No One Left To Cry To*

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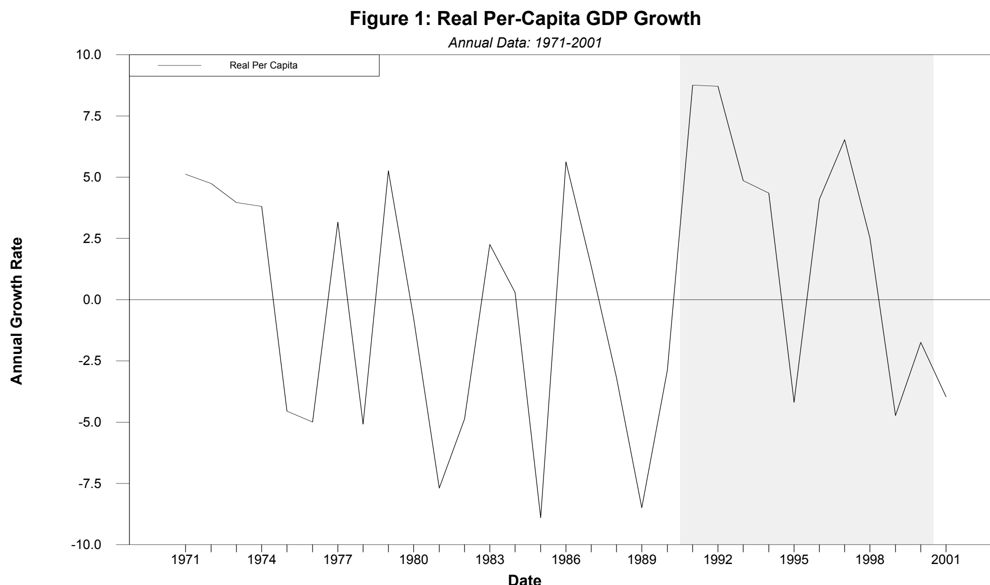
Argentina's economy is broken. It has been broken before. It is likely to remain broken for the foreseeable future. According to work for the OECD by researcher Angus Madison, in 1913 Argentina had a higher income per capita than either France or Germany. Argentina's income per capita is now much less than half that of these two countries. I would not expect this trend to reverse soon.

Figure 1 demonstrates the annual growth of real per-capita GDP in Argentina from 1971 to 2001. The ups and downs have been pretty large. Over the past 30 years, there has been virtually no rise in the Argentine standard of living – real GDP growth per person has averaged 0.3 percentage points per year.



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Why such secular stagnation in Argentina? One crucial component of the decline has been that before 1991, Argentina's economic management of its inflation and nominal exchange rates had been abysmal. Such poor monetary management has enormous welfare consequences due to a central tenet of monetary economics: namely, a necessary foundation for a stable and thriving economy is a sound currency.

Courtesy of a currency board type system and the Convertability Law, Argentina fixed its exchange rate to the U.S. Dollar at 1-for-1 and held a large amount of reserves to potentially dollarize the monetary base. The consequence was that the Argentine people had a relatively stable monetary regime from April 1991 until well into 1998. During this brief period of monetary policy sanity, the Argentine people adopted a number of additional important reforms. These reforms included an improved atmosphere for private investment and the sale of state owned enterprises. Together with the currency board, these reforms helped. As shown in Figure 1, from 1971 until 1990, real GDP growth per person averaged -0.7 percentage points per year. In contrast, from 1991 through 1998 it averaged +4.5 percentage points per year.

Unfortunately, these institutional changes in Argentina were not enough to put its economy on a sound, long-term footing. From 1999-2001, real GDP growth per person has fallen, averaging –3.5 percentage points per year. With no perceived way for the Argentine economy to right itself from this persistent real GDP decline, and with an IMF unwilling to bail them out yet again, the currency board system was recently abandoned.

But while the currency board has now become a useful scapegoat for Argentina's troubles, it is likely that that the respite that Argentina now enjoys will be brief. The reasons for this are twofold. First, the currency board regime delivered something that Argentina had not been able to provide in its recent history – a stable monetary regime. And without a stable monetary regime, long-term prosperity will always be illusive. Suffice it to say that history suggests that, given current conditions, Argentina cannot maintain a sound monetary environment

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discussions.

on its own.[1] Second, one of the real problems driving the Argentine economic malaise, namely fiscal policy, has not been fixed. Below, I briefly discuss these issues.

What the Currency-Board Regime Accomplished

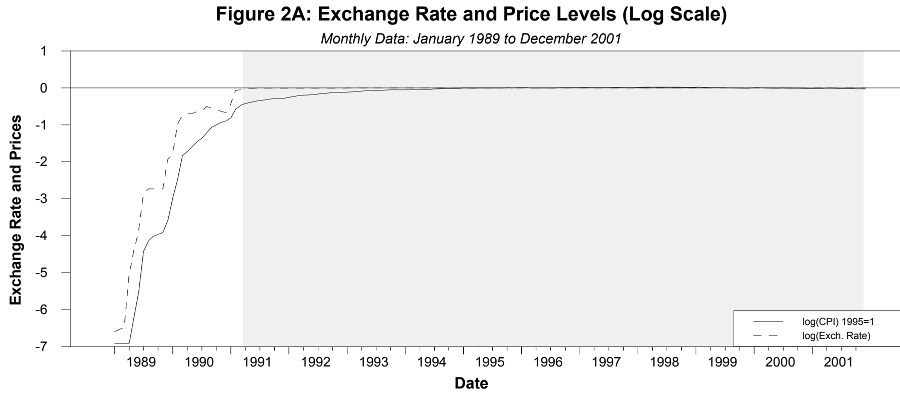
The currency board regime accomplished a tremendous reduction in nominal economic volatility (e.g. nominal prices and exchange rates). In contrast, prior to the adoption of the fixed exchange rate peg to the U.S. dollar, Argentina had been completely unable to deliver "sound money". Figures 2A and 2B demonstrate Argentina's inability to maintain a stable price level and exchange rate over this time period. Figure 2A plots (on a log scale) the monthly price level as measured by the CPI index and the average monthly exchange rate as measured by the number of Argentine Pesos it takes to purchase one U.S. dollar from January of 1989 until December of 2001. The diagram is striking. Consider first the behavior of the exchange rate. From January 1989 until the adoption of the hard peg to the dollar in April of 1991, it took an average of 292% more Argentine currency units per year just to purchase one dollar.[2] Not surprisingly, over this same period, the average rate of inflation was 285 percentage points per year.

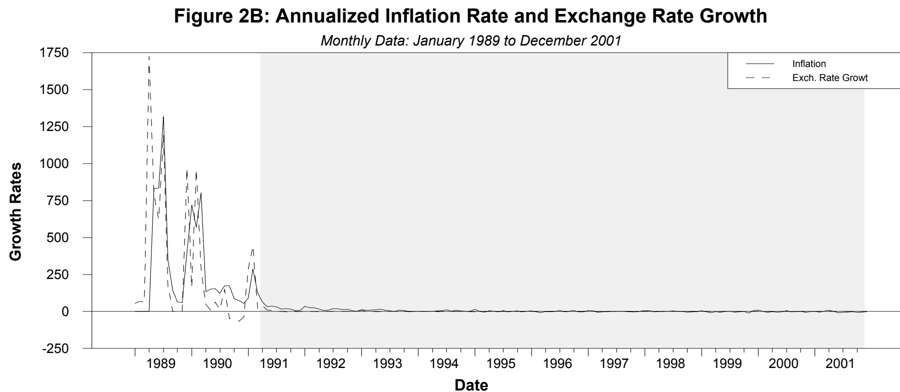
In comparison, during the time period in which the exchange rate was effectively fixed at 1-to-1 to the dollar, April 1991 until December 2001, the inflation rate averaged only 4.1 percentage points. Indeed, from 1995 to 2001, inflation has averaged just –0.2 percentage points per year. Hence, there can be no doubt that the currency board system killed inflation in Argentina. And it had been a monstrous beast. But a low and stable inflationary environment, while a critical piece to creating a thriving economy, is not sufficient by itself to guarantee

[1] I am surely not alone in this conclusion. Indeed, Ricardo Caballero and Rudiger Dornbusch (http://web.mit.edu/caball/www/ARGENTINA22802.pdf) argue that Argentina should surrender their financial sovereignty to a foreign agent, just as the League of Nations proposed for Austria after the First World War.

[2] In other words, it took about 24 percent more Argentine currency units per month just to purchase 1 dollar.

prosperity. And these other pieces could not be delivered just by adopting a currency board with the U.S. dollar. Indeed, these pieces continue to remain missing.





<u>What the Currency Board Regime Could Never Accomplish</u>

There are two main factors that led to the failure of the currency board regime. The first factor was simply due to fixing the exchange rate. While the currency-board regime did provide some breathing room for Argentine policy makers, courtesy of the rigidity of the nominal exchange rate and the resulting importation of monetary discipline and credibility, there is always a downside to fixing an exchange rate. Just as in any market, if one price cannot adjust, than either another price must adjust or some quantity must adjust. That's the way that markets work, whether you let them work freely or not.

Also, since the seminal work of Robert Mundell[3], we know that the net-benefit from sharing a currency or fixing an exchange rate with another country is greatest if you share a common business cycle and/or are strong trading partners. Clearly, U.S. and Argentina's business cycles were asynchronous and their trade relationship was weak – a predictor of potential trouble for Argentina in their adoption of the currency board. Indeed, Argentina experienced a strong currency appreciation courtesy of the U.S. Dollar due to the turbulence from the Mexican Peso crisis in 1995 and the collapse of the Brazilian currency in 1999. In particular, the latter gave such a terms-of-trade advantage to Brazil that Argentina lost out on many trade and business relocation opportunities, which further weakened Argentina's economic performance.

So while the benefits to Argentina from this currency board regime were the importation of monetary credibility and sound money, the cost was that a fixed exchange rate with an economically dissimilar country would lead to more difficult economic adjustments. And since the nominal exchange rate could not adjust, other economic factors in Argentina were required to adjust more to correct any misalignment of the real exchange rate. Accordingly, given the rigidity of Argentina's labor and product markets, the business cycle downturn never seemed to bottom out with the continued strong U.S. dollar coupled with the Peso-Dollar link.

The second leading factor in the currency board's demise was fiscal policy.[4] Indeed, excessive fiscal spending and the large amount of public debt are problems that continue to plague Argentina. The problem has never been fixed, despite the fact that the recent period of monetary stability provided an opportunity to deal with the problem. That opportunity was squandered. Another one may not come again soon.

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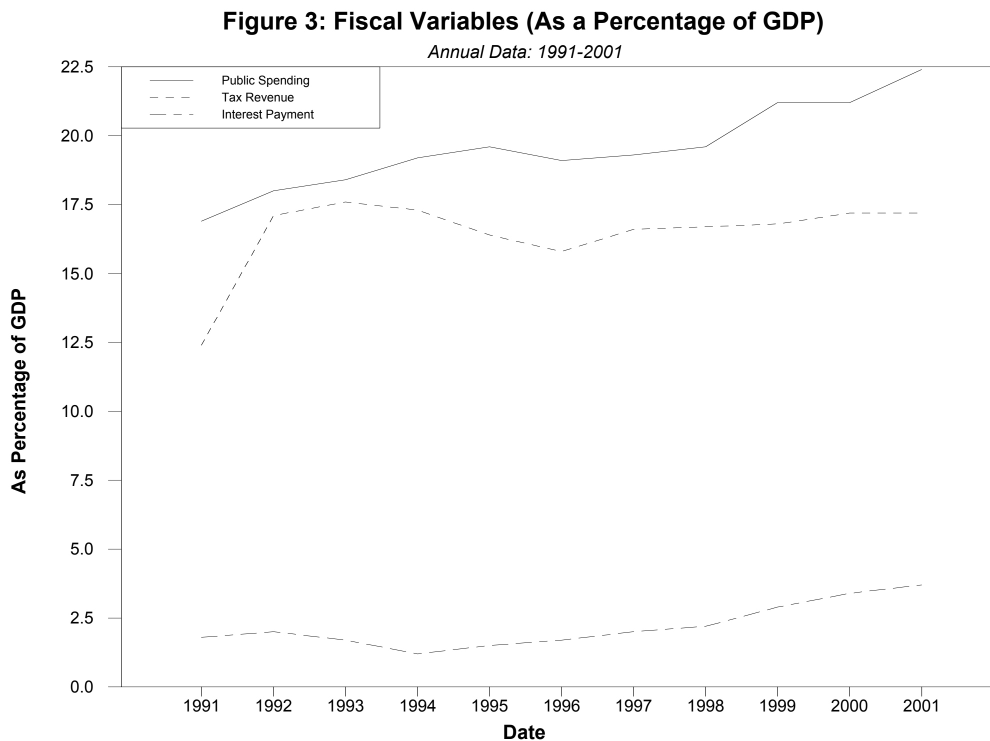
[3] Robert Mundell "A Theory of Optimal Currency Areas," American Economic Review, 1961, 51, 657-665.

[4] Indeed, Michael Mussa argues that "Moreover, in the case of Argentina, it is essential to recognize that inability to control the appetite for public sector borrowing was not only the primary cause of the present catastrophe, it has been a critical defect of Argentine public policy for decades." (page 15) of Argentina and the Fund: From Triumph to Tragedy, http://www.iie.com/papers/mussa0302-2.htm.

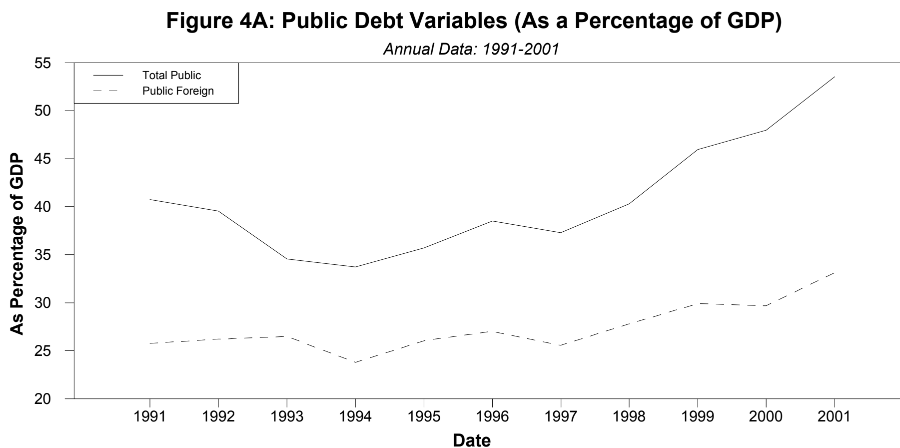
Figure 3 demonstrates the behavior of some key fiscal components in Argentina during the time period 1990-2001.[5] The data are presented as a percentage of GDP for comparison purposes. Clearly, public sector spending has secularly risen during the period of monetary stability and economic boom. Paradoxically, this is exactly the time period when Argentina should have had more courage to cut spending. Moreover, while government receipts rose dramatically in the early part of the 1990 due in part to an improving economy and the sale of public sector enterprises, government revenue appears to have stabilized at about 17.5 percent of GDP. Unfortunately, as Figure 3 demonstrates, public spending on goods and services and interest payments now approach 22.5 and 3.0 percent of GDP, respectively.

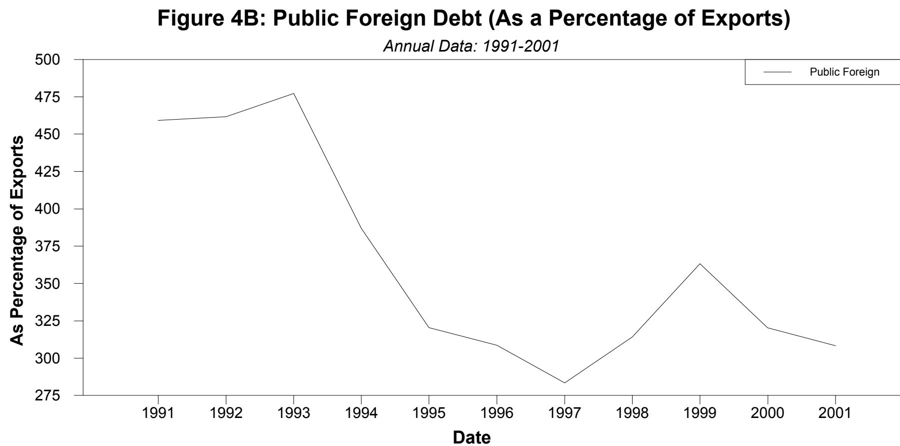


As a direct consequence of the inability to contain public sector spending, public debt has also continued to rise in Argentina. Figure 4A plots total public debt and public foreign debt as a

[5] The data for Figures 3 and 4a,b were obtained from the recent paper by Jorge Carrera, "Hard Peg and Monetary Unions: Main Lessons from the Argentine Experience," available at: http://www.bnet.fordham.edu/public/m-union/abstracts/Carrerapaper.pdf

percentage of GDP. After bottoming out in 1994, both measures of public debt have since risen rather consistently. However, a shortcoming of examining public debt as a fraction of GDP is that it ignores the fact that public debt owed to foreigners requires export earnings to service the debt and to make repayments. Hence, Figure 4B plots foreign public debt as a percentage of exports. Notice that while the ratio has fallen since 1991, as of 2001 it would still take 3 years of export earnings to pay off the public debt owned by foreigners.





Such profligate spending and large public foreign debt to export earnings has at least three major negative consequences for Argentina's economy. First, this gap between spending and revenue dampens national savings in Argentina, and requires the government to borrow from

abroad in order to maintain its appetite for spending. For fiscal policy to consume so many foreign currency resources makes it difficult to maintain the required foreign reserves to maintain the currency board.

Second, such large amounts of public debt directly bring into question the government's underlying solvency and ability to pay off these debts. As a result of such a possibility of default, foreign investors demand risk premia on Argentine government debt and encourages a switch out of Argentine Peso's towards presumably safer Dollars. This further strains the countries foreign currency resources.

Third, with the tremendous reported inefficiencies in the bloated government sector, a large fiscal sector crowds out private sector activity that can raise the Argentines future economic trajectory. The fiscal drag on expanding economic opportunity in Argentina makes it more difficult for Argentina to attract foreign capital for private sector projects, which further strains foreign currency resources.

Whither the IMF?

Historically, the IMF has been exceptionally over-involved in Argentina. Given the high rate of bailout recidivism and poor macroeconomic performance, past loan programs in Argentina (and for that matter most countries), have had substantially negative private and social rates of return. There are two important reasons why the IMF should stay clear of Argentina until fundamental reforms have taken place.

First, by insisting that Argentina fix up its fiscal mess first, a hands-off IMF can keep pressure on Argentina exactly where it needs to be. Since Argentina was unable to fix its fiscal situation during good times, perhaps only the pressure of economic bad times will make them take the difficult decisions to balance their fiscal stance.

Second, by not continuing to bailout Argentina, they can clearly signal an end to moral hazard in two distinct areas. First, other countries will now see that the IMF will not willy-nilly

bail them out from problems, which should encourage them to fix the problems themselves. Second, it is a strong signal to financial markets that these emerging markets contain real risk. Now while this risk may get priced into Argentina's interest rates, the likelihood of default will sober international investors who for too long have received risk premia returns from lending to troubled countries, only to also demand that the IMF bail-out the government so that their would be no default.

But can the IMF avoid the temptation to get back into the business of bailing out Argentina? In his discussions of the IMF's failures in Argentina, former Research Director of the IMF Michael Mussa argues that: "To merit Fund support, a critical requirement of any policy program is that it must provide reasonable assurance that the resources lent by the Fund will be repaid in a timely manner." (Mussa, page 6). Clearly, either this policy has been routinely violated or the Fund is unable to appropriately calculate "reasonable assurance". I can propose a solution, however, to better implement this requirement. Since the IMF is not an aid agency, it should only make a loan to a country if the staff is willing to allocate a portion of their retirement portfolios to the borrowing country's public and private assets. My guess is that if the Fund followed this principle, it would continue to wait until fundamental reforms are instituted in Argentina before it begins lending to it again.

Conclusion

Without a serious, permanent change in its fiscal balance, Argentina's economic performance will always be fractured. The fiscal picture could have been improved during the currency board period. Instead, it worsened. Cynically, perhaps only a further crisis will force Argentina to fix this lingering problem. Without such a fix, monetary stability will remain elusive. And while the recent devaluation of the Peso from Parity with the Dollar to a level closer to 3 Peso's to the Dollar has provided relief to the patient, this relief is likely to be only temporary. Lack of confidence in the ability of the Government to manage the economy and fix

the high level of public debt will eventually erode confidence in the value of debt, and in turn the value of its currency. And when that dark day arrives, Argentina will have no one left to cry to.