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Briefing Paper

When "Good Parents" Go Bad: The IMF in Argentina

A Reply to Nancy Birdsall's "What Went Wrong in Argentina?"

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This is a formal reply to a speech given by Nancy Birdsall,[2] "What Went Wrong in Argentina?"[3] As Argentina's economy continues to decline, and the International Monetary Fund and the Bush Administration seek to put the blame for Argentina's troubles squarely on Argentine institutions and society, independent policy analysis becomes increasingly important. This response is offered in the spirit of dialogue and debate that we feel is necessary to arrive at a more accurate assessment of the current situation, and the possibilities for Argentina to get out of its severe economic crisis and depression.

First, regarding Ms. Birdsall's basic thesis: "*'The roots of Argentina's crisis go deep' . . . The crisis in Argentina is rooted in the longstanding problems of political chicanery and social injustice, combined with truly bad luck in the last several years. It is not due to technical economic errors, and will not be resolved by economic fixes alone.*"

Most important economic problems have deep roots based on longstanding problems. The same could be said of our own Great Depression in the 1930s—which, with the collapse of the banking system, and a quarter of the labor force unemployed—is not a far-fetched comparison to Argentina's current depression. It is neither possible nor necessary to resolve all these "longstanding problems of political chicanery and social injustice," in order to bring about an economic recovery. Conversely, the longer this recovery is postponed, and the deeper and more prolonged the depression, the greater the risk of political disintegration that would make economic recovery even more difficult.

This cannot be over-emphasized, given the IMF's current negotiating position with Argentina, which seeks to impose any number of conditions, not publicly disclosed, before granting loans to Argentina. Some of these conditions—especially the cutting of 4 percentage points of GDP from public spending—will seriously worsen the depression. Others may not, but the insistence on "reforms" that are not related to economic recovery is dangerous and counter-productive.

The following will take up each of Ms. Birdsall's points, in order of presentation:

"The exchange rate"

"*But in the end, convertibility was no substitute for fiscal discipline.*"

The convertibility system was a tragic "technical economic error" of enormous proportions, and this should be stated clearly rather than denied. As will be noted below, it was neither a lack of "fiscal discipline," nor excessive public borrowing, that caused this system to collapse. It simply was not viable. It is important to state this explicitly, because the myth of Argentina's "profligacy" is widely believed, and it is being exploited politically for several purposes: (1) to cover the IMF's own failure, in which it supported the fixed exchange rate with tens of billions of dollars of loans, all the way into the abyss; and (2) to justify large pro-cyclical spending cuts that will worsen the depression.

[2] Nancy Birdsall is President of the Center for Global Development.
[3] See full text at http://www.cgdev.org/other/birdsall_CSIS_jan29.pdf.

In this section it is also stated that "*Many of the reforms in the 1990s, including deregulation of ports and privatization of banking and telecommunications, did make Argentina's economy more efficient and competitive.*"

It is not clear that this is true. As noted in the Financial Times[4], some of these privatizations, because they created unregulated monopolies, actually made Argentina one of the most expensive places in the world to do business. And of course the overvalued peso (fixed to the US dollar, which became increasingly overvalued after 1993), greatly exacerbated this problem.

"Mediocre fiscal management"

In this section it is argued that "*while fiscal deficits were never that high,*" "*Argentina needed to run strong surpluses in good times to allow for a countercyclical policy in bad times . . . with a high and rising stock of debt, the creditors, including bondholders and banks at home and abroad, needed to see there was political and social capacity to generate surpluses . . .*"

Here again the implication is that there is some feasible fiscal policy that would have saved Argentina from sliding into the crisis, default, and devaluation that occurred; and that the government just didn't have the fiscal discipline to impose it. This is not a believable story.

Table 1 shows the government's revenues, spending, and surplus or deficit, as well as GDP, for the years 1993-2001. In 1993, the government actually did run a surplus of about 1.2% of GDP. In February of 1994, when the US Federal Reserve began a series of interest rate hikes that raised US short-term rates from 3 percent to 6 percent, the government's borrowing costs started a cycle of increases that never stopped. The Mexican peso devaluation in December of 1994 was deadly, with the banking system losing 18 percent of its deposits within weeks, and GDP contracting by 7.6 percent from the last quarter of 1994 to the first quarter of 1996.

Although there was a recovery from the second half of 1996 thru the third quarter of 1997, this was not much time to "run a strong surplus" in order to counter the shocks that began in August of 1997 with the onset of the Asian financial crisis. By the second half of 1998, the economy had fallen into recession again and never recovered.

In short, there is no conceivable story wherein the government could have rapidly piled up huge surpluses, so as to counteract the enormous shocks from the Mexican, Asian, Russian, and finally, Brazilian, currency crises, and the spiraling interest costs of its debt—which rose from 1.23% to 2.90% percent of GDP from 1993 -2000, even as the government ran primary budget surpluses throughout virtually the entire period.

[4] "Argentina to negotiate new contracts with foreign utilities," Thomas Catan and Michael Scaturro, *Financial Times*, February 15, 2002. See also "Wrong numbers dog Telecom Argentina," Thomas Catan, *Financial Times*, March 19, 2002.

This latter point must be emphasized: Argentina's budget deficits throughout the period 1994-2000 were entirely attributable to interest payments, which increased rapidly due to a series of external shocks, exacerbated by growing doubts about the viability of the fixed exchange rate regime. Without devaluation, there is nothing that the government could have done to get out of this spiral of rising interest rates and increasing uncertainty.

Furthermore, to the extent that "mediocre fiscal policy" played any role in this demise, one fateful decision stands out: the privatization of Argentina's social security system in 1994. Prior to privatization, Argentina had a "pay-as-you-go" system, in which the taxes collected in any given year are used to pay current benefits; with the diversion of payroll taxes amounting to about 1.0 percent of GDP into private accounts, the government lost a significant amount of revenue. In fact, as shown in Table 2, the deficit created by Social Security privatization is almost exactly equal to the government budget deficit during these years.[5,6] It is worth noting that this privatization was strongly advocated by the World Bank.[7]

"Bad Politics"

This section describes the severe inequality in tax burdens, with the rich largely avoiding taxes, as is common in much of Latin America. While this is certainly true, it is strongly implied here that if not for this structural problem, some tax increase might have been able to save the government from its slide toward default and devaluation. "*In 1995 in Mexico, an increase from 15 to 18 percent of the VAT [value-added tax] was at least possible, and was part of a package that convinced the markets that Mexico could and would recover.* "

But Mexico recovered after a currency devaluation of 40 percent, which was followed by a surge in exports supported by the relatively high and prolonged growth of its major trading partner, the US. It is not believable that Argentina could have regained the confidence of financial markets simply by raising tax revenue; the country still had an overvalued currency and growing doubts in the markets about the viability of the convertibility system.

"*On the expenditure side, there is also a bad equilibrium. Levels of spending in the provinces were already high (and highly inefficient in generating public services) from the beginning of the 1990s, and grew with increasing levels of patronage in the late 1990s.*"

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[5] From Baker and Weisbrot, "The Role of Social Security Privatization in Argentina's Economic Crisis," Center for Economic and Policy Research (2002)

[6] The calculations in Table 2 assume that the tax revenue lost to Social Security privatization was equal to 1.0 percent of GDP based on the estimate in IMF, "Argentina: Recent Economic Developments," IMF Staff Country Report No. 98/38, 1998. The additional deficit due to privatization is measured as a share of GDP that is attributable to the combination of lost tax revenue and additional interest costs. Since the privatization began in the middle of 1994, the lost revenue for the year is assumed to be 0.5 percent of GDP. It is assumed that the government must pay interest on half of the lost revenue for the year, since the losses are spread out over the full year.

[7] See World Bank, "National Pension Administration Technical Assistance Project Technical Annex," Report No. T-7021-AR, 1996; and Robert Holzmann, "The World Bank Approach to Pension Reform," International Social Security Review, Vol. 53, Iss. 1, 2000.

The IMF has also been raising this issue of provincial spending, in an effort to shift more blame for the crisis to Argentina, as it has become more widely known that the central government did much to contain spending even during the recession. But provincial borrowing was separate from that of the central government, and not guaranteed by the latter. So the deficits of the provinces had little, if anything, to do with the creditworthiness of the central government, just as fiscal problems of California or New York do not affect the credit rating of US Treasury bonds. Furthermore, the central government's revenue sharing with the provinces did not increase with the provinces' deficit spending; from 1997-2001 as provincial deficits rose sharply, the central government's revenue sharing remained flat (1997-2000) and then fell by 12 percent in 2001.[8] Therefore, whatever reforms may be needed in the provinces, their finances explain very little, if anything, about "What Went Wrong in Argentina."

There is also a second practical issue about who is responsible for the provinces' unpayable debt. The IMF has pressured the government to take responsibility for provincial debt. Provincial loans carried a risk premium, in the form of a higher interest rate, due to the fact that they were not the debt of the central government. At the higher interest rate, investors were willing to take the chance that their loans would not be repaid. Now that investors have lost this gamble, there is no reason that the people of Argentina should be held responsible for the loans made to the provinces.

"Bad Parenting"

"*Argentina was the spoiled child of the Washington Consensus. The IMF, the World Bank, and the IDB too (as you heard I was there from 1993-98) looked fondly on Argentina's success in halting inflation and on the steps it took to open its economy to foreign investment and deregulate and privatize . . . the official creditors paid too little attention to public borrowing, worried too little about the tax evasion of the rich . . .the markets . . . enjoyed the benefits of the spoiled child's excessive borrowing through much of the decade.*"

Again, it is vital to point out that Argentina's "excessive borrowing through much of the decade" was to meet increasing interest payments, not spending; and to make up for the lost revenues from the privatization of Social Security.

"*Perhaps in a subconscious overreaction [to its mistakes in the Asian economic crisis] the IMF was not eager to insist with the Argentines on austerity as the crisis deepened in 2000-2001.*"

But the IMF noted that Argentina's austerity measures in fiscal 2000 were equal to 2 percent of GDP (the equivalent of $200 billion of deficit reduction in the United States).[9] And this was during a protracted, deep recession. It is wrong to create the impression that the IMF was too "indulgent"—if anything, its insistence on austerity worsened the recession, as well as the recession's impact on poor and working people.

[8] Source: Secretaría de Hacienda. Ministerio de Economía, Argentina
[9] "Article IV Consultation and First Review," December 2000, p.17

This notion of an overindulgent parent and spoiled child is a popular misconception and was widely disseminated during the debates in the summer of 2001 as to whether the IMF should continue lending to Argentina. Ignoring for the moment the colonial rhetoric, a better analogy would be a misguided (or greedy) uncle, who loans his nephew money on the condition that the nephew liquidate his modestly profitable business, and invest the proceeds in highly risky stocks. As these new investments turn sour, the uncle piles on more and more debt, at ever higher interest rates; the uncle then insists that the nephew cut back on basic household spending, and sell other assets, in order to meet the increasing interest payments, and maintain the uncle's "confidence," while holding onto the deteriorating stocks. When the whole scheme collapses under a mountain of debt, the uncle washes his hands of the situation and blames the nephew for his "profligacy."

"Bad luck"

In this section the "*mysteriously strong dollar and weak Euro,*" the Russian crisis in 1998 and the Brazilian devaluation in 1999 are described as "*bad luck,*" in the absence of which "*Argentina might well have muddled through.*" (The Fed's interest rate hikes of 1994-5 and the Mexican peso crisis are not mentioned). "*The spoiled kid took a lot of hits in the late 1990s, and hadn't acquired resilience.*"

It would seem more accurate to describe an exchange rate regime that cannot withstand these types of shocks to emerging bond markets as a mistake. In addition, one might question the extent to which Argentina put itself at the mercy of highly volatile, speculative capital flows—a problem that is separate from, although greatly worsened by, Argentina's convertibility system. These are bad policies—not just bad luck.

"What didn't go wrong"

"*It was not market reforms, not privatization, not foreign banks, and not the opening of its economy that created Argentina's crisis. It was not even economic or technical misjudgments, though there were some of these . . . It was, and still is, a political system that fails to make the politicians accountable to the citizens . . . The challenge now is not to weaken or undo the economic reforms [that Argentina] began, but to attack its political problems and the social injustices those political problems perpetuate.* "

The worst of the economic reforms—the convertibility system—has already been undone. The question of which other reforms will have to be undone is a longer discussion; but clearly at least some of them did contribute to the crisis, especially the complete opening up to volatile portfolio investment, combined with the de-regulation of the banking system; and the privatization of Argentina's social security system.

Most importantly it should be noted that, in spite of three and a half years of solid growth at the beginning of the convertibility regime, Argentina is facing a terrible, policy-induced collapse of its economy. Millions of manufacturing jobs have been lost, the economy is in its worst depression ever, and the country's debt—depending on how much is written off and restructured—could remain a terrible drag on future economic growth, as well as a major obstacle to addressing the problems of social injustice.

These are the problems that must be faced, as well as re-starting the banking system, restoring normal credit conditions, and reviving domestic demand in the economy. As of today, the institutions that advocated and financed the "reforms" that got Argentina into this mess—most prominently the IMF, World Bank, and US Treasury Department—have contributed nothing toward these vital needs. Even worse, they are coercing the government to adopt polices that will prolong the depression.

At the same time, these institutions seek to absolve themselves from responsibility for any and all of Argentina's problems, and promote to the public a story about a "spoiled child," who failed in spite of overly generous "help" and sound economic advice from its "parents." A more accurate and balanced view of the situation, past and present, is surely needed.

Table One

Argentina, National Government Spending and Revenues (1993-2001)

In millions of current pesos

	YEAR								
	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total Revenue	**50,726.5**	**51,078.2**	**50,293.6**	**47,668.9**	**55,376.7**	**56,726.1**	**58,455.4**	**56,570.5**	**51,318.6**
Total Spending	**47,996.0**	**51,364.3**	**51,666.9**	**52,933.3**	**59,653.3**	**60,799.6**	**63,223.8**	**63,362.1**	**59,428.9**
- Total Spending as % of GDP	20.29%	19.95%	20.07%	19.45%	20.37%	20.34%	22.30%	22.29%	22.12%
- Interest Payments (included in Total Spending)	2,914.0	3,150.3	4,083.5	4,607.9	5,745.0	6,660.3	8,223.6	9,656.0	9,630.1
- Interest Payments as % of GDP	1.23%	1.22%	1.58%	1.69%	1.96%	2.23%	2.90%	3.40%	3.58%
Deficit or Surplus (Rev-Spend)	**2,730.5**	**-285.9**	**-1,373.3**	**-5,264.4**	**-4,276.6**	**-4,073.5**	**-4,768.4**	**-6,791.6**	**-8,110.3**
Primary Spending (exclud. interest)	**45,082.0**	**48,214.0**	**47,583.4**	**48,325.4**	**53,908.3**	**54,139.3**	**55,000.2**	**53,706.1**	**49,798.8**
Primary Surplus or Deficit	**5,644.5**	**2,864.2**	**2,710.2**	**-656.5**	**1,468.4**	**2,586.8**	**3,455.2**	**2,864.4**	**1,519.8**
Primary Spending as % of GDP	**19.06%**	**18.73%**	**18.44%**	**17.76%**	**18.41%**	**18.11%**	**19.40%**	**18.90%**	**18.54%**

Source: *Secretaría de Hacienda. Ministerio de Economía, Argentina*

GDP at Current Prices

In millions of current pesos

	YEAR								
	1993	1994	1995	1996	1997	1998	1999 (*)	2000 (*)	2001 (*)
GDP Market Prices	**236,505.0**	**257,440.0**	**258,031.9**	**272,149.8**	**292,858.9**	**298,948.4**	**283,523.0**	**284,203.7**	**268,638.2**

(*) Estimates

Source: *Dirección Nacional de Cuentas Nacionales, Argentina*

Table Two

Argentina, Government Deficit due to Social Security Privatization

In percent of GDP

	YEAR							
	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Deficit Incurred by Privatization	**-0.51**	**-1.10**	**-1.20**	**-1.30**	**-1.59**	**-1.86**	**-2.59**	**-3.16**
Budget Deficit or Surplus	**-0.11**	**-0.53**	**-1.93**	**-1.46**	**-1.36**	**-1.68**	**-2.39**	**-3.02**
Deficit or Surplus Without Social Security Privatization	**0.40**	**0.57**	**-0.73**	**-0.16**	**0.23**	**0.18**	**0.20**	**0.14**