The Heritage Foundation
Backgrounder
Executive Summary

No. 1432 April 19, 2001

# Argentina's Economic Crisis: An "Absence of Capitalism"

*Ana I. Eiras and Brett D. Schaefer*

As U.S. Secretary of the Treasury Paul O'Neill explained to *The Financial Times* in February, the key factor underlying recent financial crises is not a failure of capitalism, but an "absence of capitalism." Argentina provides a cogent example; its lack of economic freedom—the necessary environment for capitalism to work effectively—resulted in continual economic decline and, ultimately, the financial crisis that erupted in November 2000.

Poor economic policies and political instability contributed to Argentina's decline from its noteworthy position as the world's 10th wealthiest nation in 1913 to the world's 36th wealthiest in 1998. Argentina is the only wealthy country to experience so great a reversal in recent history, despite the involvement of the International Monetary Fund (IMF). Indeed, the IMF's loans and guidance have aggravated, not alleviated, Argentina's problems. After more than nine bailouts and extensions of IMF loans since 1983, Argentina once again faces a financial crisis, with fewer prospects for stimulating effective economic growth in the future.

Instead of supporting a continuation of Argentina's policies that feed the current 33-month-long recession, the Bush Administration should encourage Argentina to adopt policies that will increase economic freedom and lead to long-term growth and stability. Specific policies that the Administration should encourage Argentina to implement include:

Produced by the
Center for International
Trade and Economics (CITE)

Published by
The Heritage Foundation
214 Massachusetts Ave., N.E.
Washington, D.C.
20002–4999
(202) 546-4400
*http://www.heritage.org*

This paper, in its entirety, can be found at: *www.heritage.org/library/backgrounder/bg1432.html*

- **Adopting the U.S. dollar as its official currency.** Speculation about the sustainability of Argentina's currency board helped increase interest rate premiums on debt. The best way for Argentina to address the interest rate premium resulting from currency risk would be to adopt the U.S. dollar as its own currency. This would eliminate the risk stemming from the peso–dollar exchange rate and lead to lower interest rates on the country's debt, which is what happened in El Salvador and Panama after they adopted the dollar.

- **Reduce spending and taxes.** To spur economic growth, Argentina needs to bolster productive behavior by lowering taxes to increase the incentive to work, save, and invest. To lower taxes without aggravating the fiscal deficit, it also needs to slash government expenditures. A plan introduced by the Minister of Economy includes a cut in expenditures; but instead of lowering taxes, it would shift the tax burden from businesses to international investors, imposing new costs without allowing the beneficial stimulus associated with an overall reduction in taxes. Restoring economic growth will require much deeper reductions in government expenditures and more extensive tax cuts.

- **Foster further deregulation.** President Fernando de la Rúa succeeded in getting a labor reform bill passed by Argentina's Senate and lower house. Argentina should build on this progress by scaling back regulations governing, for example, the ability of employers to lay off employees. The government also needs to scale back the wages and numbers of public-sector employees. This is particularly true in the provinces, where many public-sector workers do not contribute to production and are a drain on public resources.
- **Encourage free trade.** Argentina should expand its export markets and diversify its export base by signing agreements with other nations that are receptive to unrestricted trade. Considering the linking of the peso and the dollar, a free trade agreement between the United States and Argentina would be particularly beneficial by providing greater stability to Argentine exporters. Argentina will need to open its market in order to facilitate trade talks with the United States. If necessary, it should withdraw from the Mercosur trading bloc; if it wishes to remain a political ally of Mercosur as Chile has done, it could do so.
- **Strengthen the rule of law.** The vulnerability of the judiciary to bribery and political influence has undermined public confidence to the extent that ordinary Argentines do not use the legal system and businesses restrain investments. The Argentine government must punish corruption more aggressively, insulate the judiciary from political pressure through whistle-blower protections, and increase standards for those employed in law enforcement.

Argentina should not look on these reforms as options. Unless the country resumes strong economic growth soon, it will likely default on its debt and see its access to international capital markets crippled.

Restoring economic stability and promoting growth for Argentina will benefit the United States as well as the Argentine people. To help avert another crisis in Argentina, the Bush Administration should encourage Argentina to end its cyclical dependence on IMF loans and make the reforms necessary to stimulate growth. Economic growth would enable the government to service its debt and—if expenditures are also cut—end its reliance on IMF loans.

It is just as imperative, however, that the role played by international financial institutions in the global economy be restricted. The Bush Administration should seek to implement the recommendations of the congressionally mandated International Financial Institutions Advisory Commission, chaired by Allan H. Meltzer of Carnegie Mellon University, in order to establish a solid framework for reforming the IMF and World Bank. The reforms should maximize the organizations' effectiveness, increase accountability for their lending decisions, and limit their harmful influence in the global market.

Future crises will be less likely in an environment that promotes the efficiencies and benefits of open markets. Unless the Administration addresses the "absence of capitalism" that afflicts economies around the world by taking this approach, economic crises will become more frequent and more severe.

*—Ana I. Eiras is an Economic Policy Analyst for Latin America and Brett D. Schaefer is Jay Kingham Fellow in International Regulatory Affairs in the Center for International Trade and Economics at The Heritage Foundation.*

The Heritage Foundation
Backgrounder
214 Massachusetts Avenue, N.E. Washington, D.C. 20002-4999 • (202) 546-4400 • http://www.heritage.org

No. 1432 April 19, 2001

# ARGENTINA'S ECONOMIC CRISIS: AN "ABSENCE OF CAPITALISM"

*ANA I. EIRAS AND BRETT D. SCHAEFER*[1]

As U.S. Secretary of the Treasury Paul O'Neill explained to *The Financial Times* in February, the key factor underlying recent financial crises is not a failure of capitalism but an "absence of capitalism."[2] Argentina provides a cogent example; the lack of economic freedom— the necessary environment for capitalism to work effectively— resulted in continual economic decline and, ultimately, the financial crisis that erupted in November 2000.

Poor economic policies and political instability contributed to Argentina's decline from its noteworthy position as the world's 10th wealthiest nation in 1913 to the world's 36th wealthiest in 1998.[3] Argentina is the only wealthy country to experience so great a reversal in recent history, despite the involvement of the International Monetary Fund (IMF). Indeed, the IMF's loans and guidance have aggravated, not alleviated, Argentina's problems. After more than nine bailouts and extensions of IMF loans since 1983, Argentina is once again on the verge of a financial crisis, with fewer prospects for stimulating effective economic growth in the future.

The Bush Administration should encourage Argentina to reform its economy in a manner that increases economic freedom. To help countries like Argentina reduce the severity and frequency of financial crises in the future, the Administration also should promote reforms in the lending practices and advice of the IMF and other international financial institutions so that their efforts will result in open economies and less reliance on loans from international financial institutions.

Produced by the
Center for International
Trade and Economics (CITE)

Published by
The Heritage Foundation
214 Massachusetts Ave., N.E.
Washington, D.C.
20002–4999
(202) 546-4400
*http://www.heritage.org*

This paper, in its entirety, can be found at: *www.heritage.org/library/backgrounder/bg1432.html*

1. The authors would like to thank Anthony Kim and Eddie Colindres, research interns at The Heritage Foundation, for their assistance with this paper.
2. Gerard Baker and Stephen Fidler, "O'Neill's World," *The Financial Times*, February 15, 2001, at *http//www.FT.com*.
3. Data for 1913 from Martin Wolf, "Argentina's Riches to Rags Tale," *The Financial Times*, March 21, 2001; data from 1998 calculated from World Bank, *World Development Indicators 2000* on CD–ROM.

## ARGENTINA'S STORY: ECONOMIC POLICIES MATTER

Argentina has come a long way since its military government yielded to democracy in 1983. President Raúl Alfonsín successfully consolidated the government; brought issues like human rights back to the public debate; and made the case for trade liberalization, deregulation, and privatization. To Argentina's detriment, however, Alfonsín lacked the leadership skills necessary to carry out the economic reforms he sought. For example, the government proposed Plan Austral in 1984, with the support of the IMF, to impose fiscal discipline and control skyrocketing inflation of 627 percent that year.[4]

These targets, however, were not met; inflation rose to 672 percent in 1985, and government expenditures increased from 11 percent of gross domestic product (GDP) in 1984 to 18 percent in 1985.[5] A subsequent IMF-sponsored program, Plan Primavera, was only marginally more successful, with government expenditures falling from 16 percent of GDP in 1986 to 11 percent in 1988 and inflation falling briefly to 90 percent in 1986 before rising to 343 percent in 1988.[6]

The failure of the Argentine government to respond effectively to its economic problems contributed to an erosion of investor confidence, massive capital flight, devaluation of the peso, and hyperinflation of 3,080 percent in 1989 and 2,314 percent in 1990.[7] Alfonsín resigned five months before the end of his term in 1989 and yielded power to Carlos Menem, who had been elected president on a traditionally protectionist Peronist platform. Menem surprised the country by announcing major plans to open the economy. The reforms he initiated during his first administration (outlined below) gave an immediate boost to the economy and ushered in a period of prosperity with the promise of change.

Menem's second term, however, met with disappointment; the economy's decline exposed the limited nature of the reforms and the government's failure to open the market completely. Now Argentina faces a deep recession, and prospects of economic improvement are dubious.

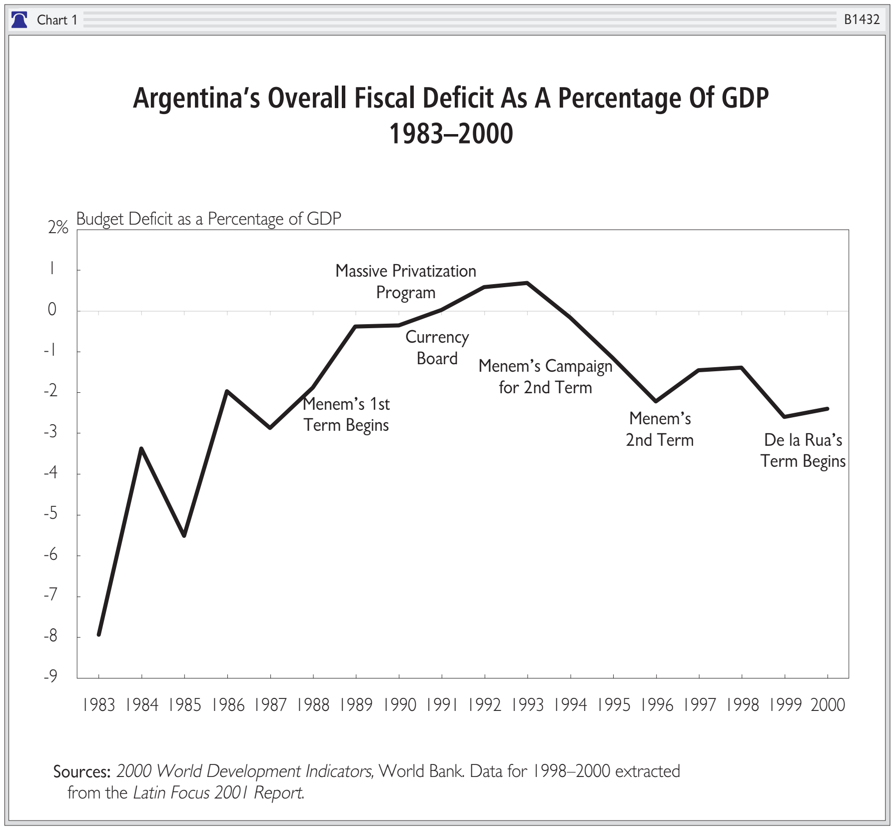
**Early Reforms.** During his first term as president, Menem instituted several serious reforms. Specifically, his government:

- **Established a currency board.** In 1991, the Argentine Congress passed the Convertibility Law, making "the peso fully convertible with the dollar at a fixed nominal exchange rate, with the domestic monetary base fully backed by the foreign exchange reserves of the Central Bank."[8] In essence, a currency board system restricts the government's ability to issue notes and coins without a full backup of foreign reserves. Domestic notes and coins are fully convertible into the reserve currency at the fixed rate. Under this law, the government's liabilities could not be financed by printing money. This reform helped to arrest the hyperinflation problem immediately.
- **Aggressively privatized state enterprises.** Between 1990 and 1994, the Menem government privatized the airlines, gas transportation and distribution, passenger and cargo railways, power generation and distribution, telecommunications, the postal service, and the water and sewage systems.[9] It also sold oil and gas extraction facilities, coal mines, petrochemical plants, steel mills, and most public banks.[10] This reduced government consumption

4. World Bank, *World Development Indicators 2000* on CD–ROM.
5. *Ibid.*
6. *Ibid.*
7. *Ibid.*
8. Economist Intelligence Unit, *EIU Country Profile*, 1996–1997, p. 14.
9. Economist Intelligence Unit, *EIU Country Profile*, 2000, p. 25.
10. *Ibid.*

through unproductive government industries that were operating at a loss, as well as inefficiency, by transferring state industries to the more productive private sector.

- **Deregulated the economy**. Menem's administration liberalized the foreign investment code, eliminated price and exchange rate controls, and removed export taxes and import quotas.[11] Deregulation reduced the cost of doing business and spurred investment, which resulted in greater economic output.



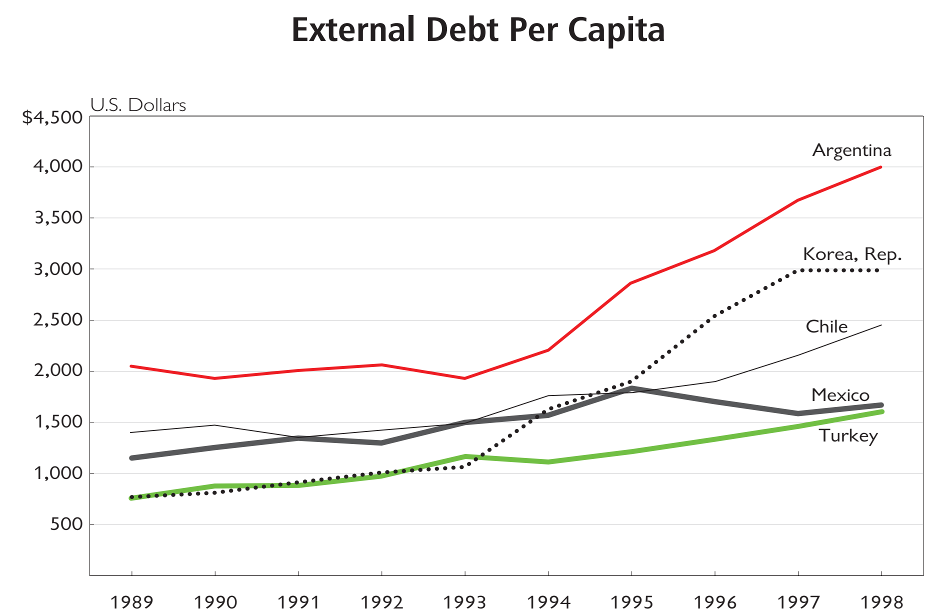

These reforms immediately rewarded President Menem and the people of Argentina with lower inflation, renewed investor confidence, economic expansion, and higher standards of living. Argentina achieved 7.9 percent annual GDP growth from 1991 to 1994—the world's 10th largest rate during that period.[12] Gross fixed investment rose by more than 120 percent.[13] The percentage of families living under the poverty line fell from 38 percent in 1989 to 13 percent in 1994.[14] Unfortunately, however, the growth was not sustainable.

**Incomplete Reforms.** Even though Menem's reforms initially spurred economic growth, the government's failure to commit fully to economic liberalization contributed to Argentina's economic decline over the past five years and a recession that is now in its 33rd month.[15] Specific problems reflecting the lack of economic freedom include the following:

- **Increasingly burdensome debt.** Government expenditures as a percentage of GDP grew from 9.4 percent in 1989 to 21 percent in 2000.[16] At the same time, GDP growth slowed from 7.9 percent between 1991 and 1994 to negative or negligible growth since mid-1998.[17] Lack of economic growth, combined with an expansion in government

11. *Ibid.*
12. Compound growth rate calculated using GDP at constant 1995 U.S. dollars. World Bank, *World Development Indicators 2000* on CD–ROM.
13. Economist Intelligence Unit, *EIU Country Profile*, 1996–1997, p. 17.
14. *Ibid.*, p. 16.
15. Gerald P. O'Driscoll, Jr., Kim R. Holmes, and Melanie Kirkpatrick, eds., *2001 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2001), p. 73.
16. World Bank, *World Development Indicators 2000* on CD–ROM.
17. Compound growth rate calculated using GDP at constant 1995 U.S. dollars. World Bank, *World Development Indicators 2000* on CD–ROM.

Chart 2 B1432




Source: *2000 World Development Indicators*, World Bank.

expenditures, generated a fiscal deficit that grew from 0.15 percent of GDP in 1994 to 2.4 percent in 2000. (See Chart 1.) To achieve fiscal balance without distorting the economy, the government could have lowered its expenditures. Instead, it chose to finance the fiscal deficit by raising taxes and incurring additional debt in financial markets and with the IMF. Raising taxes proved to be a bad tactic; it generated more tax evasion and suffocated an already hobbled private sector.

For the past seven years, the Argentine government has imposed an increasingly heavy debt burden on the people. (See Chart 2.) In 1998, Argentina's per capita debt surpassed that of Korea during the Asian financial crisis. Total Argentine public debt increased from 34 percent of GDP in 1991 to about 52 percent in 1999 (see Chart 3) and currently accounts for 23 percent of *all* emerging market debt.[18] High debt increases the cost of borrowing from capital markets because it increases the perception of investment risk.

Sustaining this level of debt will soon be impossible. Unless Argentina generates strong economic growth soon, it will not be able to service its debt without additional external bilateral or multilateral support, debt forgiveness or debt restructuring by creditors, or some combination of the two.

The new government of President Fernando de la Rúa recently announced several policies to get Argentina out of the current recession, but this plan is unlikely to boost economic activity because it does not reduce the tax burden. Instead, it will shift the tax burden from local businesses to international investors. Current Minister of Economy Domingo Cavallo announced that he "will create a check cashing tax…to support tax reductions in tradable sectors, the sector most affected by the real overvaluation of the [peso]."[19] At the same time, the plan's cuts in expenditures will not be aggressive enough. Investor doubts about Argentina are reflected in the downgrading of Argentina's credit rating by Moody's Investors Service, Standard & Poor's, and Fitch during the last week of March 2001.[20]

- **Uncertainty over the monetary system.** Argentina adopted the Convertibility Law to address its chronic problems with high inflation. Some have blamed Argentina's economic

18. Editorial, "Cavallo's Challenge," *The Financial Times*, March 31, 2001, p. 14.
19. Barclays Capital, *Emerging Markets–Latin America*, March 22, 2001.
20. "Ratings Agencies on the Mark?" *Buenos Aires Herald*, March 28, 2001.

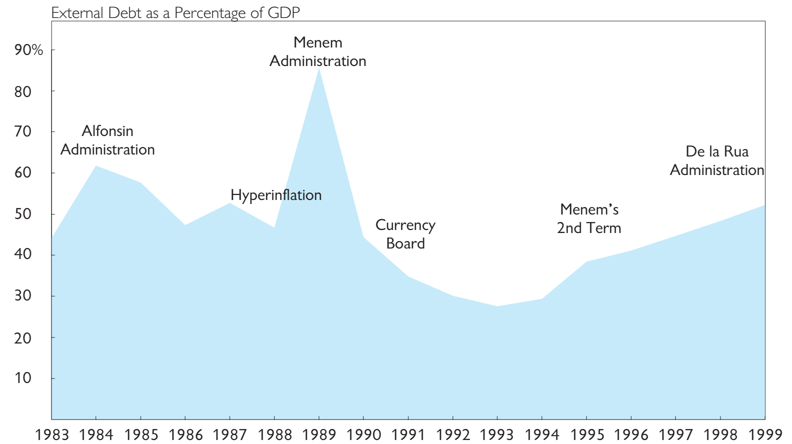
problems on the high value of the peso that is tied to a strong U.S. dollar; in fact, however, Argentina's problems derive primarily from its failure to implement economic reforms that would open its markets and bring economic stability to the country.

It is precisely the absence of those reforms that generated speculation on the sustainability of the currency board. Instead of advocating reforms, Cavallo has declared that Argentina will begin to make the peso convertible to a 50 percent dollar and 50 percent euro basket.[21] Even though Cavallo has declared that the change in the currency board would take effect only when the euro reaches parity with the dollar, markets fear that this policy is in reality a disguised devaluation.[22] The euro has devalued steadily over the past two years against the U.S. dollar.

Moreover, linking the peso to the euro will further undermine confidence in the currency board and invite currency speculation and arbitrage. Even if the new currency board policy changes over when the euro is at parity with the dollar, there is small chance that that parity would be maintained. Given the fact that 70 percent of Argentina's public debt is in dollars and foreign currency debt comprises 95 percent of total Argentine debt, the mere rumor of instability in the currency board confronts many banks, businesses, and ordinary Argentines with the possibility of bankruptcy while increasing the possibility of government debt default.[23]

Chart 3 B1432

**Argentina's External Debt as Percentage of GDP 1983–1999**




Sources: *2000 World Development Indicators*, World Bank. Data for 1999 extracted from EIU *Country Report*, March 2001.

- **Excessive regulation.** Privatization should be the means to create a competitive environment in which producers are motivated to improve their products while consumers benefit from more choices and lower prices. In Argentina, however, most privatization did not foster such competition; it simply transferred monopolies from the public to the private sector.

  Consider what happened in the telecommunications industry. In 1990, the government granted a seven-year monopoly on basic telephone service to France Telecom in northern Argentina and to Spain Telefónica in the south, with the dividing line falling in the middle of Buenos Aires. At the end of the seven-year period, monopoly rights were extended for another three years. Even though Telefónica and Telecom made substantial investments to modernize infrastructure and increase the number of available lines, telephone service

21. "Cavallo Decided to Open the Economy to the Euro," *Diario La Nación*, Buenos Aires, April 5, 2001.

22. Thomas Catán, "Argentine Minister Eyes Link to Euro," *The Financial Times*, April 16, 2001, p. 3.

23. Argentine Ministry of Economy, Undersecretary of Finance, data available at *http://www.mecon.gov.ar/financing/doc2.htm*; Charles W. Calomiris, "Argentina Can't Pay What It Owes," *The Wall Street Journal*, April 13, 2001, p. A11.

remained expensive. Prices for domestic and long-distance calls did not decline until 2000. Not coincidentally, this reduction in prices occurred shortly after the liberalization of the rapidly growing and competitive cellular phone market, which provided an alternative to traditional telephone service.[24] A similar problem occurred in the energy and water industries.

Argentina's labor system is burdened by excessive regulations that constrain the ability of businesses to adjust to fit market changes. This has forced many businesses to ignore Argentina's labor laws by employing workers outside of the legal system through cash payments.[25]

President de la Rúa, who took office in late 1999, succeeded in getting a labor reform bill passed by the Senate and the lower house in May 2000. The new labor law ended a measure that required the extension of existing collective labor contracts (some dating back to 1975) if a new contract could not be negotiated.[26] The law also allowed individual companies to negotiate contracts (rather than being bound by national agreements), extended the trial period during which new employees could be laid off without severance pay, and lowered payroll taxes for workers hired under new employment contracts. However, the labor reform bill does not affect the third of the labor force employed in the public sector. Nor does it affect workers covered by separate labor laws, such as those covering workers employed by newly privatized companies.[27]

Though the new law is a significant improvement, much remains to be done. The greatest need is to scale back the wages and numbers of public-sector employees, particularly in the provinces, many of whom do not contribute to production and thus are a drain on public funds. In the province of Formosa, for example, approximately half of the formally employed labor force is employed by the government. Reportedly, many of these workers show up only once a month to collect their paychecks.[28]

- **Barriers to free trade.** Argentina began reducing its tariffs in the 1980s. The major trade policy of the 1990s was to participate in setting up the Common Market of the Southern Cone (known as Mercosur) in 1991. Mercosur prohibits trade barriers between member nations on approximately 85 percent of tariff lines and maintains common tariffs and trade barriers against non-members.[29] The bloc—which includes Argentina, Brazil, Uruguay, and Paraguay—has significantly altered Argentina's trade relationships. Before Mercosur, Argentina's trade with Brazil averaged approximately 11 percent of its total trade.[30] A year after the preferential trade agreement was signed,[31] Brazil had become Argentina's top trading

24. The number of cellular phones in Argentina increased over 10 times in four years, from 341,000 in 1995 to 3.8 million in 1999, while charges dramatically decreased. Economist Intelligence Unit, *EIU Country Profile*, 2000, p. 20.
25. Argentine economist Alfredo Monza of the National Statistics Institute estimates that as much as 13 percent of Argentina's labor force is employed outside of the legal system. Calculated using data from "Belaboured: Reforming Argentina's Labour Laws," *The Economist*, March 25, 2001.
26. "Belaboured: Reforming Argentina's Labour Laws," *The Economist*, March 25, 2001.
27. *Ibid.*
28. Pamela Druckerman, "Buenos Aires Must Justify Bailout, But Localities Tend to Spend," *The Wall Street Journal*, March 2, 2001, p. A9.
29. Fundacion Invertir Argentina, "Argentina Business: The Complete Guide to Business with Argentina," at *http://www.invertir.com/argentina/trade.html.*
30. *Ibid.*
31. Mercosur was fully implemented in 1995.

partner. Last year, trade with Brazil encompassed 26 percent of Argentina's total trade. (See Table 1.)

Table 1 B1432

**Argentine Trade Since Mercosur Was Fully Implemented**
(in Millions of U.S. Dollars)

| | | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | Percentage of Total in 2000 |
|---|---|---|---|---|---|---|---|---|
| Brazil | Imports | $4,175 | $5,326 | $6,914 | $7,055 | $5,596 | $6,441 | 26% |
| | Exports | 5,484 | 6,615 | 8,133 | 7,949 | 5,690 | 7,025 | 27 |
| United States | Imports | 4,207 | 4,749 | 6,095 | 6,227 | 4,996 | 4,693 | 19 |
| | Exports | 1,804 | 1,973 | 2,204 | 2,212 | 2,653 | 3,091 | 12 |
| Mercosur | Imports | 6,459 | 5,801 | 7,605 | 7,931 | 6,290 | 7,197 | 29 |
| | Exports | 6,770 | 7,918 | 9,597 | 9,415 | 7,071 | 8,393 | 32 |
| Total World | Imports | | | | | 25,508 | 25,148 | |
| | Exports | | | | | 23,333 | 26,251 | |

Sources: Data from 1995 to 1998 from the *Country Profile* for Argentina by the Economist Intelligence Unit. Data from 1999 and 2000 from *Argentine Foreign Trade Statistics 2000*, Vol. 4, No. 4., February 2000, Instituto Nacional de Estadisticas y Censos.

If Argentina wanted to open its markets to trade, Mercosur was not the trade strategy to follow. Its high common external tariff (CET) of 14 percent inhibits trade with non-members.[32] The adoption of the CET reduced the government's discretion on trade policy and crippled the ability of consumers to choose from among the best and cheapest products available in the world, while also removing incentives for local producers to innovate and improve in order to remain competitive. Additionally, the interdependence on trade among members[33] made each country in the bloc highly vulnerable to other countries' economic woes.[34] Argentina, for instance, saw a 24 percent decline in exports to Mercosur countries in 1999, largely as a result of Brazil's devaluation of its *real* against the dollar during its 1999 economic crisis.[35] Interdependence also proves harmful when, in adverse economic circumstances, members refuse to comply fully with their commitments under the bloc.[36] In sum, for Argentina, Mercosur has functioned as a prison, limiting the country's potential to improve living standards.

The problems in Mercosur were aggravated earlier this year when members officially forfeited the ability to negotiate free trade agreements on their own. Next year, members will have to give up free trade agreements signed with countries outside the bloc that were negotiated before the bloc's creation.[37] This reflects Mercosur's inherent hostility

32. See Mary Anastasia O'Grady, "First, Open Markets," in O'Driscoll *et al.*, *2001 Index of Economic Freedom*, p. 29.

33. Mercosur accounts for 30 percent of total Argentine trade. See Table 1.

34. Last year, the combination of a devalued *real* and a strong peso placed stress on trade relations between Argentina and Brazil. As reported in the newspaper *La Nación*, "There has been no progress for sugar trade, discussions regarding the regional auto regime continue and, now, a new conflict arises with severe consequences for the dairy industry." *Diario La Nación*, November 12, 2000.

35. Economist Intelligence Unit, *EIU Country Report for Argentina*, June 2000, p. 33.

36. Last year, Brazil threatened to raise the tariff against Argentine milk to 46 percent, claiming that Argentina was exporting milk at lower than market prices. Argentina claimed that Brazil's reaction was a reprisal for its minimum price setting for poultry imports. "Dura Reacción Por Trabas de Brasil a la Leche Argentina," *Diario La Nación*, November 12, 2000. In response to the current recession, Minister of Economy Cavallo announced that Argentina would unilaterally adjust its tariff rates by raising tariffs on consumer goods imports to 35 percent and eliminating tariffs on capital goods imports without consulting its Mercosur partners. See Thomas Catán and Geoff Dyer, "Argentine Emergency Hastens the Decline of Mercosur," *The Financial Times*, April 3, 2001.

37. Information from the Office of Political Affairs, Embassy of Chile, March 2001.

toward free trade. Brazilian Minister of Development, Industry, and Trade Alcides Tapias provides another example in his criticism of former Argentine Minister of Economy Lopez Murphy's candid support for lowering trade barriers and increasing economic ties through direct negotiations with the United States. Tapias argues that individual countries lack leverage when negotiating with America.[38] In Mercosur, members are increasingly moving away from global free trade policies and abandoning their autonomy to set their own trade policies.

- **A weak rule of law.** There was a time when Argentina's judicial system was strong and robustly protected property rights. Argentina then was also the world's 10th wealthiest country, with foreign investment driving economic growth. For some law history experts, Argentina's judiciary weakened after the revolution of 1930, when the country's supreme court recognized the unconstitutional first military coup in its history as legitimate.[39] For the first time, Argentina had violated its own constitution, setting a precedent for the weakness in the rule of law that exists today.

  Weakness in the rule of law, coupled with a large bureaucracy, also has fostered a culture of corruption. Corruption affects the highest public officials down to ordinary Argentines who must navigate through the extensive red tape. The severity of this problem is evident in the fact that 82 percent of people living in Argentina do not trust the effectiveness of the judicial system and therefore do not use it.[40] This distrust has disastrous implications for the country's ability to generate sustained economic growth. A weak, non-transparent judicial system raises the cost of doing business and undermines an important engine of growth: local and foreign investment. By increasing risk, a weak rule of law undermines the confidence of citizens and foreign investors alike in undertaking commercial activities, saving, and making long-term investments. Risk increases because the ability to seek compensation or justice for illegal actions is hindered in a judicial system that is unreliable or subject to political manipulation.

  Argentina also encourages illegal activity through excessive taxation. According to a report by the Latin American Foundation for Economic Research (FIEL), Argentina's informal economy totals an estimated $64 billion annually—equivalent to more that 23 percent of GDP.[41] An estimated $15 billion of this is due to tax evasion. Criticism of efforts to crack down on tax evasion, such as recent comments made by the left-wing Frepaso party president Carlos Alvarez, ignores the fact that tax evasion is primarily a reaction to punitive levels of taxation imposed by the government to finance increasingly burdensome expenditures.[42] The most effective way to reduce tax evasion is to remove incentives to underreport income by lowering the tax burden.[43] IMF demands that Argentina increase its tax revenues by increasing taxes and clamping down on tax evasion demonstrate that officials at the IMF also do not understand this fact.

These many problems indicate the clear lack of economic freedom that has contributed to Argentina's inability to spur economic growth. This policy of economic protectionism has resulted in recession, a dramatic rise in crime, a high level of

38. Marcela Valente, "Argentina: Naming of New Economy Minister Boosts Markets," *Inter Press Service*, March 6, 2000.

39. For example, Ricardo Rojas, a judge and professor of law at Universidad de Buenos Aires, believes that the revolution of 1930 set a precedent for a constitutional violation, thus weakening the rule of law.

40. "Solo el 18 por Ciento de los Argentinos Confía en la Justicia," *Diario La Nación*, January 23, 2001.

41. "Argentine Black Economy Currently Generates $64bn Turnover," *World Reporter*, abstract of article in *Ambito Financiero*, February 26, 2001.

42. Marcela Valente, "Argentina: Naming of New Economy Minister Boosts Markets."

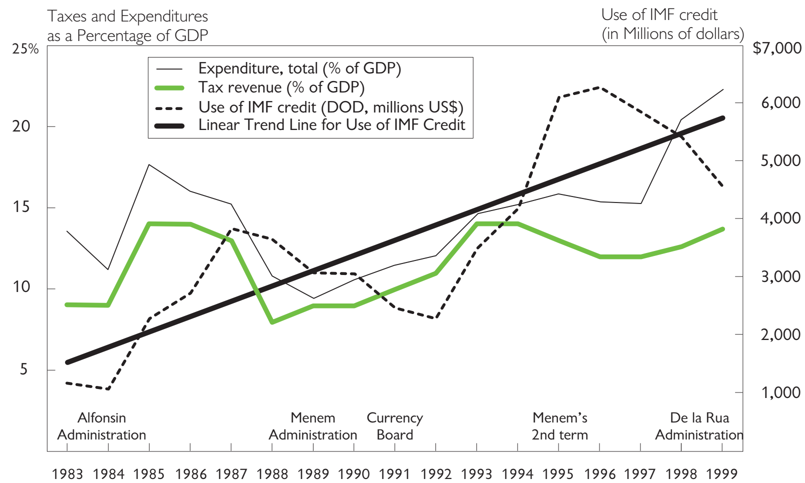
unemployment, and a reduction in living standards.[44]

## THE IMF'S ROLE IN ARGENTINA'S CRISIS

The International Monetary Fund shares the blame for Argentina's current malaise. The history of IMF lending to Argentina since 1983 (detailed in the Appendix) shows nearly continuous funding accompanied by policy recommendations. While some of these recommendations would have helped to liberalize the economy, most of them hindered economic growth, and the reliability of IMF loans encouraged moral hazard. After almost two decades of misguided recommendations and nearly continuous funding, the IMF's involvement in Argentina actually strengthened the power of political vested interests at the expense of economic growth.

Chart 4 B1432

**Argentina's Use Of IMF Credit, Total Expenditures And Tax Revenue 1983–1999**




Sources: IMF *Staff Country Report* No. 00/160., "Argentina: Selected Issues and Statistical Annex," December 13, 2000. *2000 World Development Indicators*, World Bank. *Government Finance Statistics*, IMF.

Consider the following facts:

- Since 1983, the IMF has extended to Argentina seven Stand-By Arrangements, two Extended Fund Facility agreements, and two renegotiations of its loans. The total amount lent to Argentina through these arrangements was SDR 24,117 million, or nearly $30.6 billion in U.S. dollars.[45]
- IMF loan agreements with Argentina have been in place during all of the 18 years since 1983, except 1986–1987 and 1988–1989. The loans were available without interruption, whether the country was facing a crisis or not.
- In each program, the IMF prescribed policies that retarded economic stability and long-term growth. Each IMF arrangement, for example, required Argentina to balance its fiscal budget by raising taxes, which in turn deterred economic activity and encouraged tax evasion, thereby aggravating the fiscal imbalance that the recommendation was intended to address.
- Argentina regularly failed to implement the reforms demanded by the IMF in return for credit arrangements. In each IMF arrangement,

43. Lower levels of taxation can result in increased tax revenues by decreasing the disincentives to report income. Tax rate reductions also increase economic growth and employment, resulting in a larger tax base. For instance, reduced tax rates under Presidents John F. Kennedy and Ronald Reagan resulted in increased economic activity in the United States and increased tax revenues. See Daniel J. Mitchell, Ph.D., and William W. Beach, "Taxes: Reforming the System to Make It Simple and Fair," in Stuart M. Butler and Kim R. Holmes, eds., *Issues 2000: The Candidate's Briefing Book* (Washington, D.C.: The Heritage Foundation, 2000), at *http://www.heritage.org/issues/chap2.html*.

44. Unemployment in Argentina in 2000 was about 14 percent. Economist Intelligence Unit, *EIU Country Report for Argentina*, March 2001, p. 11.

45. Two of these arrangements were renegotiated, making a total of 11 agreements between the IMF and Argentina for nine credit arrangements between 1983 and 2000. Conversion from IMF special drawing rights (SDRs) to U.S. dollars was made at the March 28, 2001, exchange rate of US$1 = 0.788617 SDR. Current exchange rates available at *http://www.imf.org/external/np/tre/sdr/basket.htm*.

for instance, Argentina was required to cut government expenditures to help balance the budget. Since 1989, however, expenditures have grown from 9.5 percent to 22.3 percent of GDP. (See Chart 4.) Only with massive inflows from privatization was the government able to run a fiscal surplus. (See Chart 1.) After most state industries had been privatized, the fiscal deficit returned. Despite ample evidence of such failure to meet IMF reform demands, the IMF continued to lend Argentina funds—and in increasing amounts. (See Chart 4.)

IMF lending in Argentina has been both self-defeating and a failure on its own terms. The most recent IMF package is a case in point. Once again, the Argentine government had tried to end the recession by increasing taxes. The efforts proved fruitless and increased skepticism among investors as to the de la Rúa government's commitment to reform and its ability to implement reforms and restore growth. This skepticism, combined with doubts about Argentina's ability to meet its upcoming debt payments, precipitated the financial crisis in November and December 2000. The IMF negotiated a $39.7 billion credit line in December 2000 (made available in January 2001) that, while it stabilized the immediate crisis, has neither resolved the problems leading to the crisis nor spurred an economic turnaround.

Even though the IMF demanded that Argentina adopt labor and social security reform, promote competition in the monopolized telecommunication and energy sectors, and expand social assistance, the primary condition for this recent arrangement is once again that the government reduce the fiscal deficit by increasing tax revenues and lowering expenditures. The deficit target was again relaxed. For 2000, the target had been relaxed from $4.3 billion to $5.3 billion;[46] for 2001, it was relaxed to $6.7 billion, and the target date for a balanced budget was extended to 2005.[47]

Except for the misguided demand that Argentina increase tax revenues, as well as its contradictory advice to increase social assistance programs while reducing government expenditures, most of the IMF's reform demands are reasonable. In any case, based on Argentina's track record, its government is unlikely to implement the reforms established in its last agreement.

Domestic resistance to reform is strong. Proposals to cut expenditures, for example, forced two Ministers of Economy to resign within weeks of one another. Minister José Luis Machinea lost credibility and resigned on March 2, 2001, when it became obvious that the $39.7 billion IMF bailout had failed to restore economic growth. His replacement, Ricardo López Murphy, has also resigned. He proposed spending cuts of $2 billion in 2001 and $2.5 billion in 2002[48] to enable Argentina to meet the IMF's fiscal targets, but his proposal led to the resignation of three cabinet officials and six government officials, mainly Frepaso party members, and to widespread strikes and protests by unions and student groups.[49]

Cavallo, the current Minister of Economy, proposed $3 billion in cuts in government spending in 2001,[50] but this proposal has encountered strong opposition, forcing him to be cautious about critical reforms that would generate economic growth. Cavallo's plan now establishes

46. Economist Intelligence Unit, *EIU Country Report for Argentina*, December 2000, pp. 16–17.

47. *Ibid.*, p. 19.

48. The cuts included a $970 million reduction in transfers to provinces in 2001, elimination of subsidies on tobacco and fuel, a $360 million reduction in spending for universities, elimination of fraud and waste in the social security agency, and elimination of funding that members of the national congress disbursed at their own discretion. Thomas Catán, "Argentina Cuts Budget by $2bn to Keep to IMF Target," *The Financial Times*, March 17–18, 2001, p. 1.

49. Thomas Catán and Richard Lapper, "De la Rúa Taken by Surprise Over 'Panic Attack' in Argentina," *The Financial Times*, March 20, 2001, p. 8.

50. Thomas Catán and Richard Lapper, "Argentina Unveils Radical Competitiveness Drive," *The Financial Times*, March 22, 2001.

wide tariff differentials between consumer and capital imports and creates a market-unfriendly tax on financial transactions that will further distort the economy.[51]

The IMF policy of continuous lending to Argentina regardless of the risk of crisis or compliance with IMF reform demands has had two negative consequences: The predictable IMF assistance signaled to the markets that investment risk would be mitigated by IMF bailouts, thereby increasing moral hazard and encouraging reckless investment decisions. In addition, Argentina has had no incentive to reform its economy because the IMF would provide funds regardless of reform.[52] These two consequences created a downward spiral leading to a third, and worse, potential consequence: If the IMF takes a stand and stops lending to Argentina because it does not reform or cannot restructure its debt, the country will have another crisis and likely will default on its debt. This could be desirable if it were to spur Argentina to undertake the reforms necessary for ensuring long-term economic stability and growth, but it would also spur capital flight from Argentina and could constrain lending to other emerging markets around the world.

## A BETTER REFORM PLAN FOR ARGENTINA

The solution to the economic crisis in Argentina lies in domestic political action. Economists agree that the $39.7 billion credit line extended by the IMF to Argentina in January 2001 to halt the recent crisis will provide only a limited respite of perhaps six months to one year. Argentina's debt of $124 billion is more than 350 percent of its export base, and almost two-thirds of foreign exchange receipts are consumed to service the debt.[53] Unless economic growth resumes, Argentina's debt obligations and external financing needs, estimated to be as much as $50 billion this year, will quickly exhaust the IMF credit line.[54] Professor Charles Calomiris of Columbia University, an expert on Argentina's finances, predicts that the country will again fall victim to economic crisis in the near future unless its debt is restructured.[55]

**What Argentina Should Do.** Argentina must take immediate action to increase its level of economic freedom. Liberalizing its economy would reassure international investors and set Argentina on the path toward long-term growth and stability. Specifically, Argentina should:

- **Adopt the U.S. dollar as its official currency.** Speculation about the sustainability of the currency board has helped to increase interest rate premiums on Argentine debt beyond the normal spread between peso and dollar debt. In these circumstances, the best way to address the interest rate premium resulting from currency risk would be for Argentina to adopt the U.S. dollar as its own currency. This would eliminate the risk stemming from the peso–dollar exchange rate and lead to lower interest rates on the country's debt, which is what happened in El Salvador[56] and Panama after they adopted the dollar.[57]
- **Reduce spending and taxes.** To spur economic growth, Argentina needs to bolster productive behavior by lowering taxes to increase

51. David Malpass, "Argentine Markets Give Cavallo Redux a Bad Review," *The Wall Street Journal*, March 23, 2001, p. A15.
52. The most recent example is the IMF's announcement that it would disburse the next $1.3 billion tranche of the Argentine funding package in May as scheduled, even though Argentina had a $940 million fiscal deficit in January—a level far in excess of IMF targets. IMF Western Hemisphere director Claudio Loser said the IMF would be flexible with Argentina's compliance with the credit's conditions, noting: "It is clear that the fiscal target for the first quarter has not been met, but the targets for the full year may be." See "IMF to Pay Next 1.3 bln USD Tranche of Argentina Aid in May; Welcomes Cavallo," *AFX News*, March 20, 2001.
53. See Adam Lerrick, "When Is a Haircut Not a Haircut? When the IMF Is the Barber," *The Wall Street Journal*, February 23, 2000.
54. "Argentina: Economic and Financial Outlook," Deutsche Bank Research, March 2001, p. 6.
55. Calomiris, "Argentina Can't Pay What It Owes."

the incentive to work, save, and invest.[58] To lower taxes without creating an economic disaster, it also needs to slash government expenditures. Cavallo's plan includes a cut in expenditures; but instead of lowering taxes, it would shift the tax burden from businesses to international investors, imposing new costs without allowing the beneficial stimulus associated with an overall reduction in taxes. Restoring economic growth will require much deeper reductions in government expenditures and more extensive tax cuts.

- **Foster further deregulation.** President de la Rúa succeeded in getting a labor reform bill passed by the Senate and the lower house. Argentina should build on this progress by scaling back regulations governing, for example, the ability of employers to lay off employees. The government also needs to scale back the wages and numbers of public-sector employees, since high public-sector wage rates make it difficult to adjust private wage rates. This is particularly true in the provinces, where many public sector workers do not contribute to production and are merely a drain on public resources.
- **Encourage free trade.** Argentina should expand its export markets and diversify its export base by signing agreements with other nations that are receptive to unrestricted trade. Considering the linking of the peso and the dollar, a free trade agreement between the United States and Argentina would be particularly beneficial by providing greater stability to Argentine exporters. The United States is Argentina's second largest trading partner, and reducing trade barriers would enhance that relationship to the benefit of both countries. Argentina will need to open its market in order to facilitate trade talks with the United States. If necessary, it should withdraw from Mercosur as an exclusive trade area; if it wishes to remain a political ally of Mercosur as Chile has done, it could do so.
- **Strengthen the rule of law.** The vulnerability of the judiciary to bribery and political influence has undermined public confidence to the extent that ordinary Argentines do not use the legal system and businesses restrain their investments. The Argentine government must punish corruption more aggressively, insulate the judiciary from political pressure through whistle-blower protections, and increase standards for those employed in law enforcement.

Argentina should not look on these reforms as options. Unless the country resumes strong economic growth soon, it will likely default on its debt and see its access to international capital markets crippled.

## WHAT THE BUSH ADMINISTRATION SHOULD DO

While economic freedom cannot be exported, it can be imported. To that end, the Bush Administration should encourage Argentina to pursue a strategy for economic growth that includes adopting the U.S. dollar as its own currency, liberalizing trade, deregulating the labor market, and reducing the role of government in the economy. The Administration should also offer technical expertise, such as experts from the U.S. Department of Justice and the Federal Bureau of Investigation, to advise Argentina's officials on how to reform the judicial system. In addition, America can aid Argentina's recovery by negotiating a free trade agreement.

The Bush Administration should address the problem of the "absence of capitalism" in the international financial system by adopting Secretary

56. "El Salvador Adopts Dollarization Scheme to Boost the Economy," Latin American Database, Gale Group Inc., December 14, 2000.
57. For a detailed discussion of the benefits and costs of adopting a foreign currency, particularly the U.S. dollar, see "Basics of Dollarization," Joint Economic Committee Staff Report, Office of the Chairman, Senator Connie Mack (R–FL), updated January 2000, at *http://users.erols.com/kurrency/basicsup.htm*.
58. Malpass, "Argentine Markets Give Cavallo Redux a Bad Review."

O'Neill's hands-off policy toward financial crises.[59] For this policy to work effectively, however, the Administration must act to restrict the ability of international financial institutions to interfere in the international economy, particularly targeting the IMF's lending habits.

Financial crises around the world have increased over the past decade, even as the IMF and the World Bank have committed ever-greater resources to combat them. In many cases, the recipients of IMF and World Bank loans are worse off today—after decades of international assistance—than they were before that aid began. The reason: Bailout packages reduce the risks associated with faulty economic decisions and frequently leave recipient countries with greater debt, lower standards of living, higher unemployment, and less savings.[60]

The Bush Administration should rely on the work of the congressionally mandated International Financial Institutions Advisory Commission, chaired by Allan H. Meltzer of Carnegie Mellon University, to establish a solid framework for reforming the IMF and the World Bank.[61] The reforms should maximize their effectiveness, increase accountability for their lending decisions, and limit their harmful influence in the global market. Future crises will be less likely in an environment that promotes the efficiencies and benefits of open markets.

## CONCLUSION

Restoring economic stability and promoting growth for Argentina will benefit the United States as well as the people of Argentina. Because Argentina is the second largest economy in South America, a full-scale financial crisis in the country could significantly harm the prospects for growth in developing countries around the world. An Argentine default could lead investors to avoid emerging markets that depend on foreign capital for growth.

To help avert another crisis in Argentina, the Bush Administration should encourage Argentina to end its cyclical dependence on IMF loans and make the reforms necessary to stimulate growth. Economic growth would enable the government to service the debt and—if expenditures are also cut—end its reliance on IMF loans.

It is just as imperative, however, that the role played by international financial institutions in the global economy be restricted. Unless the Administration can address the "absence of capitalism" that is afflicting economies around the world, bolstered by repeated but ineffective international bailouts, future crises will be more frequent and more severe.

*—Ana I. Eiras is an Economic Policy Analyst for Latin America and Brett D. Schaefer is Jay Kingham Fellow in International Regulatory Affairs in the Center for International Trade and Economics at The Heritage Foundation.*

59. Baker and Fidler, "O'Neill's World."

60. Brett D. Schaefer, "The Bretton Woods Institutions: History and Reform Proposals," Heritage Foundation *Economic Freedom Project Report* No. 1, March 2000, pp. 56–65.

61. The full International Financial Institutions Advisory Commission (IFIAC) report is available in English at *http://www.house.gov/jec/imf/meltzer.htm*, and in Spanish at *http://www.heritage.org/library/efp/efp00-04.html.*

Appendix A B 1432

## IMF Arrangements and Loans to Argentina Since 1983

| Type of Arrangement | Date Approved | Date Expired or Cancelled | Amount | Major Policy Reforms Supported by Agreement |
|---|---|---|---|---|
| Stand-By Arrangement | January 1983 | | SDR 2,020 million ($2,562 million) | • Higher excise tax collection<br>• Strengthen the tax administration<br>• Curtail outlays in general government and operating expenses of state-owned enterprises<br>•Appropriately manage interest rates and restrain domestic credit expansion |
| Stand-By Arrangement | December 1984 | June 1986 | SDR 1,694 million ($2,148 million)<br><br>In February 1986, the IMF reduced the amount to SDR 1,183 million ($1,500 million) after an Article IV consultation. | • Increase taxation on income and employer's social security contribution; have stronger tax enforcement<br>• "Reallocate" government expenditures; reduce military expenditures but expand health, housing, and education spending<br>• Phase out price and wage controls<br>• Tighten fiscal and monetary policy |
| Stand-By Arrangement | July 1987 | September 1988 | SDR 1,113 million ($1,411 million) | • Continue reducing fiscal deficit<br>• Implement a system of price control flexibility<br>• Continue strengthening tax enforcement<br>• Review exchange rate policy to ensure competitiveness<br>•Improve efficiency of state-owned enterprises |
| Stand-By Arrangement | November 1989 | March 1991 | SDR 1,104 million ($1,400 million)<br><br>In November 1990, the IMF reduced the amount to SDR 736 million ($933 million) after an Article IV consultation. | • Extend the value-added tax to more goods and services and strengthen tax enforcement<br>• Cut subsidies and industrial promotion programs<br>• Privatize telecommunications, railway systems, airline, road maintenance, collections for public utilities, and parts of the oil industry<br>• Modify the Central Bank to make it independent from the executive branch<br>• Lower import tariffs, quotas. and prohibitions<br>• Eliminate export taxes |
| Stand-By Arrangement | July 1991 | March 1992 | SDR 780 million ($989 million) | • Improve tax collection, restrain public expenditures, and sell assets to achieve fiscal surplus<br>• Downsize the public sector<br>• Continue opening the economy to trade<br>• Add flexibility to the labor market<br>• Reschedule the official debt |

Appendix A (continued) B 1432

| Type of Arrangement | Date Approved | Date Expired or Cancelled | Amount | Major Policy Reforms Supported by Agreement |
|---|---|---|---|---|
| Extended Fund Facility | March 1992 | March 1996 | SDR 4,020 million ($5,098<br><br>In March 1992, the IMF approved a credit for SDR 2,483 million ($3,149 million), which was extended by SDR 1,537 million ($1,949 million) in April 1996. | • Continue pursuing policies outlined by the [prior] Stand-By Arrangement<br>• Regularize relations with private external creditors through market-based debt and debt-service reduction<br>• Further downsize the public sector<br>• Continue deregulating the economy<br>• Develop capital markets |
| Stand-By Arrangement | April 1996 | January 1998 | SDR 720 million ($913 million) | • Reform provincial governments by strengthening tax collection, privatizing banks and enterprises, and gradually transferring the pension system to the national government<br>• Add more flexibility to the labor market<br>• Reform the health care system<br>• Monitor tax collections |
| Extended Fund Facility | February 1998 | March 2000 | SDR 2,080 million ($2,638 million) | • Continue fiscal tightening<br>• Advance labor reform<br>• Improve efficiency of the tax system<br>• Make public spending more transparent<br>• Privatize power plants, the largest National Bank (Banco Nación), and the Mortgage Bank<br>• Continue health care reform<br>• Begin a low-cost housing program for 50,000 families a year |
| Stand-By Arrangement | March 2000 | March 2003 | SDR 10,586 million ($13,423 million)<br><br>In March 2000, the IMF approved a credit for SDR 5,399 million ($6,846 million), which was extended by SDR 5,187 million ($6,577 million) in January 2001. | •Eliminate distortions in the tax system, broaden the tax base, strengthen tax enforcement and compliance, and increase transparency in the use of public resources to achieve fiscal balance by 2002<br>•Reduce government expenditures<br>•Continue labor reform to improve productivity<br>•Continue reform of Social Security<br>•Promote competition in monopoly sectors such as telecommunications and energy<br>•Expand and/or restructure social assistance programs within the limits of the budget<br>(And for the January 2001 package, take steps to reduce fiscal impediments to investment) |

**Source:** International Monetary Fund Archives, March 2001, and information on the IMF Web site at *www.imf.org*. Conversion from IMF special drawing rights (SDRs) to U.S. dollars was made at the March 28, 2001, exchange rate of US$1 = 0.788617 SDR. Current exchange rates are available at /*http://www.imf.org/externa1/np/tre/sdr/basket.htm.*