

What Went Wrong in Argentina? •

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It is a pleasure for me to be participating for the first time as President of the Center for Global Development at a sister think tank here in Washington, the Center for Strategic and International Studies. In his opening remarks, Ambassador Diego Guelar (of Argentina to the White House) said it well: “The roots of Argentina’s crisis go deep.” My message is fundamentally the same. The crisis in Argentina is rooted in the longstanding problems of political chicanery and social injustice, combined with truly bad luck in the last several years. It is not due to technical economic errors, and will not be resolved by economic fixes alone.

Let me set out what I mean by discussing five problems. I’ll begin with the exchange rate, but only to emphasize it was not an economic straitjacket in itself as much as a symptom of Argentina’s political straitjacket. The other problems are mediocre fiscal management throughout the 1990s, and three “bads”: bad politics, bad parenting, and bad luck.

The exchange rate

First, the fixed exchange rate didn’t help. The people of Argentina tried to lock in their politicians with a contract that would prevent the printing of pesos and another round of inflation. But the people forgot that their politicians still had the option of public borrowing. True, the convertibility of the peso to the dollar provided stability and the necessary incentives to drive down the “cost of Argentina.” Many of the reforms in the 1990s, including deregulation of ports and privatization of banking and telecommunications, did make Argentina’s economy more efficient and competitive. But in the end convertibility was no substitute for fiscal discipline. Indeed a problem with convertibility was that it made fiscal indiscipline more tempting, since it made borrowing less costly, at least for a while.

Mediocre fiscal management

Mediocre is not a damning word. In fact fiscal management in the 1990s was not all that bad. It was just not terrific when terrific was needed. Deficits in Argentina never rose much above 2 percent of GDP for most of the decade. But given convertibility and a

history of inflation, Argentina needed to run strong surpluses in good times to allow for countercyclical policy in bad times. Strong primary surpluses were needed to write down the large pension liability the public sector assumed in the early 1990s, and to finance the ongoing costs of paying pensions to retirees since contributions of workers were now going to their own savings, following the 1993 privatization of the pension system. Yet in the early 1990s, public savings were negative, despite the boomlet in tax revenues brought about by the abrupt end of inflation (a reverse Tanzi effect). There was a reasonable effort to reduce the deficit in 1995 to respond to the Tequila shock, but once again in the high growth years of 1996-99 no surpluses were generated.

In the last years of the 1990s, fiscal management went from mediocre to bad. The central government failed to find a way to quell rising levels of unproductive spending in the provinces, most of it padding public payrolls. (The combined provincial deficit rose from 1 to 3 percent of GDP in the last three years of the 1990s). Meanwhile the Menem government participated in the typical patronage spending that so often precedes elections in Latin America. Even so, it is worth repeating that fiscal deficits were never that high. But with a high and rising stock of debt, the creditors, including bondholders and banks at home and abroad, needed to see there was political and social capacity to generate surpluses – and ever more so as the rising cost of carrying growing public debt deepened the fiscal problem.

Bad politics

Behind mediocre fiscal management was not technical incompetence, but bad politics. The technicians, including Cavallo, were politically unable to create sustainable fiscal space – which Argentina had to have given its inflexible monetary regime. On the revenue side, Argentina's tax revenues of 20 to 24 percent of GDP are typical for Latin America, though below Brazil and the U.S. But the incidence of taxes is the outcome of a bad political equilibrium that leaves little room for increasing revenues. High rates of tax evasion and legal loopholes mean the rich pay low taxes; one IMF study suggests that the average effective tax rate for the richest 10 percent of households is below 10 percent (compared to almost 40 percent in the U.S., counting state and local as well as federal taxes). Meanwhile the middle class faces a high value-added tax (VAT) and high payroll taxes. In 1995 in Mexico, an increase from 15 to 18 percent of the VAT was at least possible, and was part of a package that convinced the markets that Mexico could and would recover.

On the expenditure side, there is also a bad equilibrium. Levels of spending in the provinces were already high (and highly inefficient in generating public services) from the beginning of the 1990s, and grew with increasing levels of patronage in the late 1990s. The tax sharing system meant the provinces shared in central government tax revenues, without any incentive to restrain their own expenditures – indeed a convoluted sharing algorithm may well have encouraged spending. Meanwhile, there was little if any government spending to deal with the needs of the poor, health, and education. Other public services that were not privatized remained inefficient and unresponsive to citizens' needs. Too much was spent on wages and too little on books, medicines, and good

management. Despite high levels of waste there was not the political room throughout the 1990s for sustainable structural reductions in spending. There could be only unsustainable across-the-board cuts in public sector wages and university spending. These cuts inflamed the beleaguered middle class and in the end failed to comfort Argentina's creditors. Corruption no doubt played a role in bloating spending, but so did perfectly legal politics as usual, in the form of classic clientelism.

Bad parenting

Argentina was the spoiled child of the Washington Consensus. The IMF, the World Bank, and the IDB too (as you heard I was there from 1993-98) looked fondly on Argentina's success in halting inflation and on the steps it took to open its economy to foreign investment and deregulate and privatize its inefficient telecommunications, power and water sectors. The Clinton and then the Bush Administrations smiled on Argentina's opening of markets and the apparent strengthening of its post-military democratic institutions. Healthy growth in most years of the 1990s, rising exports, and success in managing a real depreciation of the exchange rate (of an estimated 15 percent according to the World Bank, of perhaps a 30 percent overvaluation) all made relatively small fiscal and current account deficits seem manageable. The official creditors paid too little attention to the public borrowing, worried too little about the tax evasion of the rich, and in retrospect (and everything is easier in retrospect) tolerated too much of costly clientelist politics. The markets, like benign but indifferent neighbors, enjoyed the benefits of the spoiled child's excessive borrowing through much of the decade. Once the problem became more visible, in 2000-2001, the IMF had to settle for budget cuts that were not politically sustainable and were likely to slow growth and reduce tax revenues, undermining their very purpose. This worsened instead of strengthened the growth process, so creditors got more rather than less worried.

Indeed macroeconomic stability and reasonable growth meant that for several years in the late 1990s Argentina was not formally participating in an IMF program. The macroeconomic situation was stable. The World Bank and the IDB concentrated on social sector, banking, and municipal reform, as well as on targeted programs for the poor – ironically, since the cost to the poor (and the middle class) of the current chaos far outweighs any benefits of specific program efforts in the earlier years of growth.

In contrast to Argentina, the countries of East Asia hit by the 1997-98 financial crises had been writing down their debt throughout the earlier years of the 1990s – from about 50 percent to about 10 percent of their GDP. Given their high savings rates and their low debt, they could have and should have run countercyclical fiscal deficits during the crisis to cushion the social costs of the downturn they suffered. Indeed, the IMF after initially insisting on austerity -- big cuts in public spending – backed off after about nine months (in the cases of Thailand and Korea). Perhaps in a subconscious overreaction the IMF was not eager to insist with the Argentines on austerity as the crisis deepened in 2000-2001.

On the part of the parents, these were sins of omission. Only in August of 2001 was the IMF drawn, with a nod from U.S. Treasury, into a sin of commission – committing more resources in a last ditch effort to discipline the spoiled child. Then in December when the child needed serious guidance, indeed some benign parental bullying, the IMF and the U.S. threw up their hands and tossed the kid out of the house.

Bad luck

Still, fiscal management was not bad, and with deregulation and the opening of markets the economy was becoming more competitive. The convertibility policy was creating the incentives for reducing costs – too slowly and too little, but the direction was right. Even with its high levels of public waste and the spate of patronage spending at the end of the decade, Argentina might well have muddled through. But then there was bad luck – the bad history that made convertibility, despite its inflexibility, an incontrovertible contract with the people that no politician could afford to disown. There was bad luck in politics, with Menem succumbing to ambition and letting the budget go in the hope of another term, and his successor de la Rúa revealing a stunning lack of leadership. There was bad luck on the economic side – with a persistently and mysteriously strong dollar and weak euro undermining Argentina's competitiveness in its major European market, and a decline in grain prices in the late 1990s that put Argentina's major export at its lowest price level since 1972 (no doubt not helped by agricultural protection in the European Union and the United States). Then came the Russia crisis in 1998, which raised the risk premium for all emerging market economies; the Brazilian devaluation in 1999, the worst blow of all, with Brazil as Argentina's most important export market; and finally a global recession, which further dried up the external capital market. The spoiled kid took a lot of hits in the late 1990s, and hadn't acquired resilience.

What didn't go wrong

Later today you will grapple with the hard question: What are the options for the future? In turning to the future it helps to understand the past. It was not market reforms, not privatization, not foreign banks, and not the opening of its economy that created Argentina's crisis. It was not even economic or technical misjudgments, though there were some of those. It was, and still is, a political system that fails to make the politicians accountable to the citizens. Argentina plus Enron may mark the end of the late 20th century love affair with untrammelled markets. But the challenge now in Argentina is not to weaken or undo the economic reforms it began, but to attack its political problems and the social injustices those political problems perpetuate.

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