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Chapter Title: An Overview of Debt and Macroeconomic Problems

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1 An Overview of Debt and Macroeconomic Problems

In 1985, after forty years of financial instability, Argentina reached once again near-hyperinflation conditions. Budget deficits were the immediate cause, but the deeper roots can be traced to the ill-fated policy experiments of the 1970s. The destructive pendulum between populists and market-oriented reformists has meant that much of national wealth is held abroad. Taxes are paid by only a few, and the general atmosphere is one of skepticism about everything Argentine. Mallon and Sourrouille (1975, 11) draw attention to this steady conflict when they write

Decision makers in Argentina have quite consistently attempted to adopt policy positions that seemed designed to tear society apart rather than to forge new coalitions. . . .

Major policy disagreements in modern Argentine history have their main roots in the conflict between two divergent streams of thought: liberalism of the British Manchester School variety and what can be called national populism. . . . In general, the liberals have stood for the virtues of a society open to international opportunities and influences, whereas, the national populists have emphasized indigenous, autonomous development.

In our study we investigate the interaction between domestic macroeconomic instability and external constraints. We study these relations by focusing primarily on the past decade in which four very different periods can be distinguished.

1. The Martinez de Hoz period of the 1970s when external debts were accumulated in the context of an incompatible mix of policies: large and

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- persistent deficits, a strongly overvalued currency, and liberalization of capital flows.
2. The period from the end of the 1970s to the hyperinflation, when debt and foreign exchange problems, war, and domestic politics were the reasons for an inflation explosion.
 3. The Austral stabilization plan.
 4. The post-Austral quest for a resumption of growth.

1.1 A Long-Run Perspective

Although we focus only on the past ten years, we place our analysis in a long-run context. This is appropriate because debt problems and financial crises are at least one hundred years old in Argentina. One hundred years ago Argentina's inability to service the foreign debt nearly brought down the City of London in the famous Baring panic of 1890; the Tornquist monetary reform dates back to 1899.

It is important to view developments in this long-term perspective because it highlights how Argentina has steadily lost its position in the world economy during this century.¹ Carlos Díaz Alejandro (1970, 1) reminds us of this decline:

It is common nowadays to lump the Argentine economy in the same category with the economies of other Latin American nations. Some opinion even puts it among such less developed nations as India and Nigeria. Yet most economists writing during the first three decades of this century would have placed Argentina among the most advanced countries—with Western Europe, the United States, Canada and Australia. To have called Argentina “underdeveloped” in the sense that word has today would have been considered laughable.

If Argentina in 1900 had a standard of living like that of the U.S., then the decline has been long and deep. Summers and Heston (1984) estimate that by 1950 Argentina had only 41 percent of the U.S. standard of living (against 80 percent of that in Australia and Canada). By 1985 the standard of living had slipped to only 30 percent of the U.S. level. Figure 1.1 shows the level of per capita real income in Argentina over the past forty-five years.

There is a striking difference between the steady expansion in the thirty years before 1975 and the stagnation and decline that have occurred since then. The contrast could not be stronger: from 1945 to 1975, per capita income grew at an annual rate of 1.7 percent. From 1975 to 1985, it fell at an annual rate of 1.7 percent.

The second dimension in which Argentine performance has shown a dramatic deterioration is inflation and fiscal stability. Of course, there have been frequent precedents for massive inflation and depreciation. But the experience of the past decade, with two near hyperinflations, stands out. In

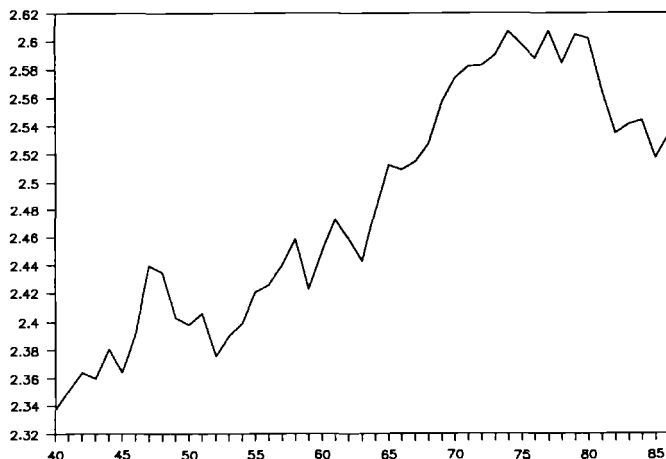


Fig. 1.1 Real per capita GDP (logarithm)

1899 *Banker's Magazine* already reported of South Americans and their currency:²

[They] are always in trouble about their currency. Either it is too good for home use, or as frequently happens, it is too bad for foreign exchange. Generally, they have too much of it, but their own idea is that they never have enough. . . . the Argentines alter their currency almost as frequently as they change presidents. . . . No people in the world take a keener interest in currency experiments than the Argentines.

The Argentine experience with the destruction of the financial system in the past fifteen years has certainly reinforced that keen interest and expertise. Figure 1.2 shows the monthly rate of inflation since 1970. In interpreting the graph, one should bear in mind that a monthly rate of inflation of 6 percent corresponds to 100 percent per year and 22 percent per month yields an annual rate of 2,500 percent. Inflation passed 1,000 percent in the Peronist period of 1975–76 and again in the pre-Austral period of early 1985. At no time in the past ten years did it fall below 100 percent for any length of time.

The third broad feature to which we want to draw attention concerns the real exchange rate. This is a key price in any economy and even more so in the case of Argentina. Figure 1.3 shows the real exchange rate over the past thirty years measured as the ratio of domestic wholesale prices to the wholesale prices of imports.³

The extraordinary variations in Argentina's external competitiveness are closely tied to macroeconomic policy mistakes, capital flight induced by these mistakes, and the present debt crisis. The outstanding episodes, clearly apparent in figure 1.3, are the real depreciation prior to 1976 and the

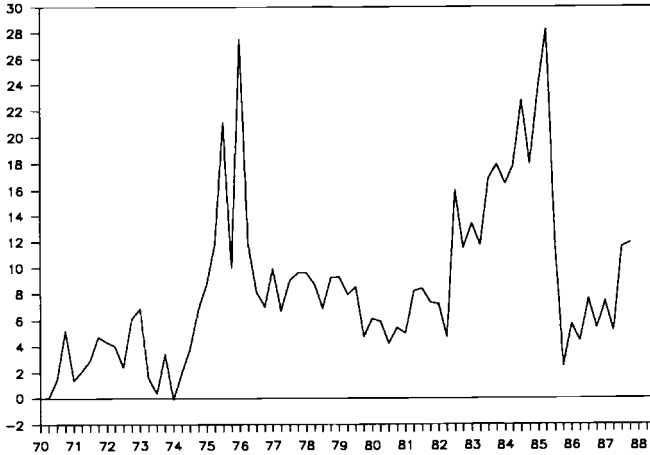


Fig. 1.2 Inflation rate of the CPI (quarterly average of monthly rates)

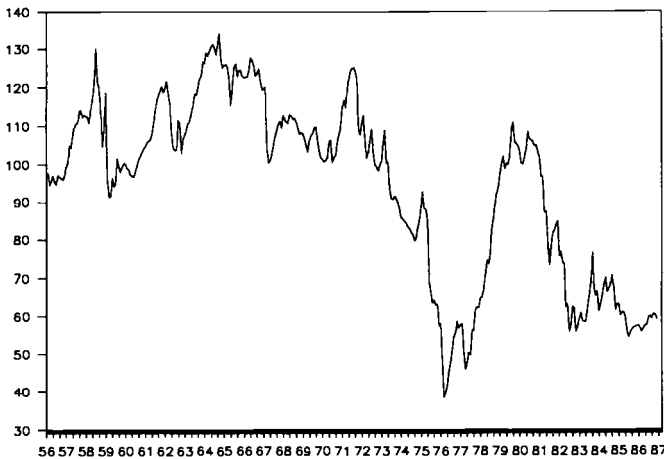


Fig. 1.3 The real exchange rate (WPI domestic/WPI imports, 1960 = 100)

appreciation of 1979–81. For the period 1970–78 the real exchange rate averaged 73; it increased to 108 over the next three years before declining back to an average of 75 in 1982–86. By March 1987 it had fallen to less than half of its peak value. The swings in the real exchange rate capture best the seesaw nature of Argentine policies. In some periods unimaginable damage is done to the productive and financial structures, and then a period of repair follows in which austerity and real depreciation restore the base for yet another political, fiscal, or foreign exchange adventure.

Table 1.1 shows the debt accumulation over the past fifteen years. There is considerable uncertainty about the size of the external debt prior to the late 1970s, and available estimates from various official sources vary widely. Estimates of the Banco Central de la República Argentina (BCRA) show that debt varied between \$2.5 billion and \$3 billion in the 1960s, ending at about the same level as it started. From 1970 on, external debt steadily increased for both the private and the public sector. Between 1970 and 1977 the external debt rose by \$6 billion, and in the next four years it rose by more than \$30 billion.

We now turn to a review of the principal episodes. We will describe and explain the relevance to these episodes of the debt problem and the role of external debt in creating domestic macroeconomic difficulties. A brief chronology of dates and important facts helps place the events in context.

1.1.1 The Martinez de Hoz Period (3/1976–3/1981)

At the time Jose Martinez de Hoz assumed power as finance minister of the military government, consumer prices had increased in the previous month at an annual rate of 5,000 percent and output had declined sharply. The black market premium for foreign exchange exceeded 200 percent.⁴ The new program was to stabilize the macroeconomy as a first priority, and then renovate industry and financial markets. Macroeconomic stabilization got under way quite rapidly so that inflation soon fell to less than 200 percent.

A financial reform was implemented to liberalize capital markets and link Argentina more effectively with the world capital market. By late 1976, foreign exchange transactions were completely liberalized on capital account, and this was done so effectively that the black market premium was zero for the next four years. Figure 1.4 shows the black market premium and brings out the striking interlude of free capital mobility between the Peronist period and the aftermath of the collapse of Martinez de Hoz's policies.

Inflation failed to decline further once it was down to the 150 percent range. To make further inroads, policymakers opted for what Fernandez (1985) has called an "expectations management approach." Beginning in 1979, they pre-fixed the rate of exchange depreciation with a *tablita*, that is,

Table 1.1 Argentina's External Debt (in billions of \$U.S. and percentages)

	1975	1978	1979	1982	1985	1987
Total external debt (\$)	7.9	12.5	19.0	43.6	48.3	56.2
Public (\$)	4.0	8.4	10.0	23.6	40.0	
Reserves (\$)	0.6	5.8	10.1	3.0	6.0	
Net debt/exports (%)	260	110	120	540	520	
Debt/GDP (%)	18.6	23.9	30.2	60.3	64.5	69.6
Interest payments/GDP (%)	0.7	1.4	1.4	2.4	5.7	5.1

Sources: World Bank, BCRA, and Morgan Guaranty.

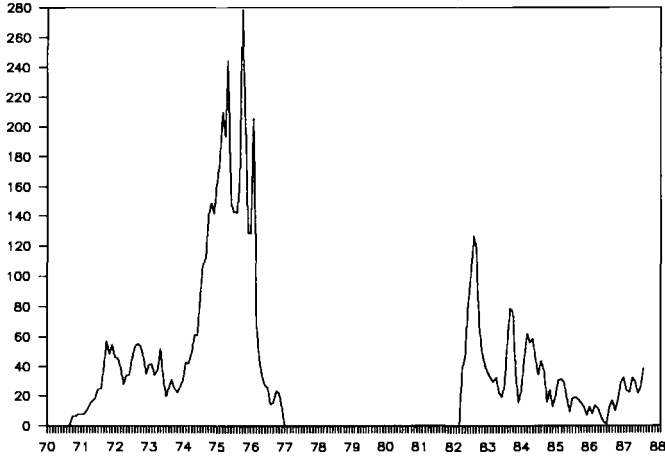


Fig. 1.4 The exchange rate gap (parallel rate as percent of official, Australs/\$U.S.)

they announced ahead of time a series of gradually declining rates of depreciation. These announcements were repeated on a rolling (though shortening) basis, so as to create an environment where economic agents could discern that a government commitment to disinflation was embodied in the timetable for reducing rates of exchange depreciation.

This policy was expected to lower inflation through three separate channels. First, reduced rates of depreciation would directly lower the rate of import price inflation. Second, reduced depreciation would serve as a discipline on domestic price setters. Third, in an environment where inflation to a large extent depended on expectations, the rule or precommitment introduced a fixed point around which expectations could rally. Needless to say, the intellectual underpinnings of such a program relied on a belief that the Chicago School's "law of one price" would be operative.

Inflation responded to this policy, falling throughout 1980 to reach a bottom well below 100 percent. But gradually, during 1978 and 1979, the *real* exchange rate appreciated because inflation consistently outpaced the rate of depreciation. We saw in figure 1.3 that the cumulative overvaluation reached 50 or even 60 percent. But while the overvaluation ultimately led to capital flight and the collapse of the financial system, in the early stages there was quite the opposite trend. The high interest rates—relative to world rates and the preannounced rate of depreciation—gave rise to an (almost) risk-free speculation in favor of Argentine assets. As a result, private sector borrowing abroad increased to take advantage of the relatively low foreign interest rates, and a massive capital inflow developed. This is shown in table 1.1 in the large increase in Central Bank reserves between 1978 and 1979 and the matching increase in private external borrowing.

The trade and employment effects of the overvaluation were slow to come. Díaz Alejandro (1964) has shown that the real income effects of a real depreciation tend to be dominant in the early stages, before substitution effects take over. For the real appreciation of 1977–80 the reverse applied: the increase in real income created an expansion in demand and thus seemed to validate the Martínez de Hoz approach by creating inflation reduction with rising real income. This was reinforced by the fact that trade protection, even with liberalization measures, kept the economy relatively closed, dampening the disinflation effects of the *tablita* as well as the employment effects in the real sector.

By 1979–80 the overvaluation had become so extreme that in financial markets there was the view that depreciation was inevitable. Even though the government asserted that the policy would be continued and could be financed, speculation increasingly went in the direction of dollar purchases. The regime of unrestricted capital mobility introduced in late 1976 maximally facilitated this capital flight. Hence, in 1979–80 the Central Bank and public sector enterprises were forced to borrow massively abroad to obtain the foreign exchange which was then sold in support of the exchange rate policy. Private speculators in turn bought the dollars and invested them abroad. With the round trip complete, commercial banks in New York, Zurich, and Tokyo had lent to the government the resources to finance capital flight which returned to the same banks as deposits. Of course, capital flight was not limited to dollar deposits—investments in financial markets were important as was real estate abroad.

A variety of estimates is available on the accumulation of external assets by Argentines during this period. These estimates are typically residuals from debt and balance of payments data. They are obtained by deducting from the recorded increase in gross external debt the current account and recorded capital flows in the form of direct investment and changes in reserves. Dornbusch (1985a), for example, calculates that capital flight in 1978–82 amounted to \$23.4 billion. In a review of various estimates, the IMF (Watson et al. 1986, 142) reports that capital flight amounted cumulatively to about \$15 billion in 1979–81. Rodríguez (1987) estimates that between 1979 and 1982 Argentina's private external assets increased from \$10 billion to \$34 billion. These estimates would have to be revised upward to reflect the extent to which the underinvoicing of exports and overinvoicing of imports was a significant channel of capital flight in this period.

Both the fact of and the motivation for the wave of capital flight in the late 1970s are very clear. Unlike in other debtor countries (for example, Brazil or Chile), mismanagement of the exchange rate combined with an opening of the capital account is almost the full explanation for the massive debt accumulation. The particular background must be understood to appreciate that in Argentina's case the government has an external debt but the private

sector has matching external assets. Moreover, that process was carried further in the next few years as the government gradually took over all external debt in the course of sustaining failing financial institutions. In 1980 about half of the external debt was owed by the public sector; by 1985 that share had increased to 82 percent.

1.1.2 From Martinez de Hoz to Alfonsín (3/1981 – 12/1983)

The end to the military government did not come easily. The Martinez de Hoz overvaluation sowed the seeds of financial destruction, but the actual unraveling came only over the next four years. The world economy contributed to the problems induced by the debt crisis: sharply declining commodity prices and much higher interest rates brought with them difficulties in servicing the external debt.

But domestic events were certainly the dominant factor. First came the reversal of the overvaluation. This process started with the change of presidents: the incoming president, months before taking office, declined to comment on his exchange rate policy. This served as an obvious indication that a devaluation was certain to occur; as a result, capital flight became massive. Central Bank reserves declined by more than \$5 billion, and public external debt increased sharply. Finally Martinez de Hoz was forced by his successor, who was not yet in office, to bring his own expectations management and credibility approach to an end by devaluing the currency.

Over the next three years exchange depreciation and inflation flourished, with inflation rising from less than 100 percent to 600 percent by the time Raúl Alfonsín took office as president. Changes in public finance and financial markets were particularly important in this period. Exchange controls were instituted once again and the black market premium reemerged (see figure 1.4). The Central Bank, in an effort to ensure continuing trade flows, started exchange rate guarantee programs only to find that it could never hold on to the guaranteed exchange rates. As a result of the bank losing a string of bets in the foreign exchange market, the budget deteriorated dramatically. The deterioration was reinforced by financial failures that turned up in the public sector, by the burden of external interest payments, and by deteriorating terms of trade. The Malvinas conflict added to the loss of confidence and to the devastation of public finance.

The economics of this period of deterioration can be expressed in terms of a simple model of deficit finance and financial markets. Suppose the budget deficit represents a fraction (g) of national income and that the velocity of high-powered money is an increasing function of the rate of inflation. Suppose the deficit is financed by money creation. Then it can be shown (see chap. 4) that the rate of inflation (π) will be a steeply increasing function of the deficit but will also depend on financial institutions.

$$(1) \quad \pi = (\alpha g - y)/(1 - \beta g)$$

The higher the level of noninflationary velocity (α) and the more responsive velocity is to inflation as measured by the parameter (β), the more dramatic is the inflation impact of budget deficits.

This framework helps to identify the interaction of deficits, external debt service, real depreciation, and financial markets in generating the inflation explosion of 1981–84. The growing burden of debt service, because of higher interest rates and real depreciation, increased the budget deficit ratio (g) and hence raised money creation and inflation. The institutional response of financial markets to higher inflation, namely a flight from money, aggravated this impact. The reduction in money holdings was facilitated by a growing range of interest-bearing substitutes. As these substitutes became more important, velocity sharply increased (α and β in eq. [1] increased), which meant that the inflation rate associated with a given deficit ratio also increased.

The 1981–84 period thus represents an unraveling of what had been merely an artificial stability during the late 1970s. Several events, each in itself extraordinary, combined to make the crisis large: the initial overvaluation had been extreme, the financial sector had been allowed to become overexposed in speculation, private capital flight had been massive, and the world economy turned unfavorable at just the wrong time. Each of these factors caused the budget to deteriorate and hence reinforced inflation.

1.1.3 Alfonsín (1/1984–1989)

These difficulties carried over to the beginning of the Alfonsín administration. Large real wage increases in 1983–84 created problems for the budget and for the external balance. Inflation rapidly escalated and negotiations with creditors and the IMF did not bring a solution.

The inflation issue soon became the single most pressing problem. In early 1985 annualized monthly rates of inflation rose 1,500 percent and more. A hyperinflation was an entirely realistic possibility because the inflation process itself eroded the real value of tax collection and promoted a financial system which provided money substitutes, so that continual money creation was in order to finance an ever-widening deficit. Because IMF programs seemed unable to cope with the inflation problem in a timely and politically acceptable fashion, and because the sheer pace of disintegration was so rapid, the government considered extreme measures. The monetary reform known as the Austral Plan was just such a measure: an all-out attempt to stop hyperinflation.

The details of the June 1985 Plan of Economic Reform, which is now called the Austral Plan, were as follows:

- A real depreciation and a sharp increase in real public sector prices; an export and import tax, a forced saving scheme, and accelerated tax collection.

- A wage–price–exchange rate freeze.
- A new money, the Austral, and a promise not to create money to finance the budget.
- A conversion scale for existing contracts that would adjust them to keep real burdens unchanged in the face of an unanticipated reduction in inflation.
- An IMF agreement and a rescheduling agreement with creditors.

The stabilization reduced inflation levels to only 1–2 percent per month. The immediate decline in inflation and the fiscal measures brought about a rapid and major shift in the budget. High real interest rates and the budget improvement created an atmosphere of an at least temporary stabilization. The black market premium vanished. For a country that had been on the verge of hyperinflation, the stabilization created an immense relief, but it also left considerable skepticism as to the possibility of stopping inflation by edict. The skepticism particularly revolved around the government's ability to achieve sufficient budget control to reduce permanently the need for inflationary money creation.

But even if skepticism existed, the stabilization proved to be an important political move and as such was a stepping stone toward a more deeply rooted stabilization. According to a public opinion survey (reviewed below in chap. 5), the initial response was overwhelmingly positive.

This was not the first time Argentina had used wage–price controls to try to stop inflation. Indeed, this was attempted in 1975–76, and the experience ended in an outburst of repressed inflation. The Austral Plan has not brought price stability—inflation by 1987–88 was back to more than 200 percent. The important achievements have been that inflation was brought down from more than 2,000 percent and that this was accomplished without either a major decline in economic activity, a rise in unemployment, or a reduction in the purchasing power of wages.

In 1985 and early 1986 there was little risk that the stabilization would collapse in the near future. This gave rise to a confidence that could have made it both possible and fruitful for the government to concentrate on two key issues: how to achieve further budget improvement so as to bring inflation down to below 20 percent per year, and how to restore investment and growth. Unfortunately that opportunity was missed. A substantial fiscal deterioration took place and reignited high inflation. Thus the problem of growth without inflation remains unsolved. But what are the ingredients of a program of growth without inflation? We turn now to this question and to the implications for external debt and debt service in this context.

1.2 Investment, Debt, and the Budget

The budget influences inflation as well as investment and growth because it influences the distribution of resources in the economy. If the government

commands a large share of the resources, less is left for the private sector. The government may use its resources to service the external debt via noninterest external surpluses or to support consumption, or it may make them available for investment. Table 1.2 shows the budget of the consolidated government.

Two points concerning the effect of the budget on the economy must be distinguished. The first is the way in which the government finances its outlays, i.e., by regular taxes, by borrowing, or by the inflation tax. The second, which may be related, is how the tax system determines the allocation of resources among sectors. As an illustration, the government can replace the inflation tax with outright taxes, and there will be little effect in the aggregate except that inflation will decline. If, however, the inflation tax declines without an offsetting increase in outright taxes, an offsetting reduction in absorption needs to occur: the government must either cut its spending or reduce its debt service.

For the country as a whole there is a tradeoff among consumption, investment, and net resource transfers abroad. This tradeoff can be recognized from the GDP identity:

$$(2) \quad \text{Output} = \frac{\text{Net Resource}}{\text{Transfer Abroad}} + \text{Investment} + \text{Consumption},$$

where consumption refers to both private and public sector consumption, and investment similarly includes both the private and public sector. With a fixed amount of resources or output available (because the economy is already at full employment), the budget and the external debt strategy now determine inflation and future output potential.

To show the range of options we can look at two particular scenarios. One possibility is to keep budget adjustments to a minimum so as not to interfere with consumption and yet foster growth via increased investment. This strategy requires, as (2) shows, that resource transfers abroad be stopped or even reversed. In a second scenario the government seeks both investment and continued, partial debt service. In this case, the resource shortage calls for crowding out of consumption by outright taxation or by the inflation tax.

Table 1.2 **The Government Budget**

Year	% of GDP	Year	% of GDP
1980	7.5	1984	11.0
1981	13.3	1985	5.6
1982	15.1	1986	4.6
1983	14.4	1987	6.3

Source: BCRA.

Note: IMF definition for 1980–82 is on a budget basis; for 1983–86, on a cash basis. Data since 1983 include operating losses of the Central Bank.

Over the past few years crowding out of investment, rather than of consumption, has been the rule. By maintaining relatively tight money and a strongly competitive exchange rate, the government has crowded out private investment, with consumption and transfers abroad absorbing the available resources. The adverse effect of positive and often high real interest rates on investment is all the more punishing in that uncertainty about future budget trends and debt service, hence interest rates, makes it unwise to repatriate capital or risk borrowing.

Figure 1.5 shows the extraordinarily low rate of investment (as a percentage of GNP) in Argentina. Net investment in fact is zero or negative. With productive capacity stagnant, there is no source of growth in the standard of living. Hence the question is how much longer the current policy mix can be sustained without doing irreparable damage to the economy's productive system and thus to the long-run viability of the economy. The flourishing of the underground economy is certainly a warning signal of a very undesirable trend.

IMF programs for Argentina anticipate that in the absence of an official change in the debt strategy, the current account deficit (as a percentage of GDP) will gradually decline and ultimately turn toward surplus. The 1986 program, for example, anticipates that Argentina's current account will reach a modest surplus of 0.2 percent of GDP by 1990. That means, of course, net resource transfers in the full amount of interest liabilities. This strategy, if it is to be consistent with even moderate growth of the economy's supply side, requires a major shift in the budget so as to contain consumption. This shift can take the form of a much higher inflation tax or a much higher outright form of taxation.

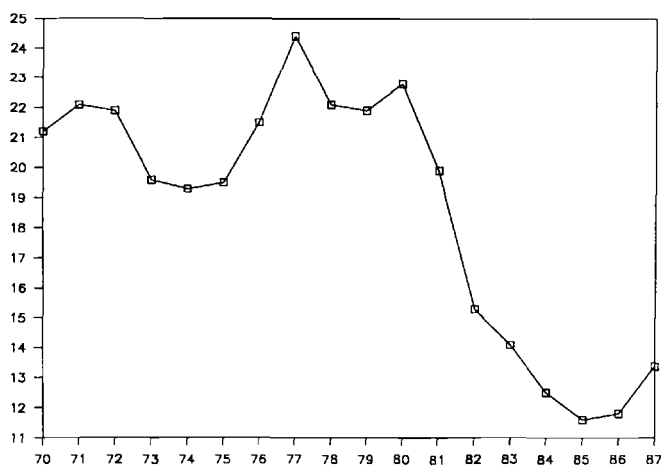


Fig. 1.5 Gross investment (percentage of GDP)

Latin American leaders advocate a different scenario. They argue that net resource flows need to be reversed and that the noninterest surpluses must come down. Resources need to be transferred inward again, they argue, to supplement scarce domestic saving in financing domestic investment. Such a reversal of resource flows compounds the problem of creditworthiness. If debtor countries like Argentina are experiencing difficulties in servicing the debt now, is it plausible that still more debt should be added? Feldstein (1987) has argued that some countries, in particular Brazil, can both borrow and grow without risking the buildup of an unsustainable debt. It is difficult to see that possibility in Argentina, however, except in the context of a major restructuring of the public sector.

But if reliance on external resources is increased by reducing net transfers abroad, one must ask the question of how the extra space thus gained should be used. Once again a fiscal reform could translate these resources into growth of productive capacity. Using resources for consumption would simply reduce creditworthiness and thus presage yet another financial crisis.

Argentina faces a crucial juncture with respect to fiscal policy. Fiscal choices today are critical because they affect inflation and growth and because there is little room left for mistakes. The external debt service is a key variable because it currently absorbs resources that could be available for growth. But resource savings due to reduced external debt service (assuming there is no debt forgiveness) can only be used productively if fiscal reform translates these savings into sharply higher growth. The decisions required to make that possible have as yet not been made. Moreover, if capital markets are unwilling to lend on a major scale, then most of the investment must be financed by reduced consumption. The policy mistakes of the 1970s directly translate into a growth crisis for the 1980s.

The implications of the present effort to stabilize the budget and hence bring about growth and financial stability go far beyond the economic sphere. Political and institutional instability in Argentina resemble that of the Weimar Republic and Central Europe in the 1920s or the Fifth Republic in France. The political instability in turn influences economics because it stands in the way of continuity and farsightedness in private investment decisions. If, as has been the case in Argentina, the average tenure of a central bank president is less than a year, the situation is certainly not conducive to a long view. (No doubt, that is the reason for the clock in the antechamber of the office of the president of Argentina's Central Bank. The inscription on the face of the clock reads "tempus fugit".) The attempt at reconstruction underway today is thus of extraordinary significance. This also implies that increased flexibility of the external constraints associated with debt service is of particular importance.