

“Structural Reforms in Argentina: Success or Failure ?”

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This paper evaluates the impact of the Convertibility Plan in Argentina on economic performance. It shows that the combination of a fixed exchange rate and far reaching structural reforms was successful through most of the nineties, as Argentina succeeded in eliminating inflation and it enjoyed its highest rates of growth since the 1920s. Nevertheless, at the end of 1998 Argentina entered a severe recession from which it has not yet recovered. A deterioration in the external environment as the dollar appreciated and less financial capital flowed to emerging markets required a reduction in nominal wages (especially in the public sector) and in government expenditures which did not take place. The lack of response eroded confidence, tax revenues fell as a result of the recession and financing disappeared. The exchange rate system finally collapsed in early 2002 and the government declared a default on public debt leading to what seems to be the most serious economic crisis that Argentina has ever experienced.

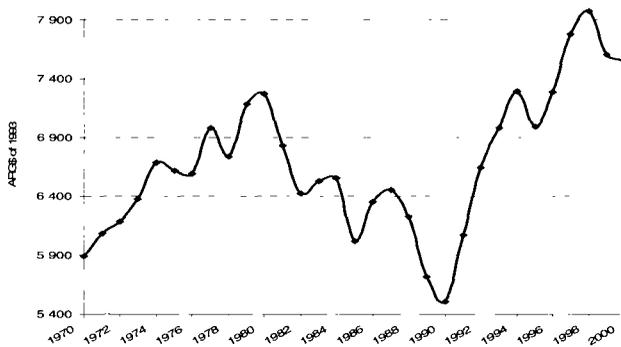
I. Introduction

Argentina implemented far reaching structural reforms in the nineties following a decade of very poor performance. The crisis of the eighties led to the end of an era characterized by high levels of government intervention in the economy, large macroeconomic imbalances and deterioration in economic and social conditions. The changes implemented during the nineties gave Argentina an opportunity to achieve sustained economic growth, monetary stability, and lower levels of unemployment and poverty.

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After almost half a century of high inflation rates and continuous devaluation of the Peso, Argentina maintained price stability and the parity of the Peso with the US Dollar for 10 years. GDP grew at annual average rate of 4.5%. (See Figure 1). Investment was one of the main engines of growth during this period, while exports also played an important role, especially in the second half of the decade.

**Figure 1:
GDP per Capita Evolution
1970-2000**



Source: FIEL according to the Department of National Accounts, Ministry of Economy

By and large, the structural reforms implemented in the nineties had a positive impact on the economy. Privatizations, in general, improved the supply of public services. Pension reform together with the creation of private pension funds (AFJPs) helped to reduce the contingent liabilities of the public sector and contributed to the development of the local capital market. The elimination of numerous superfluous regulations fostered investment, and the creation of a special regime for oil and mining generated a boom in investment in a sector with great potential for generating foreign currency.

Despite these positive aspects of the reforms of the nineties, the beginning of the new millennium finds the country in a deep economic recession and a renewed debate regarding economic policies for the future. The country is now facing its third year of what has become a long recession with a significant increase in the rate of unemployment which in May 2001 reached about 16.4%, an increase in the poverty index, a delicate fiscal situation, and restricted access to the international capital market. Sovereign risk has remained at extremely high levels, and since the beginning of 2001 Argentina has suffered

repeated reductions in the credit ratings from the three major international rating agencies.

Some of the problems that Argentina has been suffering had their origin in the deterioration of the international economic situation. The crisis of the Asian countries in 1997, the Russian crisis in August 1998, the Brazilian devaluation in January 1999 and the recent crisis in Turkey had important negative effects on the country, mainly in limiting its access to international capital markets. The increases in interest rates by the Federal Reserve (prior to 2001) and the appreciation of the dollar in recent years did not help either. Finally, the country has suffered a deterioration in most of its export prices, especially those of the agricultural and mining sectors.

The long-lasting recession does not have its origin just in external factors. Despite the improvements in the fiscal accounts in the nineties, the reductions in primary expenditures were not sufficient to offset the increases in interest payments and the fiscal situation is not sufficiently strong. The three year recession reduced revenues and made the fiscal situation worse, but the country did not take sufficient steps to eliminate the fiscal deficits. The situation was further complicated because there has been very limited access to the capital markets to finance budget deficits and to refinance the amortization of existing debts.

The second important domestic element is that there was not enough flexibility in the price system and in the labor market to compensate for the rigidity of the convertibility regime. When the economy required nominal flexibility in private and public sector wages, the adjustments were not made, at least, with the necessary speed.

The objective of this paper is to evaluate the performance of the Argentine economy in the nineties, to analyze the main structural reforms implemented in that period and to evaluate their impact. The paper reflects our views as of June 2001, when the paper was originally written. Section II provides an inventory of the reforms implemented in the nineties and evaluates their overall impact. The Argentine reform process was broad in scope and was implemented in a relatively short period of time, though progress was uneven across sectors. It was far reaching in the financial sector, and for privatisation, but there was less progress in the labor market and in reforming the tax system.

Section III evaluates the impact of the structural reforms on the Argentine economy, and contrasts the positive results obtained between 1991 and 1998 with the weak performance that Argentina has shown in the last three years. We conclude with an analysis of two problematic issues, the increase in the unemployment rate in the nineties and the deep recession that began in 1998.

Section IV focuses on the main policy problems that Argentine was facing at the end of the decade. It also provides a brief update with an overview of the end of convertibility and the Argentina default. We will show that Argentina still needed to strengthen its fiscal solvency, to improve its savings rates, to develop the capital market, to increase the amount of international

trade and to achieve more flexibility in the goods and labor markets. The paper concludes in section V, with an evaluation of the possible reasons that led to the collapse of convertibility and the default on Argentina's debt in early 2002.

II. The Economic Transformations of the Nineties

The nineties marked a turning point in the design of Argentine economic policy, as the government reversed most of the policies followed since the thirties. The country moved away from import substitution, and the active use of monetary and fiscal policies to manage the business cycle. Moreover the state no longer had a dominant role in the production of goods and services and in the allocation of resources. Those interventionist policies led to a deterioration of the economy as Argentina moved from being among the top ten countries measured by income per capita in the twenties (higher than Germany or Italy¹), to 56th in the world² more recently (with a GDP per capita similar to Hungary, Slovakia, and the Czech Republic, and way below Australia, Canada, and New Zealand).

This overall deterioration peaked in the eighties, when Argentina suffered a marked deterioration in its macroeconomic indicators, (Table 1). During the so-called lost decade the Argentine economy suffered a fall in GDP of 1.3% per year, which amounted to the worst performance at a global level with the exception of Nicaragua.³ In addition, Argentina experienced hyperinflation, with the inflation rate in 1989 exceeding 12,000 percent.

Table 1:
Turn Around after the Crisis of the 80's

Growth and Productivity in Argentina (% of growth per year)		
	1981-1990	1991-2000
Market GDP	-1.30%	4.45%
Employment	1.07%	1.64%
Total Factor Productivity	-1.0%	1.64% ¹
Exports	3.40%	9.18%
Inflation	787.0%	21.4%
Fiscal Deficit (% of GDP)	-6.4%	-2.0% ²

¹ Corresponds to the period 1991-1999

² Corresponds to the period 1986-1990

Source: FIEL

The response to the crisis was the implementation in the early nineties of a program of stabilization and structural reforms, commonly known as the 'Convertibility Plan.' The goal of this program was to restore macroeconomic

stability, and long-term growth. Even though the monetary reform was only one of its parts, the fixed exchange rate was one of the program's most visible pillars which led the overall program to be known as the Convertibility Plan.

The Convertibility Plan leaned on four broad pillars. First, the monetary reform, based on the convertibility law, had as its main objectives to eliminate inflation and restore confidence in the Peso. Second, a reduction of the fiscal deficit was aimed at consolidating price stability and guaranteeing that the government would not print money to finance expenditure. Third, structural adjustment reforms, such as deregulation of key markets, the opening up of the economy to international trade, and privatization of public sector enterprises were aimed at generating the basis for economic growth. Finally, the institutional framework was strengthened by granting independence to the Central Bank, creating institutions to regulate the recently privatized utilities and by strengthening the Securities and Exchange Commission (the CNV), etc.

Like most programs that successfully stopped hyperinflation,⁴ the Argentine stabilization program was based on a fixed exchange rate. The main components of this policy were the convertibility law and the independence of the Central Bank. The convertibility law had three fundamental elements. First, the exchange rate was fixed at one Peso to one Dollar, thus providing a strong nominal anchor that is critical to stop inflation. This was particularly important for Argentina because most prices were denominated in dollars during the hyperinflation. Second, the convertibility law forced the central bank to back the monetary base with international reserves, thus generating credibility for the program and differentiating this initiative from previous failed stabilization plans that also used a fixed exchange rate as a nominal anchor. Finally, the law imposed strict limits on the capacity of the Central Bank to finance the treasury, because it could only do it through the purchase of treasury bonds, issued in dollars and bought at market prices.

The fiscal adjustment was the second component to ensure price stability. Argentina entered the nineties with fiscal deficits that were exceeding 8% of GDP and that were mostly financed through the inflation tax.⁵ There was a rapid improvement in the fiscal accounts, which achieved a surplus of 0.4% of GDP in 1992. Consolidated public expenditures were reduced from a peak of 38% of GDP in 1989 to 31.6% of GDP in 1992. Finally, the convertibility law also led to the elimination of the large quasi-fiscal deficit that was generated at the central bank by interest rate subsidies, foreign exchange insurance and interest payments required on reserves. It is estimated that in the mid-eighties the quasi-fiscal deficit amounted to 4% of GDP, and that it was reduced to around 2% of GDP in the late eighties.

Privatizations had two main goals: to reduce the fiscal deficit and to improve economic efficiency.⁶ The government received around 16 billion dollars in privatization revenues between 1991 and 1998.⁷ In addition, there were important service improvements in privatized industries. For example, the number of fixed telephone lines increased from 3.1 million in 1990 to 8 million in 2000, or 14 million if we include cellular phones. Energy production capacity

almost doubled between 1992 and 2000, and the number of passengers who travel by urban trains increased by 120% in this period.⁸

The government also made significant progress regarding deregulation and opening up to international trade. The average import tariff was reduced from approximately 35% in the mid-eighties to 13.5% in 1999. In addition, the administrative steps required for importing goods were enormously simplified, and a major part of the quantitative restrictions were eliminated.

There was also important progress in the financial sector. The elimination of entry restrictions, the deregulation of interest rates, and an environment that favored the development of new financial instruments caused significant growth of the financial sector.

There was less progress in the labor market. The reduction in labor taxes and the creation of a new system to insure on the job injuries were steps in the right direction. The privatization of the social security system was important because it allowed workers to regard retirement contributions as savings and not as a tax. But the labor sector improvements were not large enough to ensure enough flexibility in wages and labor regulations.

III. The Impact of the Reforms of the Nineties

The monetary stability that was achieved as a result of the convertibility plan, and the structural reforms that contributed to a significant increase in productivity brought the secular stagnation of the Argentine economy to albeit a temporary halt. Without a doubt, the nineties were the decade when Argentina experienced the highest growth levels with largest degree of monetary stability since the thirties.

III.1 The Initial Impact

The inflation rate rapidly reached international levels and towards the mid-nineties it was one of the lowest in the world. Inflation ceased to be an issue in Argentina after being at the center of economic policy for almost fifty years.

High growth rates were also achieved, especially in the first half of the nineties.⁹ The highest rates of growth took place between 1991-94, when the economy grew at almost 9% per year. Growth maintained a positive trend until 1998, with a pause in 1995 as a result of the "Tequila" effect. Growth spread across the Argentine economy but was especially strong for the construction industry (that grew at 15% per year), and the mining, energy, and financial sectors.

In addition, employment grew at an annual rate of 1,8%, creating 370,000 jobs per year between 1991 and 1994. The economy was creating enough jobs to compensate for losses resulting from the reforms of the state. Unemployment did not appear as a major concern until the end of 1994 when the unem-

ployment rate reached 12.2% in October 1994 and got worse in May 1995 when it reached a peak of 18.4%.

This period of high growth continued until mid-1998, although it suffered from a severe disruption in 1995 as a consequence of the Tequila effect. However, as it is shown in (Figure 1) the Tequila recession represented only a pause in the trend. In fact, the end of the expansion occurred in 1998, after the Russian crisis, and from that moment on Argentina entered a deep recession from which it did not recover.¹⁰

Investment was one of the engines of growth, since it grew 18.8% per year between 1991 and 1994. The increase in productivity also played an important role in growth. Productivity increased at 2.1% per year between 1991 and 1998, and explains approximately half of the growth of GDP in this period. The structural reforms, especially the privatizations and the deregulation of the economy, together with the new environment of price stability played a big role in the increases in productivity.

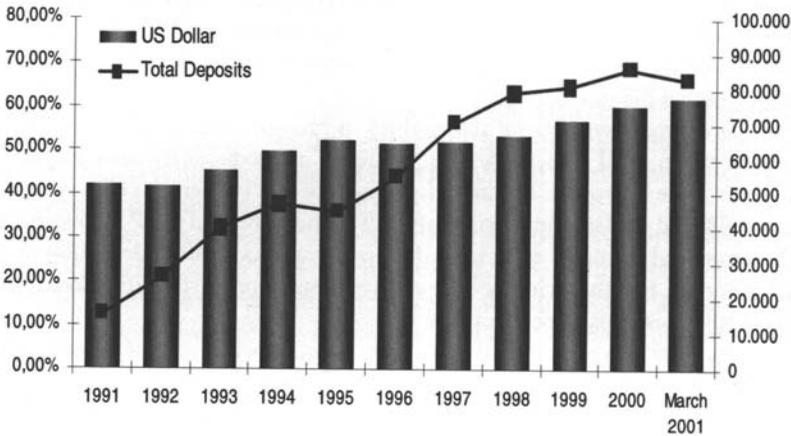
Exports also contributed to growth, especially between 1993 and 1996. During the nineties, Argentine exports grew at 8.7% per year, which means that Argentina doubled the growth rate that it had during the eighties, exceeded the growth in the world trade growth and that of the industrialized countries whose exports grew at 6.5% per year. The successful performance of Argentine exports helped the country achieve growth rates that were closer to those of countries with a higher degree of openness, such as Chile, and it fully surpassed Brazil's growth rate. This increase in exports was diversified in terms of both products and destinations.

One of the weaknesses of the Argentine economy has been its low level of domestic savings. Although there was an increase in the level of savings between 1992-95, from 14.6% to 16.0% of GDP, it fell after that to 13.1% of GDP in the year 2000. The lack of domestic savings to finance the higher levels of investment implied that Argentina ran a deficit in the current account of the balance of payments. In other words, investment that could not be financed through domestic savings was financed externally through the current account. Argentina experienced current accounts deficits throughout the nineties, and by the end of the decade it stabilized at around 3.5% of the GDP, a level that does not seem to pose a threat to macroeconomic stability.

III.2 The Growth of the Financial and Capital Markets in the Nineties

The financial sector grew strongly as a result of the remonetization of the economy. The hyperinflation of the late eighties led to a significant reduction in the use of the domestic currency. Once price and exchange rate stability were restored, there was a significant increase in money demand, which increased from 5.5% in GDP in 1991 to close to 30% of GDP in 2000, (Figure 2).

**Figure 2:
Argentina: Deposits by Currency 1991-2000**



Source: Argentine Central Bank and Estudio M. A. Broda

The convertibility regime opened the door for bimonetarism, allowing people to choose the currency in which they wanted to hold their deposits. This helped the development of the domestic financial system because most Argentines showed a significant preference to maintain their savings in dollars, a tendency that became apparent during the hyperinflation. In the past, every time Argentines chose to keep their deposits in dollars, they were forced to take their money out of the country, generating capital flight. With the changes introduced by the convertibility law and the law of financial institutions, it was legal to switch a deposit from one currency to another within the Argentine financial system. Currency substitution had no impact on total deposits, and the financial system was strengthened.

The share of dollar deposits in the banking system increased throughout the nineties. The first important increase occurred during the Tequila effect. From then on the percentage of dollar deposits increased from 48% in 1994 to 52% in 1997 and to 59% in 2000. This dollarization process was particularly important for time deposits while dollarization did not affect transaction deposits (checking and savings accounts), where the peso continues to have a predominant role. The overall growth in deposits provided the basis for the significant increase in credit to the private sector, which grew from 22,770 million Pesos in 1991 to 68,620 million in 2000.

The capital markets became more dynamic in the mid-nineties with the emergence of institutional investors who are becoming increasingly important. The private pension funds, the AFJPs, that started to operate in 1994 and

replaced the pay-as-you-go public pension system, have been the most important players in this area. The pension funds invest primarily in public bonds, stocks, corporate bonds. By 2001 they had about 22,000 million dollars in assets under management, equivalent to around 7% of GDP. Life and retirement insurance companies, and mutual funds, though smaller in size, also became important institutional investors in the nineties.

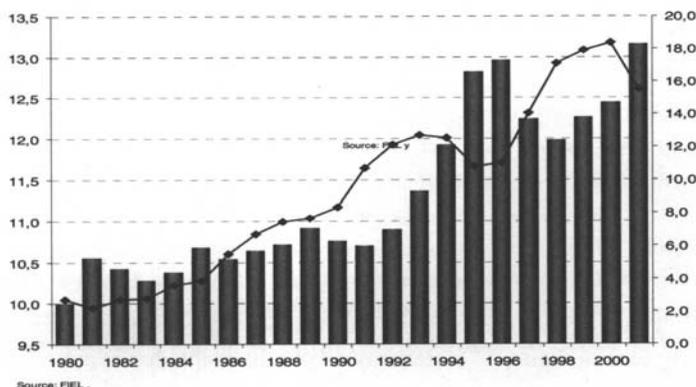
III.3 The Dark Side of the Boom in the Nineties

Although Argentina had a good economic performance through most of the nineties, there were some problems that became more apparent at the end of the decade. In particular, the country entered a long recession in 1998, and there has been an increase in unemployment and poverty. There was higher volatility of output and of capital flows in the second half of the nineties, and fiscal deterioration led to a large increase in the sovereign risk.

The increase in the rate of unemployment in 1995 and the more recent trend indicating a new rise in this rate has been the most worrisome macroeconomic issue. There was an important difference in evolution of unemployment between the first phase of the convertibility plan (1991-95), and the 1996-2000 period. In the first period unemployment increased despite a rise in output, while in the second period the behavior of GDP and unemployment were more closely correlated over the business cycle. In fact, we observe that the fall in the rate of unemployment from 18.4% in May 1995 to 13.7% in October 1997 coincided with an economic expansion. The rate of unemployment increased again in the last two years, reaching 16.4% in May 2001, as a result of the current deep recession. This indicates that, probably and in contrast to what happened at the beginning of the decade, one of the best ways to reduce the unemployment rate is to stimulate growth, (Graph 3).

Graph 3

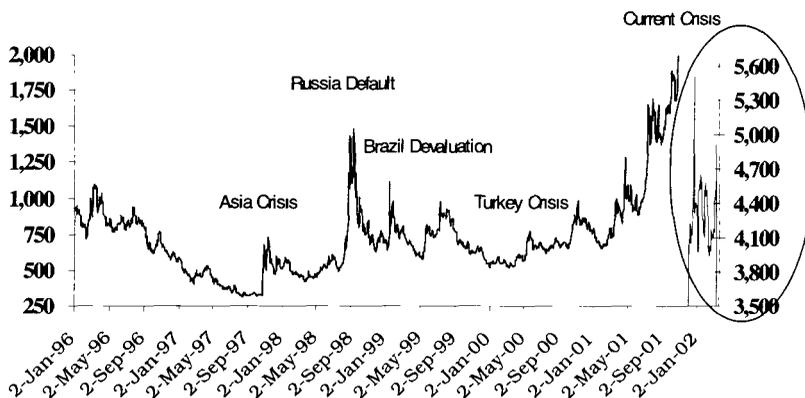
Employment Level and Unemployment Rate 1981-2001



A decrease in labor costs through lower labor taxes and through greater flexibility in the labor market should have helped to reduce the unemployment rate. Even though there were improvements in this area, such as reductions in direct and indirect labor taxes, lower severance payments or more flexibility in negotiating labor contracts, there was still much to be done. One area of concern were labor contracts in the public sector, where there were significant rigidities in wage and non-wage benefits. In addition, given that Argentina had a rigid exchange rate system in the nineties, it was critical to have a very flexible labor market.

The second worrisome issue was the volatility of capital flows and the vulnerability that the Argentine economy showed to changes in these flows. Capital Flows have been affected by external and domestic factors. Among the former were the consequences of the Tequila effect, the Asian crisis, the Russian default, the Brazilian devaluation, and more recently the Turkish crisis. Among the latter, the most relevant ones were the statements made by some candidates during the presidential campaign in 1999 about a forced restructuring of the external debt, the resignation of Carlos "Chacho" Alvarez, the vice-president, and the three changes of economic minister in March of this year. As we can see (Figure 4), the level of the country risk (measured as basis points over U.S. Treasuries) was strongly affected by these episodes.

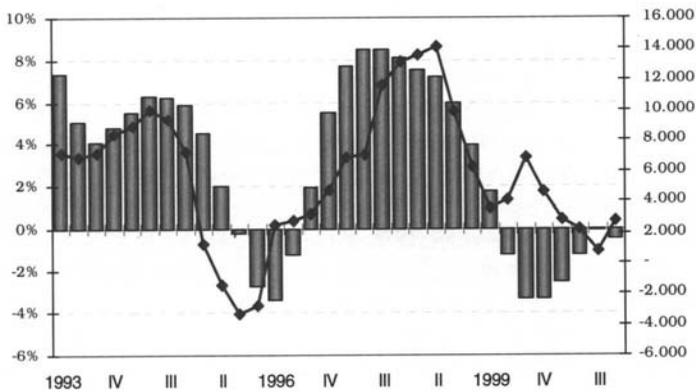
Figure 4:
Emerging Markets: Sovereign Risk
1996-2002 (Monthly Average)



The importance of capital flows on the Argentine business cycle can be clearly seen in Figure 5. It stands out from the graph that in periods of private

capital inflows, such as 91-94 or 96-97, the economy experienced an increase in growth, while in those periods when there was an outflow of capital or in those years where there were simply no inflows of private capital, the economy suffered a fall in the economic activity. Something similar happens when one analyzes the evolution of economic activity and sovereign risk, associating periods of decreases in sovereign risk with capital inflows and increases in the level of activity.

**Figure 5:
Private Capital Flows & GDP Growth MA4Q**



Capital flows to countries like Argentina certainly depend on the ‘push and pull factors.’ In other words, capital inflows depend on external factors, such as a fall in interest rates of industrialized countries (the United States in particular), contagion from crises in other emerging markets or a reduction in the degree of risk aversion to investing in emerging economies. Internal factors are also important, as they induce and make it more attractive to invest in the economy. In the case of Argentina, in the first half of the nineties the push and pulls factors favored a strong inflow of capital. The fall of interest rates in the United States between 1991 and 1993 was an important push-factor, while the structural adjustments implemented during those years pulled capital into the country. On the contrary, in 1999 and 2000 both factors played against Argentina. We observed an increase in risk aversion by institutional investors who reduced their exposure to developing countries as a result of the Russian crisis. The reversal of private capital flows was particularly strong in 2001, when Argentina faced capital outflows equivalent to 10% of GDP.

In addition, toward the end of the decade some economic indicators pointed to a reversal of many of the achievements obtained during the first years of the nineties. For example, there were increases in public spending, mainly in the provinces, and an increase in the fiscal deficit to 3% of the GDP in

2000. We could also observe a worrisome increase of public debt, stagnation of the credit from the banking system to the private sector since 1998, and a new wave of protectionist policies being implemented.

III.4 The Recession of the End of the Decade

In the second half of the nineties Argentina was not able to maintain the high rates of growth that it enjoyed during the first half of the decade. With the exception of 1996 and 1997, when the country seemed to return to high growth after the Tequila slowdown, Argentina had a poor performance, and the country has been in a severe recession since the second half of 1998.

This long and deep recession was more severe than in other countries in the region. It is true that as a consequence of the Asian and the Russian crises, many developing countries, especially in Latin America, experienced a decrease in growth rates in 1998 and 1999. Brazil had practically no growth in 1998 and 1999, while Chile suffered its first fall in output in two decades in 1999. Nevertheless, the numbers clearly show that almost all the economies of our region started growing again in 2000, while Argentina continued to be mired in a deep recession that developed into a severe crisis.

The recession of the late nineties was different from the one experienced during the Tequila effect. While in 1995 the recession was relatively short and was primarily the result of a short-term financial crisis, the more recent recession seems to have its origin in a group of adverse “real” shocks, more persistent and mostly external. The most important ones have been the depreciations of the Real and the Euro, the fall in our export prices and smaller capital inflows into developing countries as a consequence of the Russian crisis and the collapse of the hedge fund Long Term Capital Management.

The Tequila crisis was profound but relatively short, and its greatest impact was felt on the financial system, where deposits fell by approximately 17% between December 1994 and May 1995. In addition there were concerns about the maintenance of the convertibility regime as the central bank experienced a continuous loss in international reserves. In only three months, international reserves fell by 5.6 billion dollars, and by the end of March 1995 liquid international reserves were only backing 80% of the monetary base, down from the more than 90% previously.

The Tequila crisis was effectively stopped through a set of measures that allowed the public to regain confidence in the liquidity of the financial system and in the capacity of the central bank to maintain the convertibility regime. This was achieved through a financial package of around 12.0 billion dollars, which included a fiscal adjustment of 4.0 billion dollars, 6.0 billion dollars from the multinational organizations, and 2.0 billion dollars through a private sector “patriotic” bond.

The package included measures to restore the confidence in the financial system, such as the introduction of a private deposit insurance system,

and the creation of two fiduciary funds to aid bank consolidation and the privatization of provincial banks.

By the end of 1995 deposits had already reached pre-crisis levels. With deposits rising again, economic activity began to pick up, and by the end of the year the recession had been left behind. The recession lasted only four quarters, and by 1996 and 1997 the economy was once again growing along the trend started during the first years of the decade. The external factors also helped. Capital flows to emerging markets were once again on the rise, reaching record levels, while Argentina benefited from high prices for its exports of primary products from a Brazilian economy that was growing at reasonable rates and with a somewhat overvalued currency.

The more recent recession had its origin in a more complex set of causes including both “real” and financial factors. The Russian default, and the failure of many hedge funds (including Long Term Capital Management) increased risk aversion among investors and reduced the pool of funds available to emerging countries. The Brazilian devaluation in January 1999 was the second most important factor affecting Argentina. Every time that a developing country abandoned a fixed exchange regime and adopted a floating system, Argentina suffered negative effects (the Turkish devaluation was the most recent case that had an impact on Argentina). But that effect was magnified when the country that devalued was Argentina’s main trading partner. Although the Brazilian devaluation did not have an important effect on trade flows between the Argentina and Brazil, it has been a source of concern throughout the recession.

Finally, Argentina also suffered a decrease in most export prices of primary products (with the exception of oil) at the same time it was harmed by the appreciation of the dollar against the Euro and the Yen. Despite these adverse factors, exports have grown, but they did not have the dynamism that they should have had with a more favorable external scenario.

IV. Challenges at the End of the Nineties

Despite the accomplishments of the Argentine economy during the nineties, the deep recession caused a significant deterioration as measured by most economic and social indicators. During these three years GDP fell by 3.9%, the unemployment rate increase from 12.4% in October 1998 to 16,4% in May 2001, while doubts about the Argentine fiscal solvency appeared. Without growth and consolidated fiscal deficits that have exceeded 3% of GDP in the last few years, public debt reached 45 % of GDP in 2000. As time went on, it became more and more difficult to refinance the stock of public debt. It first required a 40.0 billion dollar financial package, the “blindaje”, implemented by the end of 2000, and more recently, in May 2001, a mega-debt swap of almost 30.0 billion dollars to ensure the repayment of the debt that is coming due. The country’s credit rating was reduced numerous times by the three main credit

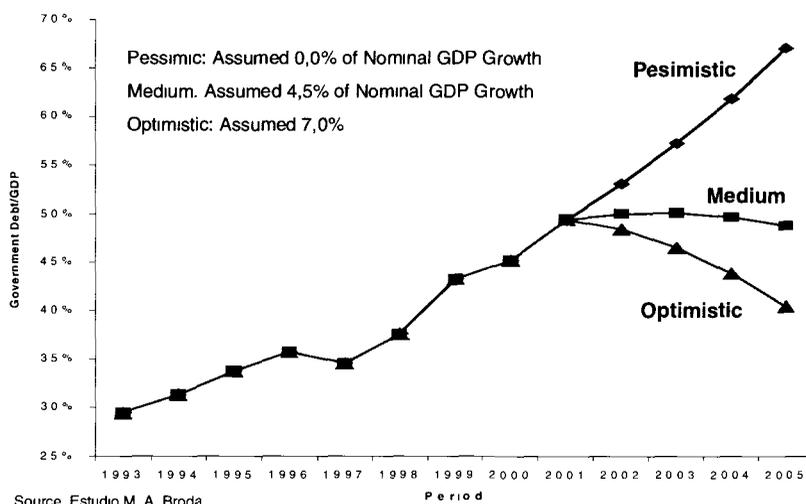
rating agencies, and by June 2001 it was similar to that of countries that were forced to restructure their debts.

It seems paradoxical that a country that implemented far reaching stabilization efforts and structural reforms, that achieved an excellent performance during most of the nineties and was shown to the world on international forums as a model to imitate for the quality of its economic policies, in the end faced an extremely delicate situation. Only four years ago, most analysts expected that Argentina today would be a country with an investment grade rating similar to Mexico, and not facing such a complex macroeconomic situation and struggling to avoid default.

IV.1 Fiscal Deficit, Public Debt and Financing

The biggest concern at the beginning of 2001 in Argentina was the perception that the public sector was facing a solvency problem and that it encountering problems in servicing its debt. As shown on Figure 6, the debt of the central government grew rapidly during the nineties, reaching 45 % of the GDP in 2000. Part of the increase was due to the explicit recognition of debts that had their origin prior to 1991. The rest of the increase in the debt had two main causes. First, there were fiscal deficits at both the national and provincial levels that were not eliminated during years of high growth, and second, the decline in the level of GDP in the last two years increased the burden of the existing debt.

Figure 6:
Government Debt / GDP
Evolution (1993-2000) and Projection (2001-2005)



The Argentine debt was not particularly large by international levels at the end of 2000 (Table 2), as it amounted to 45% of GDP for the central government and 50% of GDP if the provinces were included. Under normal circumstances this level of government debt should have been manageable for a country like Argentina. But without clear prospects for growth and with doubts about the governments' ability to reduce the budget deficit, refinancing of this debt became impossible.

Table 2:

Macroeconomic Indicators - Summary							
% Year 2000	External Debt/GDP	STDom Debt/IR	STExt. Debt/IR	M2/GDP	Fiscal Balance/GDP	Saving/GDP	X+M/GDP
Argentina ²	51,2	17,2	67,7	3,1	-2,4	15	18,6
Brasil	39,8	27,0	85,1	6,3	-4,6	17	13,8
Bulgaria	78,3	NA	19,4	1,4	-0,5	NA	NA
Chile	45,8	NA	27,2	2,2	-0,7	21	45,4
Colombia	44,2	27,1	90,7	2,6	-3,6	12	24,5
South Korea	32,2	NA	4,8	3,6	1,1	32	71,1
Philippines	80,2	106,3	49,3	1,9	-4,1	NA	NA
Hungary	5,6	43,3	48,4	1,8	-3,5	NA	84,3
Indonesia	10,6	NA	30,5	2,6	-3,4	NA	NA
Malasia	47,2	4,2	17,2	3,5	-5,8	41	175,9
Mexico	31,3	118,7	64,7	6,7	-1,1	NA	59,6
Poland	40,4	NA	31,9	2,5	-2	NA	47
Czech Republic	41,7	38,1	62,1	2,8	-2,3	26	98,3
Russia	62,1	NA	NA	1,3	2,5	NA	NA
South Africa ²	2,6	NA	168,5	8,9	-1,9	15	42
Thailand	67,9	4,2	45,6	3,5	-5,2	31	84,4
Turkey	58,5	27,8	140,5	1,5	-9,9	NA	NA
Venezuela	34,6	28,4	43,3	1,4	-1,8	18	36,1

¹ Average 1997-1999

² Corresponds M2 / PIB

Source: JP Morgan, Deutsche Bank, FM and others

When we project the evolution of the debt to GDP ratio, assuming the fiscal deficit remains within the limits imposed by the fiscal responsibility law and moderate growth of nominal GDP of about 4.5% per year, we can see on graph 6 that the deterioration could be reversed in a relatively short period of time. It is then clear that the resumption of growth is critical for the improvement in the debt indicators. Without growth, the fiscal situation will continue to deteriorate (as has been the case), moving Argentina closer to unsustainable debt dynamics and default.

One of the strengths of Argentina was that most of its debt was long-term, with an average maturity of seven-years. In practice, this means that in the following years the amortization of long-term debt will not exceed 10% of the total debt in any given year. In addition, since Argentina has a relatively small amount of short-term debt (mainly Treasury bills called Letes that are less than 4% of total debt), it was less vulnerable to debt rollover problems than other countries. Most countries have a large percentage of their debt in short-term instruments, while long-term debt represents a smaller amount. But minimizing the rollover risk does not eliminate it, and in the end Argentina faced significant problems to refinance a relatively small percentage of its debt, as there were questions about its solvency.

Rollover and refinancing difficulties were reflected in the recent recurrent reductions in the credit rating. Argentina has moved away from the very desirable investment grade to a B rating from Standard and Poor's (S&P) and B2 from Moody's, falling three stages with the first and two with the second.¹¹ These recurrent reductions in the ratings placed Argentina in mid-2001 below Brazil according to both rating agencies. For Moody's, Argentina was below Turkey (a country that has a severe financial crisis) and at the same level as Russia (which only two years ago experienced a default). According to S&P, Argentina was one step above Russia and Turkey. In the third quarter of 2001 Argentina was placed in selective default, and by the end of the year it received a default rating. To avert this situation, Argentina needed to show that it was solvent and that it had enough liquidity to service its debt in an environment of adverse financial markets. The first goal was to eliminate the fiscal imbalance. The adjustments on the fiscal accounts would have been possible if the economy was growing, as the increase in revenues would allow the government to balance its accounts without major expenditure cuts. The alternative was to adjust government spending to a level that was consistent with the available revenues for the national and provincial public sectors. Although the cuts in expenditures could be recessionary, there were no alternatives as the government did not have access to financing.

A second goal was to foster the growth of the domestic capital market, which was still small. Despite the growth of the banking system and of institutional investors, Argentina still had a low level of banking services. The M2/GDP ratio was about 15% of GDP (Table 2), which was less than Chile, Mexico, South Korea and the industrialized countries. There was a high potential for growth in the insurance sector as well, given that total primes were less than

2% of the GDP, much lower than most mature countries. The small size of the domestic capital market complicated the financing of the budget deficit.

IV.2 The end of an Era¹²

In the second half of 2001 it became apparent that Argentina was heading towards a major economic crisis. The external situation was rapidly deteriorating, in part as a result of September 11 investors' risk aversion increased, reducing financing to emerging markets, and in part because of the slowdown in the world economy. In addition, the changes in the views of the US administration and of the International Monetary Fund made it much more difficult for Argentina to receive additional financial support to overcome the crisis.

Even more important were the domestic developments. The economic recession was worsening over time, and in the last two quarters of the year economic activity was collapsing with GDP falling around 12% over the previous year. Unemployment continued to rise, exceeding 18% in October, increasing poverty and complicating the overall social situation. Confidence was also falling, apart as the level of country risk reached 4000 bps over US treasuries, a level only reached by countries that had declared default. It was clear that the markets were anticipating the worst possible outcome, given the inability of the government to continue to pay its debt.

The financial situation, which had improved temporarily in August and September following the latest agreement with the IMF, started to deteriorate in late October as depositors once again withdrew their deposits from the banking system. Total deposits fell by 6.6 billion dollars between October 26 and the end of November, almost 10% in just one month, while international reserves fell by 5.3 billion dollars. The depth of the crisis was increasing over time, as international reserves fell 2.7 billion dollars in the last week of November. The financial situation was unsustainable.

The fiscal situation was also very fragile, as the government was unable to balance its accounts and had no access to additional financing. Back in August the government, with the support of the IMF, introduced a new package, the so called zero-fiscal-deficit plan, which included reductions in public sector wages and other expenditures to balance the budget. The commitment was to reduce public expenditure as much as necessary to ensure a balanced budget. The cuts in primary expenditures were complemented by the announcement of a voluntary restructuring of the debt in order to reduce interest payments and further increase the schedule of amortizations. The zero budget deficit was the cornerstone of the plan, and was intended to generate confidence and allow a successful debt restructuring with the blessing of the IMF.

But the plan had a short life. As the recession became deeper, the government experienced a sharp reduction in tax revenues. To balance the budget the government would have had to impose further reductions in expenditures. But this was not politically feasible, and it became apparent that the

new policy was not viable. It was not possible to sustain a plan that required continued cuts in wages and pensions.

Towards the end of the year events developed at a very fast pace. In early December the government froze deposits in the banking system. The deposit freeze led to a collapsed of the payments system with significant adverse effects on economic activity. The lack of money in the economy generated social unrest which led to the resignation first of Minister Cavallo and then by President de la Rúa.

In the end, things turned sour and Argentina is now facing what appears to be its worst economic crisis ever. In less than a month Argentina declared a default on its debt, it is experiencing a balance of payments crisis as it abandoned the fixed exchange rate regime and is facing a major banking crisis. This happened amidst major political instability, as Argentina had five presidents in less than two weeks.

V. What Went Wrong?

Argentina has had a major macroeconomic crisis in each of the last three decades. The debt crisis in the early eighties, the hyperinflation of the early nineties and the break-up of the Convertibility Plan right now. In the early nineties the main concerns were the high rates of inflation, the inefficiency of public sector enterprises, and a decade of declining GDP. In the nineties Argentina eliminated inflation and improved the performance of public enterprises through privatization. Economic growth was strong between 1991 and 1998, and Argentina became an attractive country for investors. But the decade ended with a severe recession, a high unemployment rate, with difficulties in accessing the capital market and doubts about whether growth can restart soon. The serious problems that Argentina faced at the end of the decade, and the final collapse of the convertibility regime, have generated a strong debate about the effectiveness of the policies implemented in the nineties. On one side there are those who argue that Argentina did not go far enough with the reform process and point to the failure to tackle the fiscal imbalance head on through reform of the state, a new tax sharing agreement between the provinces and the central government and new structural reforms including more flexibility in the labor market and a further opening of the economy to international trade, possibly through a trade agreement with the United States. On the other side are those who argue that the problem was the monetary and fiscal orthodoxy accompanied by a rigid exchange rate policy. In addition they criticize the reliance on markets and the lack of industrial policies.

During the "Convertibility Era" Argentina strengthened its fundamentals. It reduced the budget deficit, it significantly improved the financial system to ensure its solvency and liquidity, it more than doubled its exports, it increased the investment in infrastructure through privatizations and conces-

sions, it experienced significant growth in the oil and mining sectors, and it reached record levels of agricultural and industrial production. But despite all these achievements Argentina failed to ensure fiscal solvency, and continued to rely on the international capital markets to finance the treasury and current accounts deficits.

Was the financial crisis avoidable? Was there an alternative to the devaluation? Was there ever an opportunity to refinance the debt voluntarily? The numbers indicate that if an orderly solution had been proposed in the first half of 2001 it was still possible to avoid a full financial collapse. In June 2001 Argentina still had enough reserves to dollarize the economy (perhaps following a 20 to 30% depreciation of the peso), and it had the support of the multilateral organizations to attempt an orderly debt restructuring process. If these measures had been supported by a cut in pensions and public sector wages (both at the national and provincial levels), Argentina would probably have survived, minimizing losses to depositors and maintaining credit to the private sector.

Unfortunately, in the end the decision was a disorderly adjustment that included default, devaluation, a banking crisis and infringement of property rights. Looking forward, everything indicates that the economy will continue to suffer and that it will take a long time to restore confidence. The solution to Argentina's problems cannot be found in old interventionist and populist policies that generated stagnation in the past. Argentina needs to be a "normal" country with sound monetary, fiscal and exchange rate policies, with a market economy open to international trade, and with well-defined property rights. To ensure the success of these policies, Argentina will need international financial support, at least until it re-establishes credibility and regains access to the international capital markets. And it needs support for its social policies to address the serious problems that the poorest sectors of population are suffering as a result of this recession.

Notes

1. With an income per capita of US\$2,274 and US\$1,532 according to estimates from Gear-Khamis (1990) presented in Madison (1995)
2. According to information obtained from the World Bank (2000), p. 274.
3. World Bank (2000), p. 295.
4. See Sargent (1996), Sachs (1986), and Dornbusch and Fischer (1986)
5. According to some estimates, the inflation tax generated between 6 and 7 % of the GDP in income for the government, and represented 25% of the total income of national, provincial and municipal governments in the second half of the eighties (see Kiguel and Liviatan (1991) and Artana (2001)).
6. Some sectors that were privatized included: telephones; production, transportation and distribution of electricity and gas, and water services; and all public companies that produce goods and services, such as steel and petrochemical plants. In addition, there were concessions for construction and fixing of roads, highways, ports, and airports, etc.

7. According to estimates of the Secretary of Industry
8. This data comes from articles on privatizations in *La Nación*, June 3rd 2001.
9. Some conclusions in this section are based on Artana (2001) who presents a detailed analysis of the behavior of the Argentine economy in the nineties.
10. In sections III and IV, we analyze this event.
11. Since originally writing this paper, the rating have been reduced further by all rating agencies.
12. This section was written in January 2002 as an effort to update the latest developments in Argentina.

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