Argentina: the root cause of the disaster

A recent gathering of more than 100 economists convened to discuss the causes of the catastrophe in Argentina and the lessons applicable to other emerging markets. Most speakers focused on various problems of policy implementation, particularly the failure to tighten fiscal policy during the late 1990s because of political constraints. The implication is that near-sighted politicians (particularly the provincial governors), rather than misguided economists, are to blame for the unmitigated disaster in Argentina. In contrast, our contribution focused on problems of policy design and put considerable blame on the economists – mainly Domingo Cavallo and Roque Fernández, who came up with the rigid one-peso-equals-one-dollar currency regime – and on all those at the IMF and elsewhere who accepted and defended an exchange-rate mechanism that was doomed to eventual breakdown.

[Editor's note: The text that follows is an edited version of remarks delivered by Arturo Porzecanski, head of emerging markets economics and debt strategy at ABN AMRO Inc., at a National Bureau of Economic Research conference on the crisis in Argentina, held in Cambridge, Massachusetts on 17 July 2002 (see www.nber.org/crisis/argentinaprg.html). Other speakers at the conference included leading Argentine economic policy-makers from the recent past (Domingo Cavallo, Roque Fernández, Pedro Pou, Ricardo López-Murphy and Mario Blejer, all former finance ministers or central bank presidents), top IMF officials (Anne Krueger, Anoop Singh and former chief economist Michael Mussa), a few academics and one US government official.]

Fiscal policy and the public debt of Argentina did, of course, play a major role in the tragedy there, in the sense that the country surely would have been less vulnerable to adverse economic, financial or political shocks if the fiscal accounts had been in surplus instead of in deficit, and if the stock of public debt had fallen instead of grown. But we know from recent Asian and even past Latin American experience – recall the cases of Chile and Uruguay in the early 1980s – that countries can end up experiencing major economic, financial and political crises even if their governments have been running surpluses and paying down the public debt. Therefore, while I freely agree that running a fiscal surplus is generally safer than running a deficit, and that having little debt is usually wiser than having a lot of debt – in the sense that your chances of getting into trouble are probably lower, and your chances of getting out of trouble quickly are probably higher – I am definitely not in the "It's Mostly Fiscal (IMF)" camp when it comes to explaining the debacle in Argentina.

Table 1 : Fiscal and debt trends prior to crises in selected emerging markets (% of GDP)*

	1979	1980	1981
Chile			
Fiscal balance	4.8	5.4	2.6
Government debt	44.5	30.9	22.7
Uruguay			
Fiscal balance	0.2	0.1	-0.1
Government debt	12.5	8.9	8.3
	1994	**1995**	**1996**
Indonesia			
Fiscal balance	0.3	1.0	1.3
Government debt	36.6	30.8	23.9
South Korea			
Fiscal balance	0.3	0.3	0.3
Government debt	9.4	8.4	8.0
Thailand			
Fiscal balance	1.9	3.0	2.4
Government debt	6.0	4.6	3.8

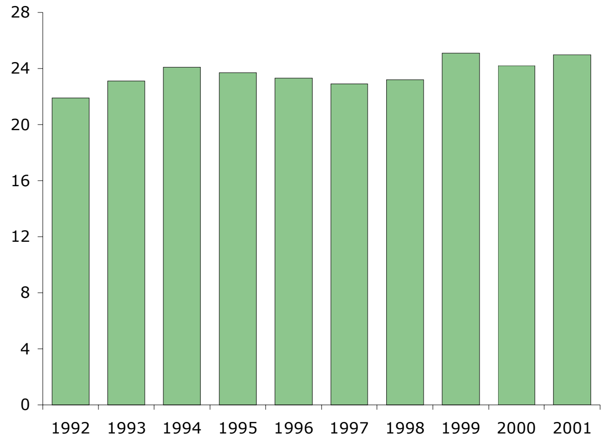
** Data for central governments, not for their public sector as a whole (because of unavailability).*

Source: IIF, IMF, ABN AMRO

Fiscal trends during the 1990s

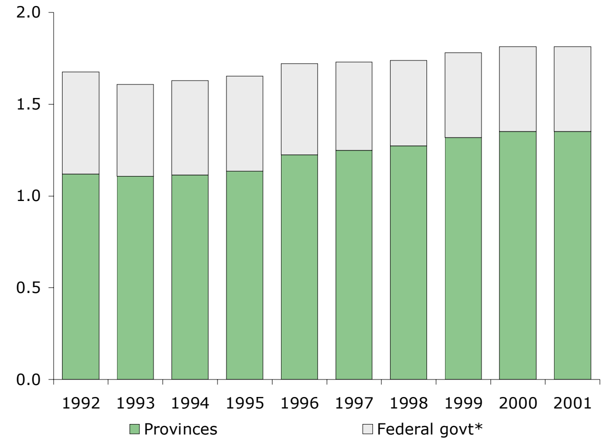
Let me highlight the facts as we know them from the available data, and that is not as simple as it sounds because even on the website of Argentina's Ministry of Economy (see www.mecon.gov.ar) you can find statistical series on spending and revenues according to various definitions and levels of aggregation that are inconsistent with one another. First, there was no significant increase in primary spending (namely, spending excluding interest payments) at the federal, state and local levels relative to GDP during the last decade if you disregard, as you should for various reasons (eg because of hyperinflation-related distortions in relative prices), the observations from the early 1990s. A comparison of annual averages between 1994-96 and 1998-2000 shows an increase in said spending of no more than half of one percent of GDP (from 23.7% to 24.2% of GDP, using a data series validated by the IMF). Therefore, we are not dealing with a country where primary government spending ran amok. A separate statistical series on the number of civil servants employed by federal and provincial governments likewise shows a minor, 7% increase in total average headcount between 1994-96 and 1998-2000 (from 1.67m to 1.78m employees), and a minuscule increase in the bureaucracy as percent of the total labour force (from 12.3% to 12.5%) during said period. This does not mean, of course, that given the rigid exchange-rate regime and two major, adverse exogenous shocks (the Mexico crisis of 1995 and the Russia-cum-Brazil crisis of 1998-99), it would not have been prudent to have held primary spending constant in nominal terms or to have cut it – in absolute terms, never mind relative to GDP. The downsizing of primary government spending and of the bureaucracy was, at the very least, a missed opportunity.

Chart 1 : Government non-interest expenditures (% of GDP)



Source: Ministerio de Economía, IMF, ABN AMRO

Chart 2 : Civil servants (m)

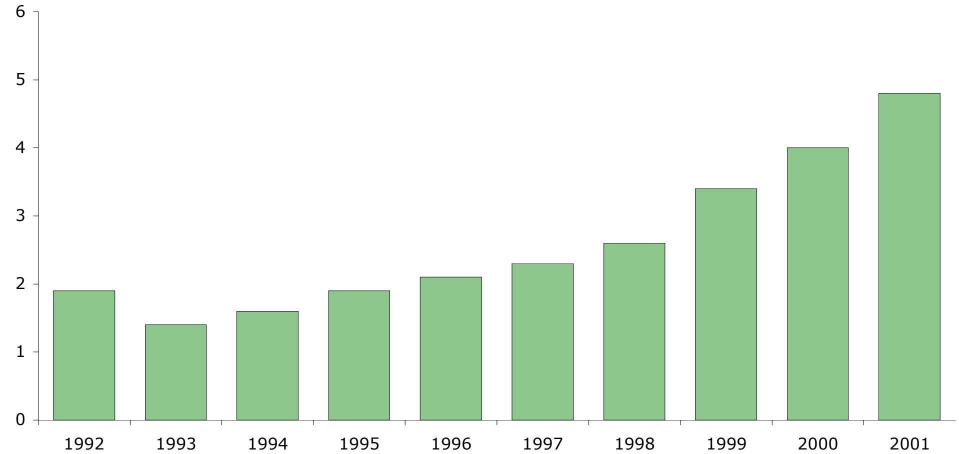


** Excluding employees at state-owned enterprises, most of which were sold off.*

Source: Ministerio de Economía, IMF, ABN AMRO

Second, there was a significant increase in non-primary government spending relative to GDP, namely, in interest payments on the public debt. These payments rose from the equivalent of 1.5% of GDP in 1993-94 to 3.5% of GDP by 1999 and more than 4% of GDP in 2000-01. While part of the explanation for this trend is the continued growth of the stock of public debt during the 1990s (from the equivalent of less than 35% of GDP prior to 1995 to more than 51% of GDP by 2000), the main explanations lie elsewhere. The government had issued Brady-type bonds that had initial coupon payments that were low but were scheduled to increase (namely, step up) during the 1990s, and then there were other government bonds that had a grace period on interest payments during which said payments were capitalised. As time passed, these chickens came home to roost with heavy budgetary implications. The increases in the government's interest bill were quite predictable and should have been offset – and not through creative accounting and financial engineering of the type that we saw in the final stages of Argentina's drama, but through the pursuit of a much more thrifty fiscal policy during the second half of the 1990s. The government had managed to register primary fiscal surpluses of 1.5% of GDP in 1992-93, but in the period 1994-2000 it posted three years of primary deficits (1995-96 and 1999) and four years of primary surpluses averaging a meagre 0.3% of GDP.

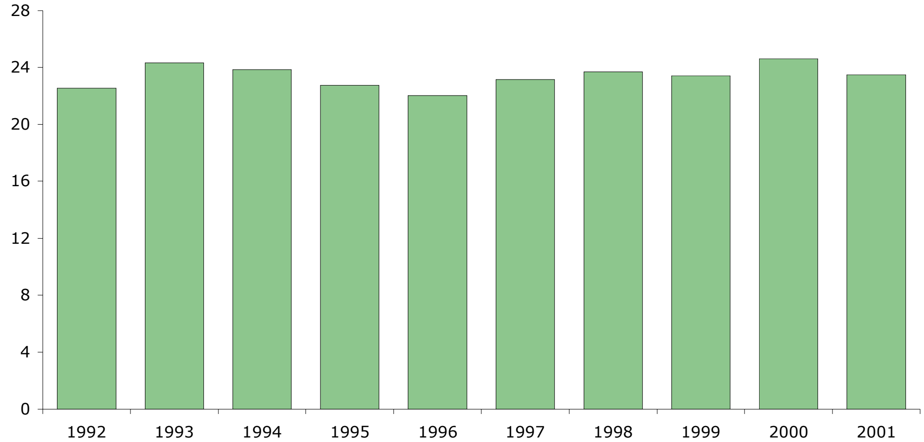
Chart 3 : Government interest payments (as accrued, % of GDP)



Source: Ministerio de Economía, IMF, ABN AMRO

Third, the government suffered from a chronic shortfall in revenues. Tax collections and other revenues net of privatisation income peaked in 1994 (at 24.3% of GDP) and declined during the next five years – despite various hikes in tax rates (eg in the VAT from 18% to 21%), base-broadening measures, enforcement initiatives and much tinkering with the tax structure. One reason is the pension reform implemented in mid-1994, which allowed for the deviation of employee contributions to privately run pension funds. The transition costs of this pension reform were on the order of 1% of GDP per annum. The fiscal implications of the reform were also quite predictable and likewise should have been offset for the sake of fiscal prudence. The other reason for the shortfall in revenues, I believe, is that as cost-cutting pressures in the private sector became intense, especially after the economy lost international competitiveness in the late 1990s (due to the dollar's appreciation and the Brazilian Real's sharp devaluation), tax evasion and avoidance grew out of control. Companies started to view tax payments as another cost of doing business that had to be minimised in the face of a grossly overvalued peso, and individuals sought to reduce their tax burden to maximise their disposable income as living standards started to fall. The structural changes that took place in Argentina during the 1990s meant that tax-paying jobs in the formal economy were destroyed (eg in state-owned companies that were privatised) and that most new jobs were created only in the underground economy. After 1998, as the employment situation worsened, most Argentines increasingly felt that they had to choose between paying taxes and paying the rent – and there is no question that more and more opted to do the latter.

Chart 4 : Government revenues (excluding privatisation income, % of GDP)



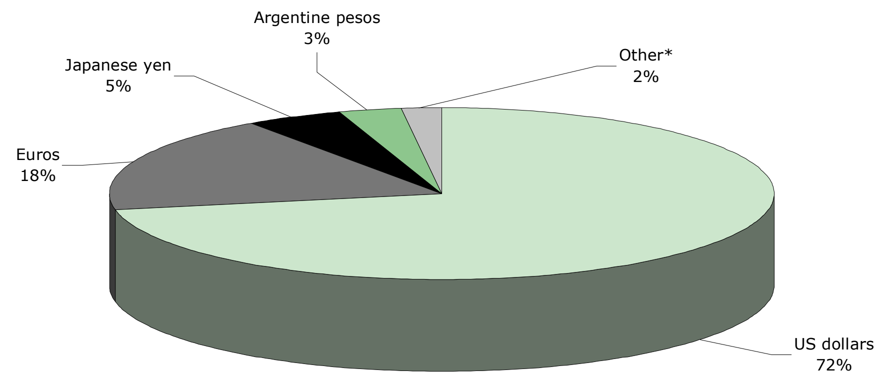
Source: Ministerio de Economía, IMF, ABN AMRO

The crucial role of the exchange-rate regime

And this leads me to delve deeper into the relationship between the exchange rate regime and the fiscal accounts, which was highly detrimental. One link is this one that I just mentioned: I believe that the fixed exchange rate regime undermined the government's revenue base by encouraging tax evasion, especially when Argentina lost international competitiveness in the late 1990s. In the face of rising interest payments on the public debt, it was practically impossible to balance the government budget, and thus to generate prudent primary fiscal surpluses, unless it was by slashing government spending via layoffs of civil servants or cuts in salaries and pensions – which the political class was understandably reluctant to approve, although under extreme duress and in the end it did.

But the most potent and ultimately deadly link is that between the exchange rate regime and the public debt. The one-to-one regime encouraged the government (and also the private sector) to take on mostly foreign-currency-denominated debt. Indeed, by late last year, only 3% of the public debt was denominated in Argentine pesos. This represented a huge potential liability, because when one peso was equal to one dollar, the public debt was equivalent to some 50% of GDP (eg in 2000), but if ever one peso no longer purchased one dollar, then the country's debt ratios would instantly grow out of control: at an exchange rate of 2 ARS/USD, the mostly foreign-currency-denominated public debt would jump to the equivalent of about 100% of GDP, and at 3 ARS/USD it would jump further to 150% of GDP. How could a government that collected tax revenues only in pesos, had long ago sold all of its assets that could attract dollars, and was legally prevented even from printing pesos – the autonomous central bank was authorised to issue pesos only in exchange for dollars – have only 3% of its liabilities denominated in pesos? And yet, I never heard any criticism of this irresponsible currency mismatch either in Washington or elsewhere – a policy that ensured that, if ever there was a change in the currency regime involving a devaluation, the public sector would be rendered instantly insolvent. All of the talk in policy and academic circles was about the fact that the public debt was creeping up over time (as noted, from the equivalent of 35% of GDP before 1995 to 51% by 2000) – a disquieting trend, to be sure, but not a lethal one as long as the exchange rate was kept unchanged.

Chart 5 : Gross public-sector debt (Dec 2001, % of total)



** Mostly British pounds and Swiss francs.*

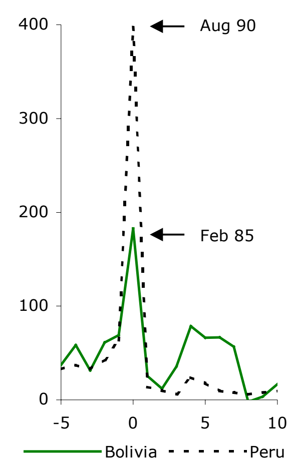
Source: Ministerio de Economía, ABN AMRO

In sum, I agree that fiscal policy in Argentina during the 1990s was not as prudent as it should have been, considering everything that was known and should have been known at the time – and I'm talking about the period of "fat cows" prior to 1998 as well as the period of "lean cows" after 1998. But I blame the artificial one-peso-equals-one-dollar exchange-rate regime much, much more for all of the ills that afflict Argentina today – including the fiscal ills.

Indeed, I regard the failure of most economists to realise back in the 1970s that the shift from fixed to floating exchange rates in the First World and the exponential growth of international capital flows put all Third World countries with artificial exchange-rate regimes at critical risk, as the greatest failure of our profession in the second half of the 20th century. These inflexible regimes were bound to prove unable to withstand the growth of market forces and the ups and downs of the world economy (commodity prices, interest rates, capital flows and the like). Moreover, they were bound to prove ruinous in a fast-globalising world, because they encouraged banks, companies and governments to take on hard-currency debt while exchange rates were held fixed artificially, only to render them all bankrupt once said exchange-rate regimes were modified or ditched. We could have prevented the many currency-cum-debt crises of the 1980s and the many currency-cum-debt crises of the 1990s – in Asia, Russia and Latin America, including in Argentina after artificially rigid exchange-rate regimes during 1977-1981 and again during 1991-2001. We should not hold politicians responsible for the mess that we economists created.

But no, an inexplicable number of leading economists in policymaking and academic roles remained enamoured of exchange-rate-based stabilisations, despite mounting evidence that they worked for a while but proved catastrophic later, and the rest were inexcusably agnostic on this absolutely crucial policy issue. Even in 1991, when Domingo Cavallo and Roque Fernández came up with the one-to-one Convertibility Plan for Argentina, there was ample evidence from around the globe that even more dollarised countries, such as nearby Bolivia and Peru, were able to halt hyperinflation in its tracks without relying on a fixed exchange rate. If, instead, government spending or the public debt had been chosen as the means to stabilise Argentina, I dare say that today we would be celebrating rather than lamenting the country's destiny.

Chart 6 : Inflation in Bolivia and Peru (peak inflation month = 0, % mom)



Source: IMF, ABN AMRO