

# ARGENTINA – WHAT WENT WRONG?

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WHILE ECONOMISTS DIFFER ON THE REASONS FOR ARGENTINA'S CURRENT ECONOMIC SITUATION, THERE ARE LESSONS FOR OTHER EMERGING MARKETS FROM THE WAY THAT COUNTRY'S FISCAL POLICIES HAVE BEEN MANAGED.

In the past year, Argentina has experienced:

- the world's largest default (\$155 billion)
- blazing street riots
- a change of president five times in the space of two weeks
- its people fleeing the country
- the peso lose 70 percent of its value
- GDP down 13.5 percent
- consumer prices up 30 percent
- unemployment of over 20 percent
- over half the country's 36 million inhabitants officially being declared 'poor'.

Its plight is all the more striking because Argentina had been widely held up as the model of successful free-market reform. Reform measures included overcoming inflation through macroeconomic discipline and open trade, openness to foreign investment, more flexible labour markets and large-scale privatisation.

So what went wrong? And who is to blame? The answer is important not just to Argentina's recovery but to all of the developing nations.

**BUSINESSWEEK CALLED IT "THE WORLD'S BOLDEST EXPERIMENT IN ECONOMIC REENGINEERING". THE RESULT ... WAS "A DEVASTATING OUTCOME GREATER THAN THAT OF ANY WAR". AND WHAT WAS THE CAUSE?**

## RICHES OF THE PAST

Fertile land, railways and the new science of refrigeration made Argentina the supplier of meat and grain to Europe in the 19th century, and by 1913 it was one of the world's 10 richest countries. With the 1920s came agricultural depression then a world slump. Argentina's leaders aggravated their country's problems by retreating into protectionism, and the country slid into economic decay and experienced repeated military coups. While democracy returned in 1983 the economy continued to languish, with two bouts of hyperinflation, and two banking crises.

During the 1970s and 1980s, Argentina's main economic problem was persistent, extreme inflation. During the 1980s, Argentina twice changed its currency, with a further adjustment in the 1990s:

- December 1983: One 'peso Argentino' equal to 10,000 old pesos.
- June 1985: One 'austral' equal to 1000 peso Argentino.
- April 1991 (Convertibility): One 'new peso' equal to 10,000 australs.

However, the changes did not stop inflation. By the end of 1990, the CPI was more than one billion times the level at the beginning of 1975!

## BOOM AND BUST

In 1991 the country embarked on free-market reform, with the cornerstone of a

currency board. (A currency board restricts domestic currency to the amount of foreign currency held. A stable money supply helps rein inflation in). Inflation was killed, the risk of devaluation removed and capital poured in 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, hydro-electric dams and banks. The state welfare system was run down in favour of private pension funds.

The model was successful. Inflation went down to zero. Between 1990 and 1998 real GDP grew at 5.8 percent p.a. (versus -0.2 percent p.a. between 1975 and 1990).

Then came four external shocks: (a) Mexico's devaluation and (b) Russia's default, which led to investments drying up and interest rates soaring, while (c) the price of commodities – 60 percent of Argentina's exports – plunged, and (d) Brazil – Argentina's largest trading partner – devalued its currency. These moves saw exports become less competitive, resulting in a crippling four-year recession and leading to deflation, falling wages and rising unemployment. The fiscal deficit rose as tax revenue fell. The Government's interest bill blew out, with debt rising to 52 percent of GDP and a debt to service ratio of 60 percent.

The conventional responses to the external shocks – adopting a tough fiscal policy and devaluation – are not possible with a currency board. Not only did Argentina lack the option of a 'quick-fix' devaluation, but the currency board also meant forsaking monetary policy too. Other measures to improve competitiveness were unavailable, as Argentina had already privatised state enterprises and liberalised trade, and other reforms – e.g. to labour markets or pension funds – were politically more difficult.

Failure turned to disaster (ironically under the same miracle worker of the 1990s, Mr Cavallo, father of the currency board) when four events took place: Argentina moved to a dual exchange rate, froze bank deposits, abandoned the currency board and defaulted on debts amounting to \$155 billion.

## CAUSE AND EFFECT?

*BusinessWeek* called it "the world's boldest experiment in economic reengineering". The result, as economist Joseph Stiglitz puts it, was "a devastating outcome greater than that of any war". And what was the cause?

**NEO-LIBERAL POLICIES**

Some economists blame the neo-liberal policies, claiming that the currency peg did not provide flexibility to meet external shocks and that the reform program did not promote domestic industry and growth. The argument runs as follows.

The peg lowered inflation but did not promote sustained growth. Introduction of the reform package and allowing foreign ownership of banks led to a seemingly more stable banking system, but one which failed to lend to small and medium sized firms. Growth slowed because firms could not get adequate finance.

With the appreciation of the dollar in the late 1990s, the Argentine currency board experienced overvaluation. Argentina's exports became less competitive. These effects spilled over to the real side of the economy leading to a recession.

Others disagree, claiming that blaming Argentina's problems on the speed and extent of its free-market reforms and on the fixed exchange rate is nonsense. Firstly, Argentine exports account for only 10 percent of GDP. Secondly, 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**

A second school of thought holds that the problem was not 'liberalisation' but its

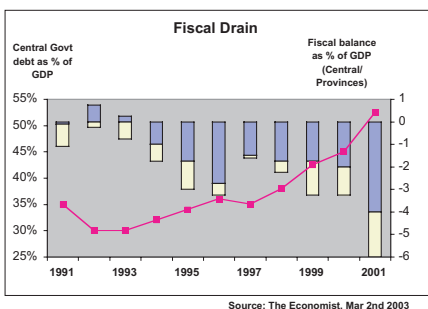
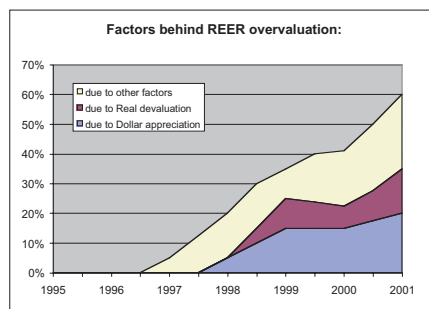
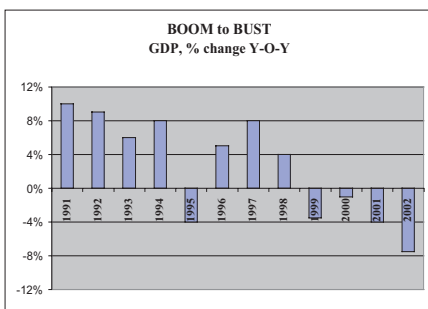
**Lessons for developing nations**

- 1** Globalisation exposes a country to enormous shocks. Adjustments in exchange rates are part of the coping mechanism. ↔ Instead of pegging its currency to a single currency, it is better to use a basket of currencies reflective of its trading pattern.
- 2** Growth requires financial institutions that lend to domestic firms. ↔ Selling banks to foreign owners, without appropriate safeguards, may impede growth and stability.
- 3** A single-minded focus on inflation without concern for unemployment or growth is risky. ↔ Government policies that leave large parts of the population unemployed will not restore economic confidence – or strength.
- 4** Timing and pacing is critical. Open markets can operate efficiently only within a strong regulatory environment. ↔ The privatisation of the state sector in a country with weak legal and regulatory systems leads to enormous corruption and too little competition, much as it did in Russia.
- 5** Such strategies require near-flawless execution. In the real world, policymakers in developing nations face too many political constraints to pull everything off overnight. ↔ Investors who stampede into such markets often end up financing unsustainable booms. One needs to calibrate the pace of liberalisation.

undermining by loose fiscal policy. Instead of printing money, as in the bad old days, Argentina printed bonds to finance its fiscal deficit. Instead of pressing forward with reforms (to labour law, social provisions, infrastructure etc.) politicians continued to buy political support. Spending by these governments grew to 30 percent of GDP. These budget deficits were hidden during the first half of the 1990s by revenue from the

sale of government companies. After privatisation, revenue evaporated and the government financed the budget gap by borrowing dollars on the international market. In recent years, this debt grew to \$150 billion as deficits grew to four percent 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 look at it the other way. According to economist Jeffrey Sachs, "The widening budget deficit 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 fell. Austerity measures were implemented but could not keep pace with falling tax revenue. The budget widened and the economy collapsed.



**CONCLUSIONS**

Clearly the debate will continue, and mistakes were made. But there are lessons for other emerging markets. **NA**

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