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2016 IIP Argentina Research Paper

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When Argentina's new president, Mauricio Macri, took office in December 2015, he faced high inflation, economic stagnation, fiscal deficit, depressed foreign trade, downward pressure on the value of the currency and a long-running debt dispute with vulture funds. In 1989, when President Carlos Menem came into power, he faced a similar economic situation. President Menem followed the Washington Consensus' neoliberal approach to address the problems in the 1990s, but his policies eventually led the country to the 1998–2002 Argentine Great Depression. Many worry that President Macri may repeat what happened in the 1990s and lead Argentina to another crisis. This paper tries to analyze the reasons for the 1998–2002 Argentine Great Depression and the likelihood that President Macri will repeat the tragedy.

Economic Situation in 1989

President Menem was elected in 1989 to succeed President Raul Alfonsin. At the time, Argentina's economic situation was full of doom and gloom. "Following more than a decade of high inflation and economic stagnation, and after several failed attempts to stabilize the economy, in late 1989 Argentina had fallen into hyperinflation and a virtual economic collapse."[1]

The data was shocking: "In 1989, only 30,000 out of 30 million Argentines paid any income taxes. That year, inflation reached an unprecedented 5,000 percent, rising so fast that some supermarkets read prices out over intercoms rather than bothering to update price

[1] Independent Evaluation Office, IMF, *The IMF and Argentina, 1991–2001* (2004), at 11.

tags."[2] The crisis interrupted the normal running of the society and it fell into chaos. Strikes swept the country and rioters looted supermarkets for their survivals. President Alfonsin decided to hand over power five months early to Menem.

Foreign trade was also severely impacted: "the ability of Latin America's third-largest economy to maintain its imports has been clouded in recent days by the sharpening foreign exchange shortage and by growing skepticism among foreign creditors."[3] In June, "an attorney charged by Mr. Menem with auditing the national treasury, estimated that Argentina's hard currency reserves are $200 million, enough to cover two weeks of imports."[4]

Menem's Economic Policies

The economic, political and social crises forced President Menem to immediately take a reformist course. His approach was to follow the Washington Consensus, which is a list of ten policies coined in 1989 by English economist John Williamson "for a conference that the Institute for International Economics convened in order to examine the extent to which the old ideas of development economics that had governed Latin American economic policy since the 1950s were being swept aside by the set of ideas that had long been accepted as appropriate within the OECD."[5] The ten policies include fiscal discipline, a competitive exchange rate, trade liberalization, liberalization of inward foreign direct investment, and privatization.[6]

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[2] *Chronology: Argentina's turbulent history of economic crises*, Reuters, Jul. 30, 2014, http://www.reuters.com/article/us-argentina-debt-chronology-idUSKBN0FZ23N20140730.
[3] James Brooke, *INTERNATIONAL REPORT; Inflation Ruining Argentine Economy*, N.Y. Times, Jun. 12, 1989, http://www.nytimes.com/1989/06/12/business/international-report-inflation-ruining-argentine-economy.html.
[4] *Id*.
[5] John Williamson, *A Short History of the Washington Consensus*, Institute for International Economics, Sep. 24, 2004, http://www.iie.com/publications/papers/williamson0904-2.pdf.
[6] *Id*.

"Menem spent the 1990s cultivating foreign investment, slashing import tariffs, and privatizing money-losing state enterprises."[7] In 1991, the Menem regime passed the Convertibility Law to peg the Argentine currency to the U.S. dollar. The new exchange rate regime was designed to tackle inflation once and for all, and stabilize the economy. It establishing a hard nominal peg with U.S. dollar's stable value, forcibly giving peso the same value. market-oriented structural reforms to promote efficiency and productivity in the economy. Moreover, as part of the Convertibility Plan, "various service sectors were deregulated, trade was liberalized, and anticompetitive price-fixing schemes were removed; privatization proceeded vigorously, notably in oil, power, and telecommunications, yielding large capital revenues."[8]

The Convertibility Plan immediately served its original purpose, and was a success for the early years. "Inflation, which was raging at a monthly rate of 27 percent in February 1991, declined to 2.8 percent in May 1991; on an annual basis, inflation fell to single digits in the summer of 1993 and remained low (or even negative) from 1994 to the end of the convertibility regime in early 2002."[9]

After the most urgent problem of inflation was solved, the fiscal austerity and economic liberalization did their jobs to improve the economy. "The overall fiscal balance of the federal government improved significantly from the previous years, with an average budgeted deficit of less than 1 percent of GDP during 1991–98. Growth performance was impressive through early 1998, except for a brief setback in 1995 when Argentina was adversely affected by the Mexican

[7] *Chronology: Argentina's turbulent history of economic crises*, *supra* note 2.
[8] Independent Evaluation Office, *supra* note 1, at 11.
[9] *Id*.

crisis. For 1991–98, GDP growth averaged nearly 6 percent a year, vindicating the market-oriented reforms introduced in the early 1990s. Attracted by a more investment-friendly climate, there were large capital inflows in the form of portfolio and direct investments. During 1992–99, Argentina received more than $100 billion in net capital inflows, including over $60 billion in gross foreign direct investments."[10]

"In October 1998, the performance of Argentina received the attention of the world when President Carlos Menem shared the podium of the Annual Meetings with the IMF Managing Director, who characterized 'the experience of Argentina in recent years' as 'exemplary.' The Managing Director further remarked: 'Argentina has a story to tell the world: a story which is about the importance of fiscal discipline, of structural change, and of monetary policy rigorously maintained.'"[11]

The Crisis[12]

The 1998–2002 Argentine Great Depression started with a combination of adverse external shocks, including a reversal in capital flows to emerging markets following the Russian default in August 1998; weakening of demand in major trading partners, notably in Brazil; a fall in oil and other commodity prices; general strengthening of the U.S. dollar against the euro; and the 70 percent devaluation of the Brazilian real against the U.S. dollar in early 1999.

Argentina's performance deteriorated from the second half of 1998. Real GDP fell by over 3% in the second half of 1998. There was a mild pickup in economic activity in the second half of 1999, spurred by increased government spending in the run-up to the October

[10] *Id*.
[11] *Id*. at 12.
[12] The facts in this section are from Independent Evaluation Office, *supra*, at 12-13.

presidential elections, but this was not sustained and GDP declined by 3.5% for 1999 as a whole. The economy never recovered through the depression.

The economic slowdown, coupled with the election-driven surge in public spending in 1999, hit Argentina's fiscal solvency hard. The country's consolidated fiscal balance had been in deficit throughout the 1990s except in 1993, but the magnitude was not large. The situation changed in 1999, when growth decelerated and the public finances deteriorated sharply. The debt-to-GDP ratio rose from 37.7% of GDP at end-1997 to 47.6% at end-1999, an increase of 10% points in just two years. The ratio would eventually reach 62% at the end of 2001.

Argentina's problems intensified in 2000, and the convertibility regime prevented the government from making effective reactions. In 2000, growing solvency concerns over the cumulative increase in public debt were exacerbated by the continued appreciation of the U.S. dollar and a further drying up of capital flows to emerging market economies. These developments would normally require a smaller current account deficit and a depreciation of the real exchange rate, but the convertibility regime placed severe limitations on the ability of Argentina to achieve this adjustment in a manner that could avoid recession.

From the spring of 2001, the authorities took a series of measures in quick succession, including: an announced plan to change the anchor of the convertibility regime from the U.S. dollar to an equally weighted basket of the dollar and the euro (the switch to take effect only when the two currencies reached parity); a series of heterodox industrial or protectionist policies (called "competitiveness plans"), involving various tax-exemption measures in sectors most adversely affected by the recession; and an exchange of outstanding government bonds totaling $30 billion in face value for longer maturity instruments (the so-called mega-swap).

However, many of these measures were perceived by the markets as desperate or impractical, and served to damage market confidence.

Despite these initiatives and the financial support of the IMF, market access could not be restored, and spreads on Argentine bonds rose sharply in the third quarter of 2001. Amid intensified capital flight and deposit runs, capital controls and a partial deposit freeze were introduced in December 2001. With Argentina failing to comply with the fiscal targets, the IMF indicated that it could not clear the disbursement scheduled for December. At the end of December, following the resignation of President Fernando De La Rua, the country partially defaulted on its international obligations. In early January 2002, Argentina formally abandoned the convertibility regime and replaced it with a dual exchange rate system.

Factors Contributing to the Crisis

Given the time length and complexity of the development of the 1998–2002 Argentine Great Depression, many factors, domestic and external, are pointed to for contributing to the crisis. IMF summarized the following three factors as critically important: (i) weak fiscal policy (Mussa, 2002); (ii) the rigid exchange rate regime (Gonzales Fraga, 2002); and (iii) adverse external shocks (Calvo and others, 2002).[13]

IMF divides all factors into two classes: one that generated vulnerability and the immediate factors that triggered the crisis.[14] "In the absence of triggering events, a crisis may not have occurred when it did, but the underlying vulnerability would have continued and a crisis could have been triggered later by other adverse shocks. In the absence of the underlying

[13] *Id*. at 14.
[14] *Id*.

vulnerability, however, the same adverse developments would not have had the catastrophic effects that were associated with the crisis, though they may well have produced some negative effects."[15]

Weak fiscal policy is one of the major reasons for Argentina's underlying vulnerability. "The weak fiscal policy created serious liquidity problems for the government when market conditions tightened and led to the eruption of a funding crisis in early 2001. If Argentina's public sector had generated surpluses in its fiscal account during the precrisis years, it could have avoided the tightening liquidity constraints in 2000 and the all-out funding crisis of the public sector in 2001. Argentina also would have enjoyed greater flexibility in using fiscal policy to cope with the impact of adverse shocks, and would have been spared from the need to contract fiscal policy when output was already declining."[16] The Menem government had used up all the money in its treasury, depriving itself of the necessary fiscal ammunition to fight the external shocks. It was also in serious debt, so it could not borrow to finance effective fiscal policies.

"Underlying this poor fiscal performance were Argentina's weak political institutions, which persistently pushed the political system to commit more fiscal resources than it was capable of mobilizing. Public expenditure could not be controlled because spending was often used as an instrument of political favor. Tax administration was also weak, leading to widespread tax avoidance and evasion, and efforts to improve tax compliance were not successful."[17] Dr. Eduardo Stordeur from Di Tella University points out that in the 1990s, the

[15] *Id*.
[16] Id.
[17] Id.

Menem regime used government spending to force stability. Such cost was high, resulting in unsustainably high government debt.[18]

Many believe that the main mistake was the pegging of the peso to the dollar. Nobel Prize winning economist and former World Bank chief economist Joseph Stiglitz is one of them: "This was 'a system doomed to failure', not because of mistakes made by the country, but because of shocks from beyond its borders that were caused by the volatility of international financial markets... Sticking to the peso-dollar peg resulted from a single-minded focus on inflation, without a concern for employment or growth"[19] This is agreed by Guillermo Perry and Luis Servén: the peg to an appreciating dollar played a dominant role in the emergence of the Argentine crisis.[20]

IMF explains how the convertibility regime hurt the country's economy during the crisis: "By all but eliminating money creation as a source of revenue, it raised the required level of fiscal discipline. While this was extremely positive in terms of its impact on inflation, it also increased the potential long-term disruptive effect if the fiscal discipline was not fully delivered. It also made adjustment to adverse shocks more difficult by eliminating nominal depreciation as an instrument of policy. Had wages and prices been sufficiently flexible downward, the required real exchange rate depreciation could have been achieved through price deflation. In the absence of downward wage flexibility, the improvement in the current account required by

[18] Presentation given by Dr. Eduardo Stordeur, Di Tella University (Mar. 21, 2016).
[19] Jan Joost Teunissen & Age Akkerman, The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, Jan. 2003, at 3.
[20] *Id*. at 6.

the series of adverse shocks that hit Argentina from late 1998 could only be achieved through a prolonged demand contraction."[21]

Even former Justice Rodolfo C. Barra agreed that the convertibility plan was a mistake for the last few years of President Menem's term.[22] Justice Barra served as a justice of the Supreme Court of Argentina between 1989 and 1993, and as Minister of Justice between 1993 and 1996. He has been a firm supporter for President Menem's economic policies, and was in charge of drafting laws for privatization in the 90's.

Dr. Jose Gabriel Palma emphasizes financial liberalization's role in generating vulnerability in Argentina's economy, especially the full opening of the capital account to international financial markets. Argentina had opened up its capital accounts since President Menem came into power, and it "had done so at a time of high liquidity in international financial markets, and slow growth."[23] "Foreign capital swamped [Argentina] due to several 'push' and 'pull' factors."[24] "Push" factors included excess liquidity in international financial markets, business cycle conditions, changes in interest rates, the rise of institutional investors always in need of new profitable assets, and demographic forces in industrial countries, while "pull" factors included the combination of radical economic reforms (in particular wholesale privatizations, and trade liberalization) and the opening up of the capital account in a context of undervalued asset markets, high interest rate spread, and expectations of stable exchange rate

[21] Independent Evaluation Office, *supra* note 1, at 14-15.
[22] Interview with Justice Rodolfo C. Barra (Mar. 18, 2016).
[23] José Gabriel Palma, *How the full opening of the capital account to highly liquid financial markets led Latin America to two and a half cycles of 'mania, panic and crash'*, Cambridge Working Papers in Economics (Jan. 2012), http://www.econ.cam.ac.uk/dae/repec/cam/pdf/cwpe1201.pdf.
[24] *Id*.

under the convertibility plan.[25] Unfortunately, not only did the tsunami of inflows have little or no positive impact on the real economy, it increased volatility and the correlation of returns on financial assets, which were both proved when adverse external shocks hit Argentina in 1998.[26]

Economic Situation Today

Argentina's new president, Mauricio Macri, took office recently in December 2015. The economic situation that he faced was not promising. His administration inherited from the last regime: "[o]ne of the world's highest inflation rates, near 30% poverty, an 'historically high' budget deficit of 7% of GDP, a slump in Central Bank reserves, and a long-running debt dispute with vulture funds."[27]

Before President Macri, former president Cristina Fernández de Kirchner and her late husband, Néstor Kirchner, who governed before her, had been in power since 2003. Their economic policies reflected "priority for financial independence, social equity, and what may be considered a commitment to 'populist' macroeconomic solutions."[28] To achieve these goals, many believe that the regime sabotaged the rule of law by micromanaging the market. Economy was distorted by their interventionist policies.

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[25] *Id*.
[26] *Id*.
[27] *Recap: The Key Points of President Macri's Speech to Congress*, The Argentina Independent, Mar. 2, 2016, http://www.argentinaindependent.com/currentaffairs/analysis/the-key-points-of-president-macris-speech-to-congress/.
[28] J. F. Hornbeck, *Argentina's Post-Crisis Economic Reform: Challenges for U.S. Policy*, Congressional Research Service, Apr. 15, 2013, https://www.fas.org/sgp/crs/row/R43022.pdf.

Inflation was high. It reached 38% in 2014, and dropped to 26.9% in 2015.[29] "Given political intervention in the National Institute of Statistics, official reports are not credible; but all estimates suggest that before the recent devaluation, inflation exceeded 20% [in 2016]."[30]

Economic stagnation was a serious problem. In 2015, before the elections brought economic hope, its economy was projected to show little or negative growth that year.[31] Argentina was still indebted to American hedge funds, making it unable to access foreign investment. The country could not develop its economy without necessary capital. For example, a massive oil field sat untouched because the country did not have the money to drill.[32] Argentina's economy relied heavily on commodities like oil and soybeans.[33] Prices for those two have tanked in 2015, and the country's two key trade partners -- Russia and China -- have slowed down. What makes it worse is that the government also suffered from a 5.4 percent GDP budget deficit (the biggest since 1982).[34]

The exchange rate of peso was also unstable. "Trade protection, managed exchange rates, and capital controls, for example, are policy adjustments required to address problems that materialize in a constrained economic system (e.g., subsidy-driven fiscal expansion, price controls, inability to borrow internationally) that cannot easily accommodate current account deficits, a market exchange rate, or standard macroeconomic responses to high inflation."[35] In

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[29] Argentina - Inflation (end of period), FocusEconomics, http://www.focus-economics.com/country-indicator/argentina/inflation-eop (last visited Apr. 26, 2016).
[30] Joseph E. Stiglitz & Martin Guzman, *What's on Argentina's balance sheet?*, World Economic Forum, Feb. 5, 2016, https://www.weforum.org/agenda/2016/02/what-s-on-argentina-s-balance-sheet/.
[31] Patrick Gillespie, *Is Argentina's economy pulling a tango turnaround?*, CNN, May 7, 2015, http://money.cnn.com/2015/05/07/investing/argentina-economy-stocks/.
[32] Id.
[33] Id.
[34] Maria Candia, *Can Mauricio Macri Save Argentina's Economy?*, Foreign Policy, Mar. 24, 2016, http://foreignpolicy.com/2016/03/24/can-mauricio-macri-save-argentinas-economy-obama-kirchner/.
[35] Hornbeck, *supra* note 28.

November 2011, the Kirchner regime introduced currency controls, named el cepo (or "the clamp"), which made it almost impossible for ordinary Argentines to purchase dollars, preferred by savers to the inflation-prone peso.[36] It substantially overvalued peso. After President Macri freed the currency, it fell by more than 30%.[37]

Macri's Economic Policies

President Macri "has wasted little time in undoing the populist policies of his predecessor. On December 14th he scrapped export taxes on agricultural products such as wheat, beef and corn and reduced them on soyabeans, the biggest export. Two days later Alfonso Prat-Gay, the new finance minister, lifted currency controls, allowing the peso to float freely. A team from the new government then met the mediator in a dispute with foreign bondholders in an attempt to end Argentina's isolation from the international credit markets."[38]

"The economic reforms seem to be working. Farmers who had hoarded grain in the hope that the tariffs would be lifted are now selling, replenishing foreign-exchange reserves that had been drained to defend the artificially strong peso. The newly freed currency fell by more than 30%, a further boost to exporters. It has stabilised at around 13 pesos to the dollar. "Substantive" talks with holdout bondholders starting in early January could lead to a return to credit markets in 2016."[39]

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[36] *Argentina lifts controls on the peso*, The Economist, Dec. 17, 2015, http://www.economist.com/news/americas/21684487-floating-currency-government-has-moved-step-closer-normalising-troubled
[37] Reuters, *supra* note 2.
[38] *A fast start*, The Economist, Jan. 2 2016, http://www.economist.com/news/americas/21684823-mauricio-macris-early-decisions-are-bringing-benefits-and-making-waves-fast-start.
[39] *Id*.

"But the devaluation has pushed up the inflation rate, already more than 25% when Mr Macri took office. To rein it back, on December 15th the central bank raised interest rates on short-term fixed deposits by eight percentage points to 38%. The government hopes to persuade business and trade-union leaders to keep tight control of prices and wages. But that may prove difficult: the unions are fragmented and little disposed to help Mr. Macri, a centre-right politician; businesses may balk at holding down prices."[40]

How Likely to Repeat the 1990s?

The similarities between the economic situations of 1989 and 2015 worry many that Argentina might repeat the 1990s and have another crisis in the near future. Both periods saw high inflation, economic stagnation, fiscal deficit, depressed foreign trade and downward pressure on the value of the currency. What makes it more worrisome is that President Macri's economic policies mimic many of the Washington Consensus is policies: he vows to restore fiscal discipline and bring down the budget deficit; he lifted currency controls to achieve a competitive exchange rate and boost foreign trade liberalization; and he has managed solve the debt issue to liberalize of inward foreign direct investment. At the same time, he vows to bring down inflation.

There is one major difference between the economic situations of 1989 and 2015: the level of inflation. In 1989, inflation reached an unprecedented 5,000%. It led to riots and President Alfonsin's early departure from the office. It was the most urgent problem to solve for the Menem regime. In 2015, Argentina's inflation rate was 26.9%. It was still one of the world's highest inflation rates, but it was incomparable to the number in 1989. This wins

[40] *Id*.

President Macri time and flexibility to address the inflation issue. The new regime was able to choose drying up money supply with high interest rates to tackle high inflation, instead of taking extreme measures such as the convertibility plan, which was believed to be a main reason for the 1998–2002 Argentine Great Depression.

It is also worth noting President Menem and President Macri's ideological differences. Professor Estela Sacristan, an expert in administrative law and regulation, points out that while President Menem was a far-right politician, President Macri is center-right.[41] President Menem was a Peronist. "Peronism is a brand rather than a party. Its official vehicle is called the Justicialist Party. To the extent that it has an ideology it is a vague blend of nationalism and labourism, expressed in the PJ's founding 'three banners' of political sovereignty, economic independence and social justice."[42] "In 1989 when he was elected president, people expected Menem to carry forward a populist plan with a nationalistic style. Within a few short months, however, he convinced many of his supporters of the need to take a sharp turn toward neoliberal, monetarist, anti-statist policies."[43]

President Macri is clearly against the Kirchner regime's interventionist policies, but Professor Sacristan points out that "he is not a big fan of the market."[44] "The party he founded and leads, Republican Proposal (PRO), started out on the right but has become more inclusive. It is non-Peronist—the political current to which his presidential rival, Daniel Scioli, belongs—

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[41] Presentation given by Estela Sacristan (Mar. 17, 2016).
[42] *The persistence of Peronism*, The Economist, Oct. 15, 2015, http://www.economist.com/news/americas/21674783-argentinas-dominant-political-brand-defined-power-not-ideology-persistence.
[43] Beatriz Sarlo, *Argentina Under Menem: The Aesthetics of Domination*, nacla, https://nacla.org/article/argentina-under-menem-aesthetics-domination (last visited Apr. 26, 2016).
[44] Sacristan, *supra* note 41.

but is not anti-Peronist; many ex-Peronists work alongside the party's conservative founders."[45] Therefore, although President Macri is introducing trade, currency and foreign investment liberalization as President Menem did, he is likely to maintain a necessary level of regulations. In this way, he can avoid the full opening of the capital account to international financial markets, which would make Argentina's economy extremely vulnerable to external shocks.

Conclusion

The similarities between the economic situations of 1989 and 2015 and the similarities between President Menem and President Macri's economic policies concern many that Argentina might repeat the 1990s and have another crisis in the near future. But the truth may not be as worrisome as it seems. When looked closely, there is one major difference between the economic situations of 1989 and 2015: the inflation in 2015 was much lower than in 1989. It gave President Macri flexibility to tackle high inflation with high interest rates, instead of taking extreme measures such as the convertibility plan, which was believed to be a main reason for the 1998–2002 Argentine Great Depression. Furthermore, while President Menem was a far-right politician, President Macri is center-right. The current regime is likely to maintain a necessary level of regulations, and avoid the full opening of the capital account to international financial markets, which was another reason for the Depression.

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[45] *Macri-economics*, The Economist, Oct. 29, 2015, http://www.economist.com/news/americas/21677250-profile-possible-president-macri-economics.