anti-inflationary measures. However, these expectations could not bear fruit. The corruption scandal in which Collor was directly involved became public in 1992. Collor resigned from presidency in September 1992 soon after the impeachment hearings in the National Congress had started. With Collor's resignation, the economic crisis was deepened. Although inflation was stabilized around 30% monthly rate, the Brazilian economy shrank between 1991 and 1993.

After Collor's resignation, his Vice President Itamar Franco was inaugurated as the President. Franco was not a reform-minded politician. In his first few months in office, Franco replaced three finance ministers. His last finance minister Fernando Henrique Cardoso, who was appointed in May 1993, had proven to be the right person for the job. After protracted period of bargaining with the political elites, Cardoso succeeded in passing several important policy measures through the Congress. Since the re-establishment of the democratic regime, National Congress and the political elites had become rather unpopular and Collor's campaigns against political elites were rather damaging. In such a state of mind, the parliament accepted the policy measures proposed by the finance minister Cardoso with some changes. The policy measures restricted the age-old indexation of wages and salaries to inflation. With this agreement, federal government increased its control over the federal budget as well as regional state governments and regional banks.

Radical reforms followed in 1994. A new set of measures called as Real Plan was introduced in July 1994. After introducing four new currency units one after the other in a matter of 8 years, Brazil introduced a new currency called Real. Unlike the previous currencies, the external value of Real was fixed at one US dollar. In order to lower inflationary expectations, the government eliminated the indexation mechanism. Tight monetary policies followed immediately. The government established its firm control over the budget making process. The government was able to balance its budget in an election year in 1994. As a result of the Real Plan, which included all necessary components of a successful stabilization program, inflation went down from 50% a month in June first to 7% in July and down to 1% in September.

Cardoso resigned from his position as finance minister and entered the race for the president's office. As late as June 1994, he was trailing far behind the populist candidate of the Workers' Party. However, his successful campaign against inflation had not gone unnoticed. In October 1994, he was elected as President, receiving 54% of the popular vote in the ballot. In a matter of 3 months, he was able to gather public support behind himself, thanks to his ability to achieve delayed stabilization in his country. Cardoso succeeded in his campaign against inflation, partly because he chose not to confront political elites directly. Instead, he bargained with them and convinced them to support his stabilization plan rather than block it. After being elected as the President, Cardoso introduced structural reforms, including privatization. Brazilian government privatized 55 companies since 1991 and raised $15 billion in revenues.

The Brazilian government, which instituted price and wage freezes at 59 different times and implemented 27 different stabilization measures, had finally succeeded in bringing inflation down by a stabilization package, including fixed exchange rate, and monetary and fiscal austerity measures. It was proven to be more difficult than had initially been thought to pass the structural reforms through the National Congress. The second stage of the privatization started in 1997. In the meantime, the recent worldwide emerging market financial crises created enormous pressure on Brazil's and other Latin American countries' fixed exchange rate regimes. In late August and in September of 1998 Brazil witnessed short-term financial capital outflows reach to billions of US dollars a day. In October 1998, Cardoso got re-elected as the President. After the elections, Cardoso and his government prepared a major tax reform bill and received IMF's support for its plan. However, all these attempts could not spare Brazil from floating its currency, which it was forced to do in February 1999.

c. Israel

Israel's experience with high inflation stands in stark contrast to experiences of Turkey, Argentina, and Brazil. Unlike these countries, the delay Israel's successful stabilization program was not too long. Having a parliamentarian democratic system like Turkey, what differentiated Israel from Argentina, Brazil and Turkey has been the existence of political institutions, and social and political control mechanisms that could prevent the emergence of political elites as an interest group independent from the rest of the society. That is why it was much easier to bring the government budget under control. Furthermore, incomes policy measures were successful in bringing inflationary expectations down rapidly, because unlike Latin American incomes policies they were not unilaterally imposed wage and price freezes, but rather followed only after a broad social consensus was reached.

There were two major factors behind the rapidly increasing inflation in Israel. These are the first and second oil price shocks, and the 1980-82 Lebanon war that created a large hole in the government budget. The first oil price shock of 1974 pushed the annual inflation rate from 10-20 % range to 50% a year. With the second oil price shock of 1979, inflation jumped to 100% level. Thanks to the Lebanon War and the ensuing strikes, the rather steep upward trend continued and annual inflation rate increased 450% in 1984.

Before the 1984 general elections the political atmosphere in Israel was quite tense. A wave of strikes against the right-wing Likud government spread all over the country. The strikes organized by public sector employees and the media workers deeply affected the Israeli economy. The election results did not allow any single party the majority in the Knesset. The left-wing and right-wing blocks formed under the leadership of Labor and Likud parties could command 44 and 41 seats in the parliament. The remaining 35 seats were distributed among 13 small and marginal parties. The fragmentation in parliament was in part a result of the proportional electoral system in effect in Israel.

While also exploring the possibility of forming a government with small marginal parties, Labor and Likud parties started bilateral talks to form a coalition government. However, the sustained increase in inflation in the post-election political vacuum further raised the pressure on both parties and Labor-Likud coalition government was formed in September 1994. While the Labor Party leader Shimon Peres became the Prime Minister for two years, the finance minister portfolio was given to the Likud Party.

With the apparent threat of hyperinflation, the "Economic and Social Council" was formed in fall 1984. The council's main duty was to advise the government on economic policy and especially in the implementation of incomes policies. Labor unions and businesses were represented in the Council as well as the Labor and Likud parties. Being an advisory body, the council was expected to provide a platform where a social consensus among major interest groups would be reached before the implementation of stabilization measures by the government. It was thought that the approval and implementation of economic policy measures by Knesset and the government would be much easier if the support of major social interest groups could be secured.

The first step towards a social consensus was taken in November 1994. (See Table A3). Through the negotiations, in which the Prime Minister Peres was directly involved, the government, labor unions and industrialists agreed upon a three-month price and wage freeze, which took effect immediately. However, the fiscal, exchange rate and interest rate policy measures were not included in the first package deal. Despite the missing components of the stabilization package, heterodox measures were effective in bringing the inflation down in a short time period. Monthly inflation rate went down from 24% in October to 3.7% in December (see Figure 5). However, the good news from the inflation front provided the government with an excuse to postpone a comprehensive stabilization, which also included orthodox measures such as tight monetary and fiscal policy. The government continued to rely on price and wage freezes, and it successfully renewed three-month price and wage freezes twice.

Insert Figure 5 about here

Initial downward trend in inflation did not last too long. In the first half of 1985, inflation started to rise again. These developments, combined with the pressure from the US government convinced the Peres government to prepare a full-fledged package incorporating orthodox elements. Work on the package was kept secret. As the first step towards a stabilization package, these measures were announced on July 1, 1985 without any prior consultation with labor unions and business representatives. Protests started on the same. Demonstrations and protests had lasted for two weeks, until an agreement between the government, business associations and unions was reached on a plan, which included temporary price and wage freezes.

The mixed “orthodox-heterodox” stabilization plan was successful in reducing the budget deficit and the inflation. Thanks in part to a $1.5 billion financial support from the U.S. budget deficit was reduced from 10% of GDP in 1985 to 3 % in 1986. Annual inflation was brought down from 1000% in July 1985 to 25% by the end of 1985 and to 20% by the end of 1986. Inflation had been stabilized below 20% since then (see Figure 5).

4. Country Experiences and Implications for the War of Attrition Model

Among the countries that succeeded in bringing inflation down, Israel’s experience fits best to Alesina and Drazen’s war of attrition model. Since the founding of the state of Israel, civil society organizations have been very active in the political and social life. Labor and Likud parties do dominate the political arena. Representing interests of different social groups, both parties are in close touch with and constantly scrutinized by civil social organizations of these groups. While Likud represents the conservative business circles, Labor party has close relationship with the Histadrut, country’s largest labor union confederation.

Representing 90% of all industrialists in the country, the Manufacturers' Association has been one of the influential interest group organizations. However, in terms of political influence, it is far behind the Histadrut that represents 1.6 million workers and employees, which corresponds to 95% of the Israeli labor force. With cooperatives, health clinics, industrial and service companies and financial institutions that play important social and economic roles in the Israeli society, Histadrut is more powerful than an ordinary labor union confederation. The general secretary of Histadrut used to have a political status comparable to Labor Party leader.

There is a two-way controlling relationship between the Labor Party and the Histadrut. Since its establishment, the Histadrut has been under the control of delegates who are also members of the Labor party. While in May 1985 the coalition government was negotiating with Histadrut behind closed doors, Labor Party block increased its votes to 67% of the total votes and strengthened its control over the Histadrut. However, despite the dominance of Labor Party supporters among its members, the Histadrut never slowed down its efforts to represent workers' and employees' interests, even during times of high inflation. An outcome of this relentless work by Histadrut was the 50% increase in real wages during 1975-84, a period of rising inflation rate.[9]

The Israeli stabilization episode summarized above is a special case of the Alesina-Drazen war of attrition model. Traditionally, fixed-income earners, who are affected more negatively by high inflation than any other group, form a rather well organized social interest group. Consequently, unlike many other countries, the political strength of the fixed-income earners does not necessarily lag behind that of industrialists and businessmen. Using their right to go on strike and general strike, employees and workers successfully prevented their real wages and salaries from declining in the face of high inflation. Thanks to their organized political strength, they did not allow government to load most of the burden of the stabilization

[9] The increase in real wages in this period can be verified in Figure 1. In almost all years between 1975 and 1984, Israeli real wages recorded an increase.

plan on their shoulders and succeeded in forcing other interest groups to carry their fair share of the burden as well.

During the pre-stabilization period, two social interest groups engaged in a war of attrition that led to a delay in stabilization. However, the stabilization was achieved at a short period compared to other countries in our study. The fact that these opposing social interest groups had relatively equal political and organizational strength helped secure the stabilization without further delay. Results of the 1984-85 general elections clearly showed that the burden of stabilization must be shared between the labor and the businesses almost equally.

Both sides would suffer from high inflation, but there was not a great degree of asymmetry between the two sides in terms of the cost of delaying stabilization. Private businesses could protect their real income by increasing prices faster and earning high returns from financial investments. Well-organized unions could use strikes and general strikes to increase nominal wages in accordance with inflation. On the other hand, both sides could realistically observe the political strength of the other side and understand that the other side was not likely to throw the towel before itself. As long as this was the case, the expected benefit of waiting one more instant was not high enough to justify waiting longer. Hence, the equality between the expected benefit and cost of waiting for one more instant was to take place rather too soon. In other words, stabilization took place not because the politically and economically weaker group called quits very early in the game, but because two equally strong social interest groups shared the burden of stabilization almost equally.[10] The fact that real wages started to rise in 1986, in less than one year after the 10% drop in real wages in 1985, shows that there was not an extraordinary burden of stabilization on fixed-income earners.

The social and political dynamics during the high-inflation episodes in Turkey, Argentina and Brazil have been drastically different from the dynamics of Israeli high inflation episode. Israel had built an uninterrupted democratic tradition since its foundation, whereas the history of Turkey, Argentina and Brazil are full of military coups that interrupted the evolution of the political system. In these countries, political parties could not perform their functions as the fundamental institutions of a democratic system. In this institutional vacuum, political elites had become an interest group with no concern to solve the problems faced by the rest of the society. Rather, they were explicitly used to promote self-interests of the political elites.

Differences between Argentina, Brazil, and Turkey are evident as well. While Argentina and Brazil were able to bring inflation under control within a decade after the restoration of democracy, it is not possible to talk about a similar achievement in Turkey. Turkish system differs from that of Argentina and Brazil, in that it leaves a large room for the political elites to maneuver for their self-interest. The Turkish experience over the last two decades proved that it is almost impossible for the Turkish society to assert its control over the political elites.[11] In Turkey, there are major legal impediments preventing social interest groups from organizing effective political protests and activities. The 1982 Constitution and the labor laws enacted afterwards restricted workers' rights to join labor unions and the ability of labor unions to organize throughout the country. Until recently, labor laws did not allow civil servants to join labor unions. Even if they are allowed to form a union with the new laws, they still have no right to strike. It was not only the labor unions. Other civic organizations have faced hurdles in organizing throughout the country as well. Protest meetings made much harder to organize. Local government authorities can refuse to grant permission for protest meetings without any justification. Consequently, it became very difficult for the rest of the society to impose pressure on political parties on various issues including inflation.

Neither Argentina nor Brazil has legal or implicit restrictions on the activities of unions and other interest group organizations. In both countries it is possible for social interest

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[10] Israeli economists also played a crucial role in the formulation and implementation of the successful 1985 stabilization plan. Two sources that discussed this episode in detail are Bruno (1993) and Keren (1995).

[11] Following requests from various social interest groups, in 1997 Turkish government decided to form the "Economic and Social Council," a body similar in name and in spirit to the informal Israeli council established in 1984 and played a key role in the 1985 Israeli stabilization episode. At the time, mainstream political elites had to make such a concession to social interest groups in order to secure their support against the religious fundamentalist party and form a new government. However, the council was not allowed to play any role in the economic policy making process afterwards.

groups to use public protest methods to impact the economic policy making process, which is determined by the power struggle between the President and the central and local political elites. Labor unions were the most instrumental organizations in activating the public opposition against the military regimes in both countries. During the democratic regimes, unions continued to form the most ardent opposition against the government and used their organizational and political power to influence governments' economic policy. Union activity was not restricted to industrial sectors only. With increasing role of service sectors in the economy, civil servants, public sector teachers, and employees in the banking, transport and health sectors start to actively participate in strikes and general strikes.

In both countries, but especially in Argentina, general strikes turned out to be the most effective mechanism through which the workers could protest government policies and display their determination. General strikes targeted work stoppages in concentrated sectors, such as transport, to bring the economy to a halt, so that political damage would be even more significant. In both countries, there was increasing participation in general strike activity over time. There were several reasons for this. First, the workers' frustration with government policies intensified with repeated failures to control inflation. Austral Plan in Argentina and Cruzado Plan in Brazil were initially supported by the public. Only when it became apparent that the political elites were not serious in their stabilization attempts, the unions organized general strikes. Second, there was a learning experience. As earlier attempts showed that general strikes could generate more political impact than any other type of protest, more and more workers decided to participate. Finally, they also learned that, unlike a strike at the factory or industry level, participation in a general strike would not endanger their jobs. Consequently, those workers who shied away from previous actions joined later on and general strikes have become a nightmare for the government over time (see Cox Edwards, 1997, p. 135).

Another factor that differentiates Argentina and Brazil from Turkey is their presidential system as opposed to the parliamentary system in Turkey. As the president is elected by popular vote, the incentives and expectations of the president and the political elites in the political arena are not the same. Because president appoints cabinet ministers, policy successes and failures of the government would directly be accredited to the president. The fact that these countries' had restored the democratic regime just before the high inflation episode started and the ever-powerful military establishment closely watched political developments, increased the pressure on presidents to take the economic and social problems more seriously. Since the military could easily use the economic policy failures as an excuse, and undertake a military coup and sack the president, the president did have more incentives than the political elites to address economic and social problems.

The situation is different for political elites. In order to get re-elected, a member of the parliament has to seek his or her party's nomination. In a political system, where party leaders' authority rather than internal party democracy counts, the politician needs to convince the leadership for his nomination for re-election. Once nominated, the politician needs to collect votes from her/his election district. It would not be very difficult for a politician to get votes from her/his district if s/he had served the interests of that locality throughout her/his term in the parliament. In such a system, it would not be wrong to expect this politician to support an increase rather than a cut in government spending.

Another institutional difference between Turkey, and Argentina and Brazil arises from the relative political strength of the central and local institutions. Argentina and Brazil's federal system allows room for the state governors to become influential political and economic players throughout the country. In their decentralized federal system, a governor's political power provides her/him with almost a free reign over the state government's finances. On the other hand, similar to members of the parliament, governors have an incentive to make use of the state governments' fiscal resources to secure re-election in the future. While states have some degree of autonomy in the use of states' funds, they do expect the federal government to provide financial support when a state government is running fiscal deficit. One of the important tasks of the governors is to lobby or force the central government to provide financial support. Therefore, the state governments have the incentive to run fiscal deficits, because in the final analysis they can rely on the central government to finance the deficit. The lack of control over state governments' budgets will spill over into the central government's finances.[12]

In Turkey, the situation is rather different. Given the centralized government system, there is no possibility of local political elites to act independently from the center. Furthermore, the lack of within-party democracy increases the power of party leadership relative to local party representatives. It is rather common in Turkey to have party leadership dismiss local party officials just because they side with the opposition in the party (Turan, 1995).

In the Argentinean and Brazilian political environment, where the interests of the president and political elites are in conflict, the central and local political elites would work hard to block the government's structural reforms. At this juncture, the political power the president commands becomes crucial. Politically weak presidents and their inability to confront political elites help explain why the high inflation episode could not be brought to end soon after the democratic regime was restored. To give an example, the Austral plan of 1985 initially included measures to reduce fiscal deficit, but they could not be implemented because they were blocked by the parliament. President Alfonsin did not have the political power to coerce political elites to accept these measures or even consider a compromise (See Perreira, 1993, p 46).

There are certain similarities in the fate of the first presidents of Argentina and Brazil after the restoration of democracy in mid-1980s. Both presidents were politically weak. They lacked popular support base from the beginning. They could not confront nor convince political elites to accept the crucial structural reforms. The failure to control inflation cost Alfonsin and Sarney dearly. Alfonsin was forced by the public to step down before his term was over. The learning curve was in effect in both countries. The subsequent presidents, Carlos Menem in Argentina, Fernando Collor de Melo and Fernando Henrique Cardoso in Brazil used all of their political capital to pass the reform measures from the parliament.

12 In 1990, total debt of the Brazilian state governments to the central bank was $ 57 billion.

Unlike their predecessors, they rallied public support behind themselves and never shied from clashes with the parliament in policy issues.

5. Some Econometric Evidence

In this section, we provide econometric evidence about the role of general strikes in determining the inflationary dynamics along with other economic variables. In our simple empirical inflation equation we have three economic variables. These are the percentage change in the nominal wage rate, percentage change in the money stock (M2) and the rate of depreciation or devaluation of the domestic currency. Each of the three variables is associated with a different source of inflation. The wage rate is included to measure the effect of changes in the cost of production resulting from higher wages. Change in the money stock is included as a measure of relaxed monetary policy. Finally, we include the depreciation rate because depreciation or devaluation is expected to lead to an increase in inflation through the increase in the price of imported goods. We assume that these variables have a lagged effect on inflation. Using lagged variables also help us avoid the simultaneity problem in our estimations.

The expected sign of the coefficient estimates for all three variables is positive. In other words, we expect that an increase in wages, money stock and the exchange rate will feed into higher inflation. In addition to these explanatory variables, our model includes lagged dummy variables for general strikes and stabilization programs. General strikes are expected to have a lagged positive effect on inflationary dynamics. On the other hand, the implementation of stabilization measures would likely to reduce inflation. In this single equation model, however, we can not test whether the stabilization is successful in reducing inflation on a permanent basis.

In the case of Turkey we use quarterly data to estimate the inflation equation, because wage data are not available on a monthly basis. This creates a problem for our estimations. It is quite possible to have lagged variables with insignificant coefficients. For that reason, we also run regressions with contemporaneous wage inflation, devaluation and change in the money stock as explanatory variables. In order to circumvent the simultaneity problem that might arise we estimated the inflation equation with instrumental variables method. The results from the instrumental variables estimation are qualitatively not different from the reported results in Table 1.

Our inflation equation has a good fit in the case of Brazil, Argentina and Israel. Both changes in the wage rate and devaluation feed into inflation with one-month lag. The wage effect on inflation is stronger in Argentina and Brazil compared to Israel. Changes in the money stock do not seem to have much influence on inflation next month. In the case of Turkey, however, only one-quarter lagged devaluation seem to have an impact on inflation. Neither the wage inflation nor the changes in the money stock do affect inflation. The lack of any wage feedback into inflationary dynamics in Turkey provides econometric evidence for this paper's main hypothesis. As the labor unions lack social and political power to obtain higher wages to protect workers' real income, changes in the wage rate play no role in the inflationary dynamics.

Table 1: Short-run Inflation Equation Estimates

	Israel (Jan. 76 – Mar. 96)	Argentina (June 81 – Apr. 92)	Brazil (Mar. 82 – June 96)	Turkey (1988.I-1998.IV)
Constant	0.009 (1.38)	0.023 (0.62)	0.046 * (3.52)	0.133 * (5.03)
Δ log w_{t-1}	0.24 * (5.46)	0.43 * (5.12)	0.46 * (8.57)	-0.015 (0.15)
Δ log e_{t-1}	0.457 * (10.4)	0.31* (6.33)	0.52 * (9.51)	0.253 (3.0)
Δ $\log M_{t-1}$	0.040 (1.10)	0.12 (1.31)	-0.012 (-0.42)	-0.105 (-1.09)
DV: General Strike$_{t-1}$	0.036 ** (2.48)	0.05 # (1.80)	0.023 # (1.76)	--
DV: General Strike$_{t-2}$	--	--	0.03 ** (2.36)	--
DV: Stabilization$_{t-1}$	-0.106 * (-4.98)	--	-0.14 * (-7.9)	--
DV: Stabilization$_{t-5}$	--	-0.13 * (-3.55)	--	--
Adjusted-R^2	0.61	0.60	0.88	0.37
D-W Statistic	2.00	2.12	1.91	2.43
Wald-test (H1)	24.6 *	13.4 *	72 *	5.01 *
Wald-test (H2)	102.2 *	64.9 *	387 *	3.03 **

Notes:

1. ***w*** is the nominal wage rate, ***e*** is the end of the period exchange rate, and ***M*** is the money stock (M1), and DV stands for Dummy Variable.
2. Superscripts *, ** and # denote statistical significance at the 1, 5 and 10 percent level.
3. Hypothesis Tests:
H1: All slope coefficients including monthly (Israel, Argentina and Brazil) or quarterly (Turkey) dummies are statistically not different from zero.
H2: Coefficients on lagged wage inflation, devaluation and money stock are statistically not different from zero.

Another important aspect of our inflation equation estimations is the incorporation of dummy variables for general strikes and stabilization programs as explanatory variables. We include these dummy variables for Argentina, Brazil and Israel, but not Turkey. This is so, because Turkey had not have any general strike or an economy-wide strike since the 1980 coup d'etat. Turkey did not have any major stabilization effort since 1980, either. Only a single stabilization program was implemented and it was right after the worst economic crisis in Turkish history in 1994.

General strike dummies do have explanatory power in the inflation equations for all three countries. According to these estimates, when all other variables including the wage rate are kept constant, monthly inflation increases between 3-to-5 percentage points one or two months after the general strike takes place. The estimated coefficients are statistically significant at least at the 10 percent level. Again this result shows the crucial role of labor unions in the inflationary dynamics of these countries. Utilizing their general strike weapon effectively, they were able to push the inflationary spiral even higher, making the inflation unbearable for political elites.

Stabilization dummies also turn out to have expected negative signs and are significantly different from zero. In Israel and Brazil, stabilization attempts help reduce inflation by 11 and 14 percentage points with a one month lag, while in Argentina it takes approximately five months before the stabilization could make a significant impact on inflation. This is too long a lag for any stabilization program to be effective. We included one-to-four month lagged stabilization dummies in the Argentine's inflation equation, but they all had statistically insignificant coefficient estimates.

6. Conclusions

It is difficult to understand the dynamics behind high and chronic inflation without analyzing the social and institutional environment. Alesina and Drazen (1991) formalize this conjecture in a war of attrition model. They show that a war of attrition among interest groups lies behind the delay in successful stabilization.

When the war of attrition model is applied to the case of Turkey, it is no difficult to see that fixed-income earners would be the first to concede and carry the burden of stabilization. It was actually what happened during the implementation of stabilization measures in 1980 and 1994. In the absence of a wage indexation mechanism and strong labor unions, workers and employees had no way of protecting their real incomes against high inflation. As the inflation rate increased, cost of living with inflation surpassed the expected benefit from waiting. Thinking that if they accepted to carry the burden, budget deficits would be cut and inflation would be brought under control, workers and employees were silent against the implementation of the stabilization program.

Yet, unlike what is implied by the war of attrition model, stabilization attempts could not succeed in cutting budget deficits and bring inflation under control permanently. The war of attrition model cannot explain why Turkish inflation could not be brought down to single digits once workers and employees concede to carry the burden of stabilization.

Alesina-Drazen model does not specifically focus on the crucial role played by political elites. Unlike the implicitly passive role assigned in the Alesina-Drazen model, political elites could become an independent interest group within the social and institutional environment of countries such as Turkey, Argentina and Brazil. Only in the case of Israel we observe the presence of institutional and social control mechanisms that can prevent political elites from becoming an independent interest group from the rest of the society. That is why Israel succeeded in bringing inflation down in a shorter period, with a social consensus.

A permanent cut in budget deficit would mean a permanent decline in the income and wealth of political elites. Budget deficit cuts require not only a decline, but also rationalization of government spending, restricting the arbitrary use of government resources by political elites for their self-interest. Such an outcome is unacceptable for Turkish as well as Argentinean and Brazilian political elites. Although the Argentinean and, to some extent, Brazilian institutions could not prevent political elites from behaving for their self-interest, the political and organizational power of labor unions and the presidential system had not allowed them to delay stabilization forever. Especially in Argentina, labor unions used their strength and organized general strikes one after the other to show that they will not be the first to concede and will not allow the government to put the burden of half-hearted stabilization attempts on their shoulders. When there was no significant consolidation in the budget deficit, unions always managed to get their wages adjusted upwards. This sets out the inflation-wage increase spiral, which later led to hyperinflation. Thanks to Olivera-Tanzi effect, it is not possible for political elites not to keep their real incomes intact in a hyperinflationary environment. They had no choice but to make sacrifice in order to prevent their real income erode in the face of hyperinflation. In Turkey, however, neither labor unions nor other interest groups are strong enough to turn the inflationary process into one that erodes the real income of political elites. As long as they can keep themselves unharmed from high inflation political elites will have no incentive to bring inflation down permanently.

Estimating a short-run inflation equation, we were able to provide econometric evidence for the above hypotheses. In Argentina, Brazil and Israel, wage increase is an important determinant of inflation along with devaluation. Furthermore, in these countries unions had the power to push inflation even further by organizing effective general strike campaigns and obtaining higher wages over and above the wage indexation.

Acknowledgements

The author thanks Peter Bernholz, Mustafa Çağlayan, Ali Çarkoğlu, Caspar de Vries, Arye Hillman, Ziya Öniş for helpful comments.

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Figure 1. Annual Inflation rate and Change in real wage

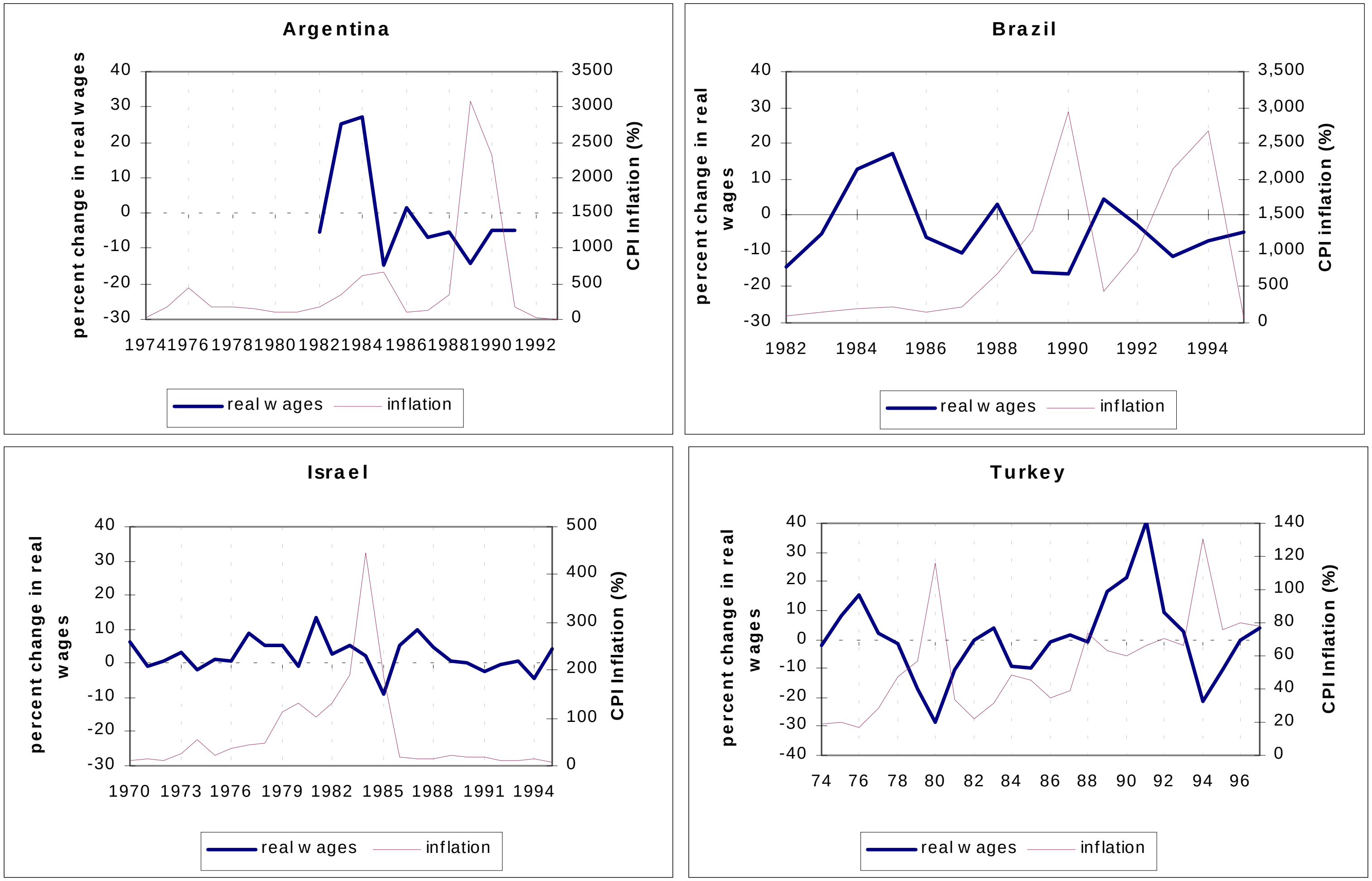


Figure 2. Turkey: Monthly inflation rate and strikes

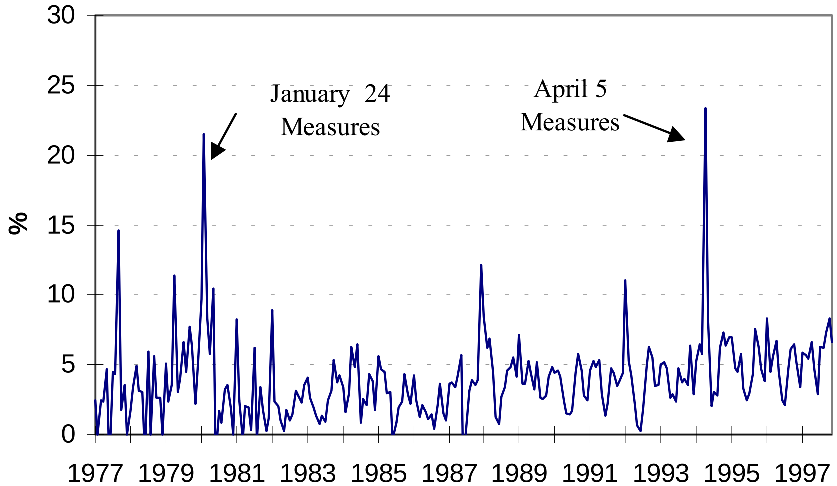
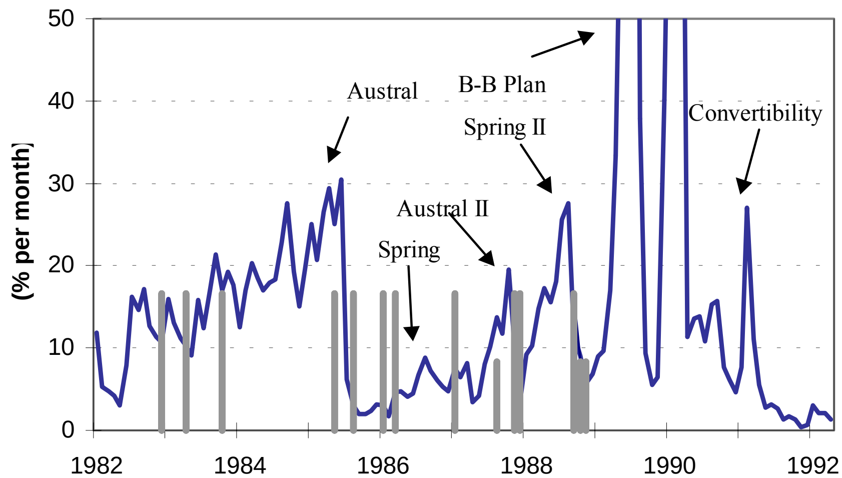


Figure 3. Argentina: Monthly inflation rate and strikes



Note: A bar indicates that there was a general strike (long bar) or a wave of strikes (short bar) in that particular month.

Figure 4. Brazil: Monthly inflation rate and strikes

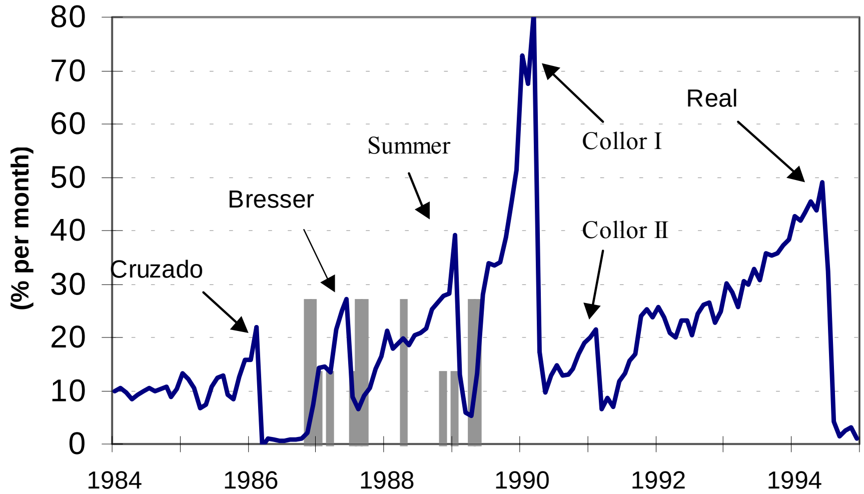
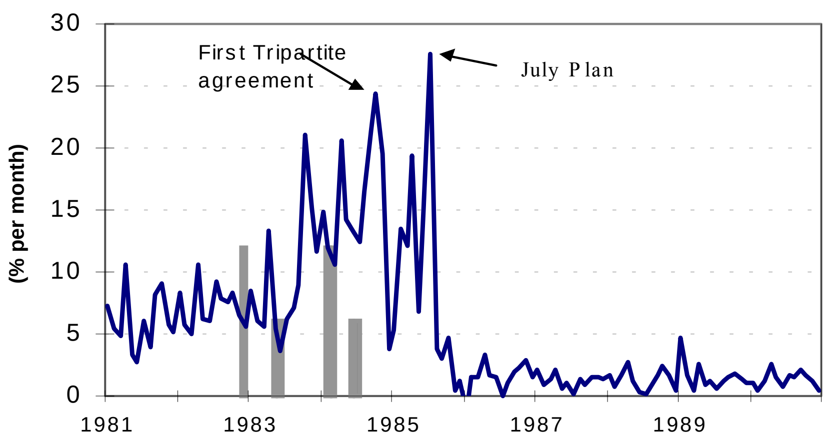


Figure 5. Israel: Monthly inflation rate and strikes



Note: A bar indicates that there was a general strike (long bar) or a wave of strikes (short bar) in that particular month.

Appendix: Chronology of Political Events

Table A1. Argentina: Chronology of Political Events and Stabilization (1982-91)

Date	Events
December 6, 1982	**General strike:** First of its kind since the military junta government was declared in 1976, the strike was organized to protest human rights abuses and to demand wage increases.
March 28, 1983	**General strike:** This 24-hour general strike was organized to protest the inadequate 12% wage increase given by the government. 85% of the labor force participated.
August 10, 1983	**Stabilization measures:** Interest rate, price and wage freeze.
October 4, 1983	**General strike:** Following the wave of recent strikes, Peronist General Confederation of Workers organized a general strike.
Dec. 14, 1983	**Price freeze:** Followed by an increase in wages two days later as demanded by CGT.
May 25, 1984	**Minister of Employment resigned,** after unsuccessfully seeking to impose legal restriction to curb union power.
June 11, 1984	**Government criticized the IMF for its conditions being too harsh to accept.**
October 3, 1984	**General strike (1):** Even though the participation to this first general strike since Alfonsin became the President was low, the government accepted unions' demands for a wage increase.
April 26, 1985	**Alfonsin:** "...the economy is in a state of war, and we need to sacrifice."
May 23, 1985	**General strike (2):** Despite a higher rate of participation compared to the first general strike against Alfonsin, it did not receive much support from the public.
June 1985	**Stabilization measures - Austral Plan I:** The most comprehensive austerity measures since then. It included measures to bring budget deficit to less than 2.5% of GDP and installing price and wage freezes. The majority of the Argentinean supported the austerity measures.
August 29, 1985	**General strike (3):** Low participation rate in this first general strike against the austerity measures.
January 1986	**General strike (4):** Approximately 90% of the unionized workers participated in this 24-hour general strike. Planned general strikes were cancelled when the government adjusted the wage rates as requested by union.
March 25, 1986	**General strike (5):** A 10-hour general strike. No information on participation rate.
August 29, 1986	**Stabilization measures – Spring Plan:** Aimed at reducing the rate of wage and price increases, with no fiscal adjustment.
January 26, 1987	**General strike (6):** Eight general strike against the Alfonsin government.
February 25, 1987	**Stabilization measures – February Plan:** Major policy measures were the devaluation and another round of price and wage freezes.
May 1987	The government allowed a steady increase in the prices and wages.

Table A1 (cont'd) Argentina: Chronology of Political Events and Stabilization (1982-91)

Date	Events
August 1987	**Strikes in the public sector:** The participation to this series of strikes in the public sector, organized to protest delay in overtime payments, was reported to be high.
October 1987	**Stabilization measures – Austral II Plan:** Aimed at cutting budget deficit with another round of price and wage freezes, this plan could not bring the inflation down, either.
Nov. 5, 1987	**General strike (7):** Ninth general strike against the Alfonsin government, participation reported to be high.
December 1987	**General strike (8):** Being the 10th general strike against Alfonsin government, it was organized by CGT and lasted 24 hours. Production stoppages reported in many factories.
April 14, 1988	Soon after the 11th general strike against him, Alfonsin signed the new labor law bill that enhanced the political power of labor unions and removed the wage and price freezes.
August 1, 1988	**Stabilization measures – Spring II Plan**
August 18, 1988	Despite the limits installed in the Spring II Plan, powerful metal workers' union succeeded in getting a 47.4% raise for its 320,000 members.
September-November 1988	**Strikes and general strikes:** Following two general strikes on September 9 and 12, workers in postal services, railroads and petroleum sectors stroke in October and November.
August 1989	**Stabilization Measures – BB (Bunge Born) Plan:** The first stabilization attempt by Menem administration targeted budget deficit seriously along with other measures. Privatization had become a cornerstone of economic policy.
February 3, 1991	**Stabilization Measures - Convertibility Plan:** It foresaw radical changes in the fiscal and monetary policies. The Central Bank was re-instituted as a currency board, with almost fully backed currency at fixed par with dollar. It included measures to cut government expenditures, as well as revenue increases through privatization of public enterprises and tax hikes.
Feb. 4-6, 1991	Short-lived strikes in two public sector factories.

Table A2. Brazil: Chronology of Political Events and Stabilization (1986-94)

Date	Events
1984	Brazilians flocked the streets to rally for direct elections to the presidency. However, the parliament did not follow the people's wishes and voted for the president to be elected by the parliament.
Feb. 28, 1986	**Cruzado Plan:** Besides the replacement of the national currency Cruzerio by the new currency Cruzado, the plan discontinued the wage and price indexation mechanism and introduced price, wage, rent and interest rate freezes. However, there was no mention of the vital fiscal austerity measures.
November 1986	**Elections at the state and federal level:** To support candidates from its party, Sarney government let the government expenditures loose. The economy continued to grow, despite rapidly rising inflationary pressures.
Nov. 21, 1986	**Attempts to salvage the Cruzado Plan:** In order to curtail inflationary pressures fed by rapidly increasing private consumption expenditures, the government decided to increase taxes on luxury consumption goods by 100 %. Price of oil and alcohol were increased as well.
Nov. 27, 29 and Dec. 12, 1986	**General strike wave:** In this first wave of general strikes against the Cruzado plan, unions did not succeed in rallying popular support against the government's policies.
Jan. 22, 1987	**Electricity workers' strike:** Started at Sao Paulo, and rapidly spread all around the country.
Feb. 5, 1987	**Cruzado plan failed:** When government failed to convince unions to reduce their wage increase demands from $60 to $132 per month, there was no way to successfully implement the Cruzado plan and bring inflation down.
Feb. 11, 1987	Central Bank Governor resigned following a dispute with the Finance Minister.
March 17, 1987	Minister of Planning resigned when his heterodox stabilization proposal did not receive support in the cabinet.
March 24, 1987	**A wave of strikes throughout the country:** The strikes organized by petroleum workers and more than 500,000 strong financial sector employees were followed by farmers' protests of the government.
June 12, 1987	**Bresser Plan:** Cruzado was devalued by 11 percent. The plan included wage and price freezes, with the provision that there would be quarterly adjustments. However, fiscal austerity measures proposed by the new finance minister Bresser Perreira did not receive political support in the cabinet and in the parliament.
July 13, 1987	**Strike in the transportation sector:** Bus drivers and other transportation workers went on strike to demand a 35% pay increase.
August 20, 1987	**General strike:** There was not a widespread participation in the general strike organized by the two largest union confederations.
Sep. 11, 1987	**General strike:** This second general strike within a month was not successful in drawing high participation.
April 7, 1988	**Supplementary stabilization measures:** A two-month long public sector wage freeze affected 1.5 million workers.
April 13, 1988	**General strike:** 200,000 public sector employees organized a 24-hour general strike to protest the latest round of wage freezes in the public sector.

Table A2 (cont'd) Brazil: Chronology of Political Events and Stabilization (1986-94)

Date	Events
November 1988	**Strikes in the iron and steel, and the oil sectors:** Production in 10 out of 11 oil refineries stopped. Three workers were killed in skirmishes between workers and security forces in a government-owned iron and steel factory. The wave of strikes ended when workers voted to accept the government offer, which was lower than what they demanded.
Jan. 15, 1989	**Summer Plan:** Summer plan proposed severe cuts in public spending, as well as a wage and price freeze and a new currency. However, Congress blocked essential measures to cut fiscal deficit.
Jan. 16, 1989	**Another round of strikes in the oil sector.**
March 14-15, 1989	**General Strike:** This two-day general strike was organized by the two largest union confederations to protest the latest wage freeze. Participation rate reached 70% of Brazilian workers, higher than the previous general strikes.
April 1989	**Another wave of strikes:** More than 2 million workers went on strike in different sectors in a matter of three weeks. The strikes hampered production and services in crucial sectors, such as banking, transportation and manufacturing sectors. With the success of these protest strikes, unions increased their political influence.
June 14, 1989	The government admitted that the Summer plan was a failure and announced its termination.
March 1990	**Collor Plan :** The Collor plan included drastic measures. The government froze savings in excess of 50,000 new cruzados and four-fifths of funds in overnight accounts for 18 months. This amounted to a withdrawal of 115 billion US dollars of private assets from circulation. The government announced sweeping increases in taxes and cuts in the public sector; it aimed to scrap all the remaining state subsidies, sell off state assets, and fire about 80,000 workers.
1991	**Collor Plan II:**
December 1992	**President Fernando Collor de Mello resigned:** After the Congress voted with a vast majority to impeach him, president Collor de Mello resigned from office before the impeachment trial went under way in the Senate.
February 1993	**Financial Movements Tax bill:** In an effort to increase tax revenues, the Congress passed a bill that will impose a tax of one-quarter of 1% on all checks, savings withdrawals deposited for less than three months, and other bank transactions through 1994. Businesses and unions jointly organized a rally against the new tax.
July 1994	**Real Plan:** A new currency called Real was put into circulation. Its value is fixed relative to the US dollar. A two-stage process was introduced to break the country's infamous indexation mechanisms. The government introduced measures to raise taxes and cut its spending.

Table A3. Israel: Chronology of Political Events and Stabilization (1982-86)

Date	Events
December 1982	**Public sector strike:** More than 200,000 public sector workers and employees participated in 48-hour and 5-day strikes. **Result:** The government gave up insisting at its 6-8% pay hike offer and accepted Histadrut's demand of 12 %.
May-June 1983	**Physicians' strike:** Physicians' protests against government started in March. Once they realized the government's unwillingness to accept their demand, 8500 physicians went on to strike on May 22. The protests peaked in June with hunger strikes. In the end, the government had to accept the 60% pay raise demanded by physicians.
January-March 1984	**Austerity budget and public sector strike:** After weeks of disputes that threatened its survival in office, on Feb. 22 the Israeli coalition government introduced an austerity budget for the fiscal year beginning April 1. The budget called for substantial cuts in military spending, government social programs and subsidies. Following seven weeks of strikes and slowdowns and three days before the budget was introduced, the government reluctantly agreed to wage increases for 350,000 public-service employees to offset the erosion of their wages through inflation.
June-July 1984	**Pre-election strikes:** The weeks before the July 23 Israeli election saw a wave of strikes by various groups of workers, including broadcasters, diplomats and teachers seeking higher standards of living before the expected imposition of economic austerity measures.
July 1984	**General elections:** Neither the Likud-led center-right alignment nor the Labor-led center-left alignment could get the majority of seats in Knesset. Out of 120 seats in the Knesset, Labor alignment received 44 seats, while Likud alignment received 41 seats.
August 31, 1984	**Coalition of Center-right and center-left:** Labor Alignment leader Shimon Peres and Likud bloc leader Yitzhak Shamir had agreed to form a national unity government and to alternate as prime ministers.
November 2, 1984	**Tripartite agreement:** The Israeli government took a major step toward curbing the country's triple-digit inflation, when it persuaded labor and business to agree on freezing wages and prices for three months. Under a complicated set of three-way agreements, basic wage rates, prices and taxes were to be frozen from November 1984 until February 1985.
January 24, 1985	**Tripartite agreement extended:** The agreement came less than two weeks before the Feb. 4 expiration of the first three-month wage and price freeze. That package deal had succeeded in cutting the nation's monthly inflation rate from 24% in October to 3.7% in December, which produced a total 1984 inflation rate of 445%. Despite the extension of the freeze, inflation soared in April and June to 19.4% and 14.9%.
July 19, 1985	**Austerity Program:** Despite the tripartite agreement, there was no serious decline in the inflation. The government had to take more drastic austerity measures. The package included mandatory price and wage freezes, devaluation of Shekel by 18.8%, $750 million cut in the government's budget, to be achieved through cuts in public sector employment and subsidies on major consumption goods. However, following the protests by Histadrut members, the implementation of the program had to be delayed for two weeks.
Jan 1, 1986	**New Currency:** Israel dropped three zeros from its currency, introduced the new shekel one of which would be worth 1,000 old shekels.