

Crying For Argentina

Symptoms, causes and crises

Over the last year, Argentina has witnessed blazing street riots, spiralling consumer prices and a drop in GDP. Five presidents came and went in the space of just two weeks. Strange to think, then, that Argentina was once the model for successful free-market reform. So what went wrong, who is to blame, and what can be learned from it all?

By Rohit Gupta

Gripped by crisis, Argentina has this year seen the peso lose around 70% of its value, its gross domestic product drop by 13.5% and consumer prices rise by almost a third. Unemployment now stands at 20% or so, and half the country's population has become officially poor. Presidents have come and gone, many people have chosen to leave, and financial problems have spilled over into violence and rioting. Late last year, Argentina defaulted on around US\$150 billion of international loans, and late in November this year, it also failed to pay the World Bank some US\$800 million.

Argentina's plight is all the more striking considering that it was once widely held to be a successful example of how to conduct free-market reforms. Inflation was overcome through macroeconomic discipline and open trade, increasing openness to foreign investment, more flexible labour markets and large-scale privatisation.

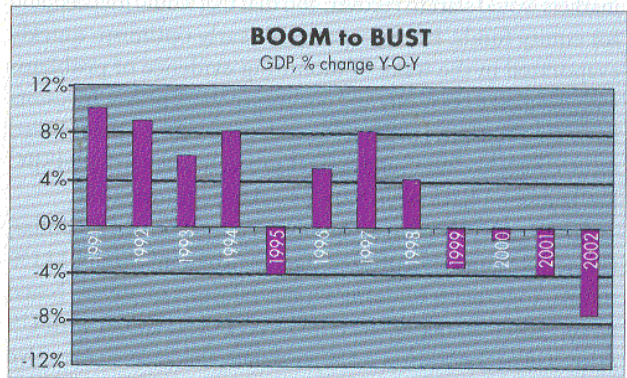
During the 1970s and 1980s, Argentina's main economic problem was persistent, extreme inflation. By the end of 1990, the consumer price index was more than a billion times the level at the beginning of 1975. During the 1980s, Argentina twice changed its currency, first introducing the 'peso argentino' (equal to 10,000 old pesos) in 1983, before replacing it with the 'austral' (the equivalent of 1,000 'pesos argentino') in 1985. Neither switch put an end to inflation.

Boom and bust

In 1991, the country embarked on free-market reform, the cornerstone of which was a 'currency board'. A currency board restricts the amount of domestic currency to the amount of foreign currency a country holds, and a stable money supply helps keep inflation in check. With the risk of devaluation removed, capital poured into Argentina from abroad.

Almost all state enterprises were privatised – the state oil monopoly, the telecoms monopoly, gas and water companies, two television channels, steel and petrochemical firms, toll roads, railways, subways, ports, airports, hydroelectric dams and banks. The state welfare system was wound down in favour of private pension funds.

The model was successful. Inflation was reduced to zero and from 1990 to 1998, real GDP grew by 5.8% a year, a marked improvement over the average decline of 0.2% *per annum* from 1975 to 1990.



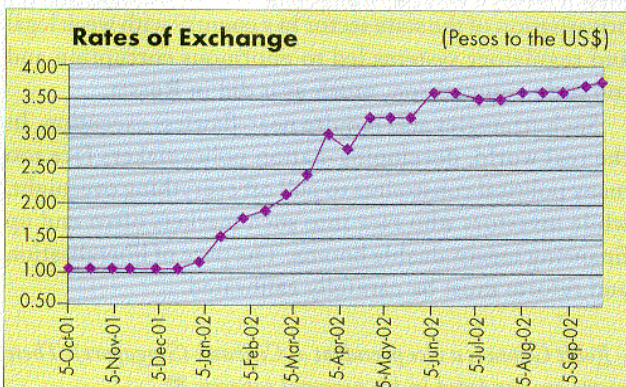
Source: IMF, J.P. Morgan

Then came a series of external shocks. Mexico devalued its currency and in August 1998 Russia defaulted on its sovereign debt, which caused investment to dry up and interest rates to rise as the credit markets closed down. Then the price of commodities, which make up 60% of Argentina's exports, plunged and Brazil, Argentina's largest trading partner, devalued its currency and so made Argentina's products less competitive. The result of all this was a four-year recession characterised by devaluation, falling wages and rising unemployment (see **Boom to Bust**). As tax revenues fell and the government's interest payments mounted, government debt rose to 52% of GDP and the debt-servicing ratio (debt-servicing payments out of total exports of goods and services) hit 60%.

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The conventional response to external shocks is to toughen fiscal policy and bring about a currency devaluation, but with a currency board in place, Argentina was not only denied the option of a 'quick-fix' devaluation but was also unable to use monetary policy changes, as interest rates mirrored those in the US. As for improving competitiveness, Argentina had already privatised state enterprises and liberalised trade. Other reforms – to labour markets and pension funds – were politically more difficult.

Failure turned into disaster under the watch of Economics Minister Domingo Cavallo who, as it happens, was the father of the currency board that steered Argentina back towards prosperity in the 1990s. First the country moved to a dual exchange rate, then bank deposits were frozen and the currency



Source: eXchangeRate.com

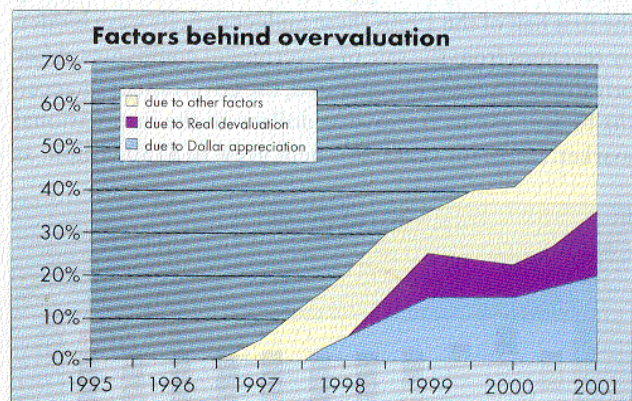
board abandoned at the start of 2002. The nominal value of the peso was allowed to float relative to the dollar (see **Rates of Exchange**). Then, in November this year, Mr Cavallo said Argentina would have to cut interest payments on its huge foreign debt, which prompted a run on the banks. Faced with the prospect of a massive capital flight, he restricted bank withdrawals.

Cause and effect?

BusinessWeek called the currency board "one of the world's boldest experiments in economic reengineering" and the results, as economist Joseph Stiglitz put it, were more devastating than the outcome of any war.

Stiglitz, like other economists such as Jeffrey Sachs and Paul Krugman, blames neo-liberal policies for Argentina's demise. The currency peg did not provide the flexibility to meet external shocks and the reform programme did not promote domestic industry or growth. Allowing foreign ownership of banks, they argue, led to a seemingly more stable banking system, but one that failed to lend to small or medium-sized firms. Growth slowed because firms could not get adequate financing.

As the US dollar began to appreciate in the late 1990s, the Argentine currency board experienced overvaluation. Argentina's exports became less competitive and these effects spilled over and took the economy into a recession (see **Factors behind overvaluation**).



Source: IMF, J.P. Morgan

Not all agree with this assessment, however. To those who blame Argentina's problems on the speed and extent of its free-market reforms and a fixed exchange rate that raised the cost of goods on the world market as the dollar gained value, Steve H. Hanke answers, "Nonsense." Hanke, a professor of Applied Economics at Johns Hopkins University

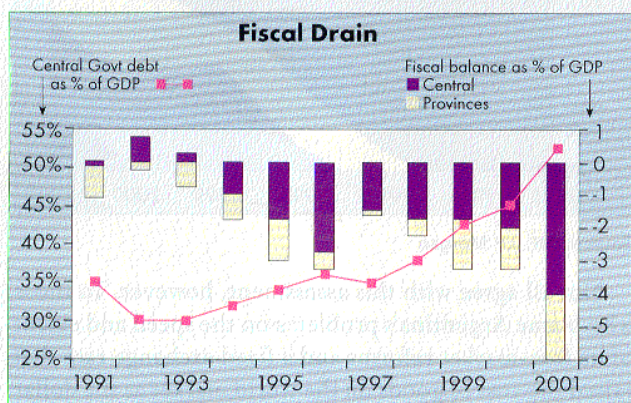
in Baltimore, points out that Argentine exports account for only 10% of GDP. If an overvalued currency causes uncompetitiveness you see declining exports, but Argentina's exports rose. Argentina needed to reduce spending and improve its tax structure.

Political largesse to blame?

A second school of thought, adopted by Hanke and Nobel-prize winner Gary Becker, holds that the problem was not "liberalisation" but the way it was undermined by loose fiscal policy. Instead of printing money like in the bad old days, the government printed bonds to finance its fiscal deficit. Instead of pressing forward with reforms to labour laws, social provisions and infrastructure, politicians continued to buy political support.

In the real world, developing-nation policymakers face too many political constraints to pull off everything overnight, while investors who race into such markets often end up financing unsustainable booms.

Government spending grew to 30% of GDP but during the first half of the 1990s these budget deficits were hidden by revenues from the sale of government companies. After privatisation revenue evaporated, the government financed the budget gap by borrowing dollars on the international market. In recent years, this debt grew to \$150 billion, as



Source: The Economist, 2 March 2002

budget deficits grew to 4% of GDP. The deficits were financed mainly with dollar-denominated debt, with additional borrowings needed merely to pay interest and roll-over debt. When further borrowings became impossible, Argentina defaulted.

Detractors like Jeffrey Sachs look at it the other way around. "The widening budget deficit," Sachs believes, "was the result of the economic collapse since 1999, not the cause of it." Brazil's devaluation made the peso uncompetitive and led investors to expect a similar devaluation in Argentina. As investors fled, interest rates rose and bank deposits fell, deepening the recession and the deficit as tax revenues dropped. Austerity measures were implemented but could not keep pace with falling tax revenue. The budget gap widened and the economy collapsed (see **Fiscal Drain**).

Learning the hard way

This debate will doubtless continue for some time yet. Mistakes were made but there are lessons for other emerging markets. Firstly, it is clear that globalisation exposes a country to enormous shocks. Adjustments in exchange rates are part of the coping mechanism, so instead of pegging a currency to a single peer, it is better to use a basket of currencies that reflect a country's trading patterns.

With the benefit of hindsight, Argentina also made other errors. Growth, for example, requires financial institutions to lend to domestic firms, so selling banks to foreign owners without putting in place the appropriate safeguards may impede growth and stability. Furthermore, a single-minded focus on inflation without any concern for unemployment or growth is risky. Government policies that leave large parts of the population unemployed are unlikely to inspire confidence or economic strength.

Timing is also crucial. Open markets can operate efficiently only within a strong regulatory environment, but the privatisation of the state sector in a country with weak legal and regulatory systems led to enormous corruption and too little competition, much as it did in Russia.

Such strategies also require near-flawless execution. In the real world, developing-nation policymakers face too many political constraints to pull off everything overnight, while investors who race into such markets often end up financing unsustainable booms. The pace of liberalisation and reform must be carefully calibrated.

~ Robit Gupta is a vice president at Citibank (Singapore). These views are rendered in his personal capacity. 