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THE LESSONS OF ARGENTINA FOR DEVELOPMENT IN LATIN AMERICA

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Several questions are repeatedly being asked throughout Latin America: Why has globalization reform failed us? Where do go from here? Those two questions are, in fact, very closely related, because one of the main items in the economic reform agenda was that globalization had enormous promise for the countries of Latin America. A related question is why is there such hypocrisy in the North, and what should Latin Americans do about it?

In terms of the first question, why has globalization reform failed us? There is very little doubt that if you were to visit Latin America from another planet and looked at the data over the last 40 or 50 years, you would not approach this last decade with a great deal of euphoria. Latin America has gone through a number of different stages. There was a stage of import substitution in the 1950s, 1960s, and 1970s. At the end of that stage, there was an enormous amount of debt borrowing – or "recycling petrodollars" – that was followed by a debt crisis.

One interpretation of the debt crisis was that low interest rates induced countries to borrow. Real interest rates were, in fact, negative during the period, so that borrowing and taking on increasing debt was prudent.

Later, for reasons having nothing to do with Latin America, but in response to inflation and anti-inflationary sentiment in the United States, the U.S. Federal Reserve raised interest rates to very high levels. The high rates were beyond the ability of Latin America to bear, leading to the debt crisis of the 1980s. It took a decade for that debt crisis to be adequately resolved. Wide reforms followed at the end of the 1980s and the beginning of the 1990s, and were considered the new democratic reform agenda. By 2002, we have now experienced a decade of economic growth under reform.

One of the interpretations of the failure of the earlier import substitution strategy was that it ended with the debt crisis imposed from the outside because of high interest rates. The high interest rates were unexpected and higher than had ever been seen before. Although general theories of efficient risk bearing place the burden on rich countries, the debtor countries were made to bear the risk instead and the Latin American countries were not able to do so.

The other interpretation is that, in fact, the import substitution strategy was itself doomed and that the debt crisis just brought it to its end. The countries had learned the lessons of the failures of the import substitution strategy and they went to the alternative – a strategy of reform that has helped to account for a decade of success.

However, data on economic growth in the 1990's shows that after a few good years in the beginning, overall growth for the decade is a little higher than half what it was in the 60's and 70's; thus, it is not correct to describe the reform decade of the 1990s as a successful decade.

Economic growth in the 90s was roughly half of what it was during the 50s, 60s, and 70s, which was a long period of sustained growth.

The reform decade of the 1990s is even worse, because the growth that has occurred has been shared very inequitably. One of the countries that has been a relative success story is Mexico. However, almost all of Mexico's growth, as the Inter-American Development Bank has pointed out, occurred in the upper 30 percent of the population, and most of the growth occurred in the upper 10 percent. People at the bottom were actually worse off.

Therefore, both in terms of growth and in terms of equity, the so-called reform decade has hardly been one that one can call a resounding success. To make matters worse, the star pupil, Argentina, has now gone into what might be described as a meltdown. There are many interpretations of what went wrong with the star pupil. Until Argentina lost its star status, its performance was constantly praised. One of the reasons Argentina's debt grew so much was that the IMF and international bankers said that the country was a good place to land. They lent money at attractive terms and Argentina borrowed. Even at the end, however, Argentina's debt-GDP ratio was only around 45 percent. In contrast, Japan's debt-GDP ratio is around 130 percent; Belgium's is over 100 percent. Argentina was not the most profligate country in the world, which is the impression one would have if one listened to the IMF rhetoric.

In fact, from the budgetary point of view, Argentina had a primary surplus in the 1990s. The term primary surplus refers to the difference between its revenues and its expenditures, excluding interest payments – if interest payments are excluded, Argentina was in surplus. Argentina's net deficit would also have not been very large, except for reasons beyond its control: the world had a global financial crisis in 1997-98. Argentina cannot be blamed for the global financial crisis, which began in Thailand and Indonesia and spread to Korea, Russia, and Brazil.

One can blame the IMF for the way the global financial crisis was mismanaged. Their mismanagement, at the global level and in the Asian financial crisis, led to very high interest rates, particularly after the problems in Russia. Even though Argentina's debt-GDP ratio was very moderate and, in fact, in many senses low, the interest rates it faced became very high. There is a paradox: if creditors believe that a country is going into default, they will charge very high interest rates. Furthermore, if they charge very high interest rates, countries will go into default. There are theoretical models showing that there are a multiplicity of equilibriums in which – with enough pessimism – countries can arrive at a self-fulfilling prophecy of a default.

In a way, the IMF served as a partial ringleader for the default, because it helped convince the creditors that Argentina had fundamental problems. Rather than saying, "Argentina has only a 45 percent debt-GDP ratio," the IMF said, "This country does not know how to manage itself." It did in Argentina just as it did in many of the countries in East Asia, where the IMF advertised incompetence. One cannot say that there was no corruption or that everything was run perfectly, but there are no governments, including the United States, where things are run perfectly. By instead advertising all these problems, it helped moved the economy to what might be called "a bad equilibrium," in which everybody believed in the default that led to the high interest rates that led, in turn, to default.

The lessons of Argentina's failed policy can be generalized. One concerns the fixed exchange rate system. In 1989, Argentina had a problem of high inflation and, in

that context, adopting a fixed exchange rate – sometimes called the nominal anchor – was thought to be a way of bringing down the inflation. It worked, but inflation is not an end in itself. People do not live off inflation numbers – they live off growth and food, but not inflation numbers.

The single-minded focus on inflation led to some very adverse consequences. It was thought that since inflation was down, the country's performance was a success and its problems were solved. That assessment, of course, was wrong. The economy did start to grow, but one has to look at this growth in perspective. Whenever an economy goes through a period of zero growth, very low growth, or negative growth, there is normally a catch-up period. So during this catch-up period, it is difficult to interpret growth: Is the perceived growth the robust growth that follows a period of stagnation, because good policies are really the beginning of a new era? Or is the growth the catch-up from the past era, and one that, once the economy has caught up, will go into a more normal phase?

The evidence in Latin America is that growth in the early period, 1990-94, was a catch-up, not part of a sustained higher level of economic growth. It certainly was not sustained and some people would say it was not sustainable. Economic growth only lasted through 1994, when the *tequila* crisis hit. It was interesting to see the lesson that was drawn from the *tequila* crisis. Upon seeing how badly Argentina was battered, with soaring unemployment and a weakened economy, one could gather that the fixed exchange rate system really had some problems. When crises occur, such as the Mexican crisis in which exchange rates changed very dramatically, a fixed exchange rate becomes misaligned relative to other exchange rates.

That, however, was not the lesson most others drew. They said, if Argentina managed to survive the crisis of

prises do. The lack of credit for firms was one of the problems that Argentine businesses were increasingly facing. The government did set up a ministry to try to address the problem – recognizing that the lack of capital flow to small- and medium-sized enterprises was stifling growth – but it did not handle the problem adequately. The privatization of the financial sector proved to be part of the Argentine problem because of a lack of the capital necessary for sustained economic growth.

There were also aspects of the privatization program that were problematic. Privatization occurred without the establishment of an effective competitive structure. Even worse, it indexed the price of some utilities to the U.S. dollar. This was particularly problematic, because the theory of adjustment of the IMF and others who advocated the fixed exchange rate system, held that without exchange rate adjustment, it is necessary to adjust domestic prices. While domestic prices were adjusted, this adjustment was not sufficiently large at a time when wages were falling at 30 percent per year.

Therefore, wages and prices were falling but utility rates were fixed in terms of U.S. dollars. The utilities received more and more money and weakened the overall economy. This should not have come as a surprise, since the theory of exchange rate adjustment held that there should be accompanying declines in prices and wages. To maintain this theory of adjustment while indexing the prices charged by private utilities was really malfeasance.

The final blow to Argentina, as the economy began to have these problems and interest rates rose from lack of confidence, was the official response of cutting expenditures. Cutting expenditures had the effect of reducing aggregate demand; reducing aggregate lowered GDP; and lowering GDP lowered tax revenues. The goal behind

this chain was to bring the government into fiscal balance. Of course, it failed, and predictably so.

The irony of this situation, of course, is that these policies had been discussed at length in long-standing debates. During the Great Depression, people like Andrew Mellon argued that the United States should break out of the depression by restoring its fiscal balance through raising taxes and cutting expenditures. At the same time, Keynes proposed an alternative approach to macroeconomics by stimulating the economy. Ironically, this is the same Keynes who had an important role in establishing the IMF, which was founded on the idea that, in the event of the kind of crisis that Argentina faced, it would lend money to help it finance deficits. There were to be conditions, stipulating that countries pursue expansionary fiscal policies.

It is interesting to note that the first example of IMF conditionality was in the late 1940s in Belgium, whose policy was excessively contractionary. Yet, sometime between the end of the 1940s and now, the IMF got mixed up. Just as my students always tell me I make sign mistakes when I am doing math on the board, I think the IMF has made a sign mistake. They thought expansionary meant contractionary and went around telling everybody to have contractionary policies, although I think there is a deeper explanation than that.

In my judgment, it is unambiguously the case that the failure in Argentina can be attributed to a whole series of mistakes from exchange rate policy, to fiscal policy, to privatization policies, and culminating in the disaster that began in December; a disaster that is, unfortunately, continuing. The IMF is continuing to recommend that the country persist with a contractionary fiscal policy, which will force the economy deeper into recession.

I had worried for a long time that these policies were not sustainable. Argentina has had double-digit unemployment rates since the *tequila* crisis. And in the end, for many who had been watching Argentina closely, the surprise was not that riots broke out in December 2001, but that it took so long for them do to so. What is commendable is the patience of the Argentine people. It was not that they eventually gave up in disillusionment at a set of policies that had failed – and for which there was no prospect of any alternative. The problem is that the current government is offering, in many ways, a continuation of the same contractionary policies.

I will later put all of this into perspective, but I want to put the Argentine experience into a little bit broader framework. As I said, the second question that I hear repeatedly as I travel around Latin America concerns the hypocrisy, the double standard between the north and the south, and what can be done about it.

The example of macroeconomic policy is perhaps the most dramatic, and one about which I have been asked most frequently this fall. Although pulling out of it now, the United States has been in recession probably since March 2001 – and during that recession, everybody agreed, including both political parties – that there ought to be a stimulatory and expansionary fiscal policy. Regardless of whether the policy the Republicans crafted was in fact expansionary rather than redistributive, it was advertised as an expansionary policy in the rhetoric, at least. Nobody said that the United States should contract. Similarly, Japan has been having an economic downturn. For the last six to seven years, U.S. administrations, both parties, and Presidents Clinton and Bush, have repeatedly given very severe lectures to Japan that it should have expansionary fiscal policy. The poor Japanese know it by heart now; they can play it back for you.

Expansion has been the standard line. Yet, when I am in Latin America, I am repeatedly asked, we do not understand, there seem to be two economic laws; how could that be? When a recession occurs in Latin America, contractionary fiscal policies are pushed. The real problem, of course, is that many Latin American students went to the same graduate courses and actually read good textbooks that discuss expansionary fiscal policy. None of the textbooks that I know of actually recommends contractionary fiscal policies in a recession. Latin Americans have read these textbooks and say, we do not understand, the IMF seems to be using a different textbook from the rest of the world. Unfortunately, I can not give them a good response.

That is not the only example of this hypocrisy. President Cardoso of Brazil recently gave a very scathing speech, pointing out that the IMF uses a double standard in its accounting systems – on whether the deficits of state corporations are included in the overall balance sheet of the government. There is in fact a whole set of peculiar accounting issues that have plagued Latin America.

As a result of these accounting issues, Latin American countries are told they have deficits. Using good accounting procedures, however, the accounts would look very different. It is almost as if there was a deliberate decision to use account procedures to make Latin America look worse, compared to the accounting procedures used in Europe. President Cardoso asked why such a double standard exists; I am asked the same question in Mexico and other countries – and again, there is no adequate answer. Occasionally, the IMF will say that it will look into the issue; but this is not a new issue – it has been going on for a long time.

Of course, the most grating issue has to do with trade; the developing countries have been repeatedly told that they ought to liberalize and take down their trade barriers. Yet, the U.S. just imposed tariffs on steel and is now engaged in increasing its agricultural subsidies beyond all prior levels. For the developing countries, of course, agricultural exports are absolutely vital. If Argentina had good access to international markets, it could alleviate many of its problems.

There is therefore a great deal of dissatisfaction with the economic policies and the rules of the game imposed by the international community. That raises two questions: Where to go from here?, which I will answer in two parts; and, What should Argentina – and in a broader sense, other Latin American countries – do?

In terms of Argentina – we should admit that we do not really know what will work. We do have fair confidence, however, about what will not work; mainly, that continuing contractionary fiscal policies will make the economy plummet. There is a responsibility of the international community to help Argentina. Largely, Argentina's predicament – while its government certainly has had some role – is tied to the international community, particularly to the advice the international community gave to the Argentine government and the willingness with which it lent money when things were good. Changing circumstances led to much higher interest rates and the international community has some responsibility.

The most important point is not to bail out banks – that is not really the priority; the real priority is job creation in one form or another. How does an economy start growing again? In terms of job creation, it is by really opening markets to the goods that are produced in these countries.

An important initiative would be for Europe and the United States to recognize that Argentina is in an emergency. In a way, the WTO recognizes the need for special actions in the event of an emergency and allows countries special protective measures. The safeguard measures are a partial example of that. One ought to consider an alternative perspective: looking not at the protective measures to be taken by Argentina – because those will not help Argentina very much – but rather, what the international community can do by opening up its markets, as an emergency measure to help countries that are in desperate straits?

This would mean, for example, a temporary suspension of Most Favored Nation provisions for say, a period of a year or two during which the United States would open its markets to Argentine goods without duty until Argentina can restore growth. This measure would have a miniscule effect on the rest of the world; it would have an enormous effect on Argentina. So I think this is where the international community ought to begin. I am actually not optimistic about this happening, although I am not completely pessimistic. I have talked to people in Europe about this idea, and it has some resonance there.

Since this may or may not happen, it is important for Argentina to look next door to its neighbor in Brazil and to use this as an occasion to perhaps strengthen MERCOSUR. It should perhaps go beyond the trade agreement that constituted MERCOSUR and consider a currency union with Brazil. What Argentina will need at some point is a restoration of confidence in its currency. Some people are talking about dollarization. I want to be provocative: I think returning to dollarization would be a mistake, even links to the dollar at the value level. There are better prospects of linking it to its next-door neighbor.

Finally, a point that I made before – the fact that it has a primary surplus means that its revenues exceed its expenditures if you exclude interest payments. Thus, if Argentina suspends interest payments, it has room for increasing expenditures that would increase aggregate demand and therefore stimulate its economy. I do not want to underestimate the consequences of those kinds of suspensions for the disruption of the financial system and in turn, the consequences of the disruption of the financial system for the overall functioning of the economy. Such measures cannot be taken lightly, but given the current circumstances, the alternatives that the current government is pursuing do not look likely to get it out of its predicaments.

Finally, let me say just a few words about the broader issues of Latin America – much of which also applies to other countries in the developing world. In Latin America, and Argentina in particular, capital market liberalization with more broad openness presents enormous risks to countries and makes life difficult, to put it mildly. It makes economic management very difficult. Some countries have learned how to manage in that very difficult situation. Chile has done that by restricting and intervening in, for at least long periods, the free flow of capital. Other countries are finding clever ways of intervening in the free flow of capital without opprobrium of the IMF. They have done it more subtly through the banking system, rather than calling it capital market regulations or controls as those are words you are not supposed to use. More clever ways of stabilizing capital flows must be found. A number of countries today are engaged in doing that, but one has to begin with the recognition that open capital market macroeconomics is fundamentally different from the kind of macroeconomics that once prevailed. It has a lot more instability.

The second observation I think that one has to recognize is that a lot of the political economy and rhetoric associated with fixed exchange rates is wrong and misguided. The rhetoric was that the fixed exchange rate would provide discipline, and that discipline would lead to strong economic growth. The same kind of vocabulary is used for capital market globalization, that opening capital markets brings the corresponding discipline, which is good for economic growth. Everybody believes in this con-

cept of discipline. Actually, these are very anti-democratic concepts, because they are saying they do not really believe in democratic processes as discipline devices. Looking at it another way, if you are going to have a disciplinarian, choose one that is not too erratic. The nature of the capital market as a disciplinarian is very erratic, punishing even when the country is not naughty. That is one of the things that happened to Argentina – a good disciplinarian punishes only when naughty, and for the right things.

The other problem is that short-term capital markets discipline countries in terms of that about which markets care. These concerns can be markedly different from those of long-term investment or labor. The contrast that I sometimes imagine would be a world in which we have free mobility of labor, rather than free mobility of capital. Imagine what would happen with free mobility of labor if a country started having bad pollution policies, causing people to have trouble breathing. All of a sudden, everybody would disappear from the country, and all that would remain would be machines. Well, that would be a very different kind of discipline, and policy would then run in a very different way. Capital market liberalization does lead to a discipline but the question is, is it the right discipline? It is an erratic discipline, and it is not even clear it is a discipline related to economic growth – the statistics show that it is not.

The other aspect is if a disciplinarian is too tough, discipline does not work. That is basically what happened to Argentina. The IMF said Argentina had to have flexible wages, meaning that the country had to be able to cut wages 20 or 30 percent a year or some such large number. The government also had to be able to cut budgets more than any government normally is able to cut. Yes, it is possible to imagine a world in which wages easily fell by

20 to 30 percent and governments easily cut budgets overnight by 20 percent or 30 percent, but I have not seen any governments like that. One could imagine such a government in a thought experiment. Without such a government and with the added stipulation that a degree of flexibility is required, which is never achieved, then the imposed system is an invitation for disaster. That is essentially what the IMF did. So, the second broad point is to think very carefully about the word discipline and what disciplines are imposed.

The third point is that countries should be very skeptical about borrowing abroad, or borrowing in general. Argentina did not borrow very much and it got into a very serious problem, from which I think any calculus of the benefits received in extra growth in, say, 1996 or 1997 is far, far outweighed by the losses it has experienced over the last several years. In general, the benefits from borrowing really have to be weighed against the cost. And the costs repeatedly appear to be much greater than people have fully taken into account.

Finally, let me say that underlying the policies in Argentina and many of the other reform strategies in Latin America have been these market fundamentalist ideas – the Washington consensus, which has argued for a minimalist role for government and very strongly against industrial policies. There is an alternative – a third way between the statist policies of the past and the market fundamentalist policies of the IMF. It is one that involves a more significant role for the government but also recognizes the importance of emerging forces.

It will be more difficult to craft such policies in today's era when there are restrictions imposed by WTO and other international agreements. Brazil, however, is beginning to show the way through more aggressive attitudes towards the United States, recognizing U.S. violations of those

international agreements. There are creative ways to living within those international agreements.

The bottom line is that there are alternative strategies involving a commitment to objectives that are broader than those of the Washington consensus, of not only growth but also equality, democracy, and sustainable growth. They use a broader vision of economic processes; one recognizing that there is an important role for markets, but also an important role for government. The wisdom here is trying to get the appropriate balance between the two.