Tough Decisions for Argentina

With the Argentine economy in its third year of recession and struggling with debt, the global economic downturn has created special complications for Argentine policymakers. Speculation as to how Argentina will pull itself out of its deepening recession is reigniting the debate over exchange rate regimes: Will Argentina maintain its current system, devalue its currency or dollarize (abandon its currency, the peso, and accept the U.S. dollar as legal tender)?

Hard-money currency regime nonconformism is already a tradition in Argentina. In 1989, when Carlos Menem was elected president, Argentina had a floating exchange rate and hyperinflation. In 1991, the Argentine Congress established the Convertibility Plan, whose cornerstone is a currency board-like system that forbids monetizing government deficits, that is, printing money to pay the bills.

Under a currency board system, outflows of foreign currency reserves must be matched by reductions in domestic monetary base. The domestic currency can be issued only in exchange for a specified foreign currency at a fixed rate. The Convertibility Plan allowed the use of either U.S. dollars or Argentine pesos in any transactions except wage and tax payments. The Argentine peso was pegged to the U.S. dollar at 1:1.

Argentina's average annual inflation rate fell from 600 percent in 1983–91 to 4.7 percent in 1991–99. The government also initiated privatization of state-owned industries and liberalized trade. The reforms returned the economy to growth. GDP grew an average 4.7 percent per year from 1991 to 1999, two recessions notwithstanding.

Economic Health Declines

Unfortunately, successes at the beginning of the decade waned toward its end. By the time Menem left office in 1999, Argentina had an increasing fiscal deficit and 14.3 percent unemployment, high by historical standards. (Unemployment averaged 4 to 5 percent during the 1980s and 7.3 percent in 1990.)

Not only was Argentina's economy suffering adverse effects from internal forces; it was also experiencing external pressures. As financial crises swept Asia in 1997 and Russia in 1998, investors who were pulling their capital out of those countries also began to withdraw it from Argentina.

Dollarization and currency boards help establish fiscal credibility, but they do not guarantee fiscal health. Argentina benefited from the currency board-like system in the early years, but that success did not lead to consistent fiscal reform and investment. As a result of expanding public debt and higher international risk premiums, interest payments alone now account for a fifth of total federal spending.

To add to the problem, until recently the current system guaranteed Argentina's 24 provinces a monthly minimum of $1.35 billion from federal tax revenues regardless of how much had been collected. Because of Argentina's continuing economic downturn, tax receipts fell 14 percent in September 2001 compared with September 2000, forcing the government to reduce payments to the provinces so it could keep paying on the national debt. Diminishing tax revenues put pressure on Argentina to meet its zero-deficit pledge.[1]

Argentina's prime lending rates have more than tripled since last March. August 2001 industrial production fell about 6 percent from the prior year, and preliminary September numbers indicate a decline of over 10 percent—the largest year-over-year drop since July 1999.

Argentina has not had one year of positive current account balance since 1990; the current account deficit has exceeded 4 percent of GDP in three of the last four years. While a negative current account deficit can reflect positive aspects of an economy, Argentina's case has required some kind of price adjustment to push the current account toward balance. The typical price adjustment for international balance is devaluation, but that is not an option under Argentina's currency regime.

The other option is deflation, which has been occurring in Argentina since 1998. Deflation helped bring the current account deficit under 4 percent of GDP last year. Deflation has significant implications for Argentina's debt burden, however. When a country with debt has deflation, nominal GDP can fall even when real GDP is growing. If the nominal value of debt remains the same, deflation means that the debt's real value increases.

Currently, Argentina's country risk premium, which reflects the perception of increased risk as measured against U.S. Treasury bonds, is its largest since 1995, when Mexico's Tequila Crisis was hammering Latin American markets. Argentina's country risk premium has risen significantly against those of Latin America's largest economies, Brazil and Mexico (*Chart 1*). Along with Argentina's ever-widening country risk premium, consumer confidence is very low. According to a recent poll, two-thirds of Argentines have little hope that recovery is on the way. Because domestic consumption accounts for about 70 percent of Argentina's GDP, reviving consumer spending is necessary to spur growth, raise tax revenues and balance the budget.

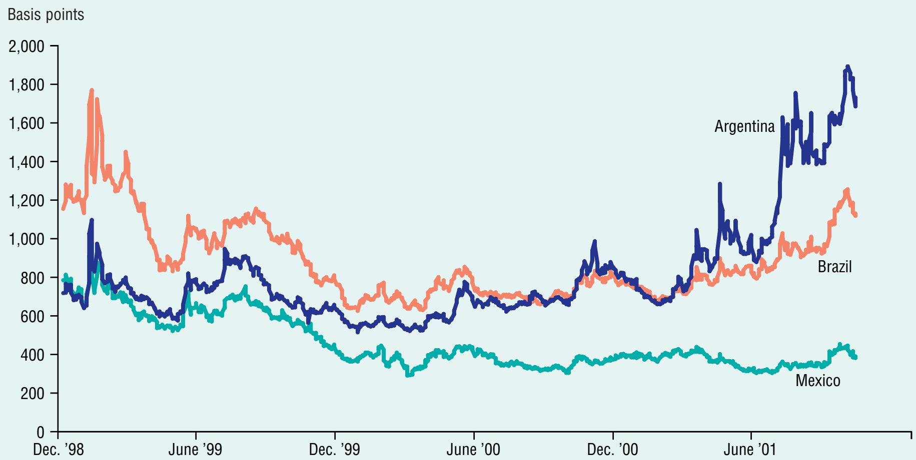
Domestic confidence in the banking system also continues to weaken, making banks vulnerable to runs. July and August saw about 10 percent of private sector savings withdrawn.

Coping with the Debt

To address these difficulties, the government is considering a debt swap as a means of reducing the monthly interest payments on both federal and provincial debt. The swap would allow creditors (local banks, pension funds and provincial governors) to exchange their existing bonds for new bonds with

Chart 1

Argentina's Risk Outpaces Others in Latin America



SOURCE: J. P. Morgan, Emerging Market Bond Index.

a lower interest rate. Policymakers depict the plan as a means of coping with the debt burden and instilling confidence. However, world capital markets have reacted negatively. Rating agencies have warned that the debt swap could be interpreted as a default if the bondholders suffer significant losses.

Ten years after the introduction of the Convertibility Plan, Economy Minister Domingo Cavallo has introduced the Competitive Plan in an attempt to reinvigorate the Argentine economy. The plan modifies the currency board. Exports (except oil) would be transacted with a devalued peso and imports with a revalued peso. Also, when the euro reaches parity with the dollar, the peso's anchor would change from the 100 percent dollar peg to a fifty–fifty dollar–euro peg.

The new rules provide an unofficial devaluation or at least attempt to achieve the effects of a devaluation: increased exports and limited imports. Since Argentina trades very little, the magnitude of the new rules may initially be limited. Argentina's exports-to-GDP ratio is currently 8 percent, the fourth lowest in the world behind Rwanda, Burundi and Haiti. The country's debt-servicing costs continue to rise in relation to exports (*Chart 2*).

Some Argentine policymakers are suggesting dollarization as an answer to Argentina's woes. They argue that market speculation over a possible devaluation has resulted in a loss of credibility and that the replacement of Argentine pesos with U.S. currency as the only official medium of exchange would eliminate Argentina's currency risks, lower interest rates and instill confidence. They consider the Convertibility Plan, which established the currency board-like system, the best policy decision of the 1990s. Now they want to take it further—with dollarization.

Conclusions

Both domestic and foreign investors remain concerned about Argentina's ability to pay its debt and retain its fixed exchange rate with the dollar. The zero-deficit spending policy is a mammoth challenge. Spending cuts are very difficult to impose when people are suffering. Declining growth and, consequently, low tax revenues do not help lessen the debt burden. However, one of Argentina's greatest strengths is its populace, whose level of education is significantly higher than that of other Latin American countries. The hope is that they will be able to make some tough decisions to ultimately manage their difficulties.

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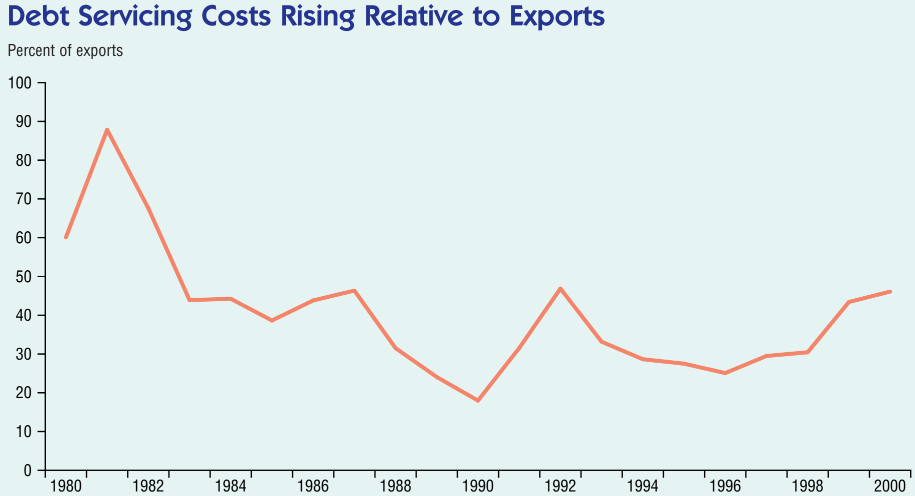
Chart 2

Debt Servicing Costs Rising Relative to Exports



SOURCES: Argentina Ministerio de Economía; International Monetary Fund, *International Financial Statistics* and *World Economic Outlook*.

Note

[1] In July, the Argentine Senate passed a zero-deficit bill that requires the government to spend only what it receives in tax revenues on a month-by-month basis.