

ARGENTINA: SLOW DEATH OR RESURRECTION?

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1. Introduction

By the end of the 1980s, Argentina was going through a period of crisis so intense that the very survival of the country was in doubt. After years of decay, both in economic and in political terms, the first democratically-elected President of Argentina, Raul Alfonsin, was forced to shorten his term amid widespread social agitation caused by runaway inflation and increasing unemployment. A long-lasting but very unstable institutional arrangement called in Latin America a *high inflation regime*, was showing strong signs of exhaustion¹. The most important of these signs was the inability to contain inflation rates within a given range compatible with survival, if not the efficient operation, of a market economy. The collapse of trade, caused by the refusal of traders to accept payments in local currency, a hallmark of an acute hyperinflationary process, leading to invasion of supermarkets and stores, and open social convulsion, led to the early ending of the Alfonsin presidency, in 1989.

Alfonsin was succeeded by President Carlos Menem, a leader of the Peronist party.² Mr Menem initially followed the trail set by Alfonsin, announcing a stabilization plan right after his inauguration and another a little later. The inability to recover some measure of control over the speed with which prices were increased led to the adoption of the *Convertibility Plan*, or, as it became more widely known, the *Cavallo Plan*, named after the Finance Minister who conceived and applied it.

Arguably, the Cavallo Plan was one of the most successful collection of policies ever implemented in a Latin American country, quickly leading to a durable reduction in the rate of inflation. By the end of the decade, Argentina was concerned with a unheard of problem

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¹ Signs that were to be repeated a little later in Brazil where an institutional arrangement similar in many aspects was also in force since the mid-1960s, leading to the adoption of the *Real Plan* in 1994.

in the region, the possibility of deflation. Even after the deep shocks that followed the collapse of the De La Rúa government, in December 2001, inflation did not return.³ On the other hand, the Plan is also blamed for causing, or for decisively contributing to, the problems that led to the 2001 collapse and the ensuing difficulties for overcoming the economic crisis.

2. *The Cavallo Plan*

In a narrow sense, the Cavallo Plan consisted of three interrelated, but basically independent, measures, that are sometimes confused even in language. Firstly, it was a *convertibility* plan, that is, a decision to allow trade in exchange market to be completely free, eliminating all kinds of controls on commercial or financial transactions with foreign currencies, particularly the US dollar. The US dollar, that had always been extensively used by Argentines as a store of value, became also a means of payment, to be used in domestic transactions side by side with the local currency. Secondly, the plan consisted in the adoption of a *fixed exchange rate regime*, that became known in Argentina as the “uno-a-uno” regime, according to which the external value of the peso was to be permanently maintained at the rate of 1:1 to the US dollar. Both these dimensions became so intertwined at the eyes of Argentines (and even of most foreign commentators that the word convertibility came to mean the combination of both characteristics). Thirdly, the Cavallo Plan introduced a monetary regime consisting of a *currency board*, that is a money supply rule according to which the issuance of money was limited by the availability of foreign reserves of the same value. The currency board was introduced to show the public that no discretion was allowed to the monetary authorities in the management of the money supply, so that no doubt could exist about the commitment to the “uno-a-uno” rule. Anybody willing to challenge the exchange rate regime could freely convert pesos into dollars,

² Officially named Partido Justicialista.

³ One could rightly argue, of course, that inflation did not return in 2002 because of the recession suffered by Argentina, the deepest in recorded history. Nevertheless, even in 2003, when the country has been living through a period of strong recovery, inflation is still very much under control. More importantly, perhaps, in the past, even deep recessions of long periods of stagnation were not enough to restrain the rate of price increases.

because the supply of pesos was equivalent to the amount of dollars held by the Central Bank.

As already noted, the Cavallo Plan was immensely successful in meeting its immediate goal of eliminating inflation. However, the plan exhibited some important internal limitations that could reduce its resistance to shocks at the same time that it did not address some important sources of fragility of the overall Argentine economy. These weaknesses ended up accumulating tensions that ultimately caused the end of this experiment in economic policy.

At least three internal limitations should be noted. Firstly, the currency board was at most an expectations trick. In modern societies, money consists not only of the paper money issued by the government (or under its authority) but also, and, in fact, mainly, of demand deposits kept at commercial banks. The currency board in Argentina guaranteed only paper money and bank reserves, what is called the *monetary base*. Bank money was *not* guaranteed by the currency board. In fact, in the event of a confidence crisis (as it eventually happened in the last months of 2001), people would try to convert all kinds of money (issued by the state or in the form of demand deposits) into dollars, only to find out that the foreign reserves under the control of the Central Bank was not enough to defend the convertibility. In fact, the liquidity of the banking system was a latent problem, since the currency board arrangement did not allow the Central Bank to operate as a lender-of-last-resort to banks, unless it was able to find ways to tap into international money markets.

Secondly, the currency board creates a direct transmission channel of disturbances in international capital and money markets and the domestic economy. There is no *cushion* between the domestic economy and the international economy under this arrangement. In the first years of the Cavallo Plan, the international financial system was overflowing with liquidity. The abundance of international liquidity translated itself in an ample supply of foreign currency to Argentina, exercising a strong pressure on the peso to increase in value. The reversals in capital flows to developing economies after the Asian and Russian crises led to pressures on the domestic supply of money and on domestic interest rates. The

Argentine Central Bank was fundamentally powerless to neutralize both kinds of movement.

Finally, as it often pointed out in particular by more orthodox analysts, particularly those connected with multilateral financial institutions, the adoption of the convertibility plan violated the conditions established in the *optimal currency areas models*. According to these models, an optimal currency area would include economies subject to largely similar external shocks, so that adjustment policies adopted by each economy would be similar in nature. Argentina and the US, however, are not integrated enough. On the contrary, trade connections between the two countries responded for only about 3% of Argentina's GDP. The US dollar was chosen as the "anchor" to the peso not because the two economies were integrated but because Argentines showed a strong preference for the dollar as a store of value and unit of account through the years. As a consequence, external shocks would be likely to have very different impacts on each economy, requiring relative price adjustments that would be more difficult to perform under the currency board regime.⁴

Besides these difficulties that were, say, *internal* to the Cavallo Plan, a major problem remained untouched by the new policy: the previous accumulation of external debt that required the Argentine economy to generate enough resources in US dollars to keep its service going.⁵ At best, the Argentine economy would move along a razor's edge between the need to accelerate growth and the difficulties such growth could create for the sustainability of its external position.

3. *The Argentine Economy in the 1990s*

⁴ The inadequacy of the Argentine currency board in terms of optimal currency areas models are discussed in Perry and Servén (2003).

⁵ As Frenkel (2003) has pointed out, it was not *solvency* that mattered but *sustainability*. For creditors it is the ability to service the debt that counts, not the way the required resources are being obtained. The debt may be sustainable even if solvency is in doubt if capital inflows are enough to cover the expected payments of interest and amortization. Of course, as Kregel (2003) stresses, this is a Ponzi scheme, bound to end up generating a crisis if nothing is done, such as a restructuring of the debt or the adoption of policies capable to generate net exports in the scale necessary to redeem the debt and reduce its service burden.

Despite the intrinsic fragilities of the Cavallo Plan, the Argentine economy performed well in the years between the adoption of the plan and the Mexican crisis of 1994/5. One reason for the relative tranquility of this period was the abundance of liquidity in foreign capital markets that allowed developing countries to borrow as much capital as they wanted (sometimes even more than they wanted) at relatively low interest rates. The currency board arrangement allowed these relaxed conditions in international financial markets to be translated into favorable domestic financial conditions, with an increasing supply of credit and a falling rate of interest. Of course, one has to keep in mind that tranquility at the present was being bought at the cost of increasing payment commitments for the future and that a significant share of this increasing debt was remunerated by variable interest rates, particularly the resources borrowed by the private sector.

It is important to keep in mind, on the other hand, that the success of the stabilization plan in drastically reducing inflation in Argentina, as it was also the case with the Real Plan in Brazil three years later, was responsible for a sharp improvement in the expectations of all economic agents, entrepreneurs, workers and bankers alike. To some extent, this renewed optimism was a reflection of the reduction of perceived uncertainty surrounding real incomes. Real wages, in particular tend to increase because of the significant reduction in volatility, pushing forward the demand for consumption goods. Banks tend to increase the supply of credit to private borrowers for the same reason. Firms plan to increase investments either because demand grows and/or because reduced uncertainty allows better planning for the future and a strengthening of animal spirits.

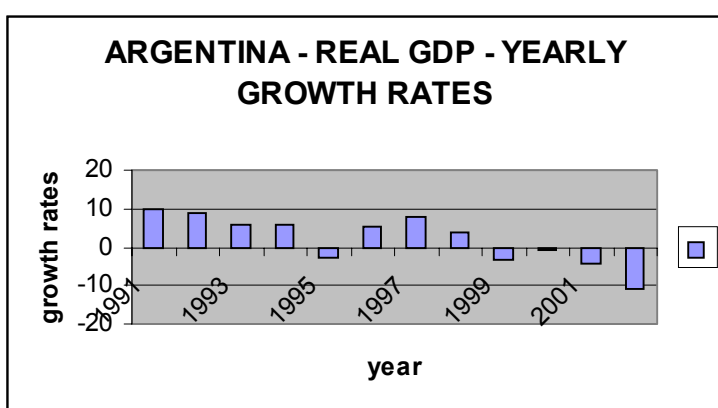
Prolonged exposure to high inflation produces a very palpable sense of fatigue. When the first so-called heterodox stabilization plans were implemented in Argentina and Brazil in the mid-1980s, they were welcomed enthusiastically by the population. The return of high inflation after each plan had deleterious effects on these economies that went beyond its material impact. Unless one understands that continuing high inflation was quickly eroding overall hopes and expectations of the general public in these two countries, generating a deep helplessness feeling and a sense of unavoidable doom, one cannot understand how stabilization plans that had so many flaws in their conception as the Cavallo Plan (and, to a

lesser extent, the Real Plan) could generate such an enthusiastic adhesion by the whole society. To deal with high inflation is not only annoying: it really consumes real resources, particularly in the form of waste of time and loss of planning horizons. People don't only get tired of inflation, they get poorer too. In these conditions, any stabilization plan that is perceived as capable of eliminating high inflation becomes something like a national treasure, to be preserved and defended against hostile forces. Even if rationally one could at some point of time realize that the strategy became obsolete and in need of replacement, it may be politically impossible to do it without causing a major commotion.

The Cavallo Plan was also helped by the overvaluation of the Brazilian currency, particularly after the creation of the new currency, the real, in 1994. The real was grossly overvalued, since the government expected that cheap imports could act (as it in fact did) to repress domestic inflationary pressures. The logic was simple: local firms would not dare rising their prices on the knowledge that not only imports were liberalized but also that they would be made artificially more competitive by the cheap dollar. The rapid increase in imports in Brazil opened an important opportunity to Argentine exporters. The overvaluation of the Argentine peso was, to some significant extent, disguised by the overvaluation of the Brazilian real.

As Heymann et alii (2003) emphasize, the fulcrum of the price stabilization strategy was to convince the Argentine public that the newly-created peso was as strong as the US dollar. To give credibility to this thesis was the immediate meaning of convertibility. To win the credibility game, the Argentine government kept raising the stakes, increasing the exit costs of such a system. Not only Argentines were stimulated to make commercial and financial deals with foreign partners, but local financial contracts were allowed to be signed to be liquidated in dollars. Casual empiricism could attest that in relation to commercial activities the bet was won: dollars and pesos circulated freely in Argentina. Traders seemed to be completely indifferent to the currency actually used in commercial transactions. Financial agents, however, seemed to be less sanguine: the interest rates paid on loans in dollar were slightly lower than those paid on loans in pesos. Be it as it may, nobody seemed to pay much attention, however, to the fact that local firms (or consumers) that were going to

receive their revenues in pesos (selling to local buyers) were free, however, to borrow in dollars. In fact, they were stimulated to do it since, as mentioned above, resources were cheaper if contracted in dollars. The currency mismatch characterizing balance sheets of firms that had their assets earning revenues in pesos, but their liabilities committing them to payments in dollars (or denominated in dollars) only seemed to become an object of concern much later in the decade when expectations as to the survival of the currency board deteriorated.



Source: Maia and Kweitel (2003)

Be it as it may, the Argentine economy performed well in the aftermath of the Cavallo Plan, reaching especially high growth rates in the first two years of the stabilization plan, as one can see from the graph above.

Beneath the surface, however, things seemed to be a lot more complicated than this. Confidence and optimism did not translate into real investment. As pointed out by Fanelli (2002), Argentina's external liabilities are practically of the same value as that of total assets owned by Argentine residents abroad. As Fanelli concludes, foreign capital actually financed investments abroad rather than the growth of capital equipment in Argentina. Under these conditions, it is not surprising that productivity growth, although impressive in the first half of the 1990s, could not be sustained so that any increase in competitiveness of

Argentine exporters was not enough to generate current account surpluses that could reduce the economy's dependence on foreign capital.

Alarm lights were first turned on during the Mexican crisis, which led to a reversal of capital flows. The impact of the crisis was sufficiently severe to force the government to seek for new instruments to strengthen the stabilization strategy. The main initiatives taken by the government were to contract stand-by lines of credit with international banks (since it was only by additional borrowing that the Central Bank could increase reserves and thus issue pesos to serve as a lender-of-last-resort) and to seek support from the IMF, which, of course, never comes alone. Macroeconomic policy in Argentina became now constrained by the conditionalities imposed by the Fund.

As can be seen from the graph above, however, the Mexican crisis was resolved and Argentina resumed at least an appearance of normality until 1999, when the final crisis began, under a combination of accumulated tensions that could not be dealt with within the confines of the currency board.

4. The Crisis

Argentine economists have been using the term *depression* to characterize the state of the economy from the end of 1998 to 2002. The term is justified both by the depth of the contraction in GDP and by the duration of the crisis. Argentina's GDP suffered an accumulated reduction of more than 20% between 1999 and 2002, having decreased about 11% in 2002 alone. After de la Rúa's resignation, which followed a sequence of ever more violent street protests, three presidents governed the country, including Nestor Kirchner, elected in 2003. Unemployment rose to previously unknown levels and the phenomenon of widespread poverty, so common in other Latin American countries, made a dramatic appearance in that country. On the other hand, foreign (and local) investors found themselves facing the largest default ever declared by a developing economy, banks had to be closed for a long period to avoid runs and, after reopening, paid a high price when the

government converted assets and liabilities denominated in dollars to pesos at different rates.⁶

Many reasons have been listed to explain the crisis. One analyst even used the expression *perfect storm* to refer to the unusual combination of bad news that not only led to a crisis but also explained its severity. Some factors seem to be consensual: overvaluation of the peso with respect to the dollar had particularly damaging effects when the dollar itself rose in value, after 1998, and the real collapsed in 1999. Argentina lost important markets both in the Brazilian and the European markets as a result of these two factors. Deprived of the possibility of changing exchange rates to seek balancing its trade balance, Argentina could only respond to those two shocks by deflating its economy, which not only proved to be politically impossible but also caused the recession to deepen.

More debatable are the roles of fiscal policy and of the IMF in the triggering of the crisis. Orthodox economists, particularly those related to multilateral institutions, tend to blame the fiscal policy for the crisis. Although generally accepting that fiscal deficits emerged after 1998 mostly because of the GDP contraction, with its consequent reduction of tax revenues, these critics blame the government for not having built a cushion in the prosperous early years of the decade, generating surpluses that could be used to strengthen public finance in the crisis years. Non-orthodox critics point out, in contrast, that, first, the problem was not the generation of fiscal surpluses but of surpluses in foreign currency to keep external debt sustainable, and, secondly, that public deficits in Argentina were lower than those accepted by the Maastricht Treaty in Europe.

There is also debate around the role of the IMF. Again, most analysts would agree that the contractionary adjustments imposed by the Fund, forcing governments to cut expenditure during a crisis to increase primary surpluses, is both a cause of further reductions of aggregate demand and income and innocuous as a remedy, since even if surpluses are actually obtained they could not be used to service foreign debt. More conservative

⁶ In a process that was called *asymmetric pesification*. Liabilities were converted at a rate of 1,40 peso for dollar, but assets at a rate of 1 peso for dollar, so the value of liabilities was increased while the value of assets was maintained at the original levels.

economists would argue, however, that there would be no alternatives since financial markets would refuse to extend credit to the government anyway, so it would not be possible to use Keynesian tools to spend its way out of the crisis, as critics such as Stiglitz have proposed.⁷ It is clear, in any case, that even the more generous analysts considered the Fund's policies to be, at best, unhelpful. Whatever these policies were, they did not address the main problem: the debt overhang that plagues Argentina, as it does other economies in the region.

As deep as the economic problems were, one should not ignore the political dimension of the Argentine crisis, particularly because of its implications for the rest of the continent. Even the more prosperous periods after the liberal reforms of the late 1980s and the 1990s were very frustrating for a large segment of the population of Latin America. Growth was episodic and erratic, never enough to spread its results to the overall population, in particular because of the inability of these economies to generate jobs and to overcome external dependency and vulnerability. Public services are bad and cannot be improved because public expenditures are primarily decided with an eye at the obtaining the primary surpluses that will calm financial markets. Vanquishing inflation was surely an important accomplishment, but price stability became the only durable gain to be obtained from these reforms, which has been a permanent source of annoyance for the population. More ominously, there has been a strong tendency to consider that the inability to choose better policies is a characteristic of democracy, since electing progressive parties and candidates has not led to any visible improvement in the situation.⁸

De La Rúa was elected promising to change the orientation of the Argentine economy. He was ousted because from day one he submitted to the same liberal policies of his predecessors.⁹ Disappointment with his inability or unwillingness to promote change led to his gradual isolation until he could only find support, it seems, in his own family and immediate collaborators. After more than a decade of promises and false starts, the

⁷ This is the view advanced in Cline (2003).

⁸ One should consult the results of the polls taken by Latinobarometer on the adhesion of Latin Americans to democracy. Consult www.latinobarometro.org. See also Carvalho (2000/1).

⁹ A serious risk that also threatens Lula in Brazil. See Carvalho (2003).

population seems to be getting tired of the liberal strategy. The risk is that the search for alternatives bypasses democratic methods, and that taking the issues to the streets prepares the way for populist or salvationist leaders that do not respect the freedoms obtained after the military were sent back to the barracks in all countries of the region.

Weak governments, devoid of vision or initiative, such as De La Rúa's, not only cause political instability but, at the end of the day, also contribute to trigger financial crises, since investors realize that they are not capable of guaranteeing their commitments. In 2001, this was precisely the situation of the Argentine government, which contributed to deepen the crisis and lead to its violent conclusion.

5. Perspectives

Against most expectations, the choice of Eduardo Duhalde to serve as interim president, in 2002, contributed to reduce the political temperature in Argentina and to recover some semblance of normality, at least enough to promote presidential elections in 2003. The new president, Nestor Kirchner, was inaugurated at Argentina's national day, May 25th.

Despite the initial fears that the circumstances of the election would diminish Mr Kirchner's authority to propose new ways for the Argentine society¹⁰, the new president has been forcefully advancing new policies and rejecting old ways, which has contributed to raise his appreciation among Argentines to very high figures.

President Kirchner's initiatives are not restricted to changing the economic situation. As importantly as his economic policies, without a doubt, are his moves to retire the military leadership, many of whom were compromised by the dirty war of the 1970s, to demand the annulment of the amnesty laws that benefited the torturers of the military dictatorship, to clean the police, to substitute justices in the Supreme Court identified as corrupt, etc.

¹⁰ Mr Kirchner came in second in the first ballot, with about 22% of the votes, closely behind Carlos Menem. Mr Menem, however, gave up running in the second ballot when he realized that he would not be able to gather enough support to beat Mr Kirchner again. It seems that Menem expected Kirchner to become a weak

More directly to the point of this paper, Mr Kirchner made a frontal attack on the problem of public debt, by proposing a drastic reduction in its value, estimated to be between 75% and 85% of its present value. Inverting the logic that has been advanced by the IMF, and has been accepted by many countries, including Lula's Brazil, the Kirchner government did not start from what financial markets demanded in terms of interest payments to determine what was the room left for domestic policies, but did precisely the opposite. The calculation of what could be offered started from an evaluation of the *internal needs* of Argentina, in terms of employment, investment and social policies, to determine what could be left to be offered to lenders. Smartly, the Argentine government treated multilateral financial institutions like the Fund as senior creditors, so these loans should be served in full. Thus, private lenders were offered the residual of the government's expected revenues after deduction of what is needed to promote growth and fight poverty and what should be used to serve debts with the multilateral institutions. The priority of internal expenditures was accepted by the Fund and is recorded in the letter of intent signed by Argentina and sent to the IMF's board of directors.¹¹

The Fund's acceptance of the Kirchner program is an important event and it took an act of boldness to achieve it. The Argentine government threatened to default its obligations to the Fund unless an acceptable agreement could be reached with the institution. The agreement was signed the day after the deadline for payment of the debt with the Fund, and is notable for the vagueness of the dispositions accepted by Argentina. The Fund made it public that it wished Argentina would follow fiscal targets similar to those set in Brazil, aiming at a primary fiscal surplus of 4.25% of GDP for the next years. Argentina only accepted 3% for 2004, leaving future targets to be set in the future. The Fund also demanded a solution to the problem of public service tariffs, for the mostly foreign firms that assumed the sectors

president, since he was chosen by only about one fifth of voters, which could prepare the way for his comeback perhaps later.

¹¹ "The main objectives are to protect the more vulnerable parts of the society and to support the growth potential of the economy through needed social and infrastructure investment in order to promote durable and equitable growth with continued low inflation." (Argentina's Letter of Intent, available at the IMF website, www.imf.org, September 10th, 2003).

privatized in the Menem years. All the Argentine government accepted was to commit to *study* the problem and advance a proposal until December 2004.¹²

One should not underestimate the importance of being able to reach an agreement with the Fund without pre-specifying future commitments. The Brazilian government, for instance, under Lula, was unable to present any alternative, but to commit to the Fund's (and the financial market's) wishes. The emphasis given by the Fund to the need of conquering credibility with financial markets usually serves as an argument to demand firm commitments that restrain the policy-making autonomy of the national government. To the dismay of many of Lula's voters, the new Brazilian government seems to be following De La Rúa's footsteps, giving up any attempt to reorient economic policies. It is Argentina the country that has really been attempting new and progressive alternatives to the liberal strategies of the 1990s.¹³

One should not underestimate the difficulties that President Kirchner's government will have to face in the immediate future. The strong reaction of lenders and investors in Europe, particularly in Italy, Germany and Spain, shows that debt restructuring negotiations will not be easy. Although many of these investors were actually earning return rates that implicitly considered high *premia* for the likelihood of default, they seemed to have been caught by surprise with the proposal made by the Argentine government during the IMF general meeting in September. The problems are not restricted, on the other hand, to foreign lenders. Pension Funds in Argentina are great holders of public debt (not always

¹² The Fund's discomfort with the terms of the agreement was made explicit by this unusual statement inserted in the press release announcing the approval of the new loan: "The Fund recognizes that a number of risks are associated with the proposed program, including those arising from the fact that key elements of fiscal and banking reforms that are crucial to sustainability will only be formulated at a later stage." IMF Press Release 03/160, September 20, 2003, www.imf.org.

¹³ A current joke in the region nowadays is that Brazilians voted for Lula and got De La Rúa. Argentines voted for De La Rúa (in the sense of choosing a president everybody expected to be weak and indecisive) and got Lula. It is interesting to notice the different attitudes of the Argentine and the Brazilian governments as to the eventual overattainment of fiscal targets. The Brazilian government led by Lula seems to be proud to reserve any windfall fiscal gains to increase the primary surplus beyond the agreed target. This is done at the expense of expenditures in infrastructure investment, even though roads are falling apart and power generation is widely expected to become a problem in the near future. The Argentine government also earned higher incomes than expected (because the economic recovery has been faster than expected). The surplus revenues are being directed to investment and to raise pensions that were heavily eroded in recent years.

voluntarily, one should say). Debt restructuring will affect their solvency and will most probably force a new reform of the pension system in Argentina.

Another important task is the reconstruction of the domestic banking system. Banks are paralyzed by the impact of the *asymmetric pesification*. It is important to strengthen the banking system as well as to develop new domestic financial channels to give the support to productive activities and investment. On the other hand, the government has still to define how it is going to finance its own activities in the future. These are important questions that are still left unanswered.

One consequence of the strategy pursued so far is certain: Argentina will have to formulate new growth strategies based mostly on domestic resources. In the short term, this may be difficult, but in the long term, one may expect that, if successful, Argentina's dependence of foreign capital will be reduced, which is an important gain. If integration with Brazil is strengthened, and assuming that Lula's government at some point will have to change its direction to avoid been seen, as it is now, as a mere continuation of the Cardoso administration, there may a reasonable chance of success in finally defining an alternative to liberalism in the region.

The challenges are overwhelming but Mr Kirchner has begun his term in a very assertive way that has resulted in a remarkable strengthening of his leadership. The political initiative is with him, both in terms of domestic politics and in terms of the economy. Although one cannot lose sight of the obstacles to overcome, it is important to notice that starting from the bottom of a depression has some advantages. Growth can be achieved by simply stimulating aggregate demand, as it has been done. While firms occupy the large amount of idle capacity created in the crisis, the government has time to formulate, debate with society and implement a long-term economic strategy that reduces the country's dependence on foreign resources. The new president has not taken any important misstep so far. It is important to give him the support he needs to keep his policies on track and to face the pressures that will certainly be raised against any political strategy with chances of effectively challenging the dominance of liberalism.

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