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Miguel A. Kiguel

Structural Reforms in Argentina: Success or Failure

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I. Introduction

Few countries in the world put in place structural changes of the magnitude that Argentina did in a relatively short period of time. The crisis of the eighties determined the end of an era in Argentina, characterized by high levels of government intervention in the economy, large macroeconomic imbalances and a constant economic and social deterioration. The changes implemented during the nineties gave Argentina a new opportunity to achieve sustained economic growth, monetary stability, and lower levels of unemployment and poverty.

There have been many achievements in the last decade. After almost half a Century of high inflation rates and continuous devaluation of the Peso, Argentina accomplished price stability and has maintained the one to one parity of the Peso with respect to the Dollar. In the nineties, a 5.0% average annual growth in the GDP was achieved, with years like 1991 and 1992 where the GDP growth exceeded 10% per year (**Graph1**). Investment was one of the main engines of that growth, while exports also played an important role but its effect were more important in the second half of the decade.

Table 1

**Turn Around after the Crisis of
the 80's
The 90's**

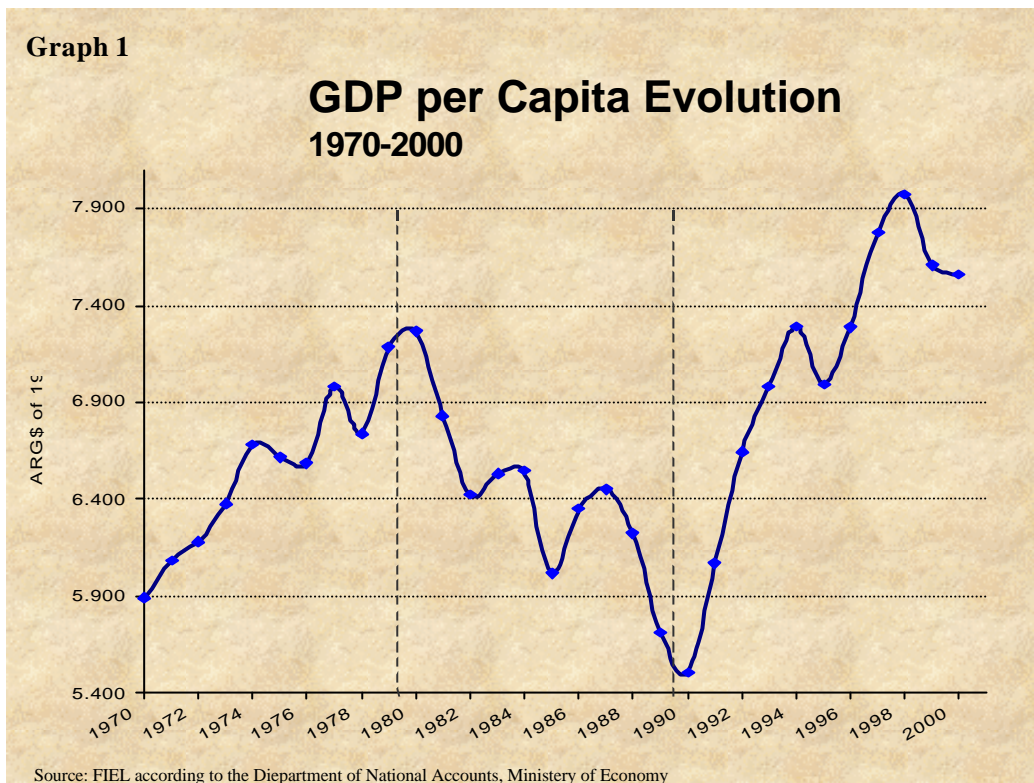
Growth and Productivity in Argentina (% of growth per year))

	1981-1990	1991-2000
Market GDP	-1.30%	4.45%
Employment	1.07 %	1.64%
Total Factor Productivity	-1.0 %	1,64% ¹
Exports	3,40%	9,18%
Inflation	787.0%	21.4%
Fiscal Deficit (% of GDP)	-6.4%	-2.0% ²

¹ Corresponds to the period 1991-1999
² Corresponds to the period 1986-1990
Source: FIEL

By and large, the structural reforms implemented in the nineties have had a positive impact on the economy. Privatizations, in general, have improved the supply of public services, the pension reform together with the creation of private pension funds (AFJPs) helped to reduce the contingent liabilities of the state and contributed to the development of the local capital markets, the elimination of numerous superfluous regulations fostered investment and the creation of a special regime for oil and mining, generated a boom in investment on exploration and exploitation in a sector with a great potential for generating currency flow.

Graph 1



Despite these positive aspects of the reforms of the nineties, the beginning of the new millenium finds the country in a deep economic recession and a renewed debate regarding the economic policies for the future. The country is now in its third year of recession, which has caused an important increase in the rate of unemployment which amounts to about 15% of the labor force, an increase in the poverty index and a delicate fiscal situation due to the scarce capability to finance the public sector's consolidated deficit that is about 3% of the GDP. The sovereign risk stays at extremely high levels, and in the last months Argentina has suffered repeated reductions in the credit ratings from the three most important international rating agencies. Toward the end of the year 2000, Argentina was force to negotiate a 'financial package' (blindaje) with the multilateral credit organizations to ensure the payment of its debts, a fact that a successful country would not be expected to face.

Some of the problems that Argentina suffers today have their origin in the deterioration of the international economic situation. The crisis of the Asian countries in 1997, the Russian crisis in August 1998, the Brazilian devaluation in January 1999 and the recent crisis in Turkey had important negative effects on the country, mainly in limiting the access to international capital markets. The increases in interest rates that the Federal Reserve implemented until the year 2000 and the appreciation of the dollar in the last years did not help either. Finally, the country has suffered deterioration in most of the export prices, especially those of the agricultural and mining sectors.

The Argentine long-lasting recession does not have its origin just in external factors. Despite the improvement of the fiscal in the nineties, the reductions in primary expenditures were not sufficient to compensate the increase interest payments. There are still too many sacred cows in the public sector that for political reasons the government has been unable to eliminate, and many subsidies that benefit specific sectors in opposition to the common good. These fiscal deficits, which may not appear to be so large if they are adjusted to take into account that the country is in its third year

of recession, are relevant because the country has access to a very limited amount of financial resources to finance the deficits of the national and provincial governments and to refinancing the maturities of all their existent debts.

The second important element is that it has not yet been possible to accomplish enough flexibility in the price system and in the labor market to compensate the rigidity that generates the convertibility regime. As a result, every time that the economy required nominal flexibility in public spending, prices, and salaries, this was not achieved, at least, without the necessary quickness.

The objective of this paper is to evaluate the performance of the Argentine economy in the nineties, carry out an analysis of the main structural reforms that were implemented and to analyze the impact that these had. Section II of this paper provides an inventory of the adjustments and tries to give an idea of their significance. One of the characteristics of this Argentine reform process is that it included a broad amount of sectors and that it was carried out in a relatively short period of time. Even though the advances were important, it is understood that structural adjustment processes are dynamic and continuous, and therefore, what yesterday was enough to reach the frontier of efficiency in certain sectors (what we can call the international benchmark), today it might not be enough. It is nonetheless useful to analyze the areas where Argentina advanced the most and those we are still lagged behind.

In section III we carry out an evaluation of the efficiency that the adjustments had on the Argentine economy, and we contrasted the positive results obtained between 1991 and 1998 with the weak performance that Argentina has shown in the last three years. We analysed the implications of current account deficits with the foresight that the major factor of external vulnerability today comes from the capital account, due to the size and speed of capital flows in that market. We emphasized the achievements obtained in the development of the capital market, but we also showed that the critical mass that the public and private sectors need in order to satisfy their financial needs were not accomplished. We conclude with two problematic issues, the increase in the unemployment rate that we can observe in the nineties, and the deep recession that took place at the end of the decade.

Section IV focuses on the challenges that have to be faced in order to assure the sustainable growth of the Argentine economy. We begin with an evaluation of the strengths and weaknesses that the Argentine economy has today compared it with other emerging economies. In this section, we will show that Argentina still needs to strengthen its fiscal solvency, to improve its savings rates, to develop the capital market, to increase the amount of international trade and to achieve more flexibility in the goods and labor markets. This section concludes with a general overview of those aspects of the economy that require more attention in order to implement policies that can help Argentina to succeed in the next decade.

II. The Economic Transformations of the Nineties

The nineties represented an important turning point in the design of the Argentine economic policies. Most of the economic policies that were adopted in the thirties when the country opted for a growth strategy based on import substitution, a

more active use of monetary and fiscal policies for managing the economic cycle and where the state played a dominant role in the production of goods and services and in the allocation of resources were reversed in the nineties.

Throughout these six decades, Argentina has been strongly receding in its relative standing in the world economy. In the twenties, Argentina was among the top ten countries with highest income per capita in the world, higher than countries like Germany or Italy¹. By the end of the eighties, Argentina had receded in a dramatic way in that ranking and today, according to the World Bank's last report it ranks 56th² in the world, with a GDP per capita similar to countries like Hungary, Slovakia, and the Czech Republic, and way below countries like Australia, Canada, and New Zealand that were comparable to Argentina decades ago.

This overall deterioration peaked in the eighties, when Argentina suffered a strong worsening in its macroeconomic indicators in the aftermath of the Mexican devaluation in 1982 that led to a balance of payments crisis, a default on its debt, a continuous reduction in GDP that ended in the hyperinflation of 1989-90. During the so-called lost decade the Argentine economy suffered a 0.7% fall in the annual GDP, which amounted to the worst performance at a global level with the only exception of Nicaragua³.

The magnitude of the economic crisis at the end of the eighties provided the opportunity of and the demand for the great transformations of the nineties. It was no longer possible to continue with a rate of inflation that at its peak reached 12,000% per year, with fiscal deficits that exceeded 10% of the GDP, and with a GDP that kept falling. Moreover, as a result of the fiscal crisis, the supply of public services that were provided by public enterprises such as energy, telecommunications, etc. had collapsed and it was necessary to look for alternatives to generate investment in those areas. There was no sector in the economy that remained unaffected by the crisis, there was a clear demand for radical changes.

The response to this crisis was the implementation in the nineties of a program of stabilization and structural reforms, that is commonly known as the 'Convertibility Plan' (Plan de Convertibilidad). The goal of this program was to reestablish macroeconomic stability, and implement structural reforms in order for Argentina to go back to a new long-term growth path. Even though the monetary reform was only one of the components of this program, the fact that the fixed exchange was one of the program's most visible pillars, led the overall program to be known as the 'Convertibility Plan.

In broad terms the 'Convertibility Plan' leaned on four pillars. The monetary reform, based on the convertibility law had as its main objective to eliminate inflation and reestablish confidence in the Peso. The reduction of the fiscal deficit aimed to consolidate price stability, and therefore to guarantee that the government would not have the need to print money to finance the fiscal deficit. Structural adjustments, such

¹ With an income per capita of US\$2,274 and US\$1,532 according to estimates from Gear-Khamis (1990) and from (Madison xxx)

² According to information obtained from the World Development Report (2000/01) (WDR) of the World Bank, page 274.

³ WDR 2000/01 page 295.

as deregulations, the opening of the economy to international trade, and the privatizations aimed to generate the bases for the economic growth. Finally, the institutional framework was strengthened with measures like the independence of the Central Bank, the creation of institutions to regulate the recently privatized utilities, the strengthening of the Securities and Exchange Commission (the CNV).

As in most of the programs that were successful in stopping hyperinflation⁴, the Argentine stabilization program was based on fixed exchange rate. The main components of this policy were the convertibility law and the independence of the Central Bank. The convertibility law has three fundamental elements that helped to stop inflation. First, the exchange rate was fixed at one Peso for one Dollar, thus providing a strong nominal anchor that is critical for the success of this type of programs. This was particularly important in the case of Argentina because most of the prices were denominated in Dollars during the hyperinflation. When the Peso was fixed to the Dollar, the price level was implicitly fixed as well. Second, the convertibility law forced the central bank to back the monetary base with international reserves, thus generating credibility in the program and contributing to differentiate this initiative from previous failed stability plans that also used the fixed exchange rate as a nominal anchor. Finally, the law imposed strict limits on the capacity of the Central Bank to finance the treasury, because it could only do it through the purchase of treasury bonds, issued in dollars and bought at a market price. In addition, and to limit the ability to finance the treasury, it was established that the stock of government bonds could not grow more than 10% per year.

The fiscal adjustment was the second element that helped to ensure price stability. Argentina entered the nineties with fiscal deficits that were exceeding 8% of GDP (Table 1) and that were mostly financed by the inflation tax⁵. The high rates of inflation had eroded tax collection through the Olivera-Tanzi effect, which reached a peak as a result of hyperinflation. The magnitude of the fiscal deficits made any sensible program to aim at a drastic reduction in the budget deficit.

The program achieved a rapid recovery of the fiscal accounts, and it generated a surplus of 0.4% of GDP in 1992. Most of this adjustment was effected through an increase in tax collections, as the government got higher revenues from the Olivera-Tanzi effect working in reverse, while it also managed to reduce government expenditures that fell by 5% of GDP during those years. The increase in tax collection was achieved despite the elimination of distorting taxes such as export taxes and high import tariffs that had been introduced in the past mainly because of their effectiveness in generating revenues in an economy that is characterized by high levels of evasion. The loss of this income was compensated by increases in more efficient taxes such as the value-added tax and income taxes.

The consolidated public expenditures were reduced from a peak of 38% of GDP in 1989 and to 31.6% of GDO in 1992 (Table 2). This reduction was supported by the privatization of public sector enterprises that took place during these years, as these

⁴ See Sargent, The End of Four Big Inflation, Sach (1986) The Bolivian Hyperinflation and Dornbusch and Fischer (198?)

⁵ According to some estimates, the inflation tax generated between 6 and 7 % of the GDP in income for the government, and represented 25% of the total income in the national public sector, provincial and municipal in the second half of the eighties (see Kiguel and Liviatan (199?) and Artana (2001)).

enterprises represented an important percentage of the public sector deficit during the eighties. Finally, the convertibility law also led to the elimination of the quasi-fiscal deficit, in other words, the one that was generated at the central bank by the subsidies, foreign exchange insurance and the interest payments on reserve requirements that constituted an important part of the fiscal unbalances. It is estimated that in the mid-eighties the quasi-fiscal deficit amounted to 4% of GDP, and that it was reduced to around 2% of GDP in the late eighties.

Table 2

National Public Sector 1986-2000 % of GDP

	National and Provincial Deficit	Consolidated Expenses	National	Provinces	Municipalities
1986	-3,9%	36%	23%	11%	2%
1987	-6,8%	38%	25%	11%	2%
1988	-8,4%	35%	23%	10%	2%
1989	-8,0%	37%	25%	10%	2%
1990	-5,0%	33%	20%	10%	2%
1991	-1,1%	31%	19%	10%	2%
1992	0,4%	32%	18%	11%	3%
1993	-0,4%	32%	16%	12%	3%
1994	-1,7%	32%	17%	12%	3%
1995	-3,0%	32%	17%	13%	3%
1996	-3,1%	31%	16%	12%	2%
1997	-1,4%	30%	16%	12%	3%
1998	-2,4%	31%	16%	12%	3%
1999	-3,4%	34%	18%	14%	3%
2000	-3,8%	34%	17%	13%	3%

Data related to National, Provincial & Municipal Spending correspond to total spending of jurisdictions.

Source: Scheme National Savings & Investment: National Treasury and National Department of Fiscal Coordination with the Provinces of Consolidated Social Expenses – Sub Secretariat of Relations with the Provinces

The government also implemented a reform of the state in order to ensure that the fiscal adjustment would be maintained over time. This reform was effected through voluntary retirements and by other mechanisms aimed at reducing public sector employment in the central administration and in the decentralize organisms such as, the social security administration (ANSES), the medical system for the retired people (Pami), the tax revenue service (DGI), etc. According to some estimates, as a result of these reforms the number of public sector employees in the national administration was reduced by approximately 120,000 people (Table 3). Unfortunately, this saving in the national public sector was compensated by increases in employment in the provinces, which increased significantly the number of public employees between 1991 and 1999. There was also a reduction in the number of de-centralized entities, of secretaries, undersecretaries, and national directions. According to a study done by FIEL the number of these last two fell from 491 to 404 between 1990 and 1995.

The privatizations had two main goals, to reduce the fiscal deficit (because public enterprises were responsible for an important part of the fiscal imbalance) and to improve economic efficiency to increase growth⁶. In addition, the majority of the public sector enterprises face financial difficulties that did not allowed them to carry out the necessary investments to provide their services.

Table 3

National Public Employment

	1992	1995	1999
National	620,007	516,732	463,585
- National Administration	344,592	339,186	302,347
- National Universities	125,022	127,030	136,345
- Financial System ¹	18,004	18,821	17,392
- State-owned Companies	132,389	31,695	7,501
Provincial	1,106,424	1,164,928	1,318,036
Total	1,726,431	1,681,660	1,781,621

¹ Same number for employees in 1998 and 1999
Source: FIEL according to

The government received around 16 billion dollars in revenues as a result of the privatizations implemented between 1991 and 1998⁷. In addition, there were important improvements in the supply of these services. For example, the number of fixed telephone lines increased from 3.1 million in 1990 to 8 million in year 2000, and to 14 million if we include cellular phones, the energy production capacity increased from 112,990 MW in 1992 20,719 MW in the year 2000, the quantity of passengers who travel through urban trains increased by 120% in this period, while homes with access to running water increased from 5.7 million in 1993 to 7.7 million in 2000⁸. Even though there were some problems in fixing the new tariffs and with the supply of some services during the first years in which these firms were under private management, many of these problems are being worked out over time. In perspective, the privatizations were clearly positive for the economy.

The government also made significant progress regarding deregulation and the opening up of the economy. The main goals of these policy measures were to increase investment and growth. The imports of goods and services were facilitated through the

⁶ Some of the sectors that were privatized were: telephones, production, transportation and distribution of electricity and gas, and water services among others, and all public companies that produce goods and services such as siderurgic and petrochemical plants. In addition, there were grants for construction and fixing of roads, highways, ports, and airports, etc.

⁷ According to estimates coming from the CEP.

⁸ This data comes from La Nacion, articles on privatizations, June 3rd 2001.

reduction of tariffs and quantitative restrictions. The average import tariff was reduced from approximately 35% in the mid-eighties to 13.5% in 1999, a clear improvement although it maintains the average tariff above the levels of the most open economies (Chile, for example, has an average tariff of 7%). In addition, the administrative steps required for importing goods were enormously simplified, and a major part of the quantitative restrictions that existed in the past were eliminated. The fall in the port authority costs was an important component of this process.

There was also important progress in the financial sector, where thanks to the elimination of entry restrictions, the deregulation of interest rates, and the new environment that favored the development of new financial instruments this sector experienced significant growth. Of course, this was helped by macroeconomic stability and a better prudential regulation that increased the soundness of the financial sector. As a result of these changes Argentina experienced a significant growth of the monetary aggregates in the nineties, and because these growth took place within the convertibility framework it led to an increase in international reserves from 6,5 billion in 1991, to more than 32 billion in the year 2000⁹.

The labor market became a little more flexible during the period of reforms, but the progress achieved in this area was no large enough as to ensure enough flexibility in this market. The reduction in labor taxes and the creation of a new system to insure in the job injures were steps in the right direction while the privatization of the social security system was important in so far as it allowed workers to regard retirement contributions as savings and not as a tax. There was progress in providing more flexibility in the labor market by reducing the severance costs, by allowing the decentralization of union negotiations. But the improvements were not large enough and there still is much to be done. Today, Argentina needs a labor market that functions in a much more flexible way to compensate the rigidity of the convertibility regime generates.

III. The Impact of the Nineties' Reforms

The monetary stability that was achieved as a result of the convertibility plan, and the structural reforms that contributed to a significant increase in productivity and growth allowed a reversion of the secular tendency to stagnation that the Argentine economy had been showing. Without a doubt, the nineties appear as the decade with highest growth levels and with largest degree of monetary stability that Argentina had experienced since the thirties.

III.1 The Initial Impact

The inflation rate rapidly reached international levels and towards the mid-nineties it enjoyed one of the lowest rates of inflation in the world. Inflation ceased to be an issue of concern in Argentina after being the center of attention for economic policy during almost fifty years.

⁹ This total includes liquidity requirements integrated by banks outside the country.

Table 4**GDP Growth by Sector (%)**

	1991-1994	1995-1998	1999-2000	1991-2000
→ Electricity, Gas and Water	10.2	6.6	6.5	7.1
→ Transportation, Storage and Communications	9.2	9.0	1.1	6.6
→ Exploitation of Mines and Quarry	11.6	0.4	10.0	5.8
→ Financial Intervention, Real Estate Activity and Rents	9.0	6.8	1.6	6.1
→ Services Total	6.7	6.0	0.5	4.4
→ Market GDP	7.73	5.81	-0.49	4.46
→ Construction	11.3	11.2	-11.3	5.9
→ Agriculture and Fishing	3.3	2.6	-2.7	2.6
→ Manufacturing Industry	6.9	5.8	-2.8	2.9

Source: FIEL according to National Accounts Department, Ministry of Economy

High growth rates were also achieved, especially in the first half of the nineties¹⁰. The major impact on growth took place during the 1991-94 period, when the economy grew at a rate of almost 9% per year. The economy maintained a positive trend until 1998, which was only interrupted in 1995 as a result of the tequila effect. The growth in the Argentine economy during this period included almost every sector, but the most outstanding one was the construction industry (that grew at 15% per year), and the mining, energy, and financial sectors. (Table 4)

In addition, we can observe that employment grew at an annual rate of 1,8%, and that 370,000 jobs were created per year between 1991 and 1994. This implies that the economy was generating enough jobs to compensate the losses that were generated as a result of the privatizations and of the reforms of the state. Unemployment did not appear as a worrisome at until the end of 1994 when the unemployment rate reached 12.2% in October 1994 and got worse in May 1995 when it reached a peak of 18.4%.

This period of high growth continued until mid-1998, although it suffered from a severe disruption in 1995 as a consequence of the 'Tequila' effect. However, as it is shown in (Graph 1) the Tequila recession represented a pause in the tendency and not a turning point for growth. In fact, the end of the expansion happened at in 1998, after the Russian crisis, and from that moment on Argentina entered a deep recession from which it has not yet recovered¹¹.

Investment was one of the engines of growth, since it grew 18.8% per year between 1991 and 1994, way above the growth in GDP (Table 5). The highest growth could be observed in (durable equipment) that grew at a rate of 32.7% per year 1991

¹⁰ Artana (2001) presents a detailed analysis of the behavior of the Argentine economy in the nineties, in which some of the conclusions of this section are based on.

¹¹ In section X we analyze this event.

and 1994, although the construction industry also had a positive behavior, growing at a rate of 12.1% per year. Imports of capital goods increased from 1,435 million dollars in 1991 to 6,010 million in 1994, which is another indication of the strong expansion in investment that took place during those years.

Table 5

Fixed Gross Internal Investment

Growth Rate per Year (%)

	Durable Equipment	Real Estate	FGII
1981-1990	7.5	-6.6	-6.9
1991-2000	9.6	3.1	5.3
1991-1994	32.7	12.1	18.8
1995-1998	14.4	8.6	10.9
1999-2000	-8.0	-8.5	-8.3

Source: FIEL according to National Accounts Department, Ministry of Economy

The increase in productivity played a key role in the increase GDP during the nineties. Between 1991 and 1998 total factor productivity grew by 2.1% per year, which explains approximately half of growth of GDP in this period and represents an important reversion in the tendency that was observed during the eighties when total factor productivity fell by 1% per year. There is no doubt that the structural reforms especially the privatizations and the deregulation of the economy together with a new environment of price stability explains much of the increases in productivity. (Table 4).

Exports also had an important role in growth, however, their major impact was visualized between 1993 and 1996. During the nineties, Argentine exports grew at 8.7% per year, which means that Argentina doubled the growth rate that it had during the eighties and exceeded the world trade growth and that of the industrialized countries whose exports grew at 6.5% per year. The successful performance of Argentine exports helped the country achieved growth rates that were closer to those of countries with a higher degree of openness, such as Chile, and it fully surpassed Brazil's growth rate (Table 6).

The increase in exports was diversified regarding both products and recipients. As we can see on Table 7 (exports by product), the fuel sector was the one that showed the greatest growth, it generated a growth rate of 21.8% between 1993 and 2000. As a result of this growth, the share of fuels increased from only 8% of exports in 1990 to 18.7% in 2000. Industrial manufactures were second in importance, as they grew at 12.1% per year between 1993 and 2000, while the primary products and agricultural manufactures lost their relative participation.

Table 6

Exports of Goods and Services

Economy	1980-1990	1990-1999
Argentina	3.8	8.7
Brazil	7.5	4.9
Chile	6.9	9.7
Colombia	7.5	5.2
Czech Republic	-	9.0
Greece	7.2	3.3
Hungary	3.6	8.2
Ireland	9.0	13.3
Korea	12.0	15.6
Malasia	10.9	11.0
Mexico	7.0	14.3
New Zealand	4.0	5.4
Poland	6.6	10.8
Portugal	8.7	5.6
South Africa	1.9	5.3
Spain	5.7	10.9
Thailand	14.1	9.4
World	5.2	6.9
Lat. America and Caribbean	5.4	8.7

Source: World Bank

Even though they faced a 7.1% price fall between 1993 and 1999, the value of Argentine exports grew at 10.1% because of an important increase in the volume in exports. This increase in export values can be seen to every region, the greatest being those to Mercosur and NAFTA and the minor ones to the European Union where the appreciation of the Euro was a negative factor. (Table 7)

One of the weaknesses that the Argentine economy still has is its low level of domestic savings. Although there was an increase in the level of savings between 1992-95, when it went from being 14.6% of the GDP to 16.0% of the GDP, from that moment on domestic savings fell to a floor of 13.1% of GDP in the year 2000. The initial increase was probably influenced by the strong growth that took place at the beginning of the decade, as it can be empirically observed that economic growth is one of the major determinants of domestic savings. The reverse took place in the second half of the nineties, especially in 1999 and 2000, as domestic savings fell as a consequence of the reduction in growth followed by recession of the end of the decade. This fall in savings is not surprising, given that consumers were trying to stabilize their consumption in response to what they considered to be a temporary fall in their income, just like it is predicted by the permanent income theory. (Table 8)

The lack of domestic savings to finance the higher levels of investment implied that Argentina had to run a deficit in the current account of the balance of payments (graph 5, current account). In other words, the investments that could not be financed through domestic savings were financed externally through the current account. Argentina experienced a deficit of the current account throughout the nineties, and by the end of the decade it stabilized at around 3.5% of the GDP.

Table 7

Exports by Destiny
Value (in million US\$), volume y mean price

Exports Destiny	1993 Value (million US\$)	1999 Value (million US\$)	Annual Growth (99-93) Volume %	Variation 1999-1993 Mean Price %
Total	13,118	23,333	11.46	-7.07
Mercosur	3,684	7,064	7.21	26.30
NAFTA	1,561	3,149	21.33	-36.77
European Union	3,646	4,639	7.51	-17.62
Rest of World	4,227	8,480	14.96	-13.07

Exports - Participation by Main Items

	1990	%	2000	%
Primary Goods	3,339.4	27.0%	5,422.8	20.6%
Agricultural Manufacture	4,663.3	37.8%	7,862.7	29.8%
Industrial Manufacture	3,364.3	27.2%	8,200.3	31.1%
Fuels	985.2	8.0%	4,925.6	18.7%
TOTAL	12,352.8	100%	26,379.0	100%

Source: FIEL according to INDEC

These current account deficits have been a source of controversy within Argentina and with the International Monetary Fund, given that throughout history it was considered that a balance of payments crisis was generally triggered by strong and sustained imbalances in the current account. Some of the examples were that the Mexican Tequila crisis occurred when the current account deficit reached 6.8% of GDP in 1994, or that the Chilean crisis of the eighties occurred when the current account deficit was about 14.5% of the GDP in 1981. There is a rule of thumb that says that current account deficits that are above 5% of the GDP are a warning sign that indicate a risk of a balance of payments crisis. However, this rule is not infallible, as there are many examples of countries that had balance of payments crises with deficits smaller to these levels, while at the same time there are also countries that had chronic deficits above those levels and never suffer any type of crisis (for example, many of the so-called Asian tigers during years of high growth)¹².

A deficit in the current account simply indicates that expenditures exceed domestic income and could be considered as an inter-temporal decision to spend more in the present and less in the future. In the case of Argentina, given that most of the external imbalance had as a counterpart an increase in investment in response to incentives generated by new economic policies, it seems to be reasonable that those were initially financed by external savings. This, in itself, should not be a worrisome issue. Moreover, given that many of these investments were financed through direct foreign investment, and not by short-term debt, it was also an indication that there were no imminent risks. Nonetheless, current account deficits still are a controversial issue and a source of concern as every time that the economy experiences an expansion the current account deficit increases. It is clear that current account deficits are larger when financing increases and that they get smaller when financing decreases, indicating that,

¹² Given numbers on South Korea and other countries in the 70's and 80's

in fact, there is an adjusting mechanism that makes deficits themselves not be a threat to stability.

Table 8

Savings Evolution in Argentina

	Foreign Savings	Domestic Savings	Total Savings
As % of Current GDP			
80's			
1985	1.16	18.00	19.16
1986	2.92	15.54	18.46
1987	4.22	15.49	19.72
1988	1.34	17.80	19.14
1989	1.85	14.75	16.60
90's			
1990	(3.73)	17.83	14.09
1991	0.20	14.87	15.07
1992	2.62	14.64	17.25
1993	3.39	15.66	19.06
1994	4.27	15.67	19.94
1995	1.93	16.01	17.94
1996	2.40	15.69	18.08
1997	4.08	15.29	19.37
1998	4.88	15.05	19.93
1999	4.35	13.53	17.87
2000	3.36	13.14	16.50

Source: FIEL according to Ministry of Economy

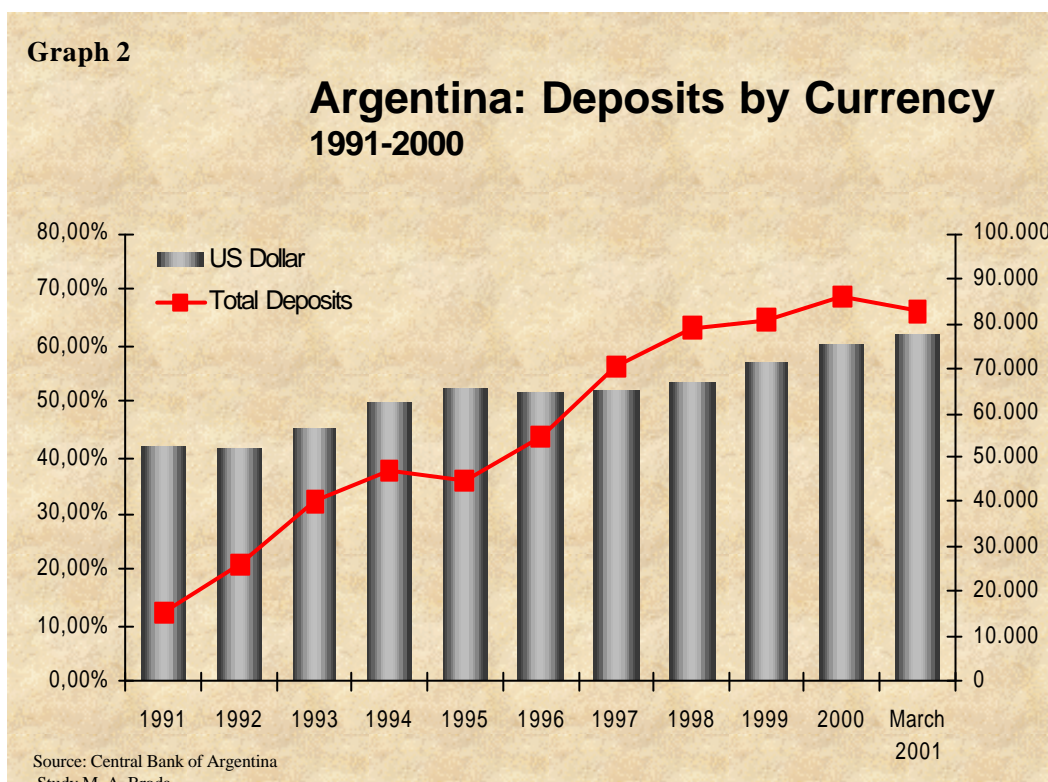
In fact, one lesson that we have learned from recent international financial crises in emerging economies is that the greatest weakness comes from the capital account. Recent balance of payment crises that occurred in Asian countries, Russia, Brazil, and Turkey clearly had their origin in the capital account and were triggered by the difficulties to finance short-term debts, either in local or foreign currency. In fact, Russia had a current account surplus before the August 1998 crisis, and Turkey had a current account deficit of just 3.6% of GDP in 2000. In the Asian countries, the vulnerability had its origin in the re-financing of short-term foreign debt, much of it owed by the private sector, which was difficult to refinance when foreign banks and international investors confidence was lost. In the cases of Russia and Brazil, just like it happened in Mexico in 1994, the difficulties had their origin in a short-term public debt denominated in local currency, which was becoming more and more difficult to refinance as investors required higher rates every time. With fixed or predetermined exchange rates, the debt in dollars was growing at exponential rates and generated an inconsistency between the exchange policy and the growth of the domestic debt. Eventually, this inconsistency was solved through devaluation and a change in the exchange regime or a default on the local debt like it happened in Russia in 1998.

II.2 The Growth of the Financial and Capital Markets in the Nineties

The financial sector grew strongly in the nineties, as a result of the remonetization of the economy. Hyperinflation led to a significant reduction in the use of the domestic currency (at that moment was the Austral) and the percentage of M3 to

GDP had fallen to extremely low levels (approximately 5.5% of GDP). The price and exchange stability that began in 1991, brought a significant increase in the demand for the local currency, now called Peso, and there was an important increase in the demand for currency and for deposits in the financial system (Graph 2, increase in deposits, percentage in dollars)

This increase in the monetary aggregates had its counterpart in the increase in international reserves, given that the convertibility law required that the issuance of monetary base had to be backed up by international reserves. Between 1991 and 1994 the monetary base increased by 8.4 billion Pesos while international reserves experienced an increase of 8.5 billion dollars.

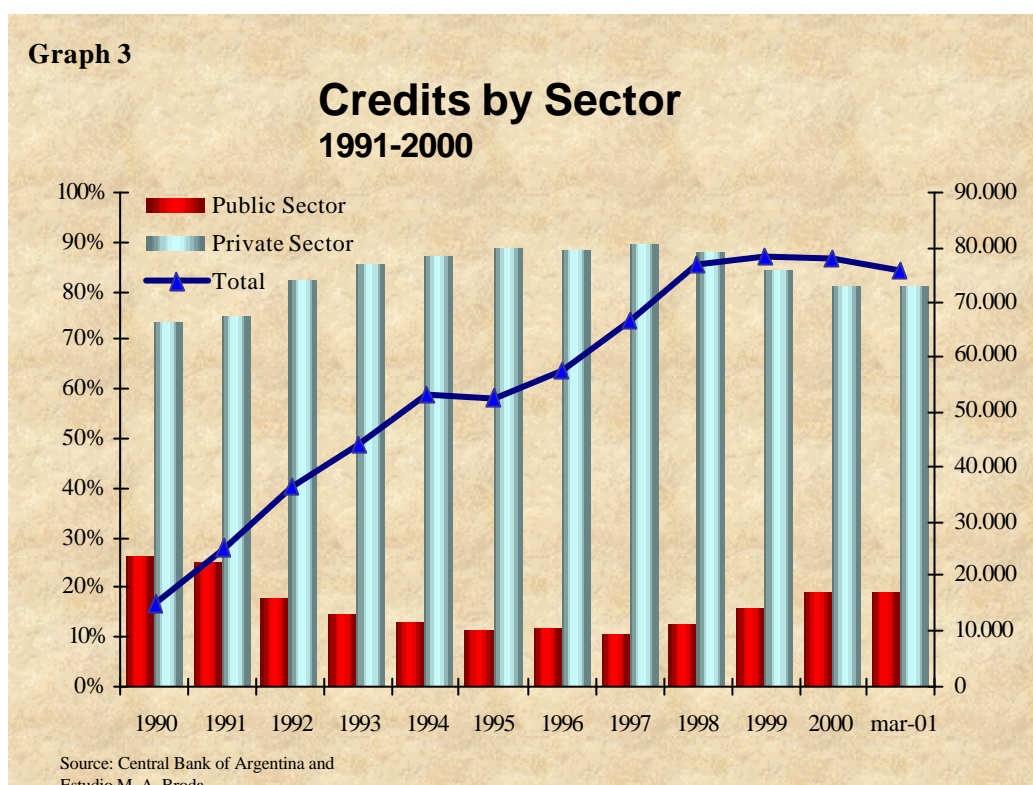


The convertibility regime opened the door for bimonetarism, allowing people to choose the currency in which they wanted to make their deposits. This helped the development of the domestic financial system because most Argentines showed a significant preference to maintain their savings in dollars, a tendency that became more apparent during the hyperinflation. In the past, every time that the Argentines chose to keep their deposits in dollars they were forced to take their money out of the country generating capital flight. With the changes introduced by the convertibility law and the law of financial institutions, it was legal to change a deposit from one currency to another within the Argentine financial system, thus, without causing an impact on total deposits, which strengthened the financial system.

The share of dollar deposits in the banking system increased throughout the nineties. The first important increase in the level of dollar deposits occurred during the Tequila effect. From then on the percentage of dollar deposits increased from 48% in 1994 to 52% in 1997 and from 59% in 2000. This dollarization process was particularly important for time deposits, where the preference for the foreign currency was greater, while the dollarization did not advance as much for transactional deposits, which

include current and savings accounts, where the peso continues to have a predominant role.

The growth in deposits provided the basis for the significant increase in credit to the private sector, which grew from 22,770 million Pesos in 1991 to 68,620 million in 2000. Among these items, the largest increases are observed in mortgages and personal loans, while loans to companies displayed a much smaller rate of growth. (Graph 3 – Loans by Sector and Graph 4 – Loans to the Private Sector).

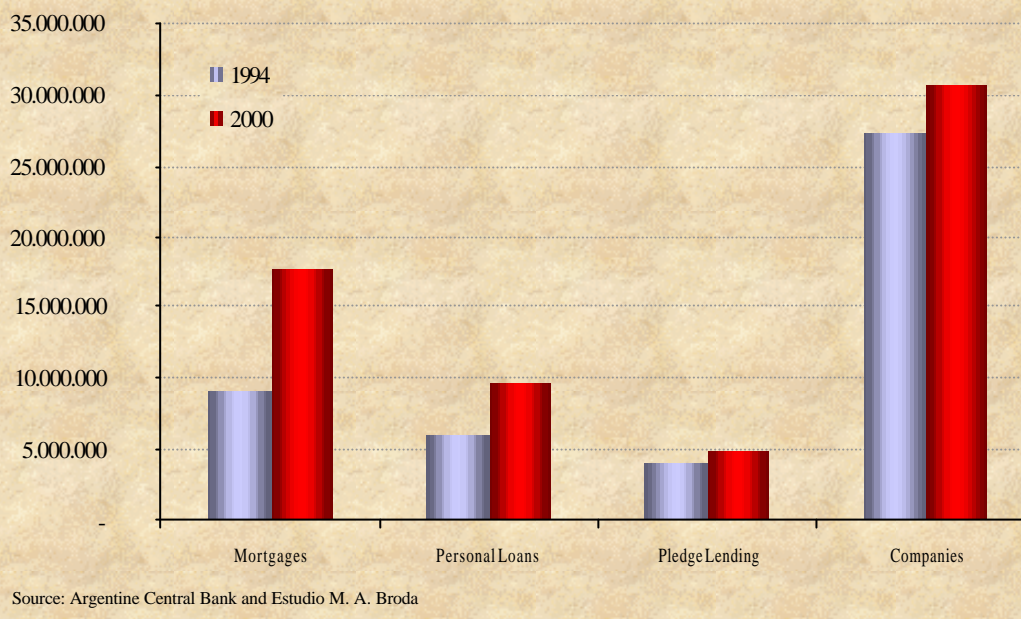


The capital market became more dynamic with the appearance of the institutional investors, who display an increasing importance over time. The pension funds, the AFJPs, that started to operate in 1994 to substitute the capitalization for the pay as you go pension system, have been, without a doubt, the most important players in this area. The pension funds invest primarily in public bonds, stocks, corporate bonds and other assets issued by the private sector have about 22,000 million dollars in assets under management, equivalent to around 7% of the GDP. (Graph 5)

Although much smaller in size, life and retirement insurance companies are the second most important institutional investors. They manage assets of around 7 billion Pesos, most of their growth took place in recent years, and like the pension funds, they have a preference for long-term investments. Finally, mutual funds also became more important in the second half of the nineties. While they offer a broad menu of alternatives, most of the assets that they manage are invested in money markets (approximately 80% of the total). As a result, the mutual funds do not have a major role in developing the long-term capital markets.

Graph 4

Loans to the Private Sector 1994-2000

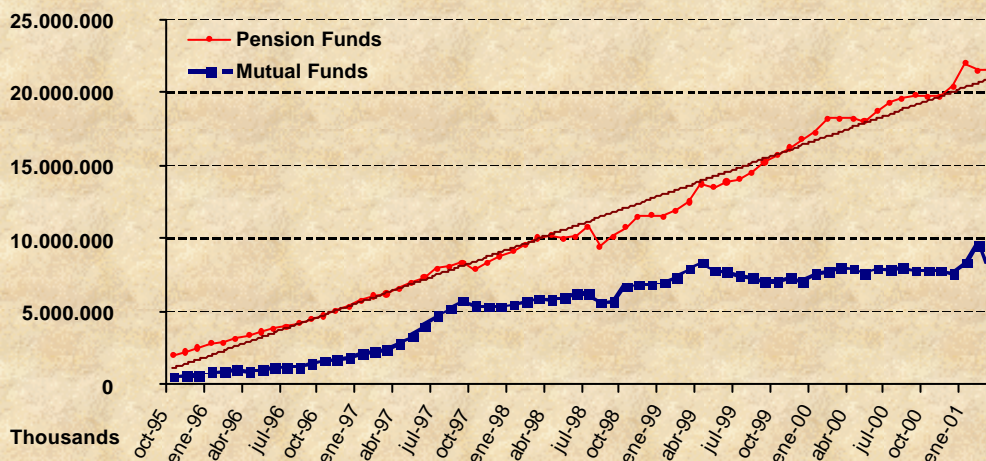


The size of the local capital market, which is still too small, has been a restriction for the domestic absorption of the private and public debt. Although there has been an important improvement with respect to the mid-nineties, when institutional investors were for practical purposes non-existent, the amounts managed by institutional investors are still too small to satisfy the needs of the private and public sectors, and it is also small compared to other of countries of the region. Nonetheless, if the managed funds keep increasing according to the existing forecasts, we could expect that in about 10 years institutional investors will play an important role in financing private investment projects the government financial requirements, which will allow Argentina to depend less on foreign savings.

Graph 5

Local Capital Market Development Institutional Investors

Pension Funds & Mutual Funds (Oct.'95 - Mar.'01) - Assets under Administration

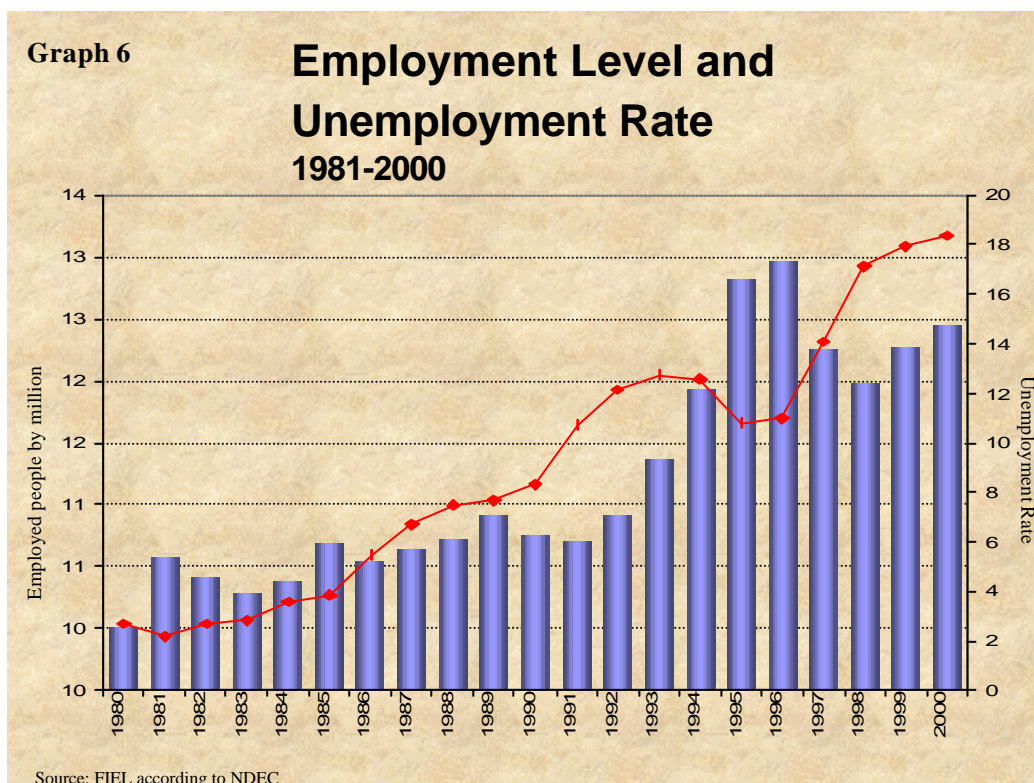


Source: SAFJP Y CAFCI

III.3 The Dark Side of the Boom in the Nineties

The improvements that took place through most of the nineties were accompanied by some weaknesses that generated critiques and questions about the overall strategy. The most important problems that were the source of the critiques have been the long-lasting recession that the country has been experiencing since 1998, the increase in unemployment and poverty, the perception of more volatility of output and of capital flows, the fiscal deterioration and consequently the strong increase in the sovereign risk, and the process of concentration in the business sector that has been observed in the economy.

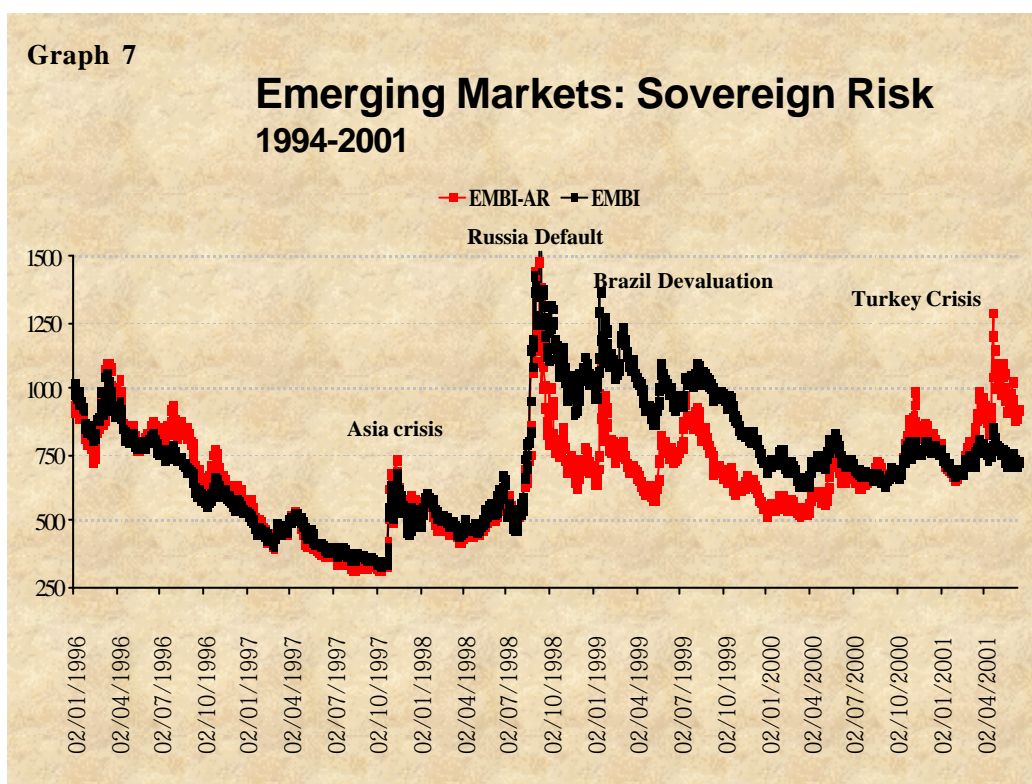
The increase in the unemployment rate in 1995 and the more recent trend indicating a new rise in this rate is perhaps one of most worrisome macroeconomic issue. The is an important difference in evolution of unemployment in the first phase of the convertibility plan (1991-95), and one that follows, as unemployment increased despite a rise in output in the former period, while the behavior in GDP and unemployment were more closely correlated over the business cycle in the latter. In fact, we observe that the fall in the rate of unemployment from 18.4% in May 1995 to 13.7% in October 1997 coincided with an economic expansion. The rate of unemployment rate increased again in the last two years, reaching 14.7% by the end of 2000, as a result of the deep recession that the economy is suffering from. This indicates that probably and in contrast to what happened at the beginning of the decade, one of the best ways to reduce the unemployment rate is by implementing measures that could stimulate growth. (Graph 6)



A decrease in labor costs through a reduction in labor taxes and through greater flexibility in the labor market is a second factor that would help to reduce the unemployment rate. Even though there have been improvements in this area, such as reductions in direct and indirect labor taxes, lower severance payments or more

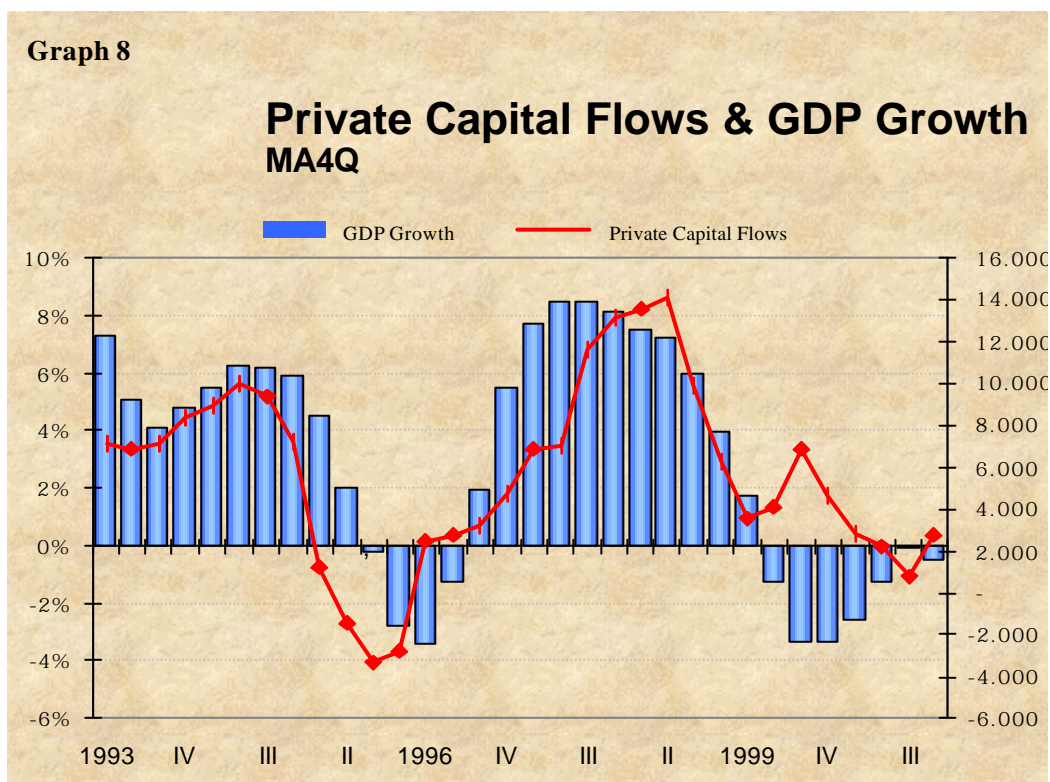
flexibility in negotiating labor contracts, there is still much to be done. One area of concern are the labor contracts in the public sector, where the rigidities regarding wage and non-wage benefits show a significant level of rigidity. In addition, given that Argentina has a rigid exchange rate system, is critical to compensate it with a very flexible labor market.

The second worrisome issue has been the dependency of the Argentine business cycle to the international financial situation faced by emerging economies and the fluctuations that our economy experiences as a result of the frequent and intense external crises. Since 1995 Argentina had to overcome the consequences of the Tequila effect, and the Asian crisis, the Russian default, the Brazilian devaluation, and more recently the Turkish crisis. In addition, the inflow of capital into Argentina has been affected by domestic ‘political crises’ that in a more sensitive international environment negatively affected the access to the international capital markets. Among these events the most relevant ones were the statements made by some candidates during the presidential campaign in 1999 about a forced restructuring of the external debt, the resignation of Chacho Alvarez, the vice-president, and the three changes of economic minister in March of this year. As we can see on (Graph 7) these episodes strongly affected the level of the country risk.



The importance of the capital flows on the Argentine business cycle can be clearly seen in (Graph 8). It stands out from the graph that in periods of private capital inflows, such as 91-94 or 96-97, the economy experienced an increase in growth, while in those periods when there was an outflow of capital or in those that there were simply no inflows of private capital the economy suffered a fall in the economic activity. Something similar happens when one analyzes the evolution of economic activity and sovereign risk, associating periods of decreases in sovereign risk with capital inflows and increases in the level of activity.

Capital flows to countries like Argentina certainly depend on the ‘push and pull factors.’ In other words, capital inflows depend on external factors, such as a fall in interest rates of industrialized countries (the United States particularly), or a reduction in the degree of risk aversion to investing in emerging economies. Internal factors are also important, as they induce and make it more attractive the opportunity to invest in the economy, such as perspectives of higher economic growth or of financial stability. In the case of Argentina, in the first half of the nineties the push and pulls factors favored a strong inflow of capital. The fall of interest rates in the United States between 1991 and 1993 was an important push-factor, while the structural adjustments that were implemented in the country during those years attracted a great part of the capital flow into our country. On the contrary, in 1999 and 2000 both factors played against. We observed a great degree of risk aversion from institutional investors that reduces their exposure in developing countries and as a result of the Russian crisis. In addition, investors have been obtaining high rates of return simply investing in the NASDAQ. In contrast, in Argentina we have seen low rates of growth, an increase in the country risk and the negative political signals that have negatively affected Argentina’s attractiveness as a place to invest.



In addition, toward the end of the decade we can see some indicators that point to a reversal of many of the achievements obtained during the first years of the nineties. For example, we see that the efforts to lower the public spending start to revert, mainly as a result of the increase in spending in the provinces. This increase in public spending led to a continuous increase in the fiscal deficit throughout the last years reaching 3% of the GDP in 2000. We can also observe a worrisome increase of the public debt and in the credit from the banking sector to the public sector, which after showing a declining trend since the beginning of the nineties, it starts to increase again in 1998 (graph 3).

III.4 The End of the Decade Recession

In the second half of the nineties Argentina was not able to maintain the high rates of growth that it enjoyed during the first half of the decade. With the exception of the years 1996 and 1997, when the country seemed to go back to the path of high growth after the slowdown suffered during the Tequila, Argentina had a poor performance and since the second half of 1998 the country is facing a severe recession and it does not show any signs of recovery.

This long and strong recession has generated questions about the reasons for its depth and length. It is true that as a consequence of the Asian and the Russian crises many developing countries, especially in Latin America, suffered a decrease in growth rates in 1998 and 1999. Brazil, for example, practically did not experienced any growth in 1998 and 1999, while Chile suffered the first fall in output in the last two decades (Table 9). It is also true that the Brazilian devaluation had an additional impact in our economy in 1999. Nevertheless, the numbers clearly show that almost all the economies of our region started growing again in 2000, including countries so diverse as Brazil, Chile, Colombia, and Mexico, while Argentina continued to be submerged in a deep recession.

Table 9

Annual Economic Growth in Latin America (%)

	1997	1998	1999	2000
Argentina	8,1	3,9	-3,4	-0,5
Brazil	3,3	0,2	0,8	3,4
Chile	7,4	3,9	-1,1	5,4
Colombia	3,4	0,5	-4,3	2,8
Mexico	6,7	4,8	3,7	6,9
Peru	6,7	1,3	-0,3	3,7
Venezuela	6,4	-0,1	-7,2	3,2

Recession ← ← **Recovery**

This recession has differences to the one experienced during the Tequila crisis, which are worth mentioning. While the Tequila was a relatively short recession and was primarily the result of a short-term financial crisis, the current crisis seems to have its origin in a group of adverse shocks, mostly external, related to changes in real variables and that have lasted for a long period of time. Among the most important factors we could mention the depreciations of the Real and the Euro, the fall in our export prices and smaller capital inflows into developing countries as a consequence of the Russian crisis and the collapse of the hedge fund Long Term Capital Management.

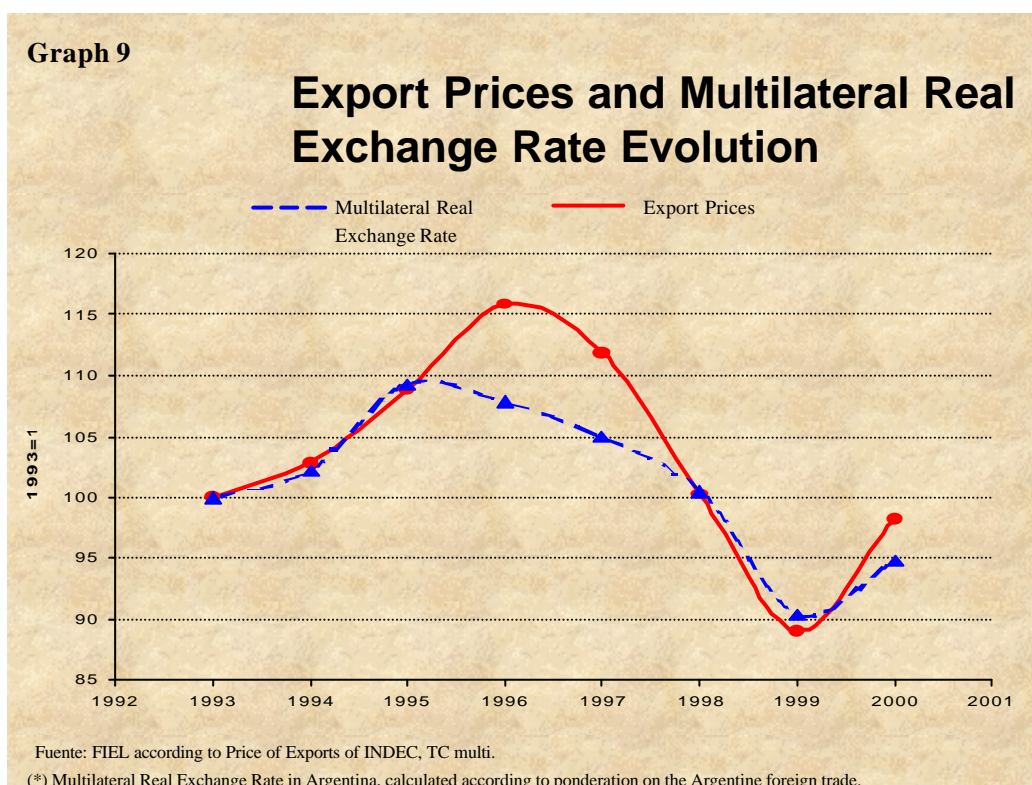
The Tequila crisis was profound but relatively short and its greatest impact was felt on the financial system, where the deposits fell between December 1994 and May 1995 by approximately 17%. The decrease in deposits led to a severe credit contraction that negatively impacted the economic activity. Additionally to this impact there was a loss of confidence in the financial system and doubts about the maintenance of the convertibility regime due to the continuous reserve losses that the Central Bank was suffering from, and a weakening of ratio of international reserves to the monetary base, as a result of an increase the ratio of government bonds that were used to back the new issuance. In only three months, international reserves fell by 5.6 billion dollars, and by the end of March 1995 liquid international reserves were backing 80% of the monetary base by 80%, a clear reduction with respect to the more than 90% that were used to back the monetary base in December 1994.

The response to the Tequila crisis was a set of measures that allowed the public to regain confidence on the liquidity of the financial system and on the capacity of the central bank to maintain the convertibility regime. This was achieved through a financial package of around 12.0 billion dollars, which included a fiscal adjustment of 4.0 billion Pesos, 6.0 billion from the multinational organizations, and 2.0 billion dollars through a “patriotic” bond, which was subscribed by the private sector. The package included measures to restore the confidence in the financial system, such as the introduction of a private deposit insurance system, and the creation of two fiduciary funds to aid bank consolidation and the privatization of provincial banks.

This package was effective in reestablishing confidence in banks and in the convertibility regime. The announcement of the measures, and their ensuing implementation, stopped the banking/exchange run. Starting in March the fall in deposits subsided and from May onwards deposits and reserves experienced a fast recovery. By the end of 1995 they had already reached pre-crisis levels. With deposits rising again, economic activity began to pick up and by the end of the year the recession had being left behind. The recession lasted only four quarters, and by 1996 and 1997 the economy was once again growing along the trend tendency that it had enjoyed during the first years of the decade. The external factors also helped to generate a quick recovery. Capital flows to emerging markets were once again on the rise, reaching record levels, while Argentina benefited from high prices for its exports of primary product, while it helped that the Brazilian economy was growing at reasonable rates and that its currency somewhat overvalued.

The current recession starts after the Russian crisis, primarily as a consequence of long-term changes in the financial and goods markets. The Russian default had a long-term impact on the functioning of the capital market for emerging market economies, due to the losses that many investment banks that were market makers in their debt faced and to the disappearance of a great part of the “hedge funds” (the best known case being Long Term Capital Management) and of investment funds that were dedicated to investing in emerging markets. As a consequence of these changes, there was a reduction in liquidity in the bond market for emerging market countries, and even today, the size of the funds that go to these countries did not recover the levels that were available in 1996 and 1997.

The Brazilian devaluation in January 1999 was the second most important factor affecting Argentina. Every time that a developing country abandoned a fixed exchange regime and adopted another a floating exchange rate system, our country suffered negative effects (the Turkish devaluation was the most recent case that had an impact on Argentina). But that effect, without any doubt, is magnified when the country that devalues is Argentina's main commercial partner. The Brazilian devaluation does not appear to have had an important effect on the trade between these two countries and on Argentine exports to Brazil. Nevertheless, there are indications that there were commercial disputes between these two countries as a result of the Brazilian devaluation and the doubts that they generated about the future of the Mercosur have reduced investment in Argentina. If we add to this the uncertainty that recent discussions generate about Argentina having to prioritize ALCA (the American Free Trade Association) over the Mercosur also has a negative impact on short-term investment.



Finally, Argentina has also suffered a decrease in most of the prices the exports of primary products (with the exception of oil) at the same time it was harmed by the appreciation of the dollar against the Euro and the Yen (Graph 9). Despite these adverse factors, exports have grown, but they did not have the dynamism that they should have had with a more favorable external scenario.

This combination of “real” and financial factors that explain the current recession makes its diagnosis to be complex. There are no easy solutions for a fast exit to the crisis. Experience indicates that the first necessary condition to recover growth is a reduction in the sovereign risk, which requires an improvement in the solvency conditions of the public sector, both at the national and provincial levels, and the ability to refinance the amortizations of public debt coming due over the next few years. But a fall of the sovereign risk also requires some an indication that the economy, under the right conditions can and will growth, because it is difficult to imagine that Argentina

will be able to ensure its solvency as long as the economy stays stagnant. Today, a major part of the economic policy discussion is focused in trying to identify economic measures that could help achieve the double objective of reestablishing growth and increasing the public sector solvency. In the next section we will analyze the opportunities and challenges that those in charge of developing economic policies face to ensure future growth.

IV. Challenges and Opportunities for the Future

The context in which the economic policies for the next decade get opened for debate is far from being an ideal one. Despite the achievements attained by the Argentine economy during the nineties, the deep recession that Argentina is suffering since 1998 has caused great damage to most of the economic aggregates and in the social situation of the country. During these three years GDP fell of 3.9%, the unemployment rate increase from 12.4% in October 1998 to 14,7% in October of 2000, while doubts about the Argentine fiscal solvency appeared. Without growth and consolidated fiscal deficits that have exceeded 3% of the GDP in the last few years, public debt grew strongly as a percentage of output reaching 50% of the GDP in 2000. As time went on, it became more and more difficult to refinance the stock of public debt. It first required a 40.0 billion dollars financial package, the “blindaje”, implemented by the end of 2000 and more recently a mega-debt swap of almost 30.0 billion dollars to ensure the repayment of the debt that is due in the next coming years. The country’s credit rating was reduced by the main three credit rating agencies and today it is similar levels to that of countries that were forced to restructure their debts.

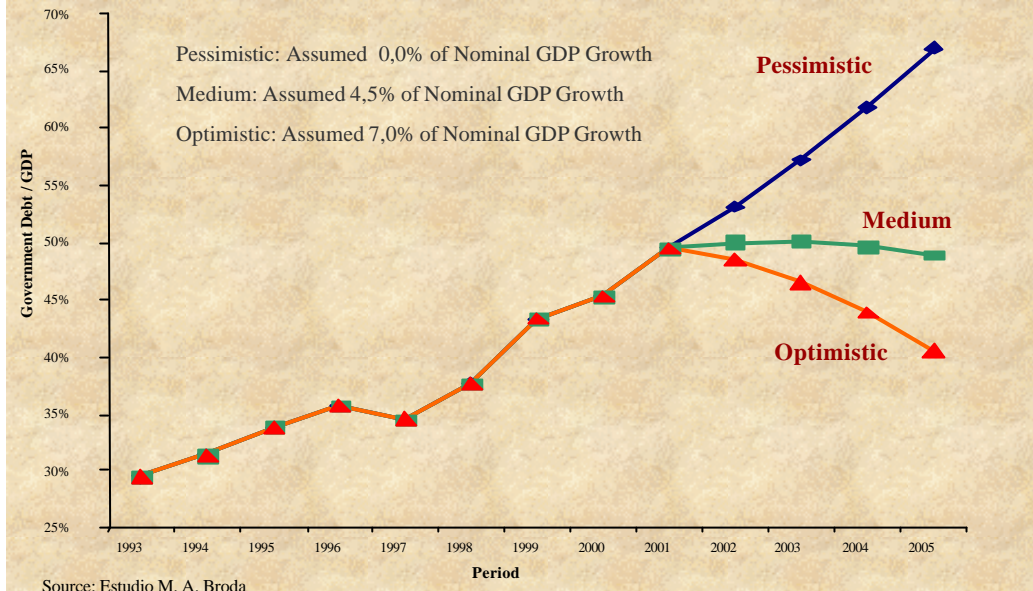
It seems paradoxical that a country that implemented far reaching stabilization and structural adjustment programs, that achieved an excellent performance during most of the nineties and was shown to the world on international forums as a model to imitate for the quality of its economic policies, is now facing an extremely delicate situation. Only four years ago, most analysts expected that Argentina today would be a country with an investment grade rating, similar to Mexico, and not facing such a complex situation and struggling to avoid default. This is perhaps a good time to take some distance from the day to day problems and analyze the current economic situation in perspective, trying to detect the strengths and weaknesses of the economy and to see how the Argentine economy appears when compared to other emerging market economies.

IV.1 Fiscal Deficit, Public Debt and Financing

The biggest concern today about Argentina is the perception that the public sector might face a solvency problem and encounter problems in servicing its debt. As it is shown on **Graph 10**, the debt of the central government grew rapidly during the nineties, reaching 44.9% of the GDP in 2000. Although part of that increase resulted from the explicit recognition of debts that their origin prior to 1991, the actual increase in public debt was only recorded in the nineties as the government started to issue the debt instruments to cancel the old obligations. The rest of the increase in the debt had two main causes, first, the existence of fiscal deficits both at the national and provincial levels that were not eliminated during years of high growth, and second, a decrease in the level of GDP in the last two years that increased the burden of the existing debt.

Graph 10

Government Debt / GDP Evolution (1993-2000) and Projection (2001-2005)



The Argentine debt does not appear to be particularly large in international comparison (Table 10), as it now amounts to 45% of GDP for the central government and it rises to 50% of GDP if we include the provinces. In normal circumstances this level of government debt should be manageable for a country like Argentina. In fact, many countries faced much higher debt to GDP ratios and more difficulties to service their debts and yet they were able to overcome them as they achieved high and sustained growth rates and took advantage of the economic boom to lower the fiscal deficit (for example, Ireland and Chile). It is true that there was a strong deterioration due to the decrease in GDP, and that if Argentina miraculously were to enjoy three years of high growth like the ones that it had at the beginning of 1990, and it takes advantage of such a boom to lower the fiscal deficit it could rapidly recover the fiscal solvency. But because that scenario does not seem to be the most likely one, the question arises whether Argentina can improve its fiscal situation in a moderate growth scenario.

If we project the evolution of the debt to GDP ratio assuming that the fiscal deficit remains within the limits imposed by the fiscal responsibility law and on a moderate growth of nominal GDP of about 3.5% per year, we can see on graph 13 that the deterioration can be reversed in a relatively short period of time. It is clear, that the resumption of growth is a necessary condition for the improvement in the debt indicators, that it will be extremely difficult to reduce the budget deficit in an environment of economic stagnation. Without growth, the fiscal situation will continue to deteriorate as was the case in the last years and the Argentine solvency will be seriously affected.

A recent study by an investment bank shows that if Argentina wants to ensure its solvency it needs generate an increase in the primary surplus equivalent to 2% of the GDP in the next years (Deutsche Bank). Although this number may seem to be

ambitious, it is in line with the adjustments that other emerging countries need to do, and could be achieved without great difficulties with a growing economy.

Table 10 **Macroeconomic Indicators - Summary**

Source: JP Morgan, Deutsche Bank, FMI and others.

% - Year 2000	External Debt / GDP	S-T Dom. Debt / IR	S-T Ext. Debt / IR	M2 / GDP	Fiscal Balance / GDP	Savings / GDP	X+M / GDP
Argentina ²	51,2	17,2	67,7	3,1	-2,4	15	18,6
Brazil	39,8	270	85,1	6,3	-4,6	17	13,8
Bulgaria	78,3	N/A	19,4	1,4	-0,5	N/A	N/A
Chile	45,8	N/A	27,2	2,2	-0,7	21	45,4
Colombia	44,2	27,1	90,7	2,6	-3,6	12	24,5
South Korea	32,2	N/A	48	3,6	1,1	32	71,1
Philippines	80,2	106,3	49,3	1,9	-4,1	N/A	N/A
Hungary	56	43,3	48,4	1,8	-3,5	N/A	84,3
Indonesia	106	N/A	30,5	2,6	-3,4	N/A	N/A
Malasia	47,2	4,2	17,2	3,5	-5,8	41	175,9
Mexico	31,3	118,7	64,7	6,7	-1,1	N/A	59,6
Poland	40,4	N/A	31,9	2,5	-2	N/A	47,0
Czech Republic	41,7	38,1	62,1	2,8	-2,3	26	98,3
Russia	62,1	N/A	N/A	1,3	2,5	N/A	N/A
South Africa ²	26	N/A	168,5	8,9	-1,9	15	42,0
Thailand	67,9	4,2	45,6	3,5	-5,2	31	84,4
Turkey	58,5	27,8	140,5	1,5	-9,9	N/A	N/A
Venezuela	34,6	28,4	43,3	1,4	-1,8	18	36,1

¹ Average 1997-1999 ² Corresponds to M3 / GDP.

One of the strengths of Argentina is that most of its debt is long-term (**Graph 11**), with an average maturity of seven-years. In practice, this means that in the coming years the amortization of the long-term debt will not exceed 10% of the total debt in any given year. In addition, given that Argentina has a relatively small amount of short-term debt (mainly treasury bill called Letes) that do not exceed 4% of total debt, it implies that Argentina is one of the countries with less vulnerability regarding the risk of rolling over its debt. Most countries have a large percentage of their debt in short-term instruments, while long-term debt represents a smaller amount. But minimizing the rollover risk does not eliminate it, and today Argentina faces a problem to refinance a relatively small percentage of its debt, as there are questions about its solvency.

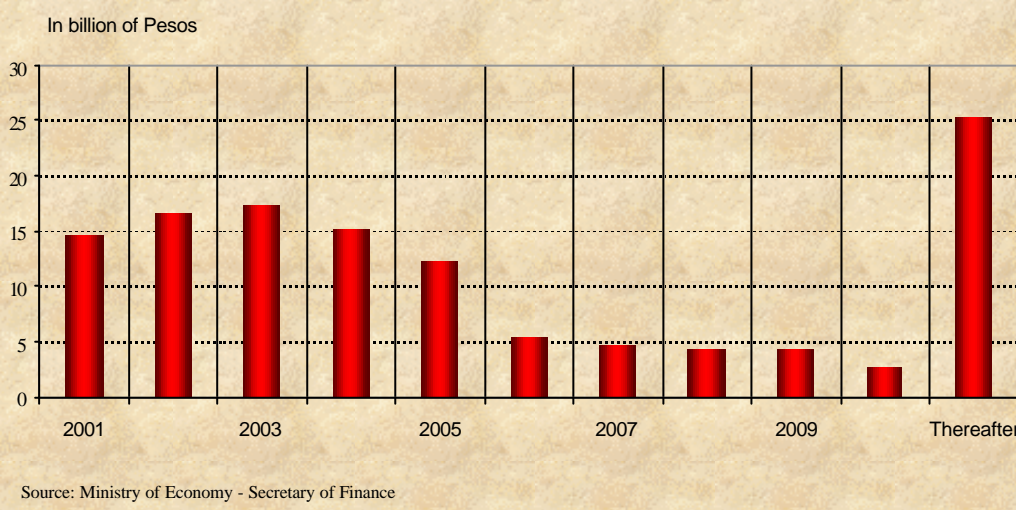
This is reflected in recurrent reductions in the credit rating that it recently experienced, being further away from the very desirable investment grade and coming closer to the rating of countries are perceived to have a high level of risk (**Table 11**). Today, Argentina has a B rating from Standard and Poor's (S&P) and B2 from Moody's, falling three stages with the first and two with the second. These recurrent reductions in the rating place Argentina below Brazil according to both rating agencies. For Moody's Argentina is below Turkey (a country that has a strong financial crisis) and in the same level as Russia (which only two years ago experience a default), while according to S&P, Argentina is one step above Russia and Turkey.

These perspectives that are manifested in the voluntary capital markets, the increase on the sovereign risk, and the lack of growth require a consistent political economy, which must be useful to support the fiscal solvency and to reestablish growth. The policy package has to attack the most serious problems, which are the following.

One of the priorities is to clear away the doubt about Argentina's capability to fulfill its commitments. This requires to clearly show that Argentina has a solvent state and that it is also able to count with enough liquidity so as to face adverse financial markets like the ones that has been facing in the last years. To do that, the first goal is to fix the financial situation in order to revert increases on the public debt as a percentage of the GDP that have been observed (see Graph 10). It is certainly true that to solve an unbalance is much more difficult during an economic recession, given that the adjustment has to come from an increase in taxes or a decrease on public spending, policies that in themselves have recessive effects. The adjustments on fiscal accounts are much easier in growing economies, where by controlling the public spending and taking advantage of the increase in associated collection with the highest activity level is feasible to improve public accounts without doing great adjustments. In fact, this type of adjustment is the one that took place in the United States during the nineties, where they took advantage of the economic boom in order to generate a fiscal surplus.

Graph 11

Strength of the Economy: Government Debt Amortizations are well distributed (before the Debt Swap)



Even though this solution might be possible to do in Argentina, it would be prudent to look for alternatives if the economy does not recover growth with the necessary strength so as to aid in a significant way an improvement of the fiscal deficit. It is clear that if that is the case it will be necessary to adapt the public spending level for it to be consistent with the resources that both the national and provincial public sectors count with. Even though it is true to carry out a decrease in spending in a recessive scenario like the current one, it is not less true that it is indispensable to adapt spending level the available financing, and that in Argentina the tolerance to put up with another tax increase does no longer exist. The alternatives for rationalizing the public spending and increase state efficiency are analyzed in detail in many chapters of this project. Look towards the future, public spending in Argentina needs to be more flexible in order for it to be adapted to the possibilities to finance it throughout the economic cycle. It would be ideal to set quasi-automatic mechanism that would allow

adapting the current spending, and not only the investment spending when fiscal problems have to be faced.

Table 11

Long Term Debt Rating - Foreign Currency
Standard & Poor's and Moody's

	Standard & Poor's	Moody's
BBB / BBB-	Korea / Uruguay / Thailand	Korea / Uruguay / Thailand
BB+	Philippines / Mexico	Philippines
BB	Colombia	Colombia
BB-	Brazil/ Peru	Peru
B+	Bulgaria	Brazil
B	Argentina / Venezuela	Argentina / Venezuela / Russia
B-	Indonesia / Russia / Turkey	Indonesia

What respects to the collection, the major benefits should be obtained by improving the tax administration system both at the national and the provincial levels, because the recurring tax increases that have been carried out from mid-1990 on through the recurring tax packages did not achieved the collecting efficiency (measured as collection to GDP). For this it is indispensable to improve the co-participation system so it achieves to align to the goals of the nation with those of the provinces, and to make it clear that any benefit that local governments obtain by being able to spend more in a province or municipality would have as a counterpart a greater tax pressure that would fall on the local tax payers.

It is difficult for a country to adjust the public spending every time there is a decrease in income. A way to avoid that extreme solution is by counting with certain ease in the fiscal situation, through a stabilizing fiscal fund like the one that was established on the law of fiscal responsibility. That effort should be complemented with a capital market that would allow to finance transitory unbalances in fiscal accounts and to finance the public debt deadlines without major alarms.

The Argentine capital market continues to be small. Despite the growth that it experience both on the banking system and administrated funds because of institutional investments, Argentina still has a low level of use of banking services. The M2/GDP quotient is about 25% (Table 10), which locates Argentina below countries like Chile, Mexico, South Korea and the industrialized countries. The is a high potential to grow on insurance as well, given that the total of the primes is lower to 2% of the GDP which locates it below the most mature countries. Likewise, the capitalization of stock exchange transactions, and given the regional tendency of reducing the number and size of the stock market companies, it is not perceived that this tendency could be reverted in

the short term. An important part of the future economic agenda is to deepen the reforms that would help to the growth of the capital market by improving the judicial security for investors and by providing incentives for companies to have public offers. The recent transparency law of the capital market is an important step in that direction.

IV.2 Improving the Conditions for Growth

A reduction in the sovereign risk is the number one priority to restore growth and the best way to achieve this objective is to ensure fiscal solvency and to secure enough financial resource to guarantee the financing of the public sector borrowing requirements. In Argentina there is a very close relationship between output and private capital inflows over the business cycle.

The fluctuations in output do not represent a new phenomenon, in fact and according to a recent report by the InterAmerican Development Bank, in the last four decades Argentina has displayed higher output volatility than the rest of the region (**Table 12 volatility**). In addition, while in Latin America we observe a decrease in the volatility of output from 4.7% in the eighties to 3.3% in the nineties, in Argentina, output volatility remained almost unchanged at a 5.5% level. This level places Argentina among the countries that have faced the highest degree of volatility among the larger countries together with Peru and Venezuela.

Table 12

Volatility in Latin America Throughout Time

Country	GDP			
	1960	1970	1980	1990
Argentina	5,4	4,3	5,6	5,5
Brazil	3,5	3,2	4,6	3
Chile	2,5	6,7	6,4	3,5
Colombia	1,4	1,7	1,5	3,3
Mexico	2,4	2,1	4,4	3,6
Paraguay	2,3	2,3	5,3	1,5
Peru	2,5	2,6	8,4	5,2
Uruguay	2,7	2,6	6,6	2,8
Venezuela	3,3	2,8	4,8	5
Mean	3,3	3,9	4,7	3,3
Median	2,7	4,6	4,6	3

Fluctuations in economic activity were affected by external and internal factors. Among the former ones, the most important were the evolution of export prices, of the economic business cycle in Brazil, of US interest rates, and of the private capital flows to emerging countries. Among the latter, the key factors were the stops and go in economic policies about inflation and stabilization and regarding industrial and commercial policies, and a stable fiscal policy.

Although it is difficult to design specific policies aimed at reducing output volatility, there are certain measures that could help to absorb the negative impacts of the economic cycles in the long run. For example, a country with fiscal solvency and a developed capital market has the option to use a counter-cyclical fiscal policy, especially if it is financed domestically. Today, this option is not available to Argentina, because the doubts about its fiscal solvency does not leave room for an expansionary fiscal policy to help the economy get out of the recession. In addition, if Argentina had a larger capital market, it would have more alternatives to finance temporary budget deficits. Finally, Argentina needs to increase the level of domestic savings, as they are way below the levels that are necessary to finance domestic investment and remain lower than in countries like Chile or most Asian countries (Table 10).

Argentina could use a fiscal stabilization fund, similar to the liquidity funds that the central bank created to provide stability to the financial sector. In fact, the fiscal responsibility law includes a proposal to create such a fund, but it could not be applied because the fiscal situation has been very stringent since 1999 (when the law was passed). The copper stabilizing fund of Chile and the coffee fund of Colombia represent successful examples of the successful use of this type of tools.

The ability of the economy for responding to external shocks also depends on the nature of the shock, real or financial, and on the prevailing exchange rate regime. The Mundell-Fleming model shows that a fixed exchange rate system is preferable to deal with financial shocks, while a flexible exchange rate system works better when the economy faces real shocks. The impact of changes in the money demand or in short-term capital movements have a smaller impact on output under a fixed exchange rate system, while if those changes terms of trade or in foreign demand generally have less impact on the economy under a flexible exchange rate system.

Given that Argentina has a fixed exchange rate system, it is better prepared to deal with financial shocks. In addition, Argentina has a strong financial system thanks to the adequate levels of liquidity that it has and the existence of mechanisms that prevent possible capital outflows. In particular, the existence of the “argendollars” allows individuals to convert their peso deposits into dollars without leaving the Argentine financial system. In fact, these strengths of the convertibility regime were important during the Tequila crisis, a financial shock that the system managed to overcome. Once the crisis was over and confidence on convertibility and on the banking system were restored, the economy started rapidly growing again.

In contrast, it is difficult for Argentina under the current circumstances to use macroeconomic policies to overcome a crisis caused by real sector shocks. Some of the factors that originated the current economic recession were a fall in terms of trade, a reduction in capital flows to emerging markets, the appreciation of the US dollar and the depreciation of the Brazilian Real in the last years. Theory says that the best way to deal with this type of situation is through the use of expansionary fiscal and monetary policies, and monetary policy would only be effective under a floating exchange rate regime. We already mentioned the difficulties that exist today in Argentina for using fiscal policy. Therefore, the only available tool to expand the economy is to achieve an adjustment of the real exchange rate to compensate the negative effect of these real

shocks. With a fixed exchange system, this can only be achieved through a reduction in wages and prices, which requires more flexibility in the labor market.

Finally, and in order to induce investment it is necessary to give clear signals about the nature of long-term productive policies. Over the years there were significant changes in economic policies, with periods that emphasized the support of the agricultural sector to others in which the efforts concentrated in supporting the industrial, import competing sectors. Commercial policies oscillated from import substitution to export promotion, while it still remains unclear whether Argentina prefers to negotiate with the European Union and NAFTA alone or with its Mercosur partners. Argentina would benefit from more trade. Today, it is still a relatively close economy, given that its foreign trade level is way below the comparable countries (chart 9). An increase in exports would definitely help to reduce the Argentine vulnerability.

V. Final Thoughts

Argentina is entering this new millenium with a great number of problems and questions that are different from the ones that were asked at the beginning of the decade. In some but that are probably more important in there essence. At the beginning of the nineties the main concerns were the high rates of inflation, the inefficiency of public sector enterprises, the lack of growth during the previous decade and the continuous deterioration that Argentina was suffering in its relative position in the world economy. The nineties solved the inflation problem, essentially eliminated the problems created by public enterprises and managed to improve their services through privatization, economy growth was strong between 1991 and 1998, and Argentina be an attractive country to invest. But the decade is ending with three years of recession, a high unemployment rate, with difficulties in accessing the capital market and with doubts about the sources of growth.

The question today in many people's minds is if the significant structural adjustments that were undertaken during the nineties were worth doing and if they represented a necessary and sufficient condition to guarantee long-term growth. Before we try to answer this question it might be useful to make a brief description of the experiences of countries that carried out deep structural adjustment programs. The experiences in Chile, New Zealand, and Ireland might be relevant for this purpose.

Experience shows it takes some time till structural reforms begin to generate some positive results, and that if some key reform is not done, the entire package could fail. This discussion is taking place today in New Zealand, a country that since the mid-eighties has been implementing an aggressive structural adjustment program. After many years of a strong state intervention, the government introduced an economic deregulation program that included the reduction of the state, and the privatization of public sector enterprises. Some progress was made in the reduction of the fiscal deficit, the Central Bank became independent with a mandate to reduce inflation rates, (which was successfully done), and the labor market became somewhat more flexible. In other words, it carried out a program that in a broad terms responded to what is known as the Washington Consensus. The main difference between Argentina and New Zealand is that the latter has a floating exchange rate system while the former has a fixed exchange

rate. However, fifteen years later, New Zealand was not able to consolidate growth, and the rates remain below those of comparable countries. What happened?

A recent study by the International Monetary Fund analyzes this issue. Its main conclusion is that the stabilizing and structural change program that New Zealand implemented improved the performance of the economy, but that in order to get all the desired results it is necessary to complete some key reforms, such as a truly flexible labor market. In addition, a large share of the structural reforms, especially those related to the development of human capital and technology, which have an impact on the long-term rate of growth, take some time to mature, and their effects could take more than a decade to materialized.

Chile started the economic reforms in the mid-seventies, and since the mid-eighties it has been showing one of the highest growth rates in Latin America. The Chilean economy suffered a deep recession at the beginning of the eighties when the output collapsed as it fell by 14,1% in 1982, and by 0.7% in 1983. But the economy recovered, and the long awaited boom started in 1985, about 10 years after the structural adjustments began. An important reason for Chile's success was that the 82-83 crisis was utilized as an opportunity to deepen the structural reforms and strengthen the growth model based on a market economy, an open economy, and macroeconomic stability.

Ireland is our their interesting case, given that a country that in the second half of the eighties suffered an unemployment rate of about 20%, a debt that exceeded 100% of the product and a fiscal deficit of about 10% of the GDP, successfully achieved to revert these indicators. Ireland's success was due to a combination of good economic policies and good luck. Ireland is now known as the Celtic tiger.

Today, Argentina is in the middle of a dilemma. After suffering a recession for three years there are strong pressures to reestablish growth. Certainly, there are no magic formulas, neither an easy way out. Argentina strengthened its fundamentals over the previous decade and now enjoys more exports, a higher level of GDP, a sound financial system, a better infrastructure, a bigger and better supply by utilities, a more vibrant mining and oil sectors, a more efficient agricultural sector and many other achievements. The problem today in Argentina is restore consumers and investors confidence that has suffered after three years of recession, and to make a strong commitment to reduce the fiscal deficit according to the rules established in the fiscal responsibility law; this should be easy to do if the economy starts growing again, but if that is not the case, the government should be ready to make the necessary cuts in expenditures to achieve this objective.

The solution to Argentina's problem cannot be found in old, interventionist policies that generated stagnation in the past. It requires a consolidation of the structural reforms implemented in the nineties, the adherence to fiscal and monetary discipline, and the completion of essential reforms that can pave the way to the re-establishment of growth. If Argentina manages to overcome the current crisis without breaking the rules of the game it could become a major turning point for the country