Argentina: Current and Future Challenges

International Financial Policy
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History and Current State of the Economy

In 1991 Carlos Menem, former President of Argentina, and Domingo Cavallo, then Economic Minister, established a convertibility plan and created a currency board. This scheme puts the Argentine peso fixed to the US dollar in parity (one to one ratio). It also limits the money supply to the level of hard currency reserves, in effect turning monetary policy over to the US Federal Reserve. Currently, the Argentine peso money supply is 85% backed by US reserves, mostly in the form of US Treasury Securities. This scheme was put in place to maintain low inflation. It helped Argentina experience a period of growth from 1991-1994, mostly driven by an increase in consumer demand. This growth period was halted by the Mexican Peso crisis in 1994-1995. Argentina was the most affected country by the Mexican Peso crisis as they experienced a de facto contraction of the money supply when investors left the region. This also severely drove up national interest rates. GDP shrank by 4.4% in 1995 after the peso was devalued to preserve the anti-inflation plans of the Menem administration. (Refer to graphs 1 and 2.) The brief recovery from this crisis was mainly led by an increase in investment and exports.

Argentina has been in recession since the fourth trimester of 1998, more or less for 33 months. There was a GDP contraction of 3% in 1999 and economic growth was estimated to be flat for the year 2000. Government forecasts for GDP expansion in 2001 are around 2.5%. Lately Argentina’s bond market has been greatly affected by rumors that the country would default on its loans. This crisis led President Fernando de La Rua to negotiate a $39.7 billion credit line with the IMF to ensure investors that Argentina will not default on its payments in spite of the existing fiscal deficit mainly caused by its large external debt. President de la Rua recently appointed a new Finance Minister, Ricardo Lopez Murphy, and assigned Domingo Cavallo as president of the Central Bank. Before leaving for break, Congress gave Mr. Cavallo “fast-track” powers to enact several policies including tax and financial reforms to speed up the economic recovery.

Fiscal Problems

Unemployment: The current unemployment rate is at 15.5%, which is up from 13.8% in 1999. This figure is not completely accurate because it does not include frictional unemployment that is presumed to be high especially in the biggest provinces of Buenos Aires and Rosario. Also, the number of people employed in a part-time rather than full-time fashion went up 26% from 1995 to 2000. The industrial and construction sectors have been the most affected by the loss of jobs. These figures are also considered rough estimates because it is presumed that 40% of workers active in the economy are not registered. Therefore, these workers do not pay any social security, pensions taxes, etc.

Deficit: Argentina has been running a fiscal deficit for quite a long time. President Fernando de la Rua’s plan for recovery after his election in 1999 included tax increases that failed to alleviate the deficit because of collection problems. He also proposed a large spending cut from the fiscal budget, which the government failed to accomplish. Because demand had been stagnant, tax revenues were flat for 2000. This, combined with larger than expected fiscal expenditures, led to a $940 million deficit in January which was already three times more than what was agreed to with the IMF as part of their bail out plan from the on-going recession. A main cause of the deficit is tax evasion and high numbers of tax loops. This affects the federal government and most provinces that are running fiscal deficits as well. Argentina also has an outstanding foreign debt that is about 69.3% of their GDP and has been running a current account deficit as well.

Corruption: This is a problem inherited from the Menem administration that has never been fully addressed. Government corruption prevents many public funds from reaching those in need. A slow and politicized judiciary system has done very little to crack down on routine tax evasion and misuse of public funds. Even during the period from 1996-1998, when the economy was in recovery, the majority of the population was still struggling through the after-effects of the peso crisis mainly due to the difficulty in the delivery of social services.
Monetary Problems

Currency Board: Argentina currently employs a ‘currency board’ system, which restrains the range of available monetary policy options. The Central Bank must maintain US dollar foreign reserves of at least 80% of the available pesos to back its currency. This system also means that Argentina’s Central Bank cannot act as the country’s lender of last resort or insure depositors. Economic models suggest that during times of crisis, Argentina’s Central Bank should provide the economy with more liquidity, and increase the money supply. However, they are unable to do so under the currency board system because this would require a fresh supply of US dollars.

There are two possible interpretations of the efficacy of Argentina’s currency board. The first, is that it may prove too costly to the country and actually acts to keep a higher risk premium on Argentine investments because there is lingering investor mistrust of the system. The other view is that Argentina’s unique position in Latin America as the only country with such hefty US dollar backing of its currency will benefit its economy.

Recent trends may support the previous conclusion, but it is still too soon to make a final judgment. By March of this year, Mr. Cavallo had persuaded Congress to approve a new .25% tax on financial transactions as a way to prevent capital flight. Furthermore, he was granted emergency powers to implement government reforms especially in the tax code.¹ One recent policy, which has slightly helped restore investor confidence in Argentina, is the sale of $350 million in treasury bonds this March. However, these were sold at an 11% interest rate, still too high to calm market fears. Argentina struggles with high interest rates because of a high, perceived risk to the investors. These high interest rates make investing difficult in Argentina.

Recommendations

Monetary/Capital Market

It is recommended that Argentina take action to restore investor confidence, decrease unemployment and increase output. These actions are likely to occur if Cavallo is able to implement his recommended fiscal and capital market reforms including new plans to ensure collection of national taxes.

The currency board system should be kept in place as a method of maintaining exchange rate stability and boosting investor confidence. Such a policy may also help reduce inflation expectations which, in turn, will assist in Argentina’s recovery. However, monetary policy is basically limited to maintaining the currency board and cannot be relied upon to solve the economic recession. Currently, Argentina could not successfully go back to an Argentine peso only system without adversely affecting the economy. An alternative would be to consider the complete dollarization of the economy to avoid the high risk premiums associated with the currency board and the constant speculation by investors.

Fiscal

Tax and Labor Reforms: As mentioned before, tax evasion is a big problem that is both caused by government corruption and by very rigid labor laws that encourage the use of unregistered labor. One of the main projects for Mr. de la Rua and for Congress should be to reform the tax code and design a program to implement a more efficient way of collecting taxes. Mr. de la Rua presented a project of modernization that will computerize most government services, including tax collection. Congress has not acted on this yet, and it is not clear that they will after vacation. The World Bank already has an anti-corruption project in place in Argentina and perhaps this could be expanded to include taxation issues. An increase in tax collection may not necessarily affect their DD curve, but it would help their current fiscal deficit and those funds used to combat tax evasion could be allocated in other areas, such as increasing government expenditures in education, that would actually shift the DD curve and increase output.

¹ Economist, “Cavallo talks, Argentina expects.” March 31, 2001, p. 34
The Labor Code has many regulations that limit the profitability of small and medium sized businesses that are needed to revitalize the economy when major investors are not willing to fund ventures in Argentina. This has resulted in an increase in the use of unregistered laborers who do not contribute to taxes or pension plans. Incentives should be put in place for business to register their employees, such as tax credits or not collecting fines for income that was not previously reported. In turn, higher numbers of registered employees could help reduce the actual percentage of people unemployed. However, the key for any plan to work will be effective enforcement mechanisms.

**Current Account:** Argentina must reduce the current account deficit to the equivalent of 3.4% of GDP to meet the IMF agreements. (Please refer to graph 3.) This can be accomplished by increasing net exports and bolstering investor confidence to increase foreign direct investment to finance the current account deficit. Diversifying the range of export products as well as export partners, will also shore up Argentina’s stability if a future currency crisis affects the region.

Without monetary policy options, Argentina cannot depreciate its currency in order to make exports more competitive on the open market, which in turn would improve their current account position. Therefore there are only two ways to improve the terms of trade. One, is to improve internal production efficiency and technology in industries they have a comparative advantage in. Two, is to relatively decrease the disposable income of their public, in order to keep them from purchasing foreign products.

Improving terms of trade by improving the comparative advantage is tricky. Improved technology to increase output is widely available to any industry willing to investigate, but actually incorporating these methods can have quite a considerable initial cost. Simple quality of life enhancements can have great impacts on the output of laborers, leading to an increase in competitiveness on open markets. One thing that Argentina could do to improve the efficiency of its production markets would be to feed running water to the 35% of the country that does not receive this luxury. However, this requires capital that is not widely available in the country and right now is hard to convince foreigners to invest in the country.

The second method, involving disposable income, is tricky politically. With less disposable income, people within the country will not have as much to spend on imports, therefore improving the terms of trade. Of course, this is assuming that when disposable income decreases consumers tend to buy less imports. In order to do this, taxes will have to be increased either on income or on imports; not exactly a popular idea in times of crisis. Since tax collection is already a problem in Argentina, this policy, though necessary, may not be an easy one to achieve. It would also violate WTO rules and could put Argentina in the position of getting retaliatory sanctions from its trading partners, which is an even riskier move during a recession.

**Limitations**

The AA/DD diagram model indicates that contractions in fiscal spending, such as those proposed by Cavallo, will decrease output. Cavallo hopes to implement a reduction of about $3 billion of the fiscal deficit to help Argentina meet its target deficit of $6.5 billion. This is crucial because Argentina agreed on this target as a condition of over $40 billion in IMF loans and credit guarantees. Again, the government cannot use monetary policy, and will be limited to alternative policies such as labor and financial sector reforms and, supporting anti-corruption policies.

Due to the currency board, there is a lack of monetary policy control available for the purpose of current account improvement, an improvement that would definitely shore up the confidence in the economy. An additional limitation to Argentina’s success may directly relate to the health of the US economy. Depreciations or appreciations of the US dollar affects Argentina’s fiscal and monetary policy. The economy remains at risk because they cannot control US monetary policy. At best Argentine policy makers should try to maintain their economic status in synchronized with the US economic status so at least comparatively Argentina would look better than if there are sharp contrasts in the status of the economies.

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2 Economist, “Over to you, Cavallo.” March 24, 2001, p.41