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The Political-Economy of Argentina's Debacle

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Abstract

In this paper I argue that political-economy considerations –and in particular the identity of the reformers- are central to understanding the Argentine crisis.
During the 90´s the main political parties remained attached to populism, and no strong party emerged at the center of the political spectrum. This had two effects in the reform process. First, it severely deteriorated it (efficiency, corruption), reducing the support of the population. Second, when a series of shocks hit the economy the anti-reform camp tried to undo most reforms, and thus convey a message to the population about the "right" model of the world.

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I. Introduction

> "Economists must not only know their economic models, but also understand politics, interests, conflicts, passions – the essence of collective life. For a brief period of time you could make changes by decree; but to let them persist, you have to build coalitions around them. You have to be a politician."
> Alejandro Foxley, Chilean Minister of Finance (quoted in Drazen, 2000)

The gloomiest Tango would be insufficient to describe the situation of Argentina: the country was left in shambles shortly after being the darling of Washington and Wall Street. Following years of impressive growth and stability, Argentina is experiencing its biggest economic depression ever recorded in peacetime.

A number of papers and media articles have since tried to explain the causes of the crisis and its severity. These papers center their analysis on the fiscal deficit, the currency board, and the functioning of international financial markets. The argument of this paper is that while many of the approaches presented so far have some merit in explaining the origins and the severity of the crisis, they are insufficient –if not misguided-, and political-economy considerations are central to understanding the unfolding of events. In particular, I argue that the identity of the reformers (and their successors) lies at the heart of the Argentine crisis. In several Emerging Market Countries (EMC), reforms were initiated not by free-marketers but by unlikely characters such as former populists and leftists (see Williamson and Haggard, 1994 and Cukierman and Tommasi, 1998). In Argentina, the hyperinflation opened a window for reforms, and these were adopted by President Menem, from the populist Peronist party, with the help of a group of competent technocrats lead by Minister Cavallo.

Even though their populist origins made possible the launch of an impressive set of (first-generation) reforms, they left substantial "illiberal" enclaves,[1] they implemented them in an efficient and often corrupted way, and they did not reform any politico-institutional rules and practices. All this worked against the reform process, as the benefits of reforms

[1] See Bambaci, Saront and Tommasi, 2002. Their main point is that the fundamental reforms executed were politically viable thanks to the maintenance of these "illiberal enclaves".

did not reach the population at large, and corruption practices were seen as part of the same "package" as reforms.

Neither the Peronist nor the Radical party (the main opposition party by then and the one that succeeded Menem in 1999) changed during the reform process, and most of their ranks remained convinced of the old protectionist and state-intervention policies. The coalitional nature of the main parties, along with the fact that Deputies are elected in provincial districts made that, amazingly, those opposing reforms received the lion share of recognition among voters in the succeeding legislative elections. Moreover, the implicit alliance between the Peronists and the political center, which provided ideological support and the technocrats, avoided the emergence of a strong pro-business political party during the initial years of the Convertibility.[2]

Once the external shocks stared to hit the economy, the population could not discern whether their ills were due to the new model (of minimal state intervention) or due to the shocks. The anti-reform camp tried to undo the reforms instead of introducing new measures to cope with the shocks, to convey the population a signal of the "right" model according to their view. This was because the remaining reforms touched the limits of ideology and the nerve of the interests that they represented (some provinces, labor unions, protected industries, etc.). They could not have reverted the reforms if these had been executed efficiently, but the setback in the reform process since 1996, the extended corruption in the political system, and the external shocks received deteriorated the sustainability basis of the reform process in Argentina.

To make matters worse, as the anti-reform camp narrowed the scope of reforms, the reforming technocrats –with the acknowledgment of the IMF- tried to increased taxes or slashed (structural) expenditures to reduce the fiscal deficit. These measures outraged the population, as they were contemporaneous with a sense of extended corruption and self-serving politicians, and an inefficient public sector.

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[2] A similar view was expressed by Alberto Ades (Goldman Sachs) at the NBER conference on Exchange Rate's Crises on Emerging Markets Countries held in Boston on July 17, 2002.

The growing dissatisfaction with the political parties led more than 40 percent of the voters to abstain or to nullify their votes in the legislative elections held in October 2001. Among those who cast positive votes, the anti-reform camp won hands over, and they quickly and mistakenly interpreted the election results as a vote against the model (of minimal state intervention). Shortly after, organized riots in the Province of Buenos Aires put an end to De la Rúa's government. Since then, the executive and legislative powers have tried to undo most of the reforms established in the 90s, and they repeatedly blamed the "model" (of minimal state intervention) of the ills the population was suffering.[3]

To my knowledge, the only paper that makes a somewhat similar argument to mine is that of Bambaci et al. (2002), but their main objective is to make a case that the reforms executed were politically viable thanks to the maintenance of some "illiberal enclaves". The argument then goes that the lack of complementary reforms impeded the possibility of adjusting within the Convertibility regime, and that the Argentine polity was unable to reach the intertemporal political agreements to provide credible agreements to the currency board (see Galiani, Heymann and Tommasi, 2002, and Tommasi, 2002). But the argument here is that it was not a matter of inability, but one of unwillingness of the anti-reform camp. They preferred a failure of the reform process, to defend their interests and to provide the public a signal of the "right" model of the world according to their view. The ironic part is that the anti-reform camp was made stronger due to the recognition of the voters to the parties that they belonged to, and that initiated and tried to continue with the reform process.

In what follows, I try to build a good case for the appreciation that political-economy considerations are key to understand the events in Argentina. In Section II I discuss the merits of alternative explanations of the crisis. In Section III I argue that the Convertibility was not thought simply as a monetary policy, but was a way to stop a long-standing distributional conflict, and an interlocked part of a supply-side policy. In Section IV I develop our case in favor of a political-economy view of the crisis. Section V draws some policy lessons.

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[3] The show included an applauded repudiation of the sovereign debt in Congress.

II. Alternative Explanations of the Crisis

Although most of the papers and policy notes written so far point out that several problems coexisted at the time of the crisis, one can characterize them in terms of the balance of payments crisis literature as belonging to two different strands.

One strand emphasizes the inconsistency between the fixed exchange rate and the fiscal policy pursued, much in the spirit of “first generation” models of currency crises. Some of these papers or media articles point directly to the inconsistency between fiscal policies and the peg, like Feldstein (2002) and Krueger (2002), while others stress one of the two aspects. Mussa (2002) and Schuler (2002), for instance, emphasize the fiscal deficit and unsustainable debt dynamics, the second one being an advocate of fixed exchange rates. Other authors point their fingers mostly to the currency board, with alternative arguments. De la Torre et al. (2002) argue that the relationship between the currency board and the financial system is essential to understanding the crisis, given that the high exposure of the banking system to fluctuations in the real exchange rate made them prone to runs. Edwards (2002) arguments that under super-fixed exchange rates overvaluation is very difficult to resolve. For Hausmann and Velasco (2002), the interaction of a grossly misaligned real exchange rate and the country’s capacity to borrow is at the center of the crisis.

The other strand of papers has a “second generation” (models of currency crises) flavor, in the sense that fundamentals per se were not the key drivers of the crisis. In Calvo et al. (2002), “sudden stops” to capital inflows played an important role, while problems in some fundamentals, namely the closedness of the economy and the penchant for dollarization, magnified the effects. According to Galiani et al. (2002), sizable external shocks generated large-scale revisions of the agents´ perceptions of permanent income, and the system was not prepared to handle the necessary adjustment.

II.1. The Fiscal Debate

It is hard if not impossible to argue against the notion that the fiscal deficit was the immediate cause of the crisis. Simply put, if Argentina’s public sector did not have big external borrowing requirements during the period 1999-2001, there would have been no crisis.

A close inspection of the numbers would reveal, however, that the excess expenditures were concentrated in the provincial level, and that at the federal level there was no feast during the 90s. There were, however, clear problems in the efficiency of spending at all government levels, a matter that is discussed in Section IV.B. In addition, it is true that in countries in which subnational governments have autonomy to borrow, it is unlikely that central governments can commit not to bail them out in times of trouble.

Table 1.B presents some key fiscal indicators. In favor of the argument that fiscal accounts were under control in the federal government, note that:

1. After recording surpluses in 1992 and 1993, federal fiscal deficits were very low as percentage of GDP throughout the period (lines 4.3 and 4.4.).
2. The public debt was among the lowest in the Emerging Markets (see line 4.7 and Ades and Buscaglia, 1999). Moreover, active debt management extended the average maturity of the debt, which was among the highest in Emerging Markets, reducing liquidity risk.[4]
3. Non-entitlement expenditures (wages and goods and services) rose from 1990 to 1994 due to an increase of wages from very low levels, remained almost flat from 1995 to 1999, and later decreased (see lines 4.2.1 and 4.2.2).
4. The transformation of the social security from a pay–as–you-go system to a fully funded one made the government to loose approximately 1.4 percent of GDP in revenues each year (line 4.8), more than the average fiscal deficit during the 11 years of Convertibility. Note however that this reform was almost eliminating the off-balance sheet debt of the social security system (Rofman et al., 1997).
5. Even considering the increase in entitlement expenditures, the primary expenditures of the federal government decreased from 15.2 percent of GDP in 1991 to 12.4 percent of GDP in 2000.

[4] At the price of an increase in the average cost, as the yield curves of Emerging Markets Countries (EMC) were typically very steep throughout the 90's. See Cruces et al., 2002.

Table 1.A. Argentina: Convertibility´s Report Card

		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 e
1. Real Sector														
1.1.	GDP (in U$S million, period average)		177.000	210.900	236.505	257.440	258.032	272.150	292.859	298.948	283.523	284.204	268.638	94.866
1.2.	Real GDP growth		10,5%	10,3%	6,3%	5,8%	-2,8%	5,5%	8,1%	3,9%	-3,4%	-0,8%	-4,5%	-10,9
1.3	Investment (as % of GDP)		14,2%	17,8%	19,7%	20,0%	18,5%	19,6%	20,9%	21,0%	17,9%	17,5%	15,7%	11,2
1.4	Unemployment rate (in %, May)	8,6	6,9	6,9	9,9	10,8	18,4	17,1	16,1	13,2	14,5	15,4	16,4	17,8
2. Prices														
2.1.	Inflation (CPI, eop)	1344,0%	84,1%	17,5%	7,4%	3,9%	1,6%	0,1%	0,3%	0,7%	-1,8%	-0,7%	-1,5%	41,0%
2.2.	Terms of trade index (1993=100)	89,8	92,5	97,2	100,0	101,5	101,8	109,8	108,4	102,5	96,4	106,1	105,6	103,7
2.3.	Nominal exchange rate (HC/US$, of. rate, eop)	0,56	1,00	0,99	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	1,00	3,60
2.4.	Real exchange rate with USA (period average,ene 1993=1)	1,92	1,13	1,04	0,97	0,96	0,95	0,98	1,00	1,00	1,04	1,08	1,13	2,8
2.5.	Multilateral RER (period avg., jan-93=1)	1,35	0,99	1,01	0,99	1,05	1,11	1,06	1,05	1,04	0,96	0,97	0,93	1,51
2.6.	Misalignment vs. GSDEEMER	7%	40%	23%	17%	9%	7%	6%	4,1%	11,9%	23,4%	26,5%	25,2%	
3. External Sector (In million of US Dollars)														
3.1.	Current Account (% of GDP)		-0,4%	-2,7%	-3,5%	-4,4%	-2,2%	-2,6%	-4,2%	-4,9%	-4,2%	-3,1%	-1,6%	9,4%
3.2	Exports	12.249	11.999	12.399	13.118	15.839	20.963	23.766	26.430	26.441	23.333	26.410	26.672	25.353
3.2.1.	*% of GDP*		*6,8%*	*5,9%*	*5,5%*	*6,2%*	*8,1%*	*8,7%*	*9,0%*	*8,8%*	*8,2%*	*9,3%*	*9,9%*	*26,7%*
3.2.2.	of which to Brazil	1.423	1.486	1.671	2.814	3.656	5.511	6.620	8.107	7.924	5.690	6.991	6.311	4.754
3.2.3.	of which Primary	3.339	3.301	3.500	3.279	3.740	4.816	5.798	5.704	6.603	5.189	5.428	6.061	5302
3.3.	Imports	4.060	8.183	13.795	15.633	20.162	18.804	22.283	28.554	29.531	24.103	23.852	19.148	8.988
3.3.1.	*% Growth*		*101,6%*	*68,6%*	*13,3%*	*29,0%*	*-6,7%*	*18,5%*	*28,1%*	*3,4%*	*-18,4%*	*-1,0%*	*-19,7%*	*-53,1%*
3.3.2.	*% of GDP*		*4,6%*	*6,5%*	*6,6%*	*7,8%*	*7,3%*	*8,2%*	*9,7%*	*9,9%*	*8,5%*	*8,4%*	*7,1%*	*9,5%*
3.3.3.	of which Consumer goods	330	1.514	3.205	3.527	3.907	3.174	3.583	4.536	4.834	4.501	4.609	3.995	1.137
3.4	Trade Balance (% of GDP)		*2,2%*	*-0,7%*	*-1,1%*	*-1,7%*	*0,8%*	*0,5%*	*-0,7%*	*-1,0%*	*-0,3%*	*0,9%*	*2,8%*	*17,8%*
3.5.	Real Services (net)	n/a	-2.720	-2.554	-3.323	-3.786	-3.818	-3.582	-4.449	-4.516	-4.156	-4.288	-4.021	-1.503
3.6	Financial Services (net)	n/a	-2.634	-2.472	-2.995	-3.694	-4.662	-5.496	-6.215	-7.409	-7.433	-7.370	-8.094	-6823
3.7.	Capital and Financial Account	n/a	n/a	9.745	12.892	13.083	7.670	12.094	15.449	18.570	13.409	8.792	-3.789	-9363
3.8.	Int. Reserves (U$S, CB+DB, eop)	6.010	8.974	12.496	17.223	17.930	19.888	22.881	31.270	32.012	33.589	33.808	19.744	10.022
3.9.	External Debt (% of GDP)		34,7%	29,9%	30,6%	33,4%	38,4%	40,6%	42,7%	47,5%	51,2%	51,5%	52,2%	139,7%

Sources: Ministry of Economics, INDEC, Central Bank of Argentina, J.P. Morgan-Chase, Goldman Sachs and own estimations

Table 1.B. Argentina: Convertibility´s Report Card

		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 e
4. Fiscal Sector (all values in million of US Dollars)														
4.1.	National Tax Collection	n/a	25.156	36.528	41.745	44.563	42.187	43.112	48.440	50.056	47.643	49.102	45.403	15.296
4.2.	Current Expenditures		29.671	35.788	44.245	47.476	48.438	49.368	55.858	57.031	60.047	60.459	56.785	17.409
4.2.1	Wages	n/a	4.954	5.652	7.627	7.642	7.250	7.213	7.554	6.844	7.354	6.899	6.542	2.054
4.2.2	Goods and Services	n/a	1.686	2.446	4.084	2.445	2.482	2.473	2.660	2.477	2.878	2.315	2.197	662
4.2.3	Current Transfers to Provinces	n/a	9.199	12.620	11.809	12.535	12.429	13.336	15.176	15.833	15.640	15.823	13.917	4.475
4.2.4	Social Securities Benefits	n/a	9.233	12.653	12.513	15.241	15.628	15.444	17.199	17.481	17.436	17.431	16.617	5.010
4.2.5	Interest	n/a	1.890	2.914	3.150	4.087	4.610	5.747	6.660	8.224	9.656	9.630	10.448	2.064
4.3.	Primary Surplus (cash basis)	n/a	3.120	4.924	5.645	2.865	2.725	-654	1.471	2.589	3.455	2.864	1.131	685
4.4.	Overall Balance (% of GDP)		-0,4%	1,4%	1,2%	-0,1%	-0,5%	-1,9%	-1,5%	-1,4%	-1,7%	-2,4%	-3,0%	-1,5%
4.5.	Privatization revenues (debt exchange excluded)	n/a	2.194	1.787	523	733	1.171	375	306	96	2.579	144	60	4
4.6.	Overall Balance, Provinces (cash basis)	n/a	-1.338	-392	-2.111	-2.653	-3.579	-1.778	-1.172	-1.867	-4.124	-3.313	-6.339	-494
4.7.	Total Public Debt (billions)					80	87	97	101	112	122	128	144	130*
	% of GDP					*31,2%*	*33,8%*	*35,7%*	*34,5%*	*37,6%*	*43,0%*	*45,0%*	*53,8%*	*138,3%*
4.7.1.	External National Public Debt (billions)	n/a	53	51	54	61	67	74	73	81	82	81	83	85
4.7.2.	Domestic National Public Debt (billions)	n/a	n/a	n/a	n/a	19	20	24	28	31	39	47	61	45
4.8.	Inflows to Pension Funds (billions)					0,8	2,3	3,8	3,7	4,1	4,4	4,3	4,0	
5. Financial Indicators (In US$ millions)														
5.1.	FDI (stock)	n/a	11.524	16.302,8	18.520,3	22.428,1	27.991,0	33.557,0	42.012,7	47.797,1	61.926	72.935	75.989	
5.2.	Peso Deposits (eop)	n/a	8.064	13.665	19.770	20.878	19.699	22.622	29.413	32.130	30.352	34.167	20.283	18.178
5.3.	Dollar Deposits (eop)	n/a	6.560	10.742	18.093	23.046	23.577	27.179	35.378	40.196	45.003	53.586	47.199	867
5.4.	Peso Loans (eop)	n/a	18.573	22.302	26.386	27.972	20.335	25.051	27.490	29.258	28.243	26.008	15.938	17.693
5.5.	Dollar Loans (eop)	n/a	12.367	20.333	25.005	31.531	32.085	41.291	48.252	57.989	59.380	56.060	59.622	3.140
5.6.	Pension fund holdings (eop)						2.497	5.326	8.827	11.526	16.787	20.381	20.786	
5.7.	Interest Rate (U$S, eop, in %)	n/a	n/a	n/a	5,8	6,1	7,4	6,0	6,6	6,7	7,1	9,2	8,6	2,1
5.8.	Interest Rate ($, eop, in %)	n/a	19,8	25,3	8,7	9,6	9,2	7,6	8,4	8,1	10,3	12,3	7,4	21,6
5.9.	EMBI Argentina (bp, eop)	n/a	563	1.026	370	1.141	875	494	461	696	544	766	4.404	6.358
5.10.	EMBI Global (bp, eop)	1.111	631	831	396	1.039	1.044	537	510	1.155	844	864	799	759
5.11.	Merval Index (eop)	317	798	427	582	460	519	649	688	430	550	417	295	155

* Until september

Sources: Ministry of Economics, INDEC, Central Bank of Argentina, J.P. Morgan-Chase, Goldman Sachs and own estimations

There were, however, obvious problems at the federal level:

1. There was a sharp increase in interest payments (line 4.2.5), due to the deficit recorded in the period and the transition from a low-coupon debt that was issued after the restructuring of domestic (mainly pensioners that were not paid their defined benefits as promised during the 80's) and external liabilities into market issued debt. This effect could and should have been anticipated, and primary surpluses should have been higher.

2. The numbers presented in Table 1.B are on a cash basis. There were, however, substantial off-balance sheet payments during the period (Mussa, 2002, pp. 21), which basically originated in the lack of compliance by the state of multiple laws during the 80's and 90's.

3. After the recession in 1995 the economy began growing fast again, but the fiscal policy was procyclical.[5] In particular, no serious effort was made to reduce the transfers to provinces (see line 4.2.3), which were automatically linked to the tax base. If they had remained at, say, the level of 1994, the federal fiscal deficit would have been reduced by US$ 3 billion annually during 1998 and 1999.

There was indeed a spending spree in the provinces during the 90's.[6] Although the transfers they received from the federal government increased from US$ 15.4 billion in 1996 to US$ 17.4 billion in 1998, their deficit went from US$ 1.8 billion to US$ 4.1 billion in the same period (line 4.6). Most importantly, the degree of vertical fiscal imbalance grew in the period (see Stein, 1999 on the problems that this brings). Half the

[5] This is indeed the case in most Latin American countries (see Braun, 2001). Talvi and Vegh (2000), for instance, claim that in countries with highly variable tax rates and political pressures for overspending it might indeed be optimal to run procyclical fiscal policies. The argument is that if taxes are not reduced in economic booms, spending ministers will waste the extra resources. This line of reasoning certainly applied for the period 1991 to 1995, in which as many as 20 distortive taxes were eliminated or reduced, but not the period starting in 1995, when taxes were increased.

[6] There behavior was not homogeneous, as there were a lot of provinces that behaved in a responsible way. Note that a small part of the increase in provincial spending is due to the transfer of education services to the provinces.

provinces depended on transfers from the federal government for more than 65 percent of their total revenues (Llach, 2002).

The picture that emerges from is that of a national public sector that, beyond efficiency considerations (see Section IV.B) was not a spendthrift, although it should certainly have increased its primary surplus once the economy recuperated since 1996. Given this situation, the question is: What was the magnitude of the fiscal adjustment needed to make the public debt dynamics sustainable? To analyze this I use equation (1), which describes the dynamics of the public debt as percentage of GDP (see Buscaglia, 2003, for further details):

$$b_t = \frac{(1+f_t)(1+CR_t)}{(1+g_t)} \left\{ b_{t-1}^d \frac{(1+\pi_t^e)}{(1+\pi_t)} + b_{t-1}^f (1+e_t) \right\} + d_t \tag{1}$$

where b_t is the public debt as percentage of GDP (the superscripts d and f denote the debt issued in domestic and in foreign currency, respectively), the real risk-free interest rate is equal to f_t , CR_t is the country risk -the spread investors demand over otherwise similar U.S. Treasuries to account for the likelihood of default-, and g is the real GDP growth rate. The percent change in prices is π, while π^e is its expected value, e_t stands for the real exchange rate depreciation in period t (I assume inflation in the U.S. is equal to zero), and d_t is the primary deficit at period t (as percentage of GDP).

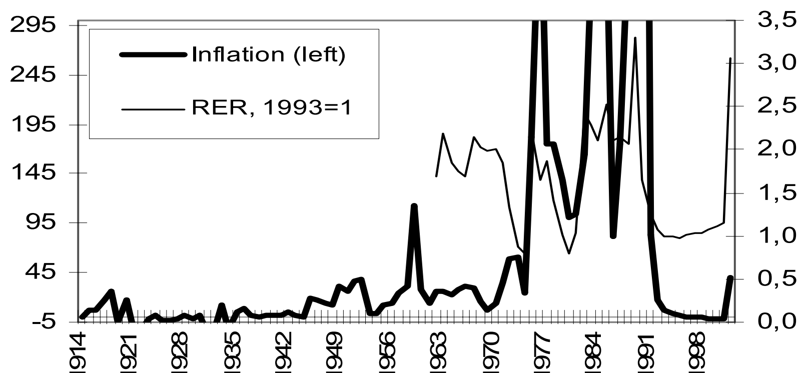
For a country with an initial debt to GDP of 43 percent (only 3.6 percent in domestic currency) as Argentina had at the end of 1999, long-run real GDP growth of 3 percent, an interest rate of approximately 7.5 percent (that is $(1+f_t)*(1+CR_t)-1=0.075$), and an expected depreciation of the real exchange rate of 2 percent a year, then a primary surplus of 2.6 percent of GDP would have been sufficient to keep the debt constant in terms of GDP. At that time, the primary surplus was equal to 1.2 percent of GDP, so an initial adjustment of 1.4 percent of GDP was needed. There was ample room to achieve this target by slashing inefficient expenditures, but the main parties and most state governors opposed this.

II.2. The Exchange Rate Debate

This debate has many aspects. The first one corresponds to the degree of overvaluation of the exchange rate during the Convertibility, and the second refers to the convenience of adopting fixed exchange rates.

From the beginning of the Convertibility there were concerns that the exchange rate was overvalued. In fact, the average real exchange rate from 1991 to 2001 was 1.1 (setting 1993=1), half its value during the previous decade, and 30 percent lower than its average value since 1972 (see Figure 1 and Table 1.A, line 2.4).

Figure 1. Inflation and the Real Exchange Rate



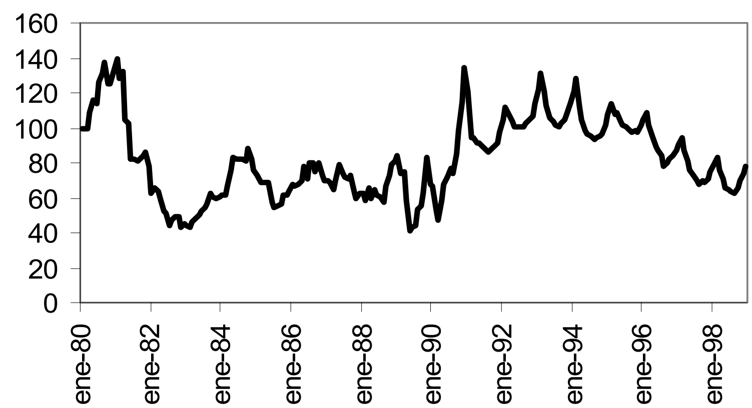
Source: 983:
344%, 1984: 626%, 1985: 385%, 1988: 387%, 1989: 4923%, 1990: 1344%

These calculations, however, ignored the significant increase in productivity that took place during the first years of the 90's. For instance, according to models that take into account productivity changes like the one calculated by Goldman Sachs (see Ades, 1997), the real exchange rate was roughly in equilibrium from 1994 to 1997 (Table 1.A, line 2.6).[7] Underlying real exchange rate discussions lays the issue of competitiveness in the tradable sector of the economy (see Buscaglia and Gasha, 2000). If costs increase for producers of nontradables, they are able to translate them to consumers, but producers

[7] In addition, as Galiani et al. (2002) point out, note that the Peso did not come into attack until very late in the game, and the reserves of the Central Bank increased every year from 1990 to 1999, from US$ 6 billion to US$ 33.6 billion in that period.

that either export or compete with imports cannot do this. If firms in the tradable sector are making profits, one can be sure that they are not facing a competitiveness problem. To measure earnings in a certain sector can prove very difficult, particularly in emerging economies, so we have to deal with some imperfect measure of competitiveness. A very useful proxy is given by unit labor costs expressed in U.S. dollars, which accounts for changes in productivity. Labor costs constitute more than 60 % of total costs in most industries, and their use as a competitiveness measure is widespread. In Figure 2 we can see that while Argentine competitiveness measured in this way was low at the beginning of the Convertibility compared to historical standards, it increased in the early 90´s along with productivity and the reduction in labor taxes.

Figure 2. Unit Labor Costs in U.S. Dollars



Source: Own calculations based on FIEL and Ministry of Economics

Certainly what reduced the competitiveness of firms was not the exchange rate policy, but all the red-tape restrictions (linked to the anti-reform political base) that could not be dismantled and that, for example, resulted in low scores in the competitiveness rankings compiled by the WEF (see Table 2).

Table 2. Competitiveness Indicators

Countries	**Competitiveness Ranking (WEF) (1)**					**Corruption Perceptions Index (TI) (2)**					
Year (# of Countries) >>	1997 (53)	1998 (53)	1999 (59)	2000 (59)	2001 (75)	1997 (52)	1998 (85)	1999 (99)	2000 (90)	2001 (91)	2002 (102)
United States	3	3	2	1	2	16	17	18	14	16	16
Singapure	1	1	1	2	4	9	7	7	6	4	5
Canada	4	5	5	7	3	5	6	5	5	7	7
United Kingdom	7	4	8	9	12	14	11	13	10	13	10
Switzerland	6	8	6	10	15	11	10	9	11	12	12
Taiwan	8	6	11	11	7	31	29	28	28	27	29
Australia	17	14	12	12	5	8	11	12	13	11	11
Sweden	22	23	19	13	9	3	3	3	3	6	5
Germany	25	24	25	15	17	13	15	14	17	20	18
Israel	24	29	28	19	24	15	19	20	22	16	18
Japan	14	12	14	21	21	21	25	25	23	21	20
France	23	22	23	22	20	20	21	22	21	23	25
Portugal	30	26	27	23	25	19	22	21	23	25	25
Malaysia	9	17	16	25	30	32	29	32	36	36	33
Hungary	46	43	38	26	28	28	33	31	32	31	33
Spain	26	25	26	27	22	24	23	22	20	22	20
Chile	13	18	21	28	27	23	20	19	18	18	17
Korea	21	19	22	29	23	34	43	50	48	42	40
Italy	39	41	35	30	26	30	39	38	39	29	31
Thailand	18	21	30	31	33	39	61	68	60	61	64
Turkey	36	40	44	40	54	38	54	54	50	54	64
China	29	28	32	41	39	41	52	58	63	57	59
Mexico	33	32	31	43	42	47	55	58	59	51	57
Indonesia	15	31	37	44	64	46	80	96	85	88	96
Argentina	**37**	**36**	**42**	**45**	**49**	**42**	**61**	**71**	**52**	**57**	**70**
Brazil	48	42	51	46	44	36	46	45	49	46	45
Peru	40	37	36	48	55	n/a	41	40	41	44	45
Colombia	41	47	54	52	65	50	79	72	60	50	57
Russia	53	52	59	55	63	49	76	82	82	79	71
Ecuador	n/a	n/a	53	59	68	n/a	77	82	74	79	89

(1) This index has qualitative and quantitative components. The sources for the quantitative components are the IMF and the World Bank .

(2) Polls are made to executives and country experts.

It is true that once there is an overvaluation in place, for whatever reason, a super-fixed exchange rate makes the adjustment more difficult (Edwards, 2002). That brings us to the monetary policy/exchange rate policy debate.

During the 90's, there seemed to be an emerging consensus in the debate on the optimal monetary policies for emerging markets that corner solutions, either floating exchange rates or super-fixed ones, were optimal (see Edwards, 2002). In academic circles, floating exchange rates won "hands down" (in words of Calvo, 1999; see also Rogoff, 1998), and the convenience of super-fixed exchange was predicated on the basis of, well, the behavior of the Argentine economy during the 90's. It is not surprising then that the fall of Argentina will tilt the debate in favor of floating exchange rates (Edwards, 2002).

At the same time, however, there is evidence of "fear of floating" among those who claim that float (Calvo and Reinhart, 2002). Several problems make most EMC to restrict the variability of exchange rates (see Hernandez and Montiel, 2001), and Argentina had and still has all of them, namely: (1) a high pass-through coefficient, which makes the volatility of the exchange rate undesirable; (2) the relative backwardness of their domestic capital markets, which makes foreign capital important for economic growth (i.e., which make domestic residents net debtors), and limits the ability of the government to borrow domestically (the "perpetrated sin" –see Buscaglia, 2003-). This forces EMC to borrow abroad (in foreign currencies, due to the so-called "original sin"), and the resulting liability dollarization reduces the effectiveness of monetary policy (Hausmann, 2001); (3) interest rates in developed countries are the key determinants of capital flows to EMC. The magnitude of these flows is so big compared to most EMC´s GDPs that it is useless to try to "lean against the wind" using monetary policy; (4) the degree to which the U.S. dollar is still the unit of account in many of these countries; (5) lack of credibility; (6) the underdevelopment of financial markets to hedge exchange rate risks; and (7) the need in many countries of the inflation tax to finance the government (i.e., the existence of fiscal dominance).

The right question then was and still is not whether Argentina *should* have floated in 1997 or later as some argue (e.g., Mussa, 2002), but whether Argentina *could* have floated. Without the proper changes in the institutional and fiscal environment (fiscal dominance and perpetrated sin), this still seems to be a difficult task.

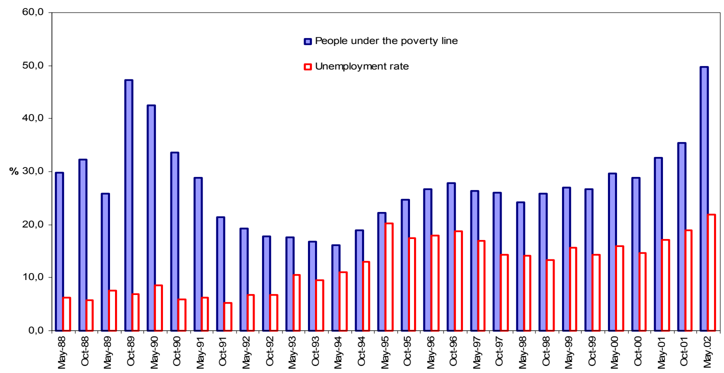
III. The Origins of Convertibility

In this section I want to argue that the Convertibility was not thought simply as a monetary or stabilization policy, but was a way to stop a long-standing distributional conflict and an interlocked part of a supply-side policy.

In the five decades before the 90´s, the country experienced a secular and convulsive decline, that was interrupted every now and then by short-lived stabilization episodes, but that accelerated from the 70´s on. In some sense, the experience of the country was the perfect example for the dynamics of deterioration depicted by Krueger (1993). During this period the economy was characterized by:

- Widespread protectionism, following the import substitution (see Edwards, 1995). Exports increased at approximately half the rate of growth of world exports in the postwar era (Llach, 1997).
- Massive intervention of the state in the economy (along with a deterioration of the civil service).
- High and variable inflation, basically due to the incapacity to restrict expenditures and establish an efficient tax system, and wild real exchange rate fluctuations (Figure 1), which distorted even more the allocation of resources.
- Decline in productivity, which *fell* from 1947 to 1990 at an annual average rate of 0.1 percent (see Llach, 1997).
- Increase in poverty (Figure 3). In 1974 only 5.1 percent of the population was below the poverty line, reaching 42.1 percent in 1989 (Llach, 1997).

Figure 3. Poverty and Unemployment in the Great Buenos Aires



Source: Indec

After decades in which neither civil nor military governments were able to change this status quo, the hyperinflation at the end of the 80´s opened the scope of reform (see Sturzenegger and Tommasi, 1998, and Tommasi, 2002 for a discussion on why reforms sometimes take so long to be launched, and the role of big crises in this process).

The Convertibility was introduced in 1991 as one key aspect of a comprehensive set of reforms that aimed to change drastically the economic environment. A currency board was adopted because dollarization was extended after hyperinflation and there was no credibility to run an independent monetary policy (Llach, 1997). But, even more importantly, it was viewed as a way to end the distributional conflicts that had led to high inflation in the past (see Heymann and Leijfonhufvud, 1995), and instead direct all political efforts to recreate the basic institutions of a market economy, which were destroyed by then, and to modernize the productive capacity of the economy.

From the very beginning the fixed exchange rate was interlocked with a number of reforms. The lack of discipline in the past and hence the lack of credibility mandated a type of “burning the ships” approach, by which investors would be reassured that the authorities would foster a supply-side revolution that would eliminate most long standing inefficiencies in the economy.[8]

[8] Rodrick (1994) argues that policymakers sometimes are required to introduce more reforms than necessary in a full credibility world in order to build credibility about their intentions.

IV. Needed: More than a "Handful of Heroes"

President Menem's government adopted an impressive set of reforms, which included among others deregulation, privatizations, opening of the economy, tax cuts and expenditure reductions. Table 3 shows the Reform Indices compiled by Lora (2001). These indices try to measure the progress of reforms in areas such as trade and financial liberalization, tax reform, privatizations and labor market reforms in an index that goes from zero (no reform) to one. That is, they concentrate on the so-called first-generation reforms (see Williamson and Haggard, 1994). We can observe that Argentina started its reforms later than the rest of the region, but that already at the beginning of the 90s it was ahead of its peers. The reforms were especially deep in the trade and financial areas, and privatizations were fast, but there was slow progress in the tax area, and even a reversal in labor market regulations (more on this below).

Table 3. Argentina: Reform Indices

	1985	1989	1990	1991	1992	1993	1994	1998	1999
Structutural Reforms Index	**0,338**	**0,366**	**0,468**	**0,551**	**0,574**	**0,602**	**0,598**	**0,604**	**0,616**
Trade Index	0,669	0,487	0,787	0,839	0,857	0,893	0,871	0,853	0,850
Financial Index	0,187	0,531	0,586	0,929	0,949	0,947	0,958	0,986	0,986
Tax Index	0,242	0,272	0,369	0,343	0,305	0,338	0,341	0,304	0,309
Privatization Index	0,000	0,000	0,061	0,072	0,190	0,277	0,268	0,330	0,394
Labor Index	0,591	0,538	0,538	0,571	0,571	0,553	0,553	0,547	0,541
Structutural Reforms Index (Latin American Regional Average)	**0,341**	**0,399**	**0,436**	**0,455**	**0,484**	**0,503**	**0,522**	**0,573**	**0,583**

Source: Lora, 2001. The index goes from 0 (no reform) to 1.

The results of these reforms were astounding: stability, high investment and growth, and reduction of poverty (Llach, 1997). The average rate of growth of GDP from 1991 to 1994 was 8.2 percent, while annual inflation was reduced from 84.1 percent to 3.4 percent in the same period (Table 1.A, lines 1.2 and 2.1). Contradicting the fears of many that deemed the exchange rate overvalued, exports increased by 32 percent (Table 1.A, line 3.2), and while unemployment was increasing due to massive layoffs in the public sector and in the newly privatized public utilities, employment was also increasing. The number of people living below the poverty line in the Buenos Aires area, for instance, almost halved (Figure 3). The increase in portfolio flows worried many analysts, but the country seemed to be using the external financing for a healthy reconstruction of its infrastructure (see Table 1.A, lines 1.3. and 5.1).[9] Before the establishment of the currency board, deposits were lower than 5 percent of GDP, but amidst stability they tripled in four years, and credit re-emerged (see Table 1.A, lines 5.2 to 5.5).

The Mexican crisis implied a big shock to the economy, and GDP fell 2.8 percent in 1995. The government, however, showed commitment and decision, and the economy started to recover in a few months. This allowed the Convertibility to be strengthened, and Menem was re-elected by a landslide.

IV.A. The Identity of Reformers

Rodrick (1993) argued "it is ironic that these reforms were instituted under a Peronist president, Carlos Menem, since Peronism has been virtually synonymous with populism and protectionism. Within a year, Argentine reforms had already gone further than those adopted over a period of decades in the outward-oriented East-Asian countries".

In this paper, I want to argue that precisely the identity of the reformers (and their successors) lies at the heart of the argentine crisis. In several Emerging Market Countries (EMC), reforms were initiated not by free-marketers but by unlikely characters such as

[9] Telephone lines, for instance, increased 44 % in this period. Most of the increase in imports was due to the increase in imports of capital goods, parts, and intermediate goods (Table 1.A), and investment and productivity were increasing fast.

former populists and leftists (Williamson and Haggard, 1994), and Argentina was no exception. This has been rationalized in several ways by the literature on the political economy of reform (Rodrik, 1993). According to Cukierman and Tommasi (1998), for instance, since voters are not fully informed about the way in which policies map into outcomes, the identity of those proposing a policy conveys valuable information to the population on the necessity to implement some reforms. The public, for instance, will be more receptive of a call for adjustment measures if they come from a populist than if they come from a conservative (with an analogous effect as the one Nixon going to China had on American foreign policy).

But neither the Peronist nor the Radical party (the main opposition party by then and the one that succeeded Menem in 1999) changed during the reform process, and most of their ranks remained convinced of the old protectionist and state-intervention policies. It is important to remark two aspects of Argentina´s politics: first, the main parties in Argentina spanned the whole political spectrum, including reformists and anti-reformists; secondly, not only Senators, but also Deputies are elected in provincial districts. The second feature induces parties to select a well-known figure for the first place in the list of candidates, and to “hide” the party bosses in lower places. While the reformists took the seat in the executive branch (Menem and later De la Rúa), that was not true in Congress in many provinces. The gridlock created in the governance of the political parties also prevented any renovation, and so – amazingly – those opposing reforms received the lion share of recognition among voters in the succeeding legislative elections.

Most importantly, the implicit alliance between the Peronists and the political center, which provided ideological support and the technocrats, avoided the emergence of a strong pro-business political party during the initial years of the Convertibility, capable of catalyzing the support that the success of the program achieved, and of pushing Argentina from a rent-seeking capitalism to a true enterprise society. In Table 4 I present the partisan composition of both chambers of Congress throughout this period. It can be seen that the Peronist party remained in control of both chambers in Congress and of most provincial governments throughout the period.

Table 4. Partisan Composition during Menem´s Administration

Panel A. Partisan Composition of the Chamber of Deputies (in %),1987-1999

	1987-89	1989-91	1991-93	1993-95	1995-97	1997-99
Peronist Party (PJ)	73	50	50	50	52	47
Unión Cívica Radical (UCR)	46	37	33	33	27	26
Center-Right Provincial Parties	6	7	9	9	8	11
Other	5	6	5	8	12	16

Panel B. Partisan Composition of the Senate (in %), 1986-1998

	1986-89	1989-92	1992-95	1995-98
Peronist Party (PJ)	47	54	62	56
Unión Cívica Radical (UCR)	39	30	23	29
Center-Right Provincial Parties	15	15	15	14
Frepaso				1

Panel C. Partisan Composition of Provincial Governorships (in %), 1987-1999

	1987-91	1991-95	1995-99
Peronist Party (PJ)	77	61	61
Unión Cívica Radical (UCR)	9	17	22
Center-Right Provincial Parties	14	22	17
Other			

Source: Bambaci et al., 2002

Even though Argentina had its "handful of heroes" (in words of Harberger, 1993), the lack of a pro-reform coalition imposed a lot of restrictions on the reform process (see Bambaci et al., 2002), and later tried to override these reforms and go back to the old days.

IV.B. The Limits of Reforms

The constituency of this pro-reform coalition allowed the implementation of many of the so-called first generation reforms, but imposed many restrictions and limits on the reform agenda (see Bambaci et al., 2002, and Lora, 2001). First of all, they maintained several "illiberal enclaves", such as the labor market regulations, patronizing social policies and the federal fiscal system.[10] Second, many of these reforms were implemented with corruption and inefficiency (see Tommasi, 2002), which reduced the attractiveness of reforms in the eyes of the public. Finally, they allowed changes in lower and some intermediate level rules, but deeper politico-institutional rules and practices were left untouched (see Tommasi, 2002).

That is, old habits die hard, and by 1996 the limits of reform were starting to emerge. The remaining reforms touched the limits of ideology and the nerve of the status quo, and were left beyond the reach of the reformist technocrats. Some reforms implied substantial changes in the way the state at its different levels operated to provide its services, which were highly inefficient on various accounts. Although the level of public expenditures is a matter of debate, corruption and inefficiencies were hampering its efficiency without doubt, and this basically reflected the clientelistic way in which the main parties used to do politics (more on this below). Also needed were further trade liberalization, fiscal discipline in the provinces, the abolition of distortionary taxes and red-tape restrictions that hindered the emergence of a new breed of entrepreneurs, to name a few.

On the contrary, from the mid 90´s the re-election objective dominated the agenda, and reforms came to a halt. As fiscal deficits increased and the main political parties and

[10] The main point of Bambaci et al. (2002) is that the fundamental reforms executed were politically viable thanks to the maintenance of these "illiberal enclaves".

lobbies were reluctant to support "efficient" expenditure cuts, reformist technocrats started imposing increasingly inefficient new taxes and draconian cuts on public expenditures, with the approval of the IMF.

These dynamics should not be underestimated. An insight from the literature on the political-economy of reform is that people have limited information about the way in which alternative policies map into economic outcomes (see Harberger, 1993). One can easily assume that in Latin America "...there have been roughly two models of the world: one in which extensive state intervention is the best policy, and one in which focused (and minimal) state intervention is the best policy" (Sturzenegger and Tommasi, 1998). People change their perceptions of the world very sluggishly: they observe economic outcomes, but it is not easy for them to discern between bad policies and bad luck. The mounting evidence of state corruption and inefficiency, coupled with rising unemployment (see Table 1.A, line 1.4 and Table 2) and repeated adjustment policies has surely shaken the support for reform policies, the IMF, and the reformist technocrats.

Increasingly, those politicians from the main parties that countered the reforms started to attack the "model" (of minimal state intervention), proposing to revert back to the old days. In addition, and as it is usually the case when the beneficial effects of a policy are widespread and the harmful ones more concentrated, pressure groups that countered reforms (unions, the old-economy industrial sector, some provinces, etc.) were more organized and influential than those representing the beneficiaries of the new environment.

IV.C. The Sacred Cows of Populism

Although budget problems after the hyperinflation and the new consensus that was emerging at the beginning of the 90's (Edwards, 1995) allowed the sacrifice of many former "sacred cows" of populism, namely the privatization of state companies, several key areas were left outside the scope of reform. According to Tommasi (2002) the political instrumentation of the reforms could be described as a 'vote-buying' strategy, in which pivotal players such as labor unions, several provinces, and some business groups received substantial benefits and exemptions through the reform process (see also Bambaci et al., 2002).

The first area left out was the tax sharing agreement between the Federal Government and the provinces, whose importance in the crisis I have analyzed in Section II. The reform process was also much slower in the provinces in general, even with regards to first-generation reforms.

The second area included the distortions of the labor market. These can be classified in three categories (Edwards, 1995): (a) high costs of dismissal, (b) high payroll taxes,[11] and (c) the nature of labor-management relations. This combination resulted in an increase in unemployment and in the black-market economy. The implications of this cannot be underestimated. Almost half the workers in Argentina were in the informal economy during the 90´s, thus staying far from health insurance, institutionalized credit, and so forth. The consequences do not stop there. The low compliance with payroll taxes undermined the transition to a fully-funded social security system and lowered the savings ratio. These distortions, along with a convoluted tax system, induced many small and medium firms to stay in the black economy, and hence out of institutionalized credit markets.

Perhaps the social policy area was the one that resisted more the impetus of reform. It was kept under the control of the populist-prone party bosses, which used its funds for electoral and personal purposes. While problems here were (are) generalized, some examples may be illustrative:

- At the PAMI, the federal Medicare-type program for the retired under the old pay-as-you go system, 22.5 percent of its beneficiaries had less than 14 years of age, and multi-millionaire frauds were discovered every now and then. The same applied to the union-run health care organizations.

[11] Although payroll taxes started to be eliminated during these years, they remained high. Moreover, in some cases workers pay for services of very bad quality, such as mandatory union-provided health insurance.

- At the provincial level, the situation was no better. In the province of Buenos Aires, for instance, social policy was based on “manzaneras”, women that alerted the government of the needs in their respective blocks. The accountability of these programs was very low and suspicions of their political use were widespread.

Finally, there was increasingly mounting evidence of the self-serving attitude of politicians at all levels (federal, provincial and municipal). The perception of corruption was high and increasing fast over time, as Table 2 shows. Beyond the un-measurable but extended suspicions of bribes in the allocation of contracts, there was widespread evidence about the high cost of the elective bodies and political appointees throughout the country. Grupo Sophia, an independent think tank, estimated that these costs amounted to US$ 5.4 billion annually (Grupo Sophia, 2001), including US$ 3.5 billion at the provincial level. Formosa, for instance, a province of only 504.000 inhabitants and a per-capita GDP several times lower the national mean, had a Congress with a budget of US$ 57 million in the year 2000 (around 5% of its GDP).

What appears from this picture is a growing dissatisfaction with a political system that behaved in a self-serving manner, and that was at the same time increasing taxes or asking for budgetary restrictions in key areas as education. Not surprisingly, tax evasion increased throughout the period. In addition, the mismanagement of the social budget and the deceleration of growth in 1998 were starting to have an impact on the poor (Figure 3).

IV.D. A Rent-Seeking Capitalism

Although privatization and deregulation had transformed the corporate landscape in Argentina, much needed to be done to transform it from a rent-seeking capitalism to a full market economy.

The growing number of exceptions in the tax code and in tariff lines (see Section IV.E) showed that there was ample room for lobbying. In addition, much of the investment growth was in areas in which the government had granted monopoly or near-monopoly powers, such as telephones, airports, and highways.[12] Although some privatizations were treated as models in other countries, some were highly criticized (as the national airline), and the anti-reform camp extended its criticism to all privatizations.

Moreover, red-tape restrictions to investment remained high. To initiate a new venture, for instance, 71 days and 12 steps were required on average in Argentina, compared to only 7 days and four steps in the U.S. Not surprisingly, the small business sector remained sclerotic in the 90's. On top of the tax problems that pushed many small firms into the black economy, the upgrade in the regulation of the domestic capital markets was not enough to improve their access to new equity capital.[13]

IV.E. Bad Luck

As in any tragedy, bad luck also had a role in the Argentine crisis. Bad luck came in three different forms: external shocks, the New Washington Consensus, and President De la Rúa´s lack of leadership. However, paraphrasing the CEO of a big U.S. corporation that once said: "I work very hard to be lucky", one could easily argue that in some cases Argentina "worked hard to get unlucky".

- *External Shocks*

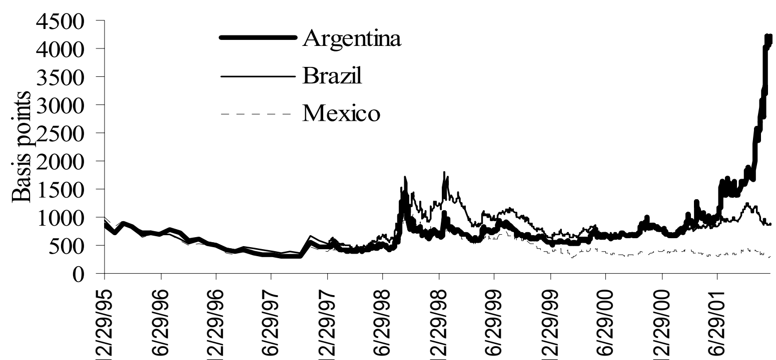
Consider the external shocks first. They were very big and protracted: after a few years of tranquility following the Mexican currency crisis of 1994, starting in 1997 one big currency crisis after the other hit the emerging debt markets each year (East Asia, Russia and Brazil). Figure 4 shows that each of these subsequent shocks increased the spread on Argentina's sovereign debt, and although once each crisis was solved it reverted, the floor was higher every time. This implied that access to the markets got harder and the

[12] Bambaci et al.(2002) argue that the government fostered the participation of big local business groups in the privatization process to neutralize their reaction, as many of them were former state suppliers.

[13] FDI, on the contrary, increased from US$ 11.5 billion in 1991 to US$ 72.9 billion in 2000 (Table 1.B, line 5.1). This process of increased foreign ownership was also subject to the attack of the anti-reform camp.

cost of servicing the debt increased (see Table 1.B, line 4.2.5). The average country spread in 1999 was 710 basis points, 356 basis points higher than the pre-Asian spreads. Given that the federal public sector borrowing requirements amounted to approximately US$ 15 billion, this implied an extra outlay of US$ 550 million per year.[14] But Argentina got itself into trouble, in part due to the high public sector borrowing requirements (see Section II), and in part due to the lack of development of the domestic capital markets. Note in Table 1.B (lines 4.7.1 and 4.7.2) that since 1998 most if not all the new sovereign debt was demanded by domestic individuals and institutions, namely by the newly created pension funds (AFJP) and mutual funds (see Ades and Buscaglia, 1999, for a detailed analysis, and the evolution of the pension fund's assets in Table 1.B). But given the lack of credibility, all these bonds were denominated in hard currencies, and issued abroad (even though locals demanded them).[15] This added a lot of confusion to the debate, as the anti-reform camp called all the new debt "external debt", and supported the sovereign default as if it would have no impact on the domestic resident's portfolios.

Figure 4. J.P. Morgan's EMBI



Source : Ministry of Economics

[14] Not all the increase in spreads is attributable to external reasons. During the 1999 electoral campaign, for example, Peronist presidential candidate Duhalde declared that he may not pay the debt if elected, and spreads increased by 150 basis points.

[15] Buscaglia (2003) has called this problem "perpetrated sin", as opposed to the so called "original sin", that refers to the inability of most small countries (such as Argentina and New Zealand) to issue debt in their own currencies in international markets. The "perpetrated sin" refers to the underdevelopment of local debt markets due to the lack of stability, institutions and credibility of some countries (such as Argentina, but no New Zealand).

On top of this, the terms of trade decreased by 12 percent from 1996 to 1999 (Table 1.A, line 2.2). But by far the biggest blow to the psyche of the reform process was Brazil's devaluation at the beginning of 1999. It had an impact on three fronts: exports, location, as many industrial firms started to move to Brazil, and –most importantly- on the policymaking debate, as it provided "evidence" in favor of the devaluation.

But one can argue that Argentina got itself into trouble. The Mercosur had an appeal to the main political parties because it was seen as an alternative to the Free Trade Area of the Americas proposed by the U.S.,[16] and to the industrial lobby since it allowed for multiple exceptions. Mercosur´s original idea of "open regionalism" soon degenerated, and there was evidence of ample trade diversion within the arrangement (see Yeats, 1998). By 1998 Argentina was sending almost 30% of its exports to Brazil –see Table 1.A, line 3.2.2. -. No macroeconomic convergence criteria were established, and hence Argentina subjected itself to a big and foreseeable shock coming from Brazil's fiscal imbalances. After the devaluation of the Real, exports to Brazil fell 29%, a shock that amounted to almost 1% of GDP, while the multilateral real exchange rate dropped by 18% (Table 1.A, line 2.5).

Ideological and vested-interest reasons impeded Argentina to open more to international markets, and hence increase and diversify its export base. Although progress in this front was impressive at first, by 1999 exports amounted to only 8.2 percent of GDP, still one of the lowest ratios in the world.

- De la Rúa´s Lack of Leadership

When President De la Rúa took office, there were several signs of strains on the system, and many claimed that there were debt sustainability problems.[17]

The literature on the political economy of reform has dealt on the issue of what makes a reform process sustainable. According to Edwards (1995, pp. 303) "…the consolidation

[16] The same applies to the Brazilian side.

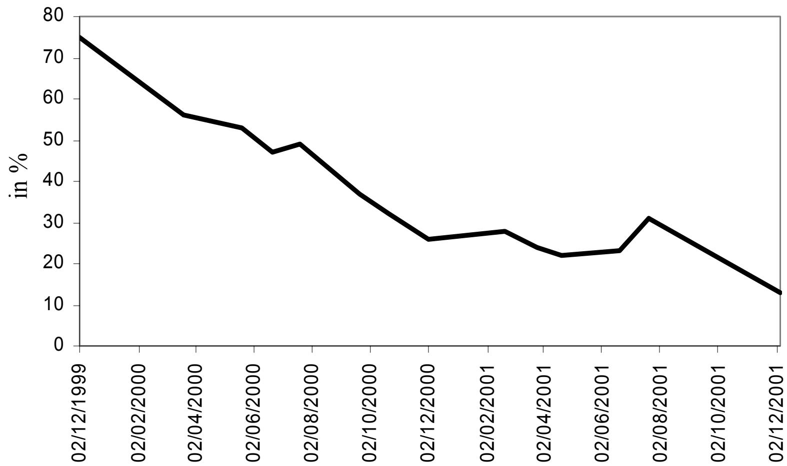
[17] For an opposite view, see Ades and Buscaglia, 1999.

of the reform process requires the population at large –or at least a majority- to recognize that the modernization effort will generate, sooner rather than later, sustainable and solid results in the form of rapid growth and improved social conditions. Consolidation also requires the creation of new institutions that …shield the economy from the short-run effects of the political cycle.” Undoubtedly, the setback in the reform process since 1996, the extended corruption in the political system, and the external shocks received deteriorated the sustainability basis of the reform process in Argentina.

In spite of this there was some room to be optimistic, given that De la Rúa got elected precisely because he opposed populist policies advocated by his Peronist adversary, Mr. Duhalde, and he promised to correct the “corruption” problems. During De la Rúa’s term, however, it became apparent that coalitions supporting the right policies needed to be built to run a successful government (see Williamson, 1994), and that having just a “handful of heroes” (in words of Harberger) was not enough.

The coalitional composition of the main parties in Argentina played a role in what followed. Although De la Rúa was in favor of the reforms of the 90´s, most members of his alliance (the Radical party and the leftist Frepaso) strongly opposed them. The Radical party bosses imposed Mr. Machinea, who had been president of the Central Bank right before Alfonsín’s hyperinflation, as Economy Minister. Instead of issuing measures that would assure the new government’s commitment to market-friendly policies, Mr. Machinea prepared an income tax increase that allegedly evaporated part of the new administration’s political capital and aborted an incipient recovery. In less than a 100 days, the positive image of De la Rúa plunged (Figure 5), along with consumer confidence.

Figure 5. Positive Image of President De la Rua (Gallup)



Source : La Nación, various issues

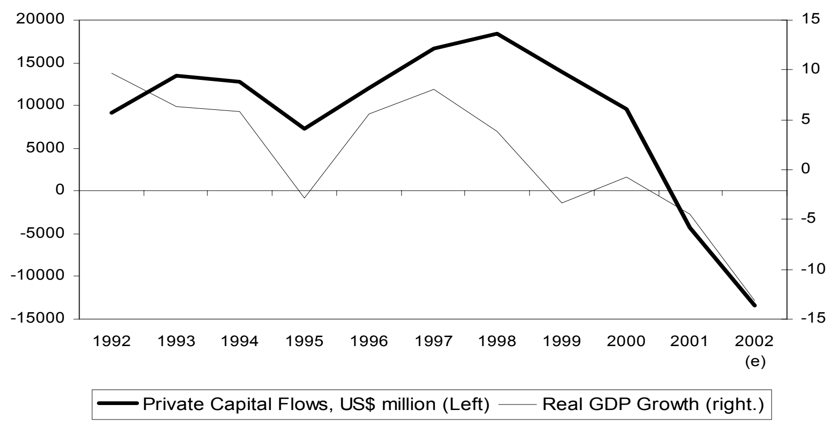
Note the contrast with Chile after Pinochet. By the time of the political transition, the reform camp was well represented by a coalition of political parties and the benefits of reforms were widespread among the population, so the incoming leftist coalition had no option but to continue along the same policy lines. To show his commitment, President Aylwin's first measures included a reduction of tariffs and budget austerity measures. In addition, measures to strengthen the independence of the Central Bank were taken shortly before by the outgoing military regime, with the support of the incoming administration (Haggard and Webb, 1993).

In Argentina, the row over the appropriate set of policies continued inside and outside the cabinet, particularly with respect to whether adjustment policies are expansionary or not. The anti-reform camp, that prevailed in the ruling coalition, wanted to run standard Keynesian expansionary policies, helped in the debate by some prominent U.S. academicians.[18] Among developed countries, Perotti (1999) has found that there is considerable support in the data for the notion that initial conditions, namely the initial

[18] Calvo et al. (2002) argue that once the fiscal imbalance became apparent and a stock adjustment was necessary, its implementation triggered a "war of attrition". Nobody wanted to adopt these unpopular fiscal cuts, and so decisions were delayed (see Sturzenegger and Tommasi, 1998). Note that those who opposed the measures most were the anti-reformists of *both* main parties, and more so the ones belonging to the ruling coalition.

level of the debt or the previous rate of debt accumulation, are an important determinant of the effects of fiscal cuts. In EMC there are even more compelling reasons to believe that this is the case, as domestic debt markets are shallow and sovereign debts are denominated in foreign currencies (see Buscaglia, 2003, for further analysis). If debt dynamics become unsustainable to the eyes of investors, country risk rises and capital flows come to a sudden stop (see Cruces et al., 2002). In fact, the correlation between private capital flows and GDP growth in the Argentine economy was 80 percent in the period 1992-2002 (Figure 6). Again, the lack of progress in the reform process can be considered as responsible of these policy dynamics, as the economy remained very exposed to capital flows.

Figure 6. GDP Growth and Private Capital Flows



Source : Ministry of Economics, and own capculations

In spite of the high approval rates with which he got into office De la Rúa was unable to build a coalition around the policies he supported, and by then both the ruling coalition and the Peronist opposition were broken along ideological lines. The political system left very narrow opportunities of reform, and hence the measures proposed were highly unpopular among the people, the markets, or both. On top of this, several mistakes were made by Cavallo during his last tenure, and his prestige decreased as fast as deposits in the financial system (see also Table 1.B, lines 5.2 and 5.3).

- The New Washington Consensus

By this time in the game, a New Washington Consensus had emerged, and central to its credo were the recommendation of floating exchange rates for all countries and "private sector involvement", a keyword for allowing if not fostering sovereign defaults (see Calomiris, 2001, and Meltzer, 2002).[19] Although big financial packages were extended to Argentina during 2000 and 2001 (Mussa, 2002), private investors learned that the stance of the official institutions had changed with respect to bailouts, and retreated from many emerging markets.[20]

IV.F. Epilogue : An Institutional Coup

The anti-reform camp was well aware of the Bayesian dynamics. After all, at least twice in the past reformist attempts were reversed after balance of payments crises (after Minister Krieger Vassena in the late 60's and after Minister Martinez the Hoz in the late 70's).

The growing dissatisfaction with the political parties led more than 40 percent of the voters to abstain or to nullify their votes in the legislative elections held in October of 2001. Among those who cast positive votes, the anti-reform camp won hands over. Former president Alfonsín and the former governor of the province of Buenos Aires, Mr. Duhalde, were elected senators. They quickly and mistakenly interpreted the election results as a vote against the model (of minimal state intervention).

At the beginning of December 2001, Radical party bosses began discussing how to abandon the "corset" of Convertibility without any government member included in the talks (La Nación, December 18, 2001), and rumors circulated that Alfonsín and Duhalde were having talks about how to conduct government after De la Rúa. Shortly after, organized riots in the Province of Buenos Aires, the stronghold of Mr. Duhalde, put an end to De la Rúa's government.

[19] In my view, Rodrick (2002) mistakenly leaves "private sector involvement" out of the list of articles of faith of the New Washington Consensus.

[20] The no-bailout policy was inherently destabilizing and hence short-lived, as the recent packages to Brazil and Uruguay showed.

After a series of short-lived attempts Mr. Duhalde assumed the presidency, mainly with the support of the Radical party and some members of the Peronist party from the province of Buenos Aires (La Nación, February 1, 2002). Default, devaluation, and asymmetric pesofication of contracts followed, and the economy went on a tailspin (see Table 1.A, line 1.2). **Since then, the executive and legislative powers have tried to undo most of the reforms established in the 90's**, including the independence of the central bank, and the fully-funded social security system, and only in some cases were stopped by international pressure and the menace of hyperinflation. Mr. Duhalde's first statements were that "this model destroyed everything" (La Nación, January 1, 2002), and since then the government has repeatedly blamed the "model" (of minimal state intervention) for the ills that the population was suffering.

This account of the crisis shows that what was under dispute was not a monetary system, but a complete set of reforms that were introduced by a populist government with the help a group of competent technocrats, but that failed to gain the necessary support to be sustainable. The coalitional nature of the main parties and the candidate selection system made anti-reformist groups to gain political power during the initial (and successful) years after the first-generation reforms were implemented. Once the economy decelerated, they tried to undo the reforms to provide voters a signal of the "right" model of the world.

V. Policy Lessons

Note that the alternative explanations of the crisis are not innocuous to the analysis of the policies that the international organizations recommended Argentina in the past, or to the ones it is now proposing. If the problem was a fixed and overvalued exchange rate, as many still claim, then the solution was to devalue and float, and we already know the consequences. As for the IMF officials the main problem was the excessive fiscal deficit, then they settled for any draconian and unpopular new taxes enacted to reduce it.

On the contrary, a political economy approach would have made the IMF ask Argentina long ago to adopt a sensible tax sharing agreement between the federal government and the provinces, to deregulate the labor market, and to reduce its dependency on Brazil through more aggressive trade pacts with other regions (or even by unilaterally reducing its tariffs as Chile), to name a few. There are obvious limits to the pressure that multilateral organizations can exert on the set of policies adopted by a country, but conditionality on the actual (and not promised) adoption of these policies would have probably averted the crisis, as the benefits of reform expanded to all sectors.

In addition, although the reduction of the deficit was necessary, political economy considerations (and purely economic ones, as claimed in Section IV.E) would have alerted the IMF against the acceptance of *any* measure to achieve that goal.

The implications for future recommendations are also very important. Now that the super-fixed exchange arrangement of Argentina has failed, most economists and bureaucrats at Washington are recommending the adoption of inflation targeting regimes across the board.[21] We should not wait for the next crisis to realize that they will be a permanent feature of those EMC that are not capable of forming solid coalitions to reform their institutions and support the transition from a rent-seeking capitalism to market economies, regardless of their exchange rate policies.

[21] Not so long ago, some influential economists were predicting that currency boards would be adopted by the major Latin American countries, like Hausmann (La Nación, April 6, 2001).

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