

1-1-1995

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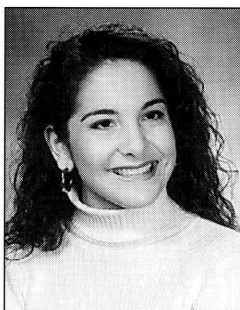
Recommended Citation

Strauss, Caren L., "The Transformation of the Argentine Economy: The Privatization and Convertibility Programs" (1995). *The changing face of Argentina*. Paper 4.
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THE TRANSFORMATION OF THE ARGENTINE ECONOMY: THE PRIVATIZATION AND CONVERTIBILITY PROGRAMS

Caren L. Strauss



Introduction

Throughout the 1980s Argentina endured a severe economic crisis. Like many of its Latin American neighbors, Argentina suffered from hyperinflation (which reached 4,923 percent per annum in 1989), an inefficient public sector, monetary devaluations and a substantial fiscal deficit. By the end of the decade the need for a more favorable macroeconomic environment had grown imperative; the need for a restructuring, an economic overhaul, was clear. Under the direction of President Carlos Saul Menem and the Minister of Economy and Public Works and Services Domingo Cavallo, the government set out to restructure and in many respects resurrect the Argentine economy.

Upon taking office in 1991, Cavallo instituted an economic stabilization plan, referred to as the "Cavallo Plan," to carry out Argentina's objectives. Perhaps the two most important

elements included in the program were the privatization and convertibility programs. The privatization program was designed as a means of reducing the country's inefficient public sector by selling off state-owned enterprises. These enterprises were a loss-making division of the economy, one that dominated heavy industry, natural resource exploitation and virtually all public services. Between 1989 and 1992 Argentina privatized the majority of its public enterprises, yielding efficient, tax-paying, privately-owned companies. The convertibility program originates from the Convertibility Law, passed in March 1991, which requires the Central Bank of Argentina to back 100 percent of the economy's monetary base with gold, foreign exchange and other external assets such as liquid international investments. A key factor in this program is the requirement of the Central Bank to maintain a foreign exchange rate parity of one Argentine peso for one United

States dollar. The convertibility program was designed as a catalyst for stability, economic recovery and growth within Argentina. Its purpose is to serve as a comprehensive plan for the maintenance of both fiscal and monetary health in the Argentine public financial environment.

The revitalization of the Argentine economy has not been easy. The privatization and convertibility programs have faced great difficulty in their development, although they have indeed achieved substantial success. This paper will delve more deeply into the origins, purposes and mechanics of the privatization and convertibility programs. In addition, it will investigate the current states and future prospects of the two programs within the context of the evolving Argentine economy.

The Privatization Program

The privatization process involves the return of major business activities to the private sector from the public sector, as well as the galvanization of the private sector through deregulation and the elimination of protectionism. (Shapiro, p. 515) The key tool in a privatization process is the concept of a transfer. A transfer is the means by which publicly-owned companies convey ownership to private firms. There exist two forms of transfer — the concession and the sale. A concession agreement firmly states the precise rules under which a firm may operate locally. (Shapiro, p. 521) It is analogous to a lease as it allows private companies to manage another company's assets for a period of time. Essentially, a concession involves a contract with private firms to supply services for which the government continues to pay, rather than the outright sale of government assets. Alternatively, a sale can transpire between a publicly-owned company and a private firm. These two forms of transfer can occur independently, but are often combined in some fashion.

The Argentine privatization process began in 1990. The program's impetus was the economic crisis that had reached an unmanageable level in late 1989. The hyperinflationary environment of the late 1980s had yielded a troubled Argentine economy, a poor fiscal situation plagued with debt, and inefficient state-

owned companies.

The public sector companies suffered a history of losses because of a complex regulatory environment involving import tariffs reaching a maximum of fifty percent in 1989, export taxes, and subsidies used to reduce the production costs to local industry. (Ministerio de Economía..., *Argentina: A Growing Nation*, p. 32) However, these subsidies were available only to a small number of exporters. The effect of these measures on prices of foreign products sold in Argentina was to discourage the purchase of these products and to encourage the purchase of substitute domestic products. A "buy Argentine" mentality also discouraged imports. This lack of exposure to competition hurt the Argentine economy. In addition, the government forced public sector companies to subordinate operations to a plethora of non-economic objectives. For example, the government required the companies to conceal unemployment levels and to strengthen the union forces within them. Inefficient management structures also aggravated the country's problems.

The Argentine government believed a privatization program would be the economy's panacea. The success of this program would be contingent upon three fundamental elements: deregulation, the availability of significant long-term financing, and the establishment of an efficient management sector.

The set of objectives outlined for the privatization program were the following:

- To increase productive efficiency, specifically through reducing costs and by lessening the political influence of corporate entities;
- To encourage investment;
- To reduce the fiscal deficit;
- To moderate internal restrictions on public-sector investment by reducing the size of the debt;
- To channel funds previously allocated to non-profitable firms to those with more promising returns. (Kessler, p. 2)

These objectives required a change in the legal framework designed for the handling of assets controlled by the state. Two acts laid the foundation for the privatization process of state-owned companies and for the concession of public utilities. The first act, associated with

State Reform No. 23,696/89 (Ley de Reforma del Estado No. 23,696/89) and otherwise known as the State Reform Law, established the basis for the privatization process in Argentina. This law authorized the partial or total privatization or liquidation of companies, corporations, establishments and productive properties totally or partially owned by the state. In addition, the act established a way of determining who could purchase those companies to be privatized and in what order they could do so: employees at any level of the company being privatized; customers of services provided by the agency; and producers of raw materials used as industrial input or processed as the main activity of the agency. (Ministerio de Economía..., *Argentina: A Growing Nation*, p. 4) The act also laid out the procedures for the capitalization of foreign debt instruments.

The State Reform Law also stated that privatizations were to be executed in one, or a combination, of the following ways: sale of the assets as a unit or individually; sale of shares or blocks of capital stock; lease for a specified period (with or without an option to purchase); administration for a specific period (with or without a purchase option and concession); and license or permit.

The second act, which laid the foundation for the successful management of the combined social and economic dangers created by economic reforms in Argentina, was the Economic Emergency Act No. 23,697 (Ley Emergencia Economica No. 23,697). The key clauses of the act include: the suspension of subsidies that have a direct or indirect effect on the National Treasury, the Central Bank or state companies' resources; the declaration of equal treatment of both foreign and national capital; and the reformation of the Central Bank's charter to allow it greater operating independence.

The first part of the privatization process began early in 1990 and lasted until March 1991. In light of the macroeconomic instability at this time, the government employed measures to increase the profitability of the enterprises intended for privatization. For example, as a result of the government's efforts, the internal taxes on the operating activities of the targeted companies were reduced. The state also initiated programs to improve the quality of

services transferred to the public. The improvement, particularly with reference to telephone services, required a considerable flow of investment funds.

This preliminary stage in the privatization process produced a set of minor transfers; and by the end of 1990, Aerolineas Argentina (the national airline) and the Empresa Nacional de Telecomunicaciones (ENTEL, the national telephone company) were under private ownership. Before the privatization of ENTEL began, the company was losing \$2 million a day. The government split the telephone company into two parts, selling sixty percent of each through debt-equity swaps. Citibank, backed by Telefónica Española of Spain and the Argentine division of Italy's Techint, bought the southern part for \$114 million in cash, in addition to cancelling Argentine public-sector debt with a face-value of \$2.72 billion. Manufacturers Hanover Bank, with the United States regional telephone company Bell Atlantic and six other Argentine companies, acquired the northern part for \$100 million in cash and \$2.3 billion in debt. Of the remaining forty percent, fifteen percent went to employees and suppliers and twenty-five percent was sold to local investors and listed on the Buenos Aires stock exchange. (Giddy, p. 306)

As a result of the privatization of these two companies alone, the state was able to reimburse United States creditor banks with over \$6.6 billion worth of foreign bonds — this figure representing approximately ten percent of the total amount of Argentina's foreign debt for 1990. In total, six firms were sold during this period and nine services were granted concession arrangements, including radio, television and oil. Argentina received \$790 million in cash and approximately \$6.8 billion in Treasury bonds from the United States as a result of the privatizations. This investment illustrates that the United States' confidence in Argentina had grown significantly. (Kessler, p. 4)

The transfers implemented in the first stage of the privatization process had a significant effect on the efficacy of the overall endeavor. Most importantly, the government signaled the intent of its future economic course by adopting a pro-market and non-interventionist policy. In addition, the beginning of the privatization program served as an important learn-

ing process for Argentina. It demonstrated the imperative need for the maintenance of a clear regulatory framework and highlighted key areas for improvement.

The second stage of the privatization process, from April 1991 into 1992, was characterized by the use of capital markets for the placement of thirty percent of the controlling stock of the privatized telephone companies. This placement of stock illustrated the first true effort by the Argentine government to increase the volume on the domestic capital market through privatizations. The increase in traded shares in the stock market contributed significantly to the strengthening of the capital markets. Also during this period, problems in companies already privatized were corrected, and guidelines were instituted to ensure the creation of regulatory entities to monitor the activities of the new companies and to increase investment requirements for the firms.

Regulatory agencies were set up to cover the sectors of activity considered vital to the efficient operation of the economy. Due to the nature of the newly privatized markets, in particular the existence of natural monopolies and the potential for agreements between a limited number of producers, the state had to determine some way to regulate business activity. For example, within the public utility market, the following agencies were created: the National Telecommunications Commission, National Electricity Agency, National Gas Agency, Tripartite Water and Sanitation Agency and Highways Concession Control Board.

The development of regulatory agencies, as well as other substantial changes made to the privatization process, brought the program even greater success. During 1992, the state sold 25 public companies, signed 31 oil contracts for exploration with private firms and granted nine public utilities or companies in concession. (Kessler, p. 6) In April 1992 a "sole payment criterion" was established whereby all privatizations which involved any amount of state revenue would have to be paid for both in cash and in foreign or domestic bonds. As a result of these transactions, the state received \$5.1 million and decreased its debt by approximately \$9.3 million. (Kessler, p. 6)

Yacimientos Petroliferos Fiscales

The largest and perhaps the most effective privatization of an Argentine company occurred in 1993. Yacimientos Petroliferos Fiscales (YPF) is the biggest company headquartered in Argentina and is engaged in the oil and gas exploration and exploitation business. The company is also involved in the sale, transport and distribution of petroleum and petroleum derivatives, petrochemicals and liquefied petroleum gas. YPF ranks first in publicly listed Argentine gas and oil companies in terms of estimated reserves; and if it were included in the United States' public list, YPF would rank eleventh. (Centro de Economía Internacional, August 1993, p. 5)

From the mid-1920s until 1990, the Argentine government maintained a monopoly in the Argentine gas and oil industry. It instituted numerous government policies through agencies and state companies, such as a national hydrocarbons plan, to regulate the actions and operations of the oil companies preceding the creation of YPF. These policies more often reflected political objectives rather than strategies to maximize profitability.

In 1989 the government began to take various measures to deregulate the oil and gas industry. This deregulation altered the monopolistic framework within which YPF operated, and gradually the company was able to enjoy the benefits of increased participation and investment by the private sector in the Argentine oil and gas industry. In August 1990 the government designated a team to help YPF become a competitive and efficient corporation. The team's plan required the identification of the assets and strategic operations that would be essential for a privatized YPF.

Decree 2778/90 dated December 31, 1990 (the Transformation Decree) determined the ultimate transformation of the state company into a corporation. On November 6, 1992, Law No. 24,145 on the Federalization of Hydrocarbons and the Privatization of YPF came into effect. This Privatization Law established the procedure for privatization of the corporation and determined that 50 percent of the capital stock of the corporation was to be sold by the

national government and the provinces within three years from the date of distribution of the shares of the corporation to the provinces.

Various other important clauses of this Privatization Act include the following:

- Assets of the corporation, other than rights over oil and gas exploration and exploitation, were sold subject to the limitation that such sales should not yield the purchase of a controlling interest in the market;
- No administrative or regulatory legislation in effect at the date of approval of the law (or issued subsequently) regulating the administration, management and/or control of companies in which the Argentine government had a share were to be applicable to the corporation;
- The corporation was granted exploration permits and exploitation concessions under the Hydrocarbons Law in select areas;
- The provinces received transfer of ownership of the oil and gas reserves located within their territories upon expiration of the exploration permits and exploitation currently in effect. (Centro de Economía Internacional, August 1993, p. 62)

As specified by this Privatization Law, the government and provinces were to sell shares of the company in local and international markets. Unlike in previous privatizations, the government established the market price on the basis of available information, setting the price at \$19 per share. (Centro de Economía Internacional, August 1993, p. 64) The shares were sold worldwide and were listed not only on the Buenos Aires stock exchange, but on both the New York and London stock exchanges as well.

Towards the end of the first quarter of 1993, the disposal of assets and agreements with third parties were virtually complete. The Privatization Act, coupled with efforts towards deregulation of the oil and gas industry, had been fruitful. Approximately 1,400 million barrels of petroleum were sold to private companies, representing 34 percent of YPF's total reserves as of January 1, 1991. (Centro de Economía Internacional, August 1993, p. 52)

The company created two strategic business groups to control operations: Upstream, for exploration and exploitation; and Downstream, for refining, transport and sales. In addition, a cost reduction program was designed to reduce the number of employees on the payroll. The personnel payroll of YPF was subsequently reduced from over 51,000 on December 31, 1990, to approximately 10,600 on March 31, 1993. (Centro de Economía Internacional, August 1993, p. 52)

As a result of these measures, YPF's financial position went from a loss of \$576 million in 1990 to one of profit in both 1991 and 1992. (Centro de Economía Internacional, August 1993, p. 53) After the sale, the state retained 20 percent of the shares and only minor representation on the board with the power to veto only key corporate decisions. (Centro de Economía Internacional, August 1993, p. 33) The total proceeds of the YPF sale, \$3.04 billion, represents the sale of 160 million shares of stock, or 46 percent of the company. (Centro de Economía Internacional, August 1993, p. 58) These proceeds were used by the Argentine government to pay benefits to retirees and to buy back debt owed to provincial governments.

YPF has enjoyed great success from the privatization. The company has worked to maintain this success by taking advantage of the opportunities privatization has presented to it. It has implemented a four-prong strategy to this end: to increase oil reserves and production, to increase the efficiency of the refineries, to improve the network of YPF service stations, and to increase the sales of natural gas.

Despite the obvious success enjoyed by YPF and many other privatized companies, it is important to note that the comprehensive privatization program was not carried out free of difficulty or setbacks. It was argued from the onset that the Argentine government may have lacked both the expertise and the political support to initiate an effective privatization strategy. A particularly pervasive question was whether or not the private sector would be able to perform at a level capable of supporting the proposed economic reforms. The Argentine privatization process was also often delayed by poor scheduling, bureaucratic roadblocks and powerful union opposition.

Nonetheless, the financial and economic results of the privatization program are many. The Argentine privatization process has covered most of the public companies once held by the government, as well as a broad spectrum of industries ranging from the telephone, electricity, water and gas industries to petroleum, shipyards and steel mills. The methods of transfer have yielded a significant inflow of funds to the public sector and have allowed for the repayment of a large portion of the national debt. In total, approximately \$5.6 billion in cash and \$4.5 billion in government securities has been repaid, and \$1.6 billion in liabilities has been transferred to new owners or concession-holders. (Ministerio de Economía..., *Argentina: A Growing Nation*, p. 17) In addition, according to Argentina's economic report for 1993, Argentina's total cash income from privatizations to date has been \$9.7 billion, and the total income from cancellation of domestic and foreign public debt has been \$13.425 billion. (Ministerio de Economía..., *República Argentina*, May 1993, p. 121)

Competition among companies has increased a great deal because of privatization. The increase in competition has forced companies to reduce costs and thereby to become more efficient, just as it has also compelled the private sector to take a greater interest in the overall economy. The private sector has worked hard to cut costs, to improve quality of service and to spur innovation — all in the best interest of the overall Argentine economy. Foreign investment has increased in Argentina as well since investors no longer harbor a great fear of the country's problems with hyperinflation and monetary devaluations.

The privatization process has not only involved domestic participants. A large number of foreign economic groups, governments, corporations and companies have participated in the program, such as British Gas and Italy's STET. (Argentina Survey, p. 6) The United States has been a key participant as well. By early 1993 U.S. companies had invested over twelve percent of the more than \$8 billion generated by the privatizations. ("Argentina and the United States...", p. 8) U.S. consulting firms such as Arthur Andersen and Price Waterhouse have helped to prepare state firms for privati-

zation and have advised private sector conglomerates in the bidding process.

Such U.S. financial institutions as Citibank, J.P. Morgan and Bank of Boston have also supported U.S., Argentine and foreign bidders. In fact, when YPF was privatized in June 1993, it was primarily through a sale in excess of \$2 billion worth of American depository receipts (ADRs) on Wall Street — a sale that received a great deal of help from Merrill Lynch and First Boston. American depository receipts are negotiable receipts representing ownership of stock in a foreign corporation that are issued by an American bank. These receipts represent shares on deposit with the American bank's foreign office. The YPF transaction was one of the largest initial offerings ever in the U.S. financial market; and as of March 1994, an estimated 45 percent of YPF shares are now owned by both individual and corporate American investors. ("Argentina and the United States...", p. 8)

The Convertibility Plan

The second critical element of the Argentine economic stabilization plan was the convertibility program. Since the 1950s, the Argentine financial system had been heavily regulated. Nominal interest rates were set by the government, an operation which created economic problems. The governmental determination of nominal rates sometimes resulted in negative real interest rates; as a result distortions in the allocation of resources occurred, and a system of implicit subsidy and taxation materialized. These subsidies directly and indirectly affected the National Treasury, the Central Bank and state companies' resources. (Ministerio de Economía..., *Argentina: A Growing Nation*, p. 25)

In the 1970s Argentina wanted to end the strong regulation governing its economic system and to move towards a more liberal strategy. A major reform was instituted in June 1977 when interest rates were freed on loans and on savings accounts and term deposits. In addition, banks were given full autonomy to choose their customers, implying that the Central Bank or any other public entity could no longer exercise any control over them. (Centro de Economía Internacional, June 1993, p. 42)

In 1982, however, financial policy reverted back to one of increased regulation so that the government could handle a high level of public company indebtedness with banks. This indebtedness was the result of an increased demand for credit in the public sector. The increased regulation took the form of high reserve requirements and rediscounts for banks and regulated interest rates. The Central Bank again became the principal intermediary in the financial system. However, at the same time monetary authorities lost control over the money supply as reserve requirements were used as borrowing by the government in order to obtain funds to subsidize the private sector.

This already difficult situation was worsened by the hyperinflation in Argentina during the 1980s. The Central Bank was not able to maintain remuneration of reserves, which is the minimum level of reserves necessary for a sustainable balance of payments. The overall surplus or deficit in a country's balance of payments is a function of a central bank's reserves. If a central bank's reserves decrease, due to an increase in exports or a decrease in capital inflows, an overall deficit will materialize. Due to a decrease in Central Bank's reserves, an uncontrollable financial deficit was created in Argentina. The country realized that only a reform of great magnitude could eliminate the deficit as well as deal with the fundamental problems in the economic system.

Argentina worked hard to construct an appropriate reform program, and in April 1991 the Convertibility Plan was launched. This plan was based upon the Convertibility Law (Law No. 23,928) dated March 1991. The Convertibility Law created the peso, the unit of currency used in Argentina today. The law established that as of January 1, 1992, coins and notes issued by the Argentine Central Bank would bear the denomination "peso" and the sign "\$." (Centro de Economía Internacional, June 1993, p. 44) The plan's framework was intended to bring about strict monetary and fiscal control.

Perhaps the most important component of the law was the parity and convertibility conditions it created for the new unit of currency. Parity was set at one peso (\$1) for each ten thousand australes (A=10,000), the former unit of Argentine currency. Convertibility was estab-

lished with the United States dollar at the rate of one peso for each U.S. dollar.

The law was set up in such a way as to ameliorate the difficult reserve situation the Central Bank suffered. The law imposed on the Argentine Central Bank the obligation to sell reserves readily at the rate of 10,000 australes, or one peso, per dollar while maintaining at all times sufficient international reserves to cover the monetary base. These international reserves could include gold and foreign currency, liquid international investments, and government securities not in excess of ten percent of total reserves. (Centro de Economía Internacional, June 1993, p. 47) This limitation on government securities as a percentage of total reserves prohibited the Central Bank from financing the public debt and from generating internal credit. In this way, reserves would no longer be used to fund government expenditures and the monetary base would remain under control.

The Convertibility Plan enhanced the Argentine economy's credibility immensely. Inflation fell from 27 percent for the month of February 1991 to a rate of less than two percent per month within only two months. This decrease brought the Argentine inflation rate much closer to worldwide rates, especially in the case of wholesale prices. Nominal interest rates also fell rapidly to levels close to 20 percent (per annum); and since inflation was decreasing, real interest rates in terms of both australes and dollars decreased as well. (Centro de Economía Internacional, June 1993, p. 47)

In addition, monetary policy was greatly simplified. For example, if there were an excess demand for pesos over dollars, the interest rate would rise until the exchange rate for the dollar fell below 0.99 pesos per dollar, at which time the Central Bank would purchase dollars, thereby restoring liquidity. In other words, the Central Bank would buy U.S. dollars with pesos in order to push the peso above 0.99 pesos per dollar. This purchase would add greater liquidity to the Central Bank's reserves. Essentially, monetary policy would be aimed to ensure that there would be no differential whatsoever between operations in pesos and those in dollars. It is interesting to note that all bank accounts are allowed in either pesos or dollars,

and banks can meet their reserve requirements using either currency. (Centro de Economía Internacional, June 1993, p. 47)

The Convertibility Program in effect led to a substantial growth in monetary aggregates, including notes, coins, savings deposits and term deposits. The program caused a marked increase in the real demand for money (both pesos and dollars). Total deposits in pesos more than doubled, and deposits in dollars grew rapidly. It is important to recognize that the growth in the total of both types of deposits was considerable for a country that had endured such a long period of hyperinflation.

The increase in the monetary base that began in April 1991 also reflects a sizeable increase in capital inflows. This inflow of funds was in large part due to the many privatizations being carried out. In addition, it was a result of the growth of capital markets which followed the signing of an agreement in early 1992 with the International Monetary Fund (IMF). This agreement provided Argentina with access to IMF resources for the financing of debt reduction agreements and assisted in a return to international credit markets. The three-year program which Argentina submitted for agreement to the IMF covers the monetary, fiscal and borrowing policies for the period of 1992-94 in order to ensure balanced public accounts and to improve the country's solvency. (Ministerio de Economía..., *Argentina: A Growing Nation*, p. 20)

The significant decline in interest rates in line with lower predicted levels of inflation has also reduced the exchange and country risk normally associated with Argentina. Exchange risk is the product of the immediate adjustment of quotes as traders receive and interpret new political and economic information. These adjustments cause both exchange losses and gains by banks active in the foreign exchange market. Country risk involves the economic and social factors that contribute to the general level of risk in the country as a whole. Due to the decrease in country risk resulting from the Convertibility Plan, there has been a large growth in offers of financing to Argentina from foreign sources. The financing has been offered for both the private and non-financial sectors, foreign-trade related operations and financial loans. (Shapiro, pp. 42, 511)

Convertibility has also resulted in a strong growth in lending. Financial institutions have enjoyed a rapid expansion in their lending abilities due to the remonetization of pesos and dollars. The process of remonetization is analogous to the U.S. central bank's open market purchases whereby additional liquidity is injected into the economy. In addition, increases in purchasing power and family incomes have resulted in more purchases of consumer goods and other services, necessitating increases in credit. Companies have also required loans in order to be able to satisfy increases in demand, to extend more credit to customers, to carry out industrial reconstruction and to take part in the privatization program. (Centro de Economía Internacional, June 1993, p. 52)

Not all of the effects of the new Argentine exchange rate parity have been beneficial to the economy, however. As a result of the Convertibility Plan's success in opening up the economy and in encouraging investment, there has been a marked increase in imports (mostly in capital goods) to Argentina. Consequently, substantial trade and current account deficits have developed, and the peso is now considered overvalued. In 1993 the trade balance was in deficit by about 3.7 billion dollars. (Arthur Andersen, p. 4)

The fact that the peso is overvalued makes Argentine products less competitive in the international market, and thus causes the volume of imports to be greater than exports. In 1993 exports comprised approximately five percent of Argentina's gross domestic product, and imports approximately seven percent. (United States Embassy, p. 5) Imports have increased dramatically since 1990; and although exports were sluggish from 1990 to 1992 and have since increased, the increase has not been great enough to eliminate the trade deficit. The current account deficit (a current account deficit indicates that a country is a net capital importer) has been more than offset by capital inflows (e.g., venture capital), however.

Future Prospects

Little now remains to be privatized in Argentina. Those state firms yet to be privatized are largely provincial rather than federal.

In the future it is likely that the government will sell off the large blocks of stock it still retains in the privatized firms. The government will also continue to deregulate the economy in an attempt to reduce the role it plays in the business operations of the private sector.

The Cavallo Plan has already received considerable support; and considering the unpopular inflationary period of only four years ago, it is expected to maintain its backing. However, the privatization program has prompted the necessity of reforms in other areas. Labor laws, bankruptcy codes and intellectual property protection are among the major areas targeted for changes.

The parity exchange rate between the peso and the dollar may or may not be manageable over the foreseeable future. Some people believe that the system will be able to be maintained while others do not, since the peso is currently overvalued. In addition, in the wake of the Mexican peso crisis, the possibility that the Mexican peso devaluation will affect Argentina's convertibility law is quite disconcerting to the Argentine political and economic communities. The fear is that the Mexican peso devaluation could cause Argentina's image to suffer. Severe troubles in raising financing from international investors for Argentina could mean that the Argentine exchange rate system would become unsustainable. Argentina relies on capital inflows to prop up the trade deficit that has resulted from an overvalued Argentine peso.

An important question is whether or not Argentina should devalue the peso. In general, forcing a currency below its equilibrium level causes inflation; in this regard, a devaluation can improve competitiveness only to the extent that it does not cause higher inflation. If Argentina were to devalue the peso and domestic wages and prices were to rise, any gain in competitiveness in the international market might disappear. Argentina's economy is almost entirely "dollarized," meaning that both households and businesses hold both assets and liabilities in dollars. For example, sixty percent of the debts of Argentina's 150 largest companies are dollar-denominated. (Argentina Survey, p. 4) In addition, many indices for prices, such as fuel, electricity and telecommunications, are

quoted in dollars, often by law. (Smith Barney, p. 8) Clearly, any change in the dollar-peso exchange rate would be reflected almost instantly in higher prices, and a devaluation would increase the burden of loan obligations expressed in pesos.

It is, therefore, likely that the political and social consequences of a devaluation would be far worse than the effects of a recession possibly brought on by the continuation of the current dollar-peso exchange rate. The Argentine government is convinced that devaluations have been used in the past as a refuge serving only to disguise bad economic decisions that have resulted in significant capital flight and hyperinflation; thus, it believes that the only means for economic recovery is by way of increased investment and productivity and lower production costs. (Ministerio de Economía..., *Argentina: A Growing Nation*, p. 60)

Increased investment has fortunately already materialized. The fixed exchange rate system has put pressure on Argentine manufacturers to invest a great deal in order to combat international competition. It is expected that the character of Argentina's investment will change from the improvement of existing capacity to an expansion of the productive base in order to export high value-added products. (United States Embassy, p. 4) The initiative to invest has also been, and will continue to be, very strong in the sectors of telecommunications, power generation, air and land transport, and health services. Imports from the U.S. have been critical for investment in these sectors. It will be essential that the United States and other countries continue to provide Argentina with what it needs to improve its outdated industrial and service bases.

Conclusion

As a result of the transformation of its economy, Argentina today has one of the world's most open economies. The country has made economic progress on both internal and external fronts. The convertibility and privatization programs have helped Argentina to achieve significant levels of internal stability and growth. This internal stability and growth has in turn increased foreign investor confi-

dence in Argentina, improving the country's position in the international markets.

The Argentine government remains firm in its stand against a devaluation of the peso and in favor of a reduction of production costs and an increase in investment. One can expect to see the reduction in production costs achieved through a reduction of financial costs in the private sector, involving further decreases in Argentine interest rates, tax reform in the provinces, and export tax reimbursements and the elimination of export taxes. (Ministerio de Economía..., *Argentina: A Growing Nation*, p. 27) Investment will be in those areas of production that will yield a more desirable

Argentine product: for example, high-value-added crops, primarily fruits, products for which there is both high international as well as domestic demand.

The Argentine economy appears to be headed towards a continued process of modernization. Argentina is likely to persist in its efforts to improve the efficiency of its economy, with the success of reforms to date and a more stable political environment supporting its endeavors. Argentina represents one of the most flourishing emerging economies in Latin America and should take pride in both its accomplishments and its promise of a bright, prosperous future.

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