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The Argentinean Crisis

Free market policies carried out by emerging economies have often been criticized. These criticisms have been stimulated by the financial and economic crises recently suffered by countries that were implementing "adequate" economic reforms. These crises include the Mexican tequila crisis of 1994–95, the East Asian crises of 1997, the Brazilian crisis of 1998 and the Argentinean crisis of 2001.

This note reviews a particular case, that of Argentina, to see whether in fact market-based economic policies could be blamed for the current economic hardships and rising poverty in this country. Argentina is a good example. It started out as one of the richest countries in the world at the beginning of the 20th century, but turned into a second world country by the end of the century. To a great extent, this was due to inadequate economic policies carried out by populist governments. These policies led to recurrent crises, with high fiscal deficits, high inflation and large devaluations.

But in 1991, newly-elected President Menem introduced significant free market reforms that were highly praised by the international community. In fact, the "successes" of Argentina's economic measures were highly praised even as late as 1998, when President Menem was invited to address the Annual Meeting of the IMF/World Bank along with President Clinton.

However, these successes turned into a major economic and political disgrace in 2001. This Argentinean crisis has been considered by many as an example of the failure of economic reforms. We will show in this note that Argentina's most recent failure can be explained by halfhearted and inconsistent economic reforms that prevented the country from reaching desirable economic and social outcomes.

We find it important to have a closer look at the economic developments of this country between 1991 and 2000, so that other governments in developing and transition economies will not misinterpret Argentina's experience and abstain from pursuing free market policies and reforms, thereby making bad policy choices. An examination of the causes of the crisis could also reduce the risk of future policy mistakes and possible financial crisis.

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In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government, which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country; support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

Initial Achievements of Economic Reforms

In 1991, after his 1989 electoral victory, President Menem carried out major economic reforms, including business deregulation, liberalization of prices and foreign trade, privatization, public administration reform and financial sector reform. All of these were highly praised free market reforms.

In addition, the government introduced the "convertibility plan" in 1991. It introduced a "currency board" foreign exchange system, fixing by law the exchange rate of the Peso to the US Dollar at 1:1. Given that inflation was still running at high rates, the Peso became quickly overvalued from its inception.

In 1992 and 1993, the fiscal budget was kept under control. The government introduced a number of sound fiscal measures, including the removal of tax exemptions and subsidies, increases in value-added taxes, improvements in tax administration, improvements in civil service efficiency, and the transfer of health & education to provinces. The fiscal budget situation was also supported by the privatization of 90% of state enterprises between 1991 and 1994. These privatizations brought in $20 billion to the fiscal budget accounts. This good fiscal performance was achieved despite the fact that President Menem had inherited a large public debt in 1991, which had reached $64 billion or 39% of GDP by then.

Based on sound economic reforms, GDP accelerated to 10% in 1992, and to 5% in both 1993 and 1994. Inflation was brought down to 4% by 1994. However, these high rates of GDP growth did not help employment, with unemployment increasing from 7% in 1991 to 11% in 1994. This reflected the fact that GDP growth was driven mainly by increases in consumption caused by an overvalued Peso, rather than by significant expansion of productive activities.

Vulnerability to External Shocks

Given the inflexibilities under a currency board foreign exchange system, the 1994–95 Mexican crisis seriously affected Argentina. The country lost international reserves, which led to a reduction in the monetary base. This reduction tightened commercial bank liquidity; interest rates increased, asset prices fell, and bank deposits declined. If Argentina had switched to a more flexible exchange rate system when inflation was reduced to single digit levels, all of the external factors would have been minimized. But it did not, with the endorsement of the international financial institutions.

In addition to the impact of the Mexican crisis on Argentina, inflation rates of 4% in 1994 and 3% in 1995 led to further overvaluation of the Peso. This overvaluation came on top of the initial overvaluation of 1991. These overvaluations led to lack of competitiveness, which affected production, employment and reduced the growth of exports.

Without the benefits of devaluation as an economic policy tool, the main alternative policy instrument to regain competitiveness would have been significant wage and price reductions. But due to a failure to carry out sufficient labor market reforms, wages were not flexible enough to preserve competitiveness. Furthermore, the currency board system prevented Argentina from expanding the money supply as a means to stimulate economic activity. As a result, GDP growth deteriorated and dropped to –2.8% in 1995. GDP recovered in 1996–98, only to fall again after 1999. Furthermore, unemployment increased from 11% in 1994 to 18% in 1995 (thereafter, it increased gradually to 22% by 2002.)

Nevertheless, with significant international financial assistance, Argentina was able to endure the crisis and maintain its fixed exchange rate system.

Policy Failures after 1995

After 1995, President Menem, already in his second presidential term, failed to carry out the necessary fiscal budget and monetary policies to deal with the high public debt he had inherited, and the lack of competitiveness of the economy arising from the overvaluation of the Peso.

In fact, consolidated deficits were not excessive, if they were measured only by their share of GDP. As a percent of GDP, according to official IMF figures, the consolidated fiscal deficits were –1.9% in 1994, –3.1% in 1995, –3.6% in 1996, –2.4 % in 1997, –2.5% in 1998 and –4.7% in 1999. But the sum of these ratios during this period amounted to 18 percentage points. In dollar terms, the sum of the fiscal deficits amounted to $50 billion between 1994 and 1999. These deficits were financed by public borrowings, which led to an increase in public debt that was already at high levels. In fact, public debt increased by $45 billion during the same period, from $90 billion in 1994 (35% of GDP) to $135 billion in 1999 (or 47% of GDP.) Public debt as a percentage of GDP increased by 12 percentage points, from 35% to 47% of GDP. But since public debt is a stock number, whereas deficits are flows, in order to make the 12 percentage points of public debt increase comparable to the 18 percentage points of cumulative fiscal deficits during the period, it is necessary to add to the debt ratio increase the effect of the 10% increases in GDP during this period. This effect brings the comparable increase in the public debt ratio to approximately 17 percentage points, a number similar to the cumulative fiscal deficits. It is clear from these numbers that the driving force behind the over-indebtedness of Argentina was the fiscal deficits. Of the $135 billion of public debt in 1999, $85 billion was external public debt.

In addition to fiscal deficits, private sector expenditures were also excessive, driven in part by the overvaluation of the peso, which made imports relatively cheap. The combination of fiscal deficits and excess private sector expenditures led to high current account deficits in the balance-of-payments. According to the statistics of the Ministry of Economy of Argentina, current account deficits were highly negative, reaching –11% of GDP in 1994, –5% of GDP in 1995, –7% of GDP in 1996, –12% of GDP in 1997, –15% of GDP in 1998, and –12% of GDP in 1999. In most developing countries, a sustained current account deficit in excess of 3% of GDP can be considered imprudent.

A portion of these large current account deficits was financed by large foreign direct investments, which increased from $4 billion in 1994 to $25 billion in 1999, averaging about $9 billion per year during this period. But a large portion of the current account deficits was also financed by external debt, both public and private. In fact, external debt-both public and private-reached $147 billion by 1999, or 47% of GDP. Of this amount, $85 billion was public and $60 billion was private debt. A large portion of this external debt was in the form of Eurobonds purchased by small investors principally in Europe, a fact that led European investors to withdraw from emerging markets securities after Argentina defaulted on this debt.

Although Argentina's level of debt as a percent of GDP may have been considered reasonable for advanced countries or for export-oriented developing countries, it was quite large for Argentina, given the fact that the level of exports of the country is small. Exports represented only 12% of GDP in 1999. As a result, external debt service was large, amounting to 75% of exports, a ratio three times higher than that considered "prudent" by most financial institutions. Furthermore, most external debt had a relatively short maturity, with the result that in 1999, debt service obligations amounted to 10% of GDP, a ratio twice the size considered "prudent."

The inadequacy of the government's fiscal deficits was also reflected by the fact that they exceeded the levels consistent with the IMF monetary programming models. Nevertheless, the IMF consistently waived its own fiscal budget conditionality, driven principally by political considerations.

Powerful provinces contributed to the fiscal deficits, which were also financed by external debt (using future federal receipts under the federal tax sharing system as guarantees) and by issuing "provincial" currency. Provincial fiscal deficits reflected large increases in provincial public employment, which increased by 20% between 1995 and 2001 (from 1.12 million workers to 1.35 million workers.) A good portion of the fiscal deficits was also caused by increasingly high public debt service.

By 1999, Argentina was already in serious trouble.

Faced with large debt service payments, high current account deficits and a fixed exchange rate, a proper policy response by the government would have been to incur surpluses in its fiscal budget, or at least to achieve a zero balance. But this was not done, due to strong political pressures from vested interests.

In addition to its lack of fiscal budget discipline, Argentina was unable to implement other economic reforms, particularly on labor matters. The country had high severance payments, centralized bargaining for wages, high wages and high wage taxes. This discouraged investments and should have been removed, since significant labor flexibility is necessary under currency boards systems because it represents one of the few policy tools available to the country to correct economic disequilibrium. Some progress in labor reform was made in 2000–2001 — with wage tax reductions improving labor market flexibility — but the reforms were insufficient and too late.

With high unemployment, 17.2% of households in greater Buenos Aires had income below the poverty line in 1995, with the unemployment ratio increasing to 20.8% by 2000, and 53% by 2002.

In 2000, the Government wanted to use IMF and other official financing to avoid default. Consequently, in December 2000, Argentina promised fiscal and other reforms in order to secure IMF financing. Based on government promises and its own poor economic modeling, the IMF and other financial institutions granted a $40 billion loan to Argentina in December 2000. The IMF justified its 2000 financing on the basis of overoptimistic GDP growth projections and low interest rates forecasts. These unrealistic assumptions led IMF staff to assure its Board of Directors that Argentina would be able to deal with its debt situation. These assumptions on its own programming model would be highly criticized later on by reviewers of the crisis. In fact, the availability of IMF financing may have delayed the implementation of necessary economic reforms by the government.

The Unfolding of the Crisis

By late 2000, international confidence in Argentina was already declining. The country found it harder to continue its heavy borrowing and carried out an arbitrary and costly debt swap, which was treated as a de facto default.

In 2001, the government introduced a number of measures to regain confidence. The peg to the Dollar was changed to one-half Dollars and one-half Euros, with the expectation that this change may help correct the overvaluation of the Peso. The government set preferential exchange rates for exporters to encourage exports. It also introduced capital flow controls, confiscated part of the assets of private pension funds to pay for state wages, increased import tariffs on consumption goods, introduced new taxes on bank checking accounts, and reduced taxes on production.

Despite these measures, the situation deteriorated during 2001as the measures lacked credibility, particularly on fiscal deficits (both at the central and provincial levels.) Investors' sentiments hardened even more and they were unwilling to continue to provide refinancing. As a result, in December 2001, the central and provincial governments of Argentina defaulted on their $132 billion foreign debt, the largest debt default in history. In November 2002, Argentina defaulted on its World Bank loans. The IMF stopped further lending to Argentina. During 2001–2002, the stock market collapsed, with the stock exchange MSCI index dropping from 2000 in 1999 to 400 in 2002.

In early 2002, the country abandoned the currency peg, leading to a sharp devaluation. It also froze bank deposits and converted Dollar deposits to Pesos, at unfavorable exchange rates. These measures caused a major political crisis, with the result that the President resigned and several other Presidents were changed in the following months.

In April 2003, the governor of a small province of Argentina was elected President, with only 22% of the votes. A member of the Peronistic party, as governor he had significantly increased provincial public employment, with over 50% of the labor forced employed by the provincial government. Although the province did not run deficits, large provincial financing was available from its large oil production.

Based on past experience, it is unclear whether the new government will have the political will to introduce the reforms needed, particularly:

(1) To implement a fiscal budget that can be maintained on a sustainable basis, based on plausible economic projections. This would require reform of the fiscal budget relationships with the provinces, a reduction in the size of the public sector and reform of the tax system.

(2) To carry out adequate monetary policies, by an independent central bank that would be able to control money supply and inflation.

(3) To maintain a flexible foreign exchange rate system.

(4) To reach a satisfactory agreement with the holders of external debt.

(5) To successfully deal with the insolvency of the banking system and the claims of depositors.

Conclusions

The main policy failures incurred by the Argentinean Government during the 1990's could be summarized as follows:

- Argentina failed to maintain a sufficiently prudent fiscal policy that effectively restrained increases in public debt.
- The large and irresponsible increases in foreign debt made Argentina even more vulnerable to international crises.

- The government failed to set a proper parity between the Peso and the Dollar when the convertibility plan was introduced. As a result, the Argentinean Peso was overvalued from its inception, making the country less competitive. Competitiveness loss was increased by inflation during the early years of the program and by the devaluations in Mexico in 1994. This led to low export growth, high imports and large current account deficits.
- The currency board arrangement made Argentina even more vulnerable to international crises, particularly the 1994 Mexico crisis. For political and historical reasons, the country failed to soft-land its fixed exchange rate in 1994 and devalue the currency to remain competitive, as other countries did.
- Minor but inadequate reforms in wages and prices prevented the country from regaining its competitiveness.

The above review of policy choices made by Argentina during the 1990's shows that the current economic and financial crisis can be explained by the incomplete and inconsistent implementation of economic reforms by the government. They prevented the country from reaching desirable economic and social outcomes from the good reforms undertaken in the early 1990's.

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