Harvard University
Economics Department

Latin America and the Washington Consensus

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Spring 2004

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1325: Latin America and the Washington Consensus

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Syllabus

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The "Washington Consensus" is a term that has been used to describe a reform program, sometimes also called "neoliberal," embraced in recent years by the governments of many developing countries. How important was the "Washington Consensus" in influencing economic reforms in Latin America during the 90's? Were there alternatives to what was done? What was responsible for economic crisis and increasing poverty: the reforms, or the lack of enough such reforms? The answers will be given and discussed by one of the economic reformers of the 90's and by a proponent of alternatives to the "Washington Consensus." Critics as well as advocates of the Washington Consensus and Latin American reformers of the 90's will be invited as guest speakers. The course will also explore alternatives for the future.

Reading material:

There is not a text book for this course. There are, however, six books that the students are encouraged to read in two steps. The next three, during the first three weeks, as general background for the course.

Yergin, Daniel and Stanislaw, Joseph. The Commanding Heights. The Battle Between Government And The Marketplace That Is Remaking The Modern World. Simon & Schuster, New York, 1998

Mangabeira Unger, Roberto. Democracy Realized. The Progressive Alternative. Verso, London, New York, 1998.

Rodrik, Dani. The New Global Economy and Developing Countries: Making Openness Work. Policy Essay Nr. 24. Overseas Development Council, Washington D C, distributed by the Johns Hopkins University Press, 1999.

The next three to be read when indicated in the reading list.

Edwards, Sebastian. Crisis and Reform in Latin America. From Despair to Hope. World Bank, Oxford University Press, 1995

Kuczynski, Pedro-Pablo and John Williamson, Editors. After the Washington Consensus. Restarting Growth and Reform in Latin America. Institute for International Economics, Washington DC, March 2003.

Stiglitz, Joseph E. Globalization and its Discontents. W.W. Norton & Company, New York, London, 2003.

Lecture 1
Latin America and Economic Ideologies

In understanding the recent history of Latin America the expression "Washington Consensus" is only useful if interpreted as a short for "Washington support for the Latin American Consensus".

I will argue along this course that by the mid 80's a Consensus emerged among economists and democratic political leaders all across Latin America on the need to introduce "new rules of the game" for the national economies in order to defeat hyperinflation and renew growth. But these reforms could not be successfully implemented unless Washington would provide help to free Latin American nations from the Debt Trap.

Washington support came with the Bush 41 and Clinton Administrations. But seems to have "gone with the wind" of the Bush 43 Administration. On the Latin American side the consensus started to disappear with Chavez in Venezuela and Duhalde in Argentina.

The purpose of the course is to examine if the lack of Washington support for the disappearing Latin American Consensus will make room for better reforms or will simply consolidate the very discouraging current landscape in Latin America. Or, even worst, will recreate the situation of the 70's and 80's.

In this first class I will describe how the ideological discussions and the course of events interacted to generate the Latin American Consensus. My story today will try also to draw the picture of the Latin American region we saw in the mid 80's.

Why the mid 80's? Because it is the date, which is usually considered the start of the implementation of the economic reforms by democratic governments. The first episode took place in Bolivia in 1985. It is easy for me to recall what I thought back then because coincidentally it is a turning point in my professional life: after publishing my book "Volver a Crecer" (Back to Economic Growth), I switched from the academia to politics.

Let's start with the ideological discussions on economic matters that took place from the mid 40's to the mid 80's.

In the aftermath of the WWII, ideological discussions in the world focused on the dichotomy Socialism versus Capitalism. Naturally this dichotomy embodied the economic aspect of the East-West confrontation that characterized the Cold War.

Latin American countries tried not to get involved in this confrontation adopting what Juan Domingo Perón, who was the Argentine President at the time, called "The Third Position" (in Spanish: "La Tercera Posición"). These ideas would be the seed of the Not-Aligned Countries Movement, which in turn several developing countries joined.

At the same time, in Latin America economic academic thinking moved towards the so called "Structuralism" as opposed to the "Orthodoxy" that had prevailed in previous decades. "Structuralism" looked like the "Keynesianism" of the Developing World. A good account of the Structuralist School is offered by Rhys Jenkins in Chapters 5 and 6 of the book entitled Industrialization and Development edited by Hewitt, Johnson and Wield.

"Structuralism" gave intellectual support to the Import Substitution Industrialization (ISI) growth strategy and the Populist Macroeconomic Policies that most Latin American governments implemented since the mid forties until the eighties with varied intensity.

The economic organization and the economic policies suggested by "Structuralism" were functional to the political regimes that prevailed in most Latin American countries in those years: either civilian governments in corporate state democracies or military dictatorships. For them "Statism" was a way to accumulate and preserve political power.

The only case of a military dictatorship that implemented economic reforms departing from the Structuralist Policies was Chile under Pinochet. But the very fact that the Economic Liberal Reforms had been decided and implemented by a repressive regime had added more passion to an already heated debate. Even though very informative from the economic point of view, the Chilean Experience could not be easily digested by the political leaders of the emerging democratic regimes of Latin America during the 80's.

In Mexico and Brazil, strong criticism to the Import Substitution Industrialization growth strategy began to be heard only after the eruption of the Debt Crisis in 1982. Indeed, economic discussions had started to take place prior to 1982 analyzing whether the development strategy based on the ISI model was exhausted. These discussions overlapped with a few, but not really frequent, episodes of Populist Macroeconomic Policies based on the Structuralist mindset. But, all in all, the ISI growth strategy had delivered rapid growth in both countries during the period 1945-1982. The good results had been undisputable until the first oil crisis in 1973, and the difficulties created by the commodity crisis of the 70's had been overcome by readily available foreign financing.

By the mid 80's the criticism regarding the Import Substitution Industrialization growth strategy that had emerged at the time of the Debt Crisis became strong and convincing because the difference in economic performance between East Asia and Latin America during the period 1965-80 spoke by itself. (See Table 1-2 in Sebastian Edwards's book, chapter 1, page 4)

In Argentina the evidence against the policies recommended by Structuralism were even more eloquent and came from a different comparison. Until the WWII, Argentina had achieved a standard of living quite close to that enjoyed by the most advanced countries in the world. This was the outcome obtained from the combination of its vigorous international trade, its infrastructure and its education system. In turn, the implementation of the Import Substitution Industrialization strategy along with Populist Macroeconomic Policies produced a disappointing outcome instead. The disappointing consequence of implementing the last set of policies was a stagnant economy suffering high levels of inflation since the mid 1970s.

In the Institute I ran at the time, we analyzed the Argentine case compared to countries with similar endowment of human and natural resources such as Canada and Australia. There was an obvious divergence among the economic performances of those countries from the WWII on. We, then, aimed at finding the reasons of Argentina's backwardness. We came to the conclusion that the disappointing performance of Argentina after the WWII was due to a certain institutional misplace, which had been a consequence of the trade and macroeconomic policies implemented thereafter.

In a well-organized mixed economy, resources are efficiently allocated by means of the signals sent by relative prices. Relative prices, in turn, are determined in competitive markets. On the other hand, redistributive policies are explicitly included in the government's Budget.

In Argentina, on the contrary, those instruments of economic policy had switched roles. Instead of being instrumental in the efficient allocation of resources, relative prices were controlled by the government aiming at redistributing income. On the other hand, instead of playing a role in the redistribution of income, the government's Budget aimed at allocating investment and employment.

You can find a synthesis of our findings in the article entitled "The Argentina that Could Have Been," authored by Yair Mundlak, Roberto Domenech and myself. (See in particular Figures 1 and 7)

This work along with the work of other authors laid the foundation of our position on the matter. We explained that Argentina's problem was not that it had too much Capitalism as Structuralists argued, nor was it that it had too much Socialism as the Orthodox Economists said. The real problem was that it has a poor combination of both Capitalism and Socialism. Our economy was a mixed of "Capitalism without a Market and Socialism without a Plan."

Our diagnosis led us to propose a different approach in order to attain sustained economic growth. We proposed a strategy based on a complete reorganization of the economy. Hence, in our political discussions we used to talk about "New Rules of the Game." This is, by the way, the expression that Daniel Yerguin came across when doing his research on economic reform in Latin America. Notably, the chapter of his book "The Commanding Heights" in which he referred to Latin America is entitled "Playing by the Rules."

I published "Volver a Crecer" (Back to Economic Growth), as a way to spread our interpretation of Argentina's maladies and their possible solutions. The book's subtitle is "Proposing New Economic Rules of the Game for Argentina." It has not been translated into the English language; however, a very short synthesis of our thesis can be found in the chapter "Three Views on Restoring Growth," from the book Inflation Stabilization. The Experiences of Israel, Argentina, Brazil, Bolivia and Mexico, edited by Bruno, Di Tella, Dornbusch and Fisher.

In that comment, I argued that in order to be effective, the change in the rules of the game in Latin America should be backed by the United States of America via similar mechanisms as those applied to help with the reconstruction of Japan and Europe in the aftermath of the WWII. I also argued that, exactly as happened in the post-war period, the benefits would spread over not only the countries being helped but also the global economy. I considered that to attain higher global growth without unleashing inflationary pressures new stimuli were needed. But they should come not from rapid expansion of consumption in the US, where the saving rates were already very low, but from increased investment in Latin America.

This account of our interpretation of our economic reality back in the mid 80's seeks to prove to you that at that time Latin- American leaders were not asking for recipes to solve the problems. On the contrary, we were asking for concrete help in order to fund increased investment levels that in turn would help to increase the productivity rates of our economies. Our countries needed that help in order to being able to obtain sustainable economic growth.

Actually, we thought we had come up with our own recipes as to how to open-up investment opportunities, how to mobilize domestic savings, and how to cure inflation. We had reached our own conclusions based on our research on the country's reality. We did not base our proposal on theoretical universal recipes. Our mindset did draw on conventional Microeconomic Theory and the then recently developed Open Economy Macroeconomics, but these were simply tools for the analysis. Our proposal was based on the research on our reality we had conducted. Even though economic reality was not always similar across Latin America, there was a common element: the Debt Trap. To get out from the Debt Trap we needed help. Hence, most Latin American leaders asked for such help to Washington.

Readings:

Edwards, Sebastian. Chapters: 1 pp. 1-13.

Hewitt, Tom, Johnson, Hazel, and Wield, David. Industrialization and Development. Oxford University Press, and The Open University, 1992. Chapters 5 and 6, pp. 128-198.

Cavallo, Domingo F, Domenech, Roberto and Mundlak, Yair. The Argentina that Could Have Been**.** The Costs of Economic Repression. Executive Summary. International Center for Economic Growth, 1992, pp. 7-25. (available on the web)

Bruno, Michael, Di Tella, Guido, Dornbusch, Rudiger and Fischer, Stanley, editors. Inflation Stabilization. The Experience of Israel, Argentina, Brazil, Bolivia and Mexico. The MIT Press, Cambridge MA & London, England, 1988, Part VI, pp. 395-407.

Dominguez, Jorge I. and Shifter, Michael, editors. Constructing Democratic Governance in Latin America. The John Hopkins University Press, Baltimore & London, 2nd ed., 2003, Chapter 4, pp. 74-99 and 392-400.

Lecture 2
Stagflation and Hyperinflation

Last class I talked about what Latin American economists and political leaders thought back in the mid 80's. Before going into today's subject, I would like to mention the article entitled "Market Reforms" by Javier Corrales. When I read it, I was impressed by its clarity and precision. Javier Corrales, by the way, is a young Professor at Amherst College, who received a PhD in Political Sciences from Harvard University.

Corrales synthesizes the state of the economy before the reforms using the expression "Increasing Statism, Declining Stateness" and characterizes the reforms as "More Markets as a Recipe for More Stateness." I strongly suggest that you read the article thoroughly because it will be a very useful reference throughout the course.

Accelerating Inflation: the clearest manifestation of declining "Stateness"

Inflation, a phenomenon that in most Latin American countries evolved into stagflation and in some cases into hyperinflation, has been the most obvious expression of the lack of capacity of the state to manage the economy. That is, the lack of "Stateness" using Corrales' terms.

To a greater or lesser extent, until the 80s almost all economies in Latin America suffered persistent inflation. Every time they tried to stop it, inflation reappeared even stronger.

In the 1950s and 1960s the Keynesians and the Structuralists understood inflation as a consequence of the adjustment of relative prices in a context where nominal prices and wages were downward inflexible.

Notwithstanding, in the 1970s and 1980s the economic thinking started to change. Economists started to blame the fiscal deficits and the distributive tensions in the economy as the main cause of persistent and accelerating inflation.

Fiscal Deficits

By that time, Latin American economies faced two kinds of abnormalities. On the one hand, economies in Latin America functioned in such a way that expenditures and investments that in a normal economy are undertaken by the private sector became the responsibility of the government and were included in the Budget. On the other hand, the Government was unable to collect the necessary taxes to pay for the increased spending.

To make matters worse, the tax system grew more and more complex including taxes at the same time very discriminatory and difficult to administer.

The consequence of this double problem was increased budget deficits, which in turn tested the capacity of the state to finance them whether through tax collection or raising debt. When the tax collection proved to be unable to fund all this spending, and governments were also unable to raise more debt, monetary emission was the answer.

Printing money is a subtle way to collect a not-approved-by-law tax, the inflation tax. “Socialism without a Plan” does not find another way to fund its disequilibria than imposing a tax on people’s monetary holdings, including savings and wages.

Distributive tensions

Lack of competition in markets and government intervention on a case-by-case basis deciding the level of the most important prices in the economy, such as wages, rates of public services and the rate of exchange cause intense distributive tension in the economy. When one sector’s income lags behind, the Government tries to compensate this lag granting subsidized credit, which in turn is also funded by printing money.

Furthermore, inflation is higher not only due to the printing of money but also due to abrupt devaluations of the currency. Usually, a fix exchange rate accompanied by fiscal and monetary expansion ends in an abrupt devaluation. The inflationary tax ends up being the main source of financing for private sector disequilibria when the economy operates as “Capitalism without a Market.” This was the case in Latin America in those years.

Increasing indebtedness

There are, and there were in those years, also periods when, due to special circumstances credit is abundant. In such moments, fiscal disequilibria and private sector financial needs get satisfied via increasing debt. Then, economies can avoid printing money, at least for a while. Nonetheless, when the distributive tension between debtors and creditors gets unleashed, inflation reappears as a means to reduce the value of monetary assets and debts causing a massive transference of wealth from creditors to debtors.

Consequences of inflation

Inflation not only causes arbitrary redistribution of income and wealth, but also discourages voluntary savings and financial investment within the countries’ borders.

When inflation turns erratic and hyperinflation looms, governments are totally unable to handle not only the public budget but also the relative prices. None of the usual economic tools bring about the outcome sought by the authorities. Hyperinflation is the most dramatic expression of the incapacity of the State to govern the economy. It means that “Stateness” evanishes.

Persistent and erratic high inflation hinders the economic performance because it negatively affects investment and the productivity of factors of production. Therefore, in Latin America the usual outcome is not a combination of economic expansion and accelerating inflation, as it is very commonly the case in mature economies. On the contrary, the phenomenon that dramatically spread across the region at that time was the so-called “stagflation”, which is the combination of recession and inflation at the same time.

The strategy to defeat hyperinflation: a complete overhaul of the “Rules of the Game”

In the presence of Stagflation and Hyperinflation, every leader in Latin America was convinced that that it was necessary to introduce deep economic reforms. Economists who advised political leaders thought of a set of reforms that would seek to reorganize the economies by enhancing the functioning of the markets via the introduction of competition and by improving the capacity of the State to govern the economy via fiscal equilibrium and transparency. This is how, in my view, the reforms of the 1990s were born. Not in Washington, but rather in the capital cities of each and every country in Latin America overwhelmed by stagflation or, worse, immersed in hyperinflationary chaos.

Bolivia: the first democratic country to implement a complete reform

Bolivia's case is a clear example of what I am describing. Hyperinflation exploded in 1985 when former President Hernán Siles Suazo was about to end his term in office. By that time, Washington did not have a clue regarding how to approach the debt trap Latin American countries were experiencing. Victor Paz Estenssoro's Administration, which had Gonzalo Sanchez de Lozada as its Minister of Planning, decided to implement a set of economic reforms that stabilized the Bolivian Economy once and for all.

Four years later, in a conference in which John Williamson coined the term "Washington Consensus", Juan Cariaga, who had been Minister of Finance during Victor Paz Estenssoro's Administration, gave the following speech. I assume that he said these words in order not to make feel uncomfortable the person who had organized the meeting.

"Although introduced in an emergency basis, the Bolivian adjustment program led, however inadvertently, to the implementation of what might be called, following John Williamson, the Washington Consensus".

The quote is taken from the chapter 3 of the book Latin American Adjustment: How much has happened, edited by John Williamson in 1989.

Bolivia was the first country to successfully fight hyperinflation with a plan decided and implemented by a democratic regime. Chile in the mid-70s had implemented an economic reform along the same lines of what Bolivians did in the 1980s but back then it had still a military regime. Chile had sought to stop the Stagflation process unleashed by Salvador Allende's socialist experiment. At the time Chile launched its reform package Washington had not achieved any consensus regarding how to stop the increasing inflationary process that the American economy itself had started to suffer in the 1970s.

Of course, at that time and in that context, officials at multilateral institutions in Washington had not come up yet with the idea of developing a recipe for economic reform in Latin America.

Readings:

Edwards, Sebastian. Chapter 2, pp. 17-40.

Williamson, John, Latin American Adjustment: How Much Has Happened? Institute for International Economics, Washington DC, April 1990, Chapter 3, pp. 41-53.

Dornbusch, Rudiger, Exchange Rates and Inflation, The MIT Press, Cambridge, Massachusetts, London, England, 1988, Chapter 22, pp.439-465.

Lecture 3
Chile as a model

By the mid 1980s, those countries in Latin America amidst stagflation processes or that saw their economies about to fall into hyperinflation, looked at Chile, the emerging model in the region.

The Chilean experience in the last quarter of the XX century has been intensely studied, and as a consequence there is a wealth of bibliography that analyzes, describes and explains Chile's economic process in that period. I cannot think of any other country in Latin America that has drawn the attention of the academia more than Chile, probably with the exception of the Argentine case from 1870 to 1930.

Chile in the last 25 years and Argentina by the turn of the XIX century attracted the attention due to the same reason. Argentina first, and Chile afterwards were the success stories in relation to economic and social development in Latin America.

Are there any common factors in those success stories?

In both, Argentina by the end of the XIX century and Chile by the end of the XX century, what stands out is the ability of the State to organize and govern the economy. This is what Javier Corrales calls "Stateness."

In my view, the main reason of Argentina's success by the turn of XIX century was not the adoption of an export-led growth strategy. Almost every country in Latin America adopted that model by that time. The success came as a result of the ability of the State to implement and sustain a particular set of policies, not only economic but also social policies. Those policies affected every aspect of economic life, from immigration policies that attracted people and capitals to the country, and the development of the transport and communications infrastructure to the creation of an education system, which was a milestone in Argentina's development process. It offered obligatory primary education to every child in the country and hence, was very successful in reducing illiteracy early on, and opened the door to social mobility.

Due to this set of policies, the country was able to take full advantage of the opportunities offered by the globalization process led by the United Kingdom back then.

I consider that Chile's success in the last few decades cannot be explained only because it opened its economy or implemented a free-market strategy that allowed for more private participation in markets, which in turn operated under competitive conditions.

By and large, almost every country in Latin America followed the same path in the same period. Chile's success should be explained due to the ability of the State not only to establish new rules of the game, but also what is more important to sustain them. These new rules of the game have not been altered. Chileans only introduced changes that improved them, but never tried to go back to the old economic "disorder."

The article by Andres Velasco entitled “The State an Economic Policy: Chile 1952-1992” explores the reasons why the Chilean State was able to achieve an increasing degree of autonomy and increasing capacity to govern the economy, or, in other words, increasing “Stateness”.

Chile during the period 1964-1990

Chapter 5 of the book by Javier Martinez and Alvaro Diaz, entitled “A Capitalist Revolution” summarizes the period 1964-1990 as a “revolution” that was not imposed by external forces nor was the outcome of an endogenous process. Rather it was a revolution imposed by the nation’s leadership. From 1964 to 1990 the country, according to those authors, was led by three different political elites, each of which had developed its own program of radical reforms. The “Revolution in Liberty” led by Eduardo Frei, the “peaceful road to socialism” led by Salvador Allende and the “neo- liberal revolution” led by Augusto Pinochet were three programs aimed at radically changing the system.

The authors explain that those three elites ended up defeated in the political arena. The Christian Democrats by the Socialists, the Socialists by the Military and the Military by the forces of a new democratic consensus. However, the combined action of the three streams brought about a real capitalist revolution.

Most interestingly, the democratic administration that took over after the Military Dictatorship did not try to undo this revolution. On the contrary, it allowed the new rules of the game to stay in place and therefore, the economy could sustain high growth rates and society could achieve progress and enjoy higher standards of living.

Which was then a key factor in the stability of the new economic and social institutions in Chile?

I find Andres Velasco’s explanation very convincing. Groups protected by the elites that alternatively had ruled the country: Conservatism, Christian Democrats and Socialism, exerted power in a discretionary fashion. This use of power affected so deeply property rights, freedom and security of the groups occasionally in the opposition that clientelism as a way to do politics fell into an insurmountable crisis by the time of the Military Coup of 1973.

Every sector that had benefited from the State’s arbitrary use of power, had also suffered significant losses when they lost power. Therefore, when the technocrats that advised the Military proposed a complete overhaul of the economy and to set “rules” which in turn would significantly reduce the arbitrary use of power, every sector ended up endorsing the proposal.

By accepting the new strategy, these groups and elites would forgo the benefits of the arbitrary use of power in their own benefit, but by the same token they would be protected against the high risks that usually had accompanied abrupt changes in Government top positions.

What did Latin American leaders and economists learn from the Chilean Experience?

Economists across Latin America interested in public policy had followed the Chilean reform and had compared it with the situation in their own countries. Several of these economists were already involved in public policy discussions and public policy making. Others would enter that arena soon. To us, the

Chilean experience became a crucial piece of learning. What did we learn from it? We understood the importance of the discussion about “rules versus discretion”. In Europe and the US academia was discussing these topics in regards to monetary policy. The Chilean experience showed us, Latin Americans that an economic organization should be based upon clear rules of the game, and it should not leave room for discretion and arbitrariness. Such an organization is important not only in monetary policy, but also in fiscal policy, in trade policy, and more generally, it is important for the smooth functioning of every aspect of the economy and the society at large.

The ideological origin of Chilean reforms and its influence on other LA economies

From 1972 to 1977, Chile experienced stagflation and was at the brink of hyperinflation. In such dramatic moments, Chile started to shape the new rules of the game that the democratic process would consolidate in the 1990s.

In 1974 I came to Harvard to attend a PhD in Economics, and stayed until 1977. During those years, I had the opportunity to discuss with other colleges about what was going on in Chile and Argentina. Several of them would actively participate in politics and in Chile’s Administration later on.

Among them, I remember Jose Piñera, who would be Minister of Mines and Labor during the military rule and would foster the labor and social security reform, his brother, Sebastian Piñera, who would be a Senator and the President of the Party for National Renovation, Eduardo Aninat, who would be Minister of Finance of Eduardo Frei Administration, and Jorge Dosermeaux, who is currently member of the Board of Chile’s Central Bank. Alejandro Foxley and Vittorio Corbo used to visit Harvard and MIT. Alejandro Foxley would be Minister of Finance of Patricio Aylwin Administration and the President of the Christian Democratic Party. Vittorio Corbo is currently the President of Chilean Central Bank.

I remember our discussions back then, and hence, I am certain that neither the multilateral organisms nor the US Treasury had a say or influenced the process that was taking place in Chile. What I certainly do remember is that the Chilean economists were very aware of and concerned about the drama Chile was going through, as any other Latin American economist was.

In the summer of 1976 and the spring of 1977 I worked with Professor Richard Musgrave as a member of a Fiscal Reform Mission to Bolivia organized by Harvard University. Professor Arnold Harberger from Chicago University and several Chilean economists were part of the mission as well. Professor Harberger was mentor of several Chilean ministers back then.

I remember our discussions in relation to Chile’s situation over dinner in La Paz. That experience helped me understand the great influence Chile’s experience would have on Victor Paz Estenssoro Administration in Bolivia during the 1980s, when hyperinflation imploded in a context that resembled Chile in 1976.

Without any doubt, Chile and Bolivia’s experiences helped me to understand my country’s problems in the 1980s, and to design the economic reform program we launched in 1991 in order to curb the hyperinflationary process that exploded in 1989 and 1990.

In those years, although I was well aware of what was happening in Latin America in the political, economic, and social arena, I had never heard of the Washington Consensus. Yet, by that time the US demonstrated its interest in providing support to Latin American countries that were pursuing democratization processes.

Standard wisdom says that the US decided to support Latin America economic growth as a means to foster the Washington Consensus in the region. I believe that the situation was somewhat different. I think that the Brady Plan and the negotiation of NAFTA were the positive responses to the demands made by the new Mexican Administration headed by Carlos Salinas de Gortari, who had taken over in December 1, 1988.

Hence, next class we will discuss the Mexican Way.

Readings:

Edwards, Sebastian. Chapter 3, pp. 41-65.

Bosworth, Barry P., Rudiger Dornbusch and Raul Laban, editors. The Chilean Economy. Policy Lessons and Challenges**.** The Brookings Institution, Washington DC, 1994, Chapter 8, pp. 379-429.

Martinez, Javier and Diaz, Alvaro. Chile. The Great Transformation. The Brookings Institution, and the UN Research Institute for Social Development, Washington DC, Geneva, 1996. Chapter 5, 130-141.

Lecture 4
The Mexican Way

As early as in 1976, when Latin America suffered another of its recurrent monetary and financial crisis, economic thinking in the region had begun to question excessive fiscal expansion and the Import Substitution Industrialization as sound growth strategies. Most economists thought that the ISI strategy was exhausted and it was indeed preventing LA countries to achieve the stability and growth that had enjoyed earlier.

By that time, Chile had started the economic reform we referred to last class. Nonetheless, this process did not take off in Mexico due to concurrent circumstances. On the one hand, large oil reserves were discovered and on the other hand abundant money in financial markets coming from the recycling of the Petrodollars made it easy to get external financing.

Most Latin American leaders became convinced that Latin America should seek macroeconomic stability and trade openness after the 1982 Mexican debt crisis fueled a long and painful stagflation process.

President De la Madrid took office on December 1st, 1982. His Administration made great efforts to cut government expenditures and to open the economy. Notwithstanding, in the period 1982-1987 inflation remained high and exports did not increase enough to become the engine of growth. At that point, the cause behind the persistent stagflation process seemed clear. Since 1982 Mexico had been transferring abroad as much as 5% of its GDP, in net terms.

In order to be able to generate such large Current Account Surplus in its Balance of Payments Mexico kept the domestic currency deeply devalued, which in turn led to a very low investment rate. The continue devaluation of the domestic currency fueled inflation, which remained persistently high. A high exchange rate would supposedly foster exports; however, the low investment rate set a limit to that process, along with insufficient productivity increases.

By 1985, a similar attempt by the Bolivian Government to continue transferring abroad a significant proportion of its GDP while trying to satisfy simultaneously domestic social demands had ended in Hyperinflation. To stop it, Victor Paz Estenssoro's Government had to introduce a reform program, which included the suspension of payments on the debt, which, by the way, started to be the recommendation that Jeffrey Sachs and other scholars started to make to the indebted nations of Latin America.

It was at this time that Mexico started to seek the restructuring of its external debt. The process should contemplate both capital and interest lessening and longer maturities.

As part of the program, Mexico started a privatization process that would help it obtain the resources needed to afford its internal debt. But that was not enough to reverse the net transfer of resources abroad, which in turn was the key to strengthen the currency and to increase the rate of investment.

By that time, Wall Street and Washington favored debt-equity-swaps as a method to cut external debt and at the same time foster private investment in indebted countries. Nonetheless, Mexico rejected the idea on the grounds that it would fuel inflation because the Mexican Central Bank would have to issue domestic currency in exchange of the debt being swapped.

Mexico looked for an alternative solution. It proposed a scheme to restructure the debt based on external support. In 1989, the US Administration accepted such a scheme. To the best of my knowledge, this is how the "Brady Plan" was designed and launched.

The "Brady Plan" produced a double positive effect on the Mexican economy. On one hand, it would allow Mexico to lessen significantly its debt burden. On the other hand, Mexico was able to attract foreign savings. As a matter of fact, in 1988 it transferred resources abroad equivalent to some 5.7% of GDP, whereas in 1989, the transfer was very close to zero. This trend strengthened during the following years reaching the inflows of foreign savings a significant 8% of GDP in 1994.

The openness of the economy and prudent macroeconomic policies undertaken by the De la Madrid Administration, along with the successful restructuring of the debt accomplished by Salinas de Gortari Administration during the first year in office contributed to restore the confidence in the Mexican economy. Thus, the foreign currency drain stopped, and the stagflation inertia that had dominated the period 1982-1987 was curbed.

Salinas's initial success against stagflation made it possible to gain the political and public support needed to undertake the process of economic reform implemented later on. I believe that his initial success drew the attention of the US and contributed to its willingness to negotiate NAFTA.

How "orthodox" was the Mexican Stabilization Plan?

The Mexican stabilization plan implemented in December 1987, which was called "The Solidarity Pact", was not the standard IMF stabilization recipe. As a matter of fact, initially the IMF did not give its support. On the contrary, we could classify the plan as a "heterodox" one. A heterodox plan along the lines of those implemented in Argentina and Brazil in 1985, which by 1987 had failed to curb inflationary inertia.

The most important difference between the Mexican Solidarity Pact and the Argentine Austral Plan and the Brazilian Cruzado Plan was rooted on Mexico's emphasis on accompanying heterodox economic measures with prudent macroeconomic policies and the openness of the economy.

Lessons learned from Chile and Bolivia's previous experiences indicated that those two ingredients were the key to the sustainability of stabilization policies in the long run. Those elements had been absent in both Argentina and Brazil's plans.

I already mentioned that my stay in Cambridge from 1974 to 1977 gave me the opportunity to follow quite closely the Chilean and Bolivian experiences, as I was close to those who would design and implement the economic reforms in those countries. The same comment applies with regards to Mexico. One of my best Mexican friends at that time was Pedro Aspe. So, through him I could follow very closely the Mexican experience.

Pedro Aspe was in Cambridge attending his PhD at MIT at the same time I was attending my PhD at Harvard. We and other Latin American students had discussed extensively about our countries. No question about that, Chile was a case in point because it had started to implement its economic reform package by that time.

In writing our respective PhD dissertations, Pedro and I, analyzed the stagflation process that our countries were suffering. Argentina was going through the traumatic experience of another Military Cup. The Peronist Administration, which had been elected in 1973, was ousted from power in 1976 by the Military Junta amidst economic chaos. In 1976, Mexico suffered its first serious financial crisis since 1940 and the first devaluation of the Peso after 22 years.

From 1978 to 1987 Pedro and I stayed in touch and well informed of what was going on in both countries. I was the Director of a think tank in Argentina, the IERAL from the Mediterranean Foundation, whereas Pedro was faculty at the ITAM in Mexico City. He was starting his political career. He first served at the Institute of Statistics and then at the Secretariat of Planning and Budget.

In July 1987, Pedro Aspe invited me to participate in the Conference on Structural Change and Modernization in Mexico and the World, which took place in Mexico City. I remember that during the first day of the Conference, we shared the panel with Martin Feldstein from Harvard University, Rudiger Dornbusch from MIT, Carlos Salinas, who was the Secretary of Planning and Budget at that time, and President De la Madrid Hurtado.

The speeches given at that Conference were later on compiled in a book, which was published in Spanish by the Fondo de Cultura Economica. They reflect clearly that there was a “Latin American Consensus” at that time. Such a Consensus received the support of academicians such as Rudiger Dornbusch from MIT and Jeffrey Sachs from Harvard, whose economic ideas were rather different from those championed by Wall Street and Washington. As a matter of fact, regarding the debt problem, both Dornbusch and Sachs suggested that Mexico would never overcome stagflation and achieve macroeconomic stability and economic growth if it did not stop the net transfer of resources, which in turn was determined by its foreign debt.

I recall that I described the typical Latin American economic organization as “Capitalism without a Market and Socialism without a Plan”. I advanced my interpretation of the kind of economic reform that was needed to overcome the debt trap, and suggested that a new set of rules of the game was necessary along the lines of those implemented by Chile and Bolivia. This interpretation was widely supported, in particular by Latin American attendees.

At that Conference, President De la Madrid and future President Carlos Salinas de Gortari subtly unveiled that they were about to launch what in December 15 would be presented as the “Solidarity Pact.” The “Solidarity Plan” was a plan of stabilization and growth, which curbed inflation and allowed Mexico to undertake deep economic reforms. I believe that the best description of such a plan has been provided by Pedro Aspe and is included in the Syllabus. It is the Chapter 1 of Pedro Aspe’s book The Mexican Way. Additionally, the most detailed description of the negotiations that preceded the Brady Plan and NAFTA has been offered by Carlos Salinas de Gortari in his book Mexico: the Policy and Politics of Modernization, which is also included in the syllabus.

What did go wrong?

I have no doubt that the most radical economic changes of recent Mexico took place during the six years of Carlos Salinas de Gortari Administration. Successive Administrations tried to solve the most urgent problems at hand but were unable to introduce other reforms or reverse the reforms already in place.

Miguel Angel Centeno, in the first edition of his book Democracy within Reason: Technocratic Revolution in Mexico, published in 1993 admires Salinas' skills to obtain both PRI and population support in the difficult internal and external negotiations that institutionalized the economic reform. In its second edition, published in 1996, he includes a Post-script in which he tries to make sense of what happened in 1994 and 1995. He says: "The ultimate irony of the Salinato is that it was partly brought down by mistakes right out of a final exam for intermediate macroeconomics."

Although I do not agree with this conclusion, I included this reading in the Syllabus for a reason. Most of the analysis produced by the economic thinking in relation to the Tequila crisis endorses the previous simple explanation. I think that the available political and economic analysis simplistically find the causes of the crisis in basic macroeconomic mistakes the Mexican authorities supposedly made. From my point of view, this explanation of the crisis does not address what to me was the fundamental mistake made by Mexico during the transition from the Salinas to the Zedillo Administration. The mistake was to use US support to prevent a default on the debt rather than using it to prevent the extreme devaluation of the Peso. My point is that the mismanagement of the economic and political relationship between Mexico and the US is key to understand both the Tequila crisis and the relative lack of action characteristic of the Administrations that followed Salinas'.

Nonetheless, before analyzing the causes and consequences of the Mexican Crisis of 1994-1995, it will be useful to analyze more closely the role that Washington played in relation to the implementation of the economic reforms in Latin America. This is the topic of our next class when we will discuss "The Washington Consensus and US Leadership."

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Lecture 5
The Washington Consensus and US Leadership

In 1989 John Williamson, a senior researcher at the Institute for International Economics in Washington, organized a conference to evaluate to what extent Latin American countries had adjusted their economies as a way to solve the debt trap.

In order to determine whether the countries in his study had seriously tried to “adjust” their economies, Williamson made the effort to define “economic adjustment.” He would then use the word “adjustment” as synonymous of “policy reform” in his background paper entitled “What Washington means by policy reform.” In that paper, he tried to explain Washington’s economic recipe for Latin America. The term “Washington” was understood as the IMF, the World Bank and the US Executive Branch, although in a broader definition of the term, it would also include the IADB, congresspersons interested in Latin America and Washington think tanks doing research on Latin America’s economic policies.

The proceedings of that conference were published afterwards in a book edited by John Williamson. The book clearly reflects the economic policy package that was gaining consensus. Macroeconomic prudence, economic openness, competition and market transparency were almost unchallenged ingredients of the economic recipe. It is also clear from the reading of the book, that most of that package was no less than the “Latin American Consensus” as revealed by the measures many decision-makers had been adopting in the region.

The Latin American Consensus

This “Latin American Consensus” had been the result of the reflection of national leaders and researchers on the experiences and interests of their own countries. By no means was it a Washington’s imposition. This is the position endorsed by Enrique Iglesias in his article “From Policy Consensus to Renewed Economic Growth,” Sebastian Edwards in his book: Crisis and Reform in Latin America. From Despair to Hope, and Daniel Yerguin in: The Commanding Heights.

The ingredients of the “Washington Consensus” that did not reflect the “Latin American Consensus” produced heated debate and ended up causing what Moises Naim calls “Washington Confusion.” For instance, the “debt-equity-swaps” -a mechanism to induce private investment- was explicitly rejected by most Latin American countries. Similarly, decisions regarding the opening up of the Capital Account of the Balance of Payments, which relates directly to the interest rate and the exchange rate regime, should only be made taking into account the particular economic context in each country and not following a general formula.

It is my conviction that the so-called “Washington Consensus” is irrelevant to understand the economic reforms that took place in Latin America. What matters is the “Latin American Consensus”. Notwithstanding, I also contend that Washington played a key role in relation to Latin American economic reforms, in particular from 1989-2000, yet from a different perspective. Simply put, the key was Washington support to the reforms undertaken by the governments in the region.

Washington support was required and welcomed by LA leaders

Since the debt crisis in 1982, many Latin American leaders had been asking Washington to adopt a leadership position in relation to LA. US leadership at the end of the 1980s and early 1990s translated into three key decisions adopted by the Bush 41 Administration. Firstly, the joint work of the USTR and the Cairns Group in order to include Agriculture in the Uruguay Round of the GATT; secondly, the Brady Plan, which allowed Latin American countries to restructure their debts obtaining reductions in principal and interests; and thirdly, the Initiative for the Americas, which led to NAFTA.

Most Latin American leaders from different political parties, including myself, welcomed this change of Washington politics in relation to Latin America. We even drew a parallel between this new American approach to LA and the Marshall Plan, which the US launched after WWII to rebuild Europe. We also thought that it was a smart coordination with Japan's initiative called "Miyasawa Plan."

None of us interpreted those initiatives as a way to impose any particular economic package or "adjustment" required by Washington. On the contrary, we were proud that the economic reforms under way had been designed and implemented domestically, and were a clear and eloquent response to stagflation and hyperinflation.

The IMF, the World Bank and the IADB helped sometimes to solve problems and sometimes made mistakes. Nonetheless, they seldom imposed programs that had not been first designed domestically, at least in those countries that undertook economic reforms.

The standard picture that shows Latin American leaders deciding economic reforms imposed by Washington, as if they were Washington's puppets, is not realistic.

Bush 41 and Clinton's Administrations support to the economic reforms undertaken in Latin America mainly meant facilitating commercial and financial integration of LA economies to the global economy. Such a policy continued to be positively evaluated by most Latin American leaders, even in the aftermath of the Mexican and Brazilian crises of 1995 and 1999, respectively.

Why after Argentina's crisis in 2001-2002 the opposite opinion seems to prevail?

Rodrik offers one possible explanation in his paper "Feasible Globalization." According to Rodrik, Argentina made the greatest effort to globalize its economy. He considers that in order to adopt the purest neo-liberal model possible, it gave up its ability to adopt institutional innovations based on domestic needs and knowledge. So, Rodrik's argument goes, if a conflict arises between the demands from the foreign creditors and the needs of the Argentine people, the second would prevail. In a democracy, this would naturally lead to the abandonment of the neo-liberal model. US support is seen as one of the main reasons why Argentina adopted the neo-liberal model. Therefore, Argentina's failure is used as a way to demonstrate the negative effects of Bush 41 and Clinton Administrations decision to support LA countries from 1989 to 2000.

Yet, I have a different explanation. In 2001, several concurrent situations jeopardized Argentina's possibilities to overcome its financial problems. Let me explain. Argentina was embarked in a process of debt restructuring; however, US leadership to generate international support for this process was completely absent. At the same time, the IMF decided to use Argentina as a sort of case study in relation to a "moral hazard" problem that according to them would exist in international financial markets.

The combination of these situations led to the total destruction of the economic organization built during the 1990s and what is worse the Argentine People had to bear a cost three or four times higher than what would have been, had the rules of the game in place been kept and the orderly restructuring of the debt been completed.

Populist leaders who organized the riots to oust a democratically elected government adopted the measures demanded by large highly indebted private sector pressure groups, which allowed them to significantly decrease the real value of their debts. In exchange, these groups would give their support, I mean, economic support and support in the media. However, to save face when they realized the terrible suffering of the ordinary people they caused, those leaders needed scapegoats. They, hence, blamed the decision makers who preceded them, and their supposedly foreign bosses: the US Government, the IMF and the international bankers.

Alternative views and a more detailed discussion of what happened will be addressed in the coming classes on Mexico, Brazil and Argentina's crises. Before talking about those crises we need to analyze Argentina's experience up to 1998.

A short digression on Globalization and Institutional Convergence

I contend that it is not accurate to think of "Globalization" as a US creation designed to impose the institutions and interests of Anglo-Saxon Capitalism on less developed countries. On the contrary, I find the explanation offered by Marina Whitman in his recent article "American Capitalism and Global Convergence" most enlightening.

She contends that globalization is leading to a systemic convergence that includes not only the emerging economies but also in particular American-style Investors Capitalism, German-style Social Capitalism, and Japan-style Mercantilist Capitalism.

If this process is taking place in the developed world, we could expect no less in the less developed countries, which are making great efforts to find in the globalization process new opportunities to emerge from underdevelopment and backwardness.

However, it is not the same to say that there is a process of convergence, to say that such a process is the outcome of an explicit decision made by leaders of the Global Economy trying to impose conditions on emerging economies. I also contend that convergence does not mean that LDCs should import Anglo-Saxon Capitalism institutions. As a matter of fact, in some cases is the other way around. There are some institutional innovations decided and implemented in some emerging economies that are now being studied and adopted not only by other emerging economies but also by more developed countries. An example will illustrate my point; Chile's "Unidad de Fomento" (unit of development) is a predecessor of the Indexed Units of Account to which Robert J. Schiller refers in Chapter 15 of his book entitled The New Financial Order. Risk in the 21st Century.

Looking for Alternatives

In the short description of our course included in the Syllabus we mention that we would discuss alternatives to the Washington Consensus. Today we are starting that discussion, so we better set the terms of that endeavor.

Are we looking for universal alternatives to Global Capitalism? Do we want to reedit the 20th Century long discussion on Socialism versus Capitalism as universal social systems? I think the answer is No.

Are we looking for local alternatives to US-style Capitalism? Do we want to engage in Michael Albert's Capitalism versus Capitalism discussion? Again, my answer is No.

We will discuss alternatives to what? Roberto says that he is proposing a universal alternative to the Washington Consensus or the so-called neo-liberal paradigm. I cannot engage in a discussion on universal alternatives to the Washington Consensus because I do not consider the Washington Consensus as a relevant and accurate description of a Social System Paradigm. It would be like looking for alternatives to a ghost, and I think none of us wants to become Ghostbusters.

I think that Roberto is looking for an alternative to the Latin American Capitalism as reshaped by the Latin American Consensus of the eighties and nineties and USA support during the Bus h 41 and Clinton's Administrations. But the more I read his papers, the more I listen to his presentations and the more I think on his points, I come to the conclusion that he wants to make Latin American Capitalism more inclusive. Hopefully, most inclusive! That makes me very happy, because if that is so, then we at least

Now, the key question is: Should we adopt a revolutionary attitude or an evolutionary one? Should we implement a new complete overhaul of the rules of the game, as the Latin American Consensus of the eighties and nineties did, or should we work to improve those rules of the game whenever they are incomplete or mistaken?

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Lecture 6
Argentina until de Brazilian Crisis

By the second semester of 1998, Washington considered Argentina the most successful economy amongst those that had restructured their debt under the umbrella of the Brady Plan.

By that time, no ‘Washington Consensus” sponsor would acknowledge that Argentina’s economic reform package differed in several aspects from the 10 policy recommendations that constituted the core of the so-called Washington Consensus. On the contrary, Argentina was pointed out as the IMF, the World Bank and the US Government “best student.”

Carlos Menem, Argentina’s President at that moment, was invited to join Bill Clinton at the podium at the IMF-World Bank Annual Meeting that took place in Washington in October 1998 and to offer an address on his successful experience.

Many Argentine economists were invited to explain Argentina’s experience in international conferences and seminars. Everybody praised Argentina’s performance.

Having been the most important Minister of Menem’s Administration during seven years, I resigned in 1996. After leaving I kept denouncing the mafias I had fought against while in the Ministry because they continued operating somehow protected and interacting with those in power. When I was invited to give talks or speeches abroad, those comments were not welcomed. I was considered too critical of Menem’s government. They said that I had become an ambitious politician and by the same token, they evaluated my successor at the Ministry, Roque Fernandez, as a more orthodox and less politicized economist.

The description of Argentina’s 1989-1998 economic reforms provided by the readings is detailed and thus, I am not going to revisit them. Instead, I would like to comment on different aspects of our experience that I find relevant in order to understand how the decisions were made and how the reforms were designed. I will also mention to what extent we learnt from our neighbors and from our own history and what the influence of the “Washington Consensus” was.

The first strategic decision Menem made after his inauguration was not in the realm of the economy but in the foreign policy arena. Menem decided that Argentina should become a trustworthy nation to its neighbors, to the US, to Europe and to Japan, and to the extent possible to every nation in the world.

This line of action may seem obvious. It was not. It was a profound change in Argentine politics. Argentina had had a distant and sometimes conflictive relation with the US ever since the First Pan American meeting in 1890. The relationship with Europe had deteriorated due to the South Atlantic War, which was still unsolved because the peace had not been signed. Furthermore, we did not have diplomatic relations with the United Kingdom. Close to home, Argentina had been at the brink of fight a war against Chile in 1978 and we still had border conflicts with our neighbor. On the other hand, Argentina and Brazil had embarked in a very expensive nuclear race, and none of those countries had ratified the Tlatelolco Treaty, which aimed at preventing the existence of nuclear weapons in Latin America. On top of that, Israel secret service had disclosed that Argentina’s Air Force was secretly developing a middle-range missile to be exported to Iraq. Also, Argentine state-owned companies after signing partnerships with Japan investors had stopped the projects without notice or explanation.

Guido Di Tella and I had noticed that Argentina's international situation was Menem's primary concern. Although we were two of the economists Justicialist leaders would listen to the most and Argentina's economy was facing collapse, Menem would seek our insights on foreign policy rather than on economic matters.

Back in 1989, Menem was convinced that the changes that were taking place in the world would open a window of opportunity for progress and advancement to those nations ready to seize them. In order to take advantage of the opportunities he envisioned will come out, nations rather than get isolated should actively seek to be part of the globalization process. Menem had in mind that by the turn of the XX Century, Argentina enjoyed one of the ten highest per capita incomes in the world. This achievement had been possible because the country had been able to take advantage of the opportunities offered by the globalization process that took place at that time. Naturally, we shared his vision.

Instead, Menem still endorsed the traditional Peronist corporatist mindset regarding economic organization. It was then not surprising that he appointed the CEO of the largest Argentine multinational company as Minister of Economy, and a union leader as Minister of Labor. Back then Menem did not have a clear strategy of setting "Rules of the Game" for the economy. On the contrary, he used to make decisions based on the urgent problems at hand or in relation to topics that his closest advisors or the ministers themselves brought to his attention.

The decision making process did not follow a clear order and produced limited good results. By the beginning of 1991 stagflation was rampant and hyperinflation was a constant threat. Meanwhile, Menem's positive image had fallen to a low 15%.

Nonetheless Argentina had made progress in international affairs. Argentina was able to establish good international relations with its neighbors, Chile and Brazil, and it had also improved its relations with the US, Europe and Japan. It had also been involved in the Gulf War as a member of the International Task Force sponsored by the United Nations Organization, which in turn helped Menem to establish a close personal relationship with George Bush.

In 1991 Menem restructured his Cabinet. I was appointed Ministry of Economy and Guido Di Tella became Minister of Foreign Affairs. Up to that moment, Di Tella had been Argentina's Ambassador to the US and I had served as Minister of Foreign Affairs. At that very moment, Menem made the decision to produce a complete overhaul of the economy. He had understood how important was to provide the economy with clear and foreseeable "Rules of the Game" in lieu of decision-making processes based on discretion and urgencies. We had had long talks about these issues when we traveled together while I was his Chancellor.

I drew heavily from Chile, Bolivia and Mexico experiences when I outlined the plan, and used these examples when I explained my ideas to Menem. Chile was an excellent example regarding openness, privatization and deregulation. Bolivia, in turn, was a very good case study in relation to monetary policy because as well as Argentina, they had suffered a hyperinflationary process that ended up in a de-facto dollarization of the economy. Finally, Mexico had gotten US support to restructure its external debt with a 35% discount.

Menem envisioned that an intense political work would be needed in order to obtain the support of the Peronist Party, the Congress and the Governors. No doubt, the milestone would be the Monetary Reform. Notwithstanding, a Monetary Reform would not produce results by itself. On the contrary, it should be accompanied by a new budget system, balanced and accountable, by opening up the economy and by introducing competition in markets.

An immediate success against hyperinflation would grant his Administration the necessary support from the public opinion and the political leaders. We needed to use this support wisely and quickly to bring about all reforms needed not only to consolidate the stabilization process, but also to foster economic growth. We foresaw that introducing this reform package we would be able to offer Argentina a long period of sustained economic growth.

In the years that followed, the outcome was astonishing. Inflation went down from its hyperinflationary level to a 3% per annum in 1994. The economy grew 38% in 4 years. The Peronist Party won the parliamentary elections in 1991 and most of the Governorships. In 1993 Menem reached an agreement with Raul Alfonsín, the leader of the opposition party, to amend the Constitution, which allowed him to be reelected in 1995.

In 1991 Argentina formed MERCOSUR, the regional trade block in the Southern Cone, along with Brazil, Paraguay and Uruguay. In 1994, our MERCOSUR partner, Brazil, decided to launch an economic reform package along the same lines of Argentina's, although not that structured and complete. That plan, called the Real Plan, had very good results both in terms of reduction of inflation and growth. This coincidence, then, brought about a harmonious period between the two nations.

At the beginning of 1995 the Tequila Crisis had a harsh impact on Argentina's economy. There were significant capital outflows and in three months, banking deposits went down by 18%. However, rather than abandoning the rules of the game in place, we deepened the economic reforms. We got external financial support to privatize provincial banks and to implement economic reforms in several provinces as well. Therefore, we contained the recessive trend and were able to emerge from the recession after one year.

The economy resumed growth in 1996 and enjoyed another expansionary period that lasted almost three years. One of the consequences of the Tequila Crisis was the increase in unemployment rates. However, between May 1995 and October 1998 unemployment went down from 18.5% to 12.5% of the economic active population due to both renewed economic growth and a reform in the labor legislation.

In April 1991, the IMF had not given its support to the Convertibility Plan and had not granted Argentina a Stand by loan. Three months later, it changed its position and gave a significant support, which by the way was a key factor in implementing the Brady Plan Argentina on Argentinean Debt. Japan followed suit and also gave Argentina its support by means of granting another loan.

In 1994, Argentina had decided to decline the use of the last two disbursements of the Extended Facilities loan that the IMF had granted to support the country's Brady Plan. Notwithstanding, in 1995 the IMF was willing to make those disbursements and provide additional financing in order to ameliorate the consequences of the Tequila effect on our economy. Hence, we were able to demonstrate that a country can achieve a significant adjustment in the Current Account of the Balance of Payments and at the same time, maintain the value of the domestic currency. From 1994 and 1995 the Current Account Deficit was adjusted down by 3% of GDP.

Even though Argentina had a rigid monetary system, its economy was flexible enough to adjust to external shocks. Facing this evidence, the IMF came up with its theory of "two corners" in relation to the exchange rate system. The argument goes: either a clean floating exchange rate system or a strong peg would work, whereas intermediate exchange rate systems are crisis prone.

By 1998, Argentina's Currency Board was so prestigious a system, that I was intensely criticized when I stated that it was a temporary mechanism that should be superseded by a floating exchange rate regime. I am convinced that in 1997 Argentina missed and excellent opportunity to switch from its strong peg to a floating exchange rate system, when there were significant short-term capital inflows. Even in 1999 after the Brazilian devaluation, my proposal to give the Peso limited flexibility by paring it to a basket of foreign currencies was also criticized.

Back then I had this feeling that after eight years in place, our monetary system had made its way into the "Washington Consensus". I must say, however, the story coined at that time, the one that said that Argentina's economic reform was the outcome of applying the "Washington Consensus" recipe, did not make me feel very happy.

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Lecture 7
Crisis in Mexico and Brazil

The Stagflation that plagued Mexico from 1982 to 1987 convinced Mexico's government to launch its economic reorganization plan aimed at stabilizing the economy and foster economic growth. Seven years later, when the economy had already grew 18% and inflation had gone down from 160% in 1987 to 9% in 1994, Mexico suffered a deep monetary crisis.

The hyperinflationary process of 1993/1994 led Brazil to launch its Plan Real in June of 1994. Five years later, when Brazil had grown 20% and inflation had been reduced from 2000% in 1993 to 4% in 1998, the country suffered a severe monetary crisis.

Governments in both countries understood that they needed to recover their ability to manage the economy if they were to achieve stability and growth. These are two good examples of the reforms that Corrales describes as "more markets as a recipe for more stateness." However, after seven years in the Mexican case and five years in the Brazilian case, the State was unable to prevent the occurrence of monetary and financial crises. Those crises were costly for both countries in terms of forgone income, employment and inflationary pressures.

Both countries experienced the same situation. Markets anticipated the crises and the devaluation. Therefore, the Central Banks had to allow a fall of the International Reserves and an increase in interest rates, whereas decidedly ruled out the likelihood of devaluing the currency. Finally, however, they decided to devaluate. When they did it, they announced a limited devaluation (15% in Mexico, and 14% in Brazil). Notwithstanding, the announcement was followed by a massive demand of foreign exchange and the lost of reserves. In the days that followed, they had no choice but to opt for a floating exchange rate regime, which led to an extreme devaluation of the domestic currency. The new exchange rate system did not help to improve the situation. On the contrary, in both countries it increased the amount of debt outstanding and the risk of a default of the State and many private debtors.

Both countries managed to control the outburst of inflation that followed the devaluation, which in turn demonstrated that the economic reforms at least managed to remove the inflationary inertia that had contributed to fuel the stagflation and the hyperinflation a few years before. Nonetheless, the costs of these crises in terms of unemployment and lost of income eroded the popularity of both the economic reforms and the governments that had fostered them.

Since then the market reforms have lost momentum. It seems that neither Mexico nor Brazil could find the way to achieve sustained economic growth that trickles down the whole population, and to shrink the gap that separates these countries from the most advanced nations in the world.

The following are the questions we are trying to answer in this class: Why the governments were unable to limit the devaluation to the originally planned values? Could those devaluations have been avoided? Could they have changed the exchange rate regime without suffering such deep crises?

The Tequila Crisis

In trying to answer the first question, I find the discussion on a paper by Rudiger Dornbusch and Alejandro Werner entitled "Mexico, Stabilization, Reform and No Growth" really enlightening. Such a discussion took place during a seminar hosted by Brookings Institution in 1994. The authors proposed 20% devaluation without changing the exchange rate system, and set forth that such a devaluation if accompanied by the Solidarity Pact would bring about the real effects needed to foster economic growth. Obviously, the authors blamed the use of the exchange rate as an anchor to control inflation and the overvaluation of the peso that this policy would cause for the reduced economic growth showed by the Mexican economy.

When Guillermo Calvo commented on this paper, he stated that the authors had overlooked the credibility crisis that such policy would cause. Breaking one of the most announced and defended Government policies would foster speculation that would end up in overshooting and severe consequences to the stability of the financial system and the financial solvency of the Mexican government.

In December of 1994, Zedillo's Administration went ahead and devalued the currency as Dornbusch and Werner had proposed. The crisis that followed unfolded exactly as Calvo had predicted. No matter this so clear experience, in January 1999, the Brazilian authorities made the same mistake. They tried to produce a limited devaluation and kept the exchange rate system after having broken it. In both cases the reaction was exactly the same: excess demand of foreign currency as a consequence of the lost of credibility.

I will not go into all the details in relation to Guillermo Calvo reasoning. I would like however to make a few points. Trying to bring about a small devaluation and keep the exchange rate system was inconsistent with the economic reform both countries had undertaken. We have already explained in previous classes, that such reforms had in their core the abandonment of discretion and unpredictability when it comes to economic policy and the adoption of predictable and credible rules of the game. Hence, the alteration of the exchange rate rule destroyed the government's credibility and unleashed a destabilizing speculative process.

In order to answer the second question, I think Calvo's comment and Robert Rubin description on how Clinton Administration handled the Mexican crisis are both useful.

Calvo contends that the Mexican government should have obtained US support to handle the bank run instead of devaluing the currency. In exchange of that support, Mexico should have committed to open investment opportunities and to foster the increase in productivity. From Robert Rubin writings, it is clear to me that who was the Secretary of the Treasury of the US back then considered that it was in the US interest to avoid Mexico's default on its debt. Thus, it is safe to assume that the mutual compromise that Calvo envisioned was perfectly possible. To the best of my knowledge an agreement along those lines had been preliminary discussed when Lloyd Bentsen was the Secretary of the Treasury.

Summing up, the devaluation that took place on December 20, 1994 could have been avoided, exactly as Argentina avoided the devaluation in 1995. Argentina managed to avoid that devaluation despite the Tequila Crisis fueled both a run against the Peso and a bank run that caused a drop in bank deposits in the order of 18%. To me the answer in the Mexican situation was to deepen the economic reforms under way in order to reduce the deficit in the Current Account of the Balance of Payment and therefore be able to correct the misalignment in the relative prices of the economy.

The crisis of Plan Real

The Plan Real was launched in 1994 in order to curb the hyperinflation. It drew heavily from the success stories of Chile, Bolivia, Mexico, Argentina and Peru. As well as the Argentine Plan, the Plan Real was based on a monetary reform that tried to break the inflationary inertia. However, both plans had a different approach toward the use of foreign exchange. The Plan Real did not allow the use of the dollar in domestic financial transactions, nor backed the new domestic currency, the Real, with the international reserves. Nonetheless, markets expected that the Real would keep its value vis a vis the dollar which in turn led to the dramatic reduction in inflationary expectations. The exchange rate was not fixed 1 to 1 to the dollar as in the Argentine case, but it floated around that value for some time. Immediately after the Plan was launched, the Real appreciated the most. Thus, the exchange rate was .80 Real to the Dollar, whereas before the crisis the exchange rate was 1.20 R/u$s

In the four years that followed the launching of the Plan, inflation went down as dramatically as in the Argentine case after the launching of the Convertibility Plan. Nonetheless, in other respects the Brazilian economy did not react as Argentina's economy from 1991 to 1994. Argentina enjoyed a notable increase in productivity and fast economic growth. In Brazil, productivity did not increase much and economic growth was in the order of 3% per annum. Moreover, during the first four years of the Convertibility Plan the fiscal deficit was eliminated, whereas in Brazil during the first four years of the Plan Real the fiscal deficit was on average as high as 6.8% of GDP. By the end of 1998, it was very clear that Brazil needed to deepen the structural reforms in order to foster productivity and cut the fiscal deficit. This kind of policy was particularly needed in Brazil's states, which had dramatically increased their expenditures and debt.

The 1998 Russian Crisis strongly impacted on Brazil's economy, and dramatically exposed the economy's weaknesses, just when the country was about to go to the polls and Fernando Henrique Cardoso reelection was at stake. Financial markets assumed that the government would not deepen the economic reforms fostering productivity and reducing the fiscal deficit, rather the ghost of the devaluation loomed. These expectations were self-fulfilling. The banks and big businesses indebted in dollars increased their demand of assets in dollars in order to match their financial positions. The government issued new debt to be adjusted by the value of the dollar in such a way that the private sector managed to pass on the foreign exchange risk to the public sector. Once this sort of transfer of currency risk had taken place, the private sector, particularly the industrial sector and the banks of Sao Paulo started to press in favor of devaluation.

When the government tried to cope with this demand by announcing a limited devaluation in the order of 14%, an incredibly large increase in the demand of dollars followed. The Central Bank could not afford a further decline in the international reserves and decided to let the exchange rate to float. Naturally, we know what transpired. The reaction resembled what had happened in Mexico four years before. The overshooting that followed significantly reduced the relative price of non-traded goods and wages and seemed to reinstall inflationary pressures in the economy.

In order to avoid an even deeper crisis, the government had to implement the delayed economic reforms; in particular the states had to adjust their budgets and the Federal Government had to contain the fiscal deficit as well. However, they had to make such harsh decisions amidst a climate of unpopularity and dissatisfaction due to the negative effects that the devaluation brought about. In this context, they could never implement economic reforms aimed at increasing productivity.

In the aftermath of the devaluation, Brazil achieved primary superavit from 1995 to 1998 in the order of 0.2% and from 1999 to 2002 in the neighborhood of 3.6%. However, the devaluation was not the right tool to solve the fiscal disequilibria. On the contrary, the service of the Public Debt increased tremendously; hence the final outcome of the devaluation was an increase in the fiscal deficit, which went up from 6.8% of GDP in 1995-1998 to 7.15% of GDP in 1999-2002.

Simply put, had the government implemented the same fiscal adjustment without the devaluation, the fiscal deficit could have been abridged from 6.8% of the GDP to 3.4% of the GDP. Hence, the economy could have showed a better performance from 1999 on. Furthermore, the costly consequences of Brazil's devaluation on its own economy and on its neighbor's economies, particularly, Uruguay and Argentina's, could have been avoided.

Answers to the questions

Why limited devaluations were not possible after all? To me, the answer is clear: you need to recognize how powerful can be an stabilization policy based on credible rules of the game that creates positive expectations and fosters domestic savings in the domestic currency. Thus, if you break a key rule of such stabilization plan, you bring about a deeply destabilizing speculative reaction, which ends up in a devaluation larger than originally needed in order to revert any exchange rate overvaluation.

The other key question is whether or not these so damaging devaluations, which led to a traumatic floatation of the exchange rate, could have been avoided. I am convinced, they could have. Both in the Mexican and the Brazilian cases, the multilateral organisms and the US Treasury had disclosed their will to support fiscal adjustment programs and economic reforms aimed at increasing productivity. Therefore, the initial devaluations could have been avoided, and could have been replaced by mechanisms aim to gradually change the value of the currency without falling in the destabilizing speculative processes that actually transpired.

Was it likely to change the exchange rate regime without falling into a monetary crisis? I think the answer is yes, it was. Two conditions were, however, necessary. The exchange rate regime could have been changed had existed neither fiscal deficit nor an immediate concentration of foreign debt payments. Hence, fiscal adjustment and foreign debt restructuring are key preconditions to introduce successfully flexibility in the exchange rate regime in such a way that the decision do not lead to a costly monetary and financial crisis.

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Lecture 8
Brazil and Mercosur

I have already contended that the economic reforms implemented by most Latin American countries in the 1990s cannot be labeled as a Washington-driven institutional model. Nonetheless, I have also pointed out that most Latin American reformer countries, particularly, Mexico and Argentina, enthusiastically accepted Bush 41 and Clinton Administration's support both to facilitate the access to international capital markets and to negotiate international trade agreements. However, Washington's influence on Brazil was by far less important than on the other Latin American nations. Brazil was not very enthusiastic regarding the FTAA and only asked for the IMF support to cope with the Real Plan crisis, but not before that moment.

Notwithstanding, the same economic ideas were simmering in Brazil as well. During the 1980s Brazil's economists and decision makers came to the same conclusion as their Latin American colleagues as to how to cure Latin America's maladies. They were also convinced that the market should rule over private sector decisions and fiscal discipline should rule over the public sector. They were part of the Latin American Consensus that had been building up at that time and that contributed the groundwork of the economic reform of the 1990s. Furthermore, Brazilian academicians helped to conceptualize this consensus in particular through the joint work of American academicians and Brazilian economists like Mario H. Simonsen. Chapter 22 of Rudiger Dornbusch book Exchange Rates and Inflation was back in 1988 the most complete elaboration on macroeconomic theory for open economies, and the economists who were designing and implementing the economic reforms would frequently refer to it. The chapter I am referring to is entitled "Inflation Stabilization: The Role of Income Policies and of Monetization" and was co-authored by Dornbusch and Simonsen.

Despite the intellectual contributions of its economists, Brazil implemented a lighter economic reform than its neighbors Chile and Argentina, and at a lower pace. In terms of pace and depth of the reform, Brazil's experience resembles that of Mexico. However, a major difference is rooted in the fact that Mexico entered NAFTA, but Brazil tried to lead its own trade agreement: MERCOSUR.

In 1960, South American nations and Mexico had created the Latin American Free Trade Agreement (known as ALALC from its Spanish name) which afterwards would be renamed Latin American Association for Integration (known as ALADI from its Spanish name). Block members had granted preferential treatment to their partners in the treaty on a case-by-case basis, and had signed several Economic Complementation Treaties on specific topics. Among those treaties, it stood out the 1985 Agreement signed by Argentina and Brazil aimed at fostering free trade on capital goods.

This integration scheme was appropriate under an ISI growth strategy because it aimed at increasing the scale of production. As a matter of fact, in relation to the goods included in the treaty the regional market was treated, as it was domestic. However, in the same manner the protected industry sector opposed the openness of the economy; it rejected these agreements as well. Therefore, the integration process was a lengthy and difficult one.

By 1990, those governments that were working on the economic reforms realized that in order to succeed they would need to remove the anti-export bias created by the previous growth strategy. Hence, trade openness and the creation of investment opportunities were deemed as necessary tools towards that end. MERCOSUR, thus, was the outcome of initiatives aimed at fostering openness. From the beginning, the idea was to gain ground in regional openness but distinctively instead of case-by-case and sector-by-sector negotiations, the process would be general and automatic.

In March 1990, we talked about forming an Argentina-Brazil block for the first time. That year, during the Rio Group summit in Mexico City, the Mexican Chancellor informed that Mexico would propose the US the negotiation of a bilateral free trade agreement. As a consequence, Argentina and Brazil's Chancellors decided that it would be worthwhile to reevaluate the whole integration process in South America (namely ALADI without Mexico).

At that time, at the Ministry of Foreign Affairs I worked on the idea of enhancing a Latin American Free Trade block by using the PAR (Preferencia Arancelaria Regional – a generalized cut in intra-regional tariffs-), which was an instrument already approved by ALADI although it had never been applied. My proposal consisted of setting an initial PAR of 20%, which after five years would reach 100%. This PAR would be applied on the whole set of tradable goods and there would be only a few exceptions that would be disappearing over time. This PAR should be agreed on and applied by the 10 South American nations. Mexico would not be included as it was seeking a probably similar scheme but in North America.

There would not be commitments in relation to tariffs towards non-member countries. Each nation could individually decide the protection levels for its domestic production. However, the greater the protection towards non-member countries, the higher the preferred tariffs the trade partners would enjoy. I envisioned that this arrangement would foster openness in trade policy in each country.

Itamaratí, on the other hand, had a different stand on the matter. They preferred to deepen the bilateral integration process initiated in 1985. They thought of forming a custom's union and eventually a common market along the same lines of the European Union. Brazil's emphasis in relation to the custom's union had to do with Brazil's intent to prevent the opening process that Chile's experience had foster in Latin America.

The industrial sector in Sao Paulo did not want to dismantle the protectionist scheme in place and, hence, had to find a way to prevent that Argentina implement a Chilean-style tariff scheme. If Brazil entered in a free trade agreement with Argentina, and Argentina was open to the world, Argentina's competition in Brazil's market would have been equivalent to allow an opening process faster than what Brazil was ready to accept.

Simply put, Brazil's emphasis in regards to the Custom's Union and its lack of interest in a free trade area has always been linked to its interest in controlling the processes of trade openness towards third parties.

As usually is the case in negotiation processes, the agreement went half way between both initial strategies. Argentina succeeded in enlarging the regional block by including Uruguay and Paraguay and leaving the door open to the other South American nations, and also making sure that the intra-regional tariff reduction would be fast and across the board. Brazil was able to impose the common external tariff to be negotiated in a four years period. The Asuncion Treaty, signed in March 1991, created MERCOSUR, only a few days before Argentina's Convertibility Law was passed.

Four years later, when the intra-regional tariffs had been eliminated, the Ouro Preto Treaty was signed, which set the External Common Tariff. By that time, Brazil had implemented the Plan Real and both Argentina and Brazil shared the view that negotiating as a block rather than individually with the US and the European Union would provide MERCOSUR countries an edge and thus, they would be able to gain access to those markets.

From 1994 to 1998 MERCOSUR gained prestige and its members enjoyed a significant trade growth not only among them, but also with the rest of the world. At that time, many thought that it was a better alternative to the free trade negotiation with the US because NAFTA, which had started January 1, 1993, had not shielded Mexico from suffering another deep crisis.

Truth is, MERCOSUR success was not rooted in the implementation of free trade mechanisms; rather it was the consequence of the simultaneous success of Argentina and Brazil's stabilization Plans: the Convertibility Plan and the Plan Real. The simultaneity of both stabilization efforts brought about a sort of monetary integration, whose expansionary effects overwhelmed the integration process.

In the aftermath of the devaluation of the Real in 1999, MERCOSUR entered a crisis, which has been unable to overcome despite the political statements with regard to the integrationist spirit of Argentina and Brazil. Argentina's crisis in 2002 seems to have recreated a climate of monetary integration, though. As a matter of fact, both countries announce monetary policies based on inconvertible national currency and similar inflation targets. However, Argentina's debt crisis and Brazil's high interest rates reflect a precarious situation, and thus it is not possible to envision MERCOSUR implementing clear rules to effect monetary and trade integration.

We have witnessed recently a sort of revitalization of MERCOSUR in the political arena; however, in the economic realm MERCOSUR still is a dying entity, which does not show any signs of recovery or improvement. At this point, the future of MERCOSUR and the role it play in fostering growth in Latin America very much depends on Brazil's decision and role and whether Argentina joins its trade partner in the effort.

Changes that only Brazil can introduce

To me, there are four changes Brazil has to bring about in order that MERCOSUR be part of a successful growth strategy.

Firstly, it has to emphasize and allocate resources to investment in integration-infrastructure. This infrastructure has to reach the Andean countries as well. To me, the inadequacy of infrastructure limits the ability of South American countries to integrate. As a matter of fact, it is easier to transport people and goods between any Latin American country and the nations in the Northern Hemisphere than among neighbor countries in South America. Hence, without a significant investment in transport, communications and energy infrastructure, each country will privilege its relationship with the US and Europe rather than the other countries in the region.

Secondly, Brazil has to give up its protectionist policy based on high tariffs in relation to the production of capital goods. If it aims at promoting this industry, it should do it through subsidies instead of tools that make those goods more expensive. Brazil's protectionist policy in the 1990s determined that within MERCOSUR goods such as transportation equipment, computers and machinery were very expensive. Therefore, as the other countries in the region are trying to reduce the investment cost, it will not be able to reach agreements with the other countries, if it keeps such a policy in place.

In order to have a successful integration process, a coordination of some sort regarding monetary regimes and policies is necessary. Otherwise any integration process based only on commercial agreements will be subjected to recurrent weakening monetary crises. Hence, thirdly, Brazil's own monetary and financial arrangements should succeed as those of Chile did in dramatically reducing the real interest rates in medium and long-run transactions. In my view, this is a necessary condition to gain the other countries will to coordinate monetary policies and regimes with Brazil.

Fourthly, Brazil should demonstrate that it is interested in that every MERCOSUR member has wider access to third countries markets. By the same token, it will not have to impede that its partners seek bilateral agreements that may widen their access to important markets. I my opinion, in case that the other countries think that through integration Brazil tries to obtain a leadership position only to advance its own interests without paying attention to its neighbors' interest, it will find it difficult to accomplish effective integration agreements.

I am aware that this would be a radical change in comparison with Brazil's policies and role from MERCOSUR inception up to the Argentine crisis.

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Lecture 9
The new "Washington Consensus" that triggered the Argentine Crisis

The economic rules set forth by the Convertibility Law helped to tame hyperinflation and definitively curbed inflation, which had been a problem that had haunted Argentina's economy for over four decades. Furthermore, the new rules of the game also created the conditions to attract investment back to the country, which in turn fostered productivity and economic growth. The growth rates enjoyed by Argentina's economy between 1990 and 1998 had only been achieved throughout the first decade of the 20th century.

On top of those positive results, this "new economic order" proved strong. As a matter of fact, it withstood very critical situations, such us the capital flight that followed the Tequila Crisis. Moreover, the system in place was strong enough to overcome the recession suffered in the aftermath of the Mexican crisis and to recoup growth within a year. The best example of how the economy bounced back to economic growth is the behavior of the unemployment rates. In fact, unemployment went down slightly at the beginning, rose considerably during the crisis, in 1995, and went down again from 1995 to 1998.

I contend that the origin of Argentina's more recent economic problems can be traced back to 1999 and recognizes three sources. Firstly, there was a credit crunch, which primarily affected small and medium sized enterprises. Secondly, after Brazil devalued the Real, Argentine products lost competitiveness in relation to their Brazilian substitutes. Thirdly, the depreciation of the euro and other currencies vis à vis the US dollar from 1999 to 2002 clearly resulted in an overvaluation of the dollar-pegged peso.

Let's elaborate on the three sources I mentioned above. As I said, since the second semester of 1998 credit was insufficient to meet the private sector financing needs. This development was the result of two concurrent phenomena. On the one hand, the provinces, especially the Province of Buenos Aires, were spending heavily and financing their expenditures through commercial bank borrowing therefore causing what is named as crowding out. On the other hand, the 1998's Russian crisis dramatically reduced the inflow of foreign capital available to emerging countries. Indeed, the first sign that credit would be restricted was the high lending rates the provinces were charged, which by the way, they seemed keen to accept in order to continue borrowing. In the private sector, however, due to the higher cost of credit investment decisions were put off and small and medium sized enterprises struggled to maintain their reducing working capital. Needless to say, this situation severely impacted employment rates, as SME are mostly labor-intensive.

The Brazilian devaluation, on the other hand, had a notoriously harmful effect on Argentina, as Brazil had become one of the major Argentina's trade partners since MERCOSUR inception. At the time of Brazil's devaluation, trade with Brazil accounted for almost one third of Argentina's foreign trade. These circumstances severely affected agricultural businesses and manufacturing companies producing import substitutes.

On top of that, the Argentine dollar-pegged peso substantially appreciated from 1999 to 2002 mainly due to the dollar strength with respect to the Euro, which in turn discouraged exports further.

In order to reverse the critical situation, several adjustments should have been made, which unfortunately were decided when it was a bit too late, and therefore, were unable to prevent the crisis. The economic measures, that in my view, should have been taken earlier than 2001 refer to cutting provinces heavy expenditure and stopping their bank borrowing, imposing some restrictions on Brazilian imports and shifting from the dollar-peso peg to a peg to a basket composed by the dollar and the euro.

The Argentine Crisis and the rules of the game implemented during the 1990s

In late December 2001 and January 2002 the economic rules of the 1990s were under attack: Hence, the Convertibility Law, which provided that every Argentine Peso issued be backed by one US Dollar, was revoked, and all contracts and transactions in the economy were compulsorily pesofied. To be clear, all US dollar-denominated contracts were turned into Argentine pesos, however, at asymmetrically different exchange rates. The abandonment of the Convertibility and the ensuing pesofication had devastating effects, among which we can mention:

- A sharp nominal devaluation of the Argentine currency. As I mentioned before, by virtue of the Convertibility Law one Peso was worth one US dollar, but after the Law was repealed, the peso depreciated to be worth USD 0.25; nearly two years later it stabilized at approximately USD 0.33.
- A differential and limited inflationary impact. The prices of internationally tradable goods tripled but the value of most other non-tradable goods –including salaries- hardly increased. As a result of differential inflation, real salaries shrunk by 30 percent on average.
- A dramatic fall in consumption and investment. This translated into a further GDP drop throughout 2002, which was quite as large as the accumulated decrease the country had suffered from 1998 to 2001.
- A fall in exports volumes throughout 2002. However, in 2003 foreign trade has been increasing at the average rate of the 1990s.
- A 60 percent fall in GDP in terms of US dollars, as a consequence of the real effect of devaluation and the decrease in consumption and investment.
- A domestic redistribution of wealth in the order of USD 30 billions which were diverted from savers' bank deposits and pension funds to private-sector debtors and Provincial Governments. The Federal Government did not benefited from this redistribution policy, as it incurred more debt to compensate financial institutions for the asymmetric pesofication.
- About 20% of GDP was diverted from workers and service suppliers (including privatized utilities) to the producers of non-agricultural tradable goods and import substitutes.
- A stabilized economy and partial recovery of consumption and investment during 2003. Notwithstanding, in terms of US dollars, 2003 GDP was less than 50 percent of 2001 GDP.

What triggered the crisis?

So far, several explanations have been given in order to explain the 2001 crisis, which shattered the economic rules of the 1990s. The International Monetary Fund argues that the determining factor was the Federal Government and Provincial Administrations reluctance to cut back public expenditure and thus stop borrowing to finance their fiscal deficit. The advocates of the currency-board system and supporters of the forced- dollarization policy blame it on the plan to broaden the dollar-peso peg, which would eventually become a basket peg, and on the Competitiveness Plan launched in 2001. They insist that the economy should have been fully dollarized in the first place. Some consider that the crisis was due to the stagnation of exports caused by an overvalued peso. Others put it down to President De la Rúa's decision to preserve the convertibility policy and to avoid resorting to devaluation as an instrument for financing fiscal deficit. And lastly, there are those who claim that it took too long to propose an orderly debt-restructuring program.

The government's reluctance to cut back expenditures

Michael Mussa, a former chief economist of the IMF, has argued that the factor that triggered the crisis was the USD 2 billion fiscal adjustment that the Central Government failed to support in March 2001, while Ricardo López Murphy was Argentina's Minister of Economy. Actually, I do not agree with Mussa's position because shortly after Ricardo López Murphy's resignation, I was appointed to take over his position and together with President De la Rúa succeeded in getting parliamentary support for a USD 3 billion fiscal tightening package. This measure along with the Competitiveness Plan, which would help to improve the relative prices of internationally tradable goods without abandoning convertibility, allowed us to avert the bank run of March 2001.

Notwithstanding, in July 2001, IMF Managing Director Horst Köhler took notice of Argentine political leaders' criticism against the Zero Deficit legislation and implied that the IMF would discontinue their support to the country and would not approve the Financial Aid Program that Argentina was applying for in order to contain another bank run which had started early that month. However, in August we came to an agreement with the provincial governors, and the Zero Deficit Law was finally passed. This proved that the Central Government was working hard in building the necessary internal political support, and at that moment it was not clear that it lacked it. IMF Managing Director Köhler had to reconsider his previous statement and the new loan was finally approved in August 2001.

I contend that, fiscal statistics do not support the idea that Argentina had refused to cut back the expenditures. In 2000, the Federal Primary Outlays decreased by USD 1.5 billion, and in 2001 USD 3.5 billion was additionally trimmed. This cuts included 13% reduction in public sector wages and pensions over USD 500. Furthermore, in the second half of 2001, the provinces -whose primary expenditure in 2000 and the first half of 2001 had shown the same levels of 1999- took pains in balancing their budgets to achieve a USD 2 bn adjustment. Even without any further tightening, by 2002 National and Federal consolidated primary public expenses would have been USD 7 billion less than in 1999.

Almost all governors and –needless to say- President De la Rúa knew that the abandonment of the economic rules of the 1990s would mean a much tighter and costlier adjustment than the one they were voluntarily applying. Naturally, they knew that otherwise Public Expenditure would have to be reduced by means of inflation. For that reason, to assume that they refused to make the necessary adjustments only to stir up the crisis and undermine the economic policies of the 1990s is to assume that they were on the verge of political irrationality. And, believe me, they are not irrational –I can tell you from my long time experience working with them.

The Central Government's decision not to force dollarization on the economy and the implementation of the Competitiveness Plan

Steve Hanke, the world's main supporter of currency boards, and several think-tanks like the Argentine CEMA or the Cato Institute, argued that the economic rules of the 1990s were at crisis because I opposed the plan to dollarize the economy and launched the "Competitiveness Plan" instead. According to them, this raised doubts as to whether the country would continue to uphold the Convertibility Law.

I did not want to force a dollarization policy because I was convinced that introducing the US dollar as Argentina's only legal currency was not appropriate for our economy. In 2001, in particular, I thought that if the Central Government considered it constitutional to enforce the currency conversion of contracts so that those, which had been originally denominated in pesos, were forcefully honored in US dollars, the reverse could also be valid. In other words, enforcing a dollarization process would have set a constitutional precedent for the compulsory pesofication of contracts. My point is that, under the Convertibility Law it would have been possible the dollarization, the "Eurization" and even the pesofication provided that it was a voluntary decision, not a forced one. The Convertibility Law clearly stated the possibility of using multiple currencies and established no such thing as a conventional currency board, although unfortunately many economists have persistently mischaracterized it as such.

By promoting a compulsive dollarization of the economy, President De la Rúa's Government would have accelerated the crisis, which eventually subverted the economic order of the 1990s. A dollarization process would have added to the real cause of the crisis and therefore, triggered the collapse much earlier in 2001, and would have provided more powerful political and judicial arguments than the ones used in January 2002. Hence, the decision not to force a dollarization cannot be considered what triggered the crisis.

Neither could it be blamed on the Competitiveness Plan. This comprised a series of measures intended to set relative prices right so as to favor tradable goods without undermining the convertibility rules. Indirect taxes and subsidies served as the instruments of this plan, which also eliminated regulations that discouraged investment and productivity. Little could the Competitiveness Plan have contributed to spark the crisis which disrupted the economic order of the 1990s when it was precisely aimed at correcting the maladjustment of relative prices that adversely affected internationally tradable goods. The purpose of the plan was to correct the so-called misalignment of the real exchange rate without modifying the nominal exchange rate present in all of the contracts in force. In any case, what raised doubts about the dollar-peso fixed parity was actually the maladjustment of the real exchange rate rather than the attempts to redress the imbalance.

The stagnation of exports

Most of the technical papers that deal with the Argentine Crisis, especially those produced abroad, consider the stagnation of exports to be the result of an overvalued dollar-pegged peso. This is the typical explanation that any theory textbook would give when referring to stabilization plans based on a fixed exchange rate. However, those who write on Argentina and ascribe the crisis to the dollar-peso parity seem to have missed or overlooked some of the factual data available on the Argentine case. It is so common a misconception that even US Secretary of the Treasury Mr. Paul O'Neill made the same mistake when he said to The Economist1 in July 2001 [sic]: "Argentines have been off and on in trouble for 70 years or more. They don't have any export industry to speak of at all. And they like it that way. Nobody forced them to be what they are."

After he gave this statement, I pointed out that he might have been misinformed. I explained to him that indeed during the 1990s Argentina's exports performance had been similar as that of Chile, and had almost doubled Brazil performance, not otherwise, as Mr. O'Neill seemed to believe. After this gaffe, he asked the IMF to grant Argentina a USD 8bn package to support an orderly debt restructuring program that would help reduce the country's interest bill. The IMF Board thus approved the monetary aid at the end of August 2001. The IMF USD 5bn disbursement contributed to strengthen the Financial System and contained the bank run that had taken place in July and August, fueled by the uncertainty in regards to IMF support to the Zero Deficit policy.

President De la Rúa's decision to underpin convertibility instead of devaluing the peso to finance the fiscal deficit

According to Joseph Stiglitz, it was President De la Rúa's determination to underpin the convertibility plan what actually triggered the crisis. This view was also shared by those, who claimed that the economic collapse did not stem from the unbridled public spending and borrowing but from the Government's decision not to implement Keynesian policies to spur economic recovery in 1999, when it became clear that the country had gone into a recession.

In my opinion, had President De la Rúa's Administration decided to abandon convertibility and applied Keynesian policies, the economic order of the 1990s would have been subverted two years earlier. This entailed the serious risk of an eventual hyperinflationary process because devaluation with no fiscal austerity and large monetary issuances could have caused so drastic a depreciation that dollar indebted individuals and institutions would have demanded that their contractual obligations be pesofied or that a subsidy of some sort relieve their debt burden and keep them away from bankruptcy.

Background knowledge and experience in relation to the negative consequences of such policies in Argentina in previous decades was so vast that no Argentine political leader or economist seriously proposed such an alternative.

The lack of decision to orderly restructure the public debt

Allan Meltzer and Charles Calomiris2, among others, have argued that Argentina showed no willingness to restructure its public debt. However, their restructuring proposal of April 2001 was unfeasible in

[1] See *The Economist*. July 19th, 2001. See also, www.economist.com
http://www.economist.com/displaystory.cfm?story_id=701377.
See also interview with CNN, August 17, 2001, quoted in several Argentina mass media (For an example, refer to *La Nación*, August 18th, 2001, Buenos Aires, Argentina. Page 7, Economía; or lanacion-online at www.lanacion.com.ar/01/08/18/de_328554.asp. Also: www.bradynet.com/bbs/argentina/100081-0.html
"And Argentina is now, after a 41 billion intervention, in a very slippery position. We're working to find a way to create a sustainable Argentina, not just one that continues to consume the money of the plumbers and carpenters in the United States who make $50,000 a year and wonder what in the world we're doing with their money".

practice. As a matter of fact, Meltzer-Calomiris proposal had assigned the IMF the role of last resort lender. However, the IMF showed no disposition at all to allocate the money necessary to support a last resort-lending scheme. As I will discuss later in this paper, the factor that actually triggered the crisis of the economic rules of the 1990s started to transpire by the time we launched the orderly debt restructuring option, after the IMF had accepted to support it through the USD 8 bn provision that it approved in August 2001.

By November 30th 2001, Argentina had successfully completed the first phase of the restructuring scheme, which covered 55 billion dollars of debt principal (almost 60 percent of the expected restructured value). This included the voluntary swap of old bonds and loans –which in some cases paid interest rates of as much as 20 percent per annum- for guaranteed loans which used tax receipts as collateral and paid annual interest rates not higher than 7 percent. It also attained a three-year deferment of capital amortization payments. This first tier of the restructuring option brought in USD 4bn worth of annual interest reduction over 2001 total of USD 14bn.

The second phase of the debt swap scheme was meant to bring the interest bill down by another USD 3bn so that, in terms of interest, public expenses for 2002 would have totaled USD 7bn instead of 2001 USD 14bn. The USD 7bn cutback in Provincial and National Primary Public Expenditure plus this further reduction in the order of USD 7bn guaranteed Zero Deficit for 2002. However, this was not enough to prevent the crisis of the economic rules of the 1990s. Thus, it could not be alleged that the origin of the crisis was due to the Argentine Government's indecision to orderly restructure its debt.

The reason that actually triggered the crisis: Argentine influential leaders and decision makers' perception that there was external support to conveniently ease all types of debts –including private sector liabilities

At the end of November 2001 it was clear that the Central and Provincial Governments had decided to significantly cut back Primary Public Expenditures, so that during 2002 expenses would be USD 7bn below the levels of 1999. Besides, the Central Government had shown no disposition to prevent the voluntary dollarization of the economy, that is to say, people's own decision to convert their pesos into US dollars. The exports incentive policies and the protection concerning imports from Brazil had been successfully implemented, without the need to adjust the nominal exchange rate or increase the fiscal deficit3. Exports continued to grow and imports had fallen enough to eliminate the deficit of the Current Account of the Balance of Payments deficit. Neither the most important Argentine political leaders nor the economists who advised political parties would suggest increasing deficit and abandoning convertibility to finance it through monetary issuance. Furthermore, on November 1st 2001, Argentina had launched the first tier of its Public Debt Orderly Restructuring Scheme, which was gaining

[2] These authors argued that there could be "default without disruption" and proposed "an IMF-backed facility that stands ready to buy all debt of a government running a financial crisis to the private sector at a support price significantly below its expected restructured value". See Lerrik, Adam and Allan H. Meltzer. "Beyond IMF bailouts: default without disruption." Carnegie Mellon Gailliot Center for Public Affairs, Quarterly International Economics Report, May 2001, p. 1.

[3] Brazil had accepted that the imports tariff arising from the so called "*Factor de Convergencia",* a "convergence factor" between the US dollar and the average between the dollar and the euro be also applied on imports from Mercosur, the Common Market of the South. Likewise, Brazil had agreed to negotiate safeguards for some sectors.

considerable support from banks and pension funds, namely, the most important holders of national and provincial bonds.

But which were the signals coming from abroad? The IMF delay to send the assessment mission which would consider whether Argentina had fulfilled the goals for the third quarter of 2001 set in August's program, the lack of IMF public support to the Debt Orderly Restructuring Scheme announced by the Federal Government on November 1st, the IMF informal comments suggesting that bond holders abroad would not be treated in the same way as domestic ones, the overt public discussion concerning a future Sovereign Debt Restructuring Mechanism (SDRM) which implied exchange controls during its implementation, and the diffusion of opinions by former IMF and IADB officials supporting devaluation and advocating pesofication were precisely the signals coming from abroad.

All these signs startled bank savers and fueled the bank run. Besides, heavily indebted companies and provincial governments took such signs as "Washington's" acknowledgement that Argentina's debt problem could only be resolved through significant "haircuts" that domestic and international bond holders would have to accept. Had the message not been clear enough for Argentine leaders, Allan Meltzer mentioned this idea in interviews with the Argentine press[4], Moreover, during a trip to Buenos Aires he told national senators that the restructuring process which the Argentine Government had embarked on would not generate enough "haircut" so the country should simply default on all of its debt.

In my view, it was in this context, that Eduardo Duhalde, the main leader of the Peronist Party, and Ignacio de Mendiguren, then head of the UIA (an organization which represents most Argentine industries) came to the conclusion that the Institutional Coup –presumably sponsored by the Radical Party against their own political peer, President De La Rúa, to put an end to the so-called "Neoliberalism of the 1990s"- could provide them with the opportunity to "erode" all debts, public and private, held at home and abroad. This could be achieved through what the "new" Washington Consensus seemed to suggest: Devaluing the Argentine Currency and Pesofying all of the economy's contracts. A recent discussion concerning the "successful" depreciation of the peso sheds new light upon the factor, which actually triggered the crisis of 1990s rules of the game.

Some recent statements by Argentina's Minister of Economy, his 2002 predecessor, and the former Minister of Production

Former Minister of Production Ignacio de Mendiguren and Former Minister of Economy Jorge Remes Lenicov, who devised the measures implemented early in January 2002, have recently stated:

"Hadn't Argentina devalued its currency, the economy would have been knocked out with a dollarizing blow by the Right."[5]

"What was done during those months of 2002 and what Lavagna went on doing has allowed Argentina to stop falling apart, has helped to prevent hyperinflation and contain social outburst."[6]

[4] See *Revista 3 Puntos*. Año 4 N. 231. Interview with Allan Meltzer by Pablo Rosendo González. www.3puntos.com/seccion.php3?numero=231&seccion=protagonista.
[5] www.lanación.com.ar, Friday, November 28th, 2003

The day before, Minister of Economy Roberto Lavagna had said:

"Almost two years after 2001 collapse, Argentina is at an international level the most successful case of devaluation in the world."[7]

Has the devaluation been really successful?

Connecting the three statements quoted above it becomes clear that those who praise devaluation and its effects seem to consider that the redistribution of income and wealth caused by the devaluation was necessary[8], and that the measure of the success lies in the fact that hyperinflation has not occurred. The reasoning that evaluates positively the outcome of the devaluation on the grounds that the economy has eventually stopped falling apart and that social outburst has been contained, underestimates the actual cost of the currency depreciation in terms of the further fall of GDP after devaluation and the 50 percent reduction of GDP in terms of dollars.

I believe that devaluing the peso was an extremely negative policy decision because it redistributed wealth and income in a way that was not only unnecessary but also unfair and inefficient.

Such measures as devaluation, pesofication and the forced rescheduling of fixed-term deposits have given rise to a huge contingent liability against the Argentine State. As a matter of fact, Argentina faces countless lawsuits as a consequence of the violation of contracts and the unconstitutional modifications in the legislation in place. These disputes are far from being settled; rather they are still awaiting a resolution. In my view, the only reason why hyperinflation has been averted is precisely because so far a final ruling on those legal actions has been postponed. Nonetheless, the income distribution tensions and the ensuing fiscal and monetary derailment entail a potential risk.

Additionally, if the economy stopped shrinking it is simply because the further drop in consumption and investment derived from the peso depreciation was absolutely unnecessary. The 1998-2001 contraction had been deep enough to balance the Current Account of the Balance of Payments. The additional fall experienced in 2002 caused a Current Account surplus stemming from nothing other than a drastic outflow of capital abroad.

It was only natural that the outflow stopped and started to reverse when dollar savers saw that assets, goods and services in Argentina were worth less than one third. However, this cannot be regarded as a sign that the problem is resolved but rather as an indicator that net investment was negative. In fact, investment plunged so deeply that even after the recovery of 2003 it is merely half way below the level it reached during the 1990s. As a matter of fact, the current Investment level is still insufficient to counterbalance capital depreciation; as a consequence, the economy's output capacity will continue to fall.

There exists the impression that the so-called social outburst (characterized by people taking to the streets to bang their pots and also by looting and other ways of demonstrating) at the end of 2001 was soon

[6] www.lanación.com.ar, Friday, November 28th, 2003
[7] www.lanación.com.ar, Thursday, November 27, 2003
[8] It would seem that, for Mr. De Mendiguren, the intent to "*dollarize* the economy" would have been negative because it would have prevented the re-distribution of wealth and income.

contained for the mere reason that those who had stirred up trouble then took power and -allow me to say- politically “rewarded” those leaders who had fueled the riots by granting them several hundreds of A$150 monthly allowances to allocate in their districts under the “Jefes y Jefas de Hogar” welfare scheme. However, one might guess that, far from disappearing social anxiety must be now deeper than in 2001 because real wages have fallen dramatically and unemployment has gone up. Why is it then that social discontent in 2001 was so deep about the 13 percent reduction affecting only the public sector’s monthly money wages over USD 500 and now that all real salaries are 30 percent lower no word of criticism is heard? From my point of view there exists a latent social discontent, which can manifest itself at any moment.

To attain sustainable growth, it is necessary that Argentina undo most of the effects of the devaluation and rebuild a context of legal certainty so that domestic savings and, after some time, probably foreign savings be once again available to finance high levels of investment.

Rebuilding legal certainty to attract investment

Those who have invested in Argentina whether domestic or foreign investors feel that the country lacks legal institutions able to guarantee property rights, as they saw how their own property rights were destroyed by the devaluation and the ensuing pesofication. These circumstances have given rise to countless court and out-of-court conflicts that remain unresolved. The further the peso depreciates in real terms the more difficult it will become to find a way out of such situation.

For a year now the market has tended to undo the initial overshooting. This trend would accentuate if the government eventually eliminated taxes on exports and allowed the peso to float freely vis à vis any other convertible currency that individuals should choose to employ for financial contracts. For the peso to compete on an equal footing with the other currencies, medium and long-term peso-denominated contracts should be indexed by a price index

In those conditions, the peso would most probably appreciate –its present value is around USD 0.50 in real terms (compared to the dollar/peso convertibility rate) - to quickly stand at USD 0.80 approximately, and in the long term, reach a rate that is close to that of convertibility. The fact underlying this estimation is the significant slide of the dollar vis à vis the euro and other currencies throughout 2002 and 2003.

With the peso thus evolving in real terms, it should not be too difficult to find a fair resolution to most judicial conflicts. Publicly and privately held debts could be reasonably restructured so that Argentine debtors would be able to honor their obligations and Argentine and international creditors would eventually reach an agreement. In turn, those who invested in infrastructure and public utilities would start to regain profitability and recover their investments.

What is the main obstacle preventing the implementation of this solution? In practice, the pressure groups, both internal and external, which in 2001 converged to disrupt the economic order of the 1990s and managed to erase most of the economy’s liabilities, are still influential.

The way to erode that power away is that workers, pensioners and ordinary citizens in general understand that behind the praise for a “high exchange rate” lies the intention to maintain a depreciated peso in real terms, which means nothing other than low real wages and low savings in real terms. The reaction, both by the Public Opinion and by the Federal Government with regards to the statement that Argentina's devaluation has been the most successful in the world seems to be showing increasing public awareness about the harmful effects of a highly depreciated currency.

Additionally, in order to prevent Washington from misleading Argentine policymakers in the future, Argentina's debts with multilaterals should be pesofied in the same fashion that contracts ruled by Argentine legislation were arbitrarily converted into pesos before. Indeed, should this be the case, multilaterals would certainly foster the appreciation of the Argentine currency. After all, in the light of the latest agreement between the IMF and our country, it becomes clear that multilaterals' main concern is that they are fully repaid. Nonetheless, two years ago they suggested that Argentina's problems would be resolved only if domestic and external creditors suffered a significant write-off.

Questions and Answers

Before I conclude, I would like to answer some of the questions, which I have been asked in the last few weeks. They refer to my interpretation concerning the events of December 2001-January 2002.

Was it imperative to devalue the peso in order to ease the financial crisis and the debt problems, which arose at the end of 2001?

No, it was not. On the contrary, the depreciation of the peso exacerbated the financial crisis and the debt problems, to such an extent that until two years after the collapse, there still is no clear sign of a feasible solution.

The way out of the financial crisis and debt problems was the orderly debt restructuring underway at the moment of President De la Rúa's resignation. As I said before, the goal of the debt restructuring scheme launched on November 1st 2001 was to bring the interest bill down from the USD 14bn paid by the Public Sector (Central and Provincial Governments) in 2001 to USD 7bn payable in 2002, and to achieve a three-year deferment of all capital maturities.

The first phase of the debt restructuring scheme was successfully finalized on December 15th 2001: around USD 55bn of bonds held by domestic and some foreign creditors were voluntarily swapped for guaranteed loans which would use tax revenues as collateral and pay interest rates not higher than 7 percent per annum. This restructuring option represented USD 4bn of interest reduction per year. Hence, the second phase of the scheme would require cutting only USD 3bn of the interest bill on the USD 45bn bonds held internationally.

Another part of the debt-restructuring plan consisted of a second offering to be launched by mid January 2002. This offering would take advantage of the voting power attained in the first phase in order to impose exit consent clauses, which in turn would discourage holdouts. The full restructuring process was meant to conclude by mid February 2002. After this date, the exchange controls implemented on December 1st 2001 could have been lifted and the financial system normalized.

In the meantime, we were going to use the pending loans from the IMF (a USD 1,3bn disbursement which had not been released in November 2001 plus the remaining USD 3bn from the USD 8bn package granted earlier in August) to bring liquidity to the banking system.

We foresaw that once the debt had been restructured and the zero deficit target secured by virtue of the primary expenditure cut back in the second half of 2001 and the USD 7bn interest reduction, the expectations of savers and creditors who had swapped their bonds would have improved, and funds would have gradually flowed back into the financial system. These conditions would have helped the private sector, whose limited accessibility to credit had contributed to the long lasting recession, as its borrowing capacity had deteriorated since 1998.

Did the default on Argentina's debt announced by President Adolfo Rodríguez Sáa interrupt the restructuring process?

No, it did not. After being appointed as interim President, Adolfo Rodríguez Sáa announced that Argentina would default on its foreign debt. This, however, did not mean that the country should interrupt the orderly restructuring process, because the already exchanged debt was not supposed to be affected by a default. Besides, if the second public offering had been launched as planned -on January 15th 2002-, foreign creditors would have decided to swap their bonds to ensure that they would continue earning interest, though at lower rates.

But such measures as the devaluation and the pesofication undid it all. On the one hand, these two policies, coupled with the unilateral decision to slash interest, resulted in a default on the debt that had just been turned into a guaranteed loan. On the other hand, it became clear that Argentina's government did not intend to immediately resume interest payments, not even those concerning the debt, which had just been restructured with tax receipts as collateral.

Needless to say, the default on all of the public debt aggravated the financial crisis. Banks had to face a deluge of lawsuits filed by savers whose deposits had been compulsively pesofied and rescheduled.

Was devaluation inevitable after savers rushed to exchange their pesos for US dollars?

No, it was not. On December 1st 2001 it became necessary to implement temporary restrictions on cash withdrawals. At that time, peso-denominated bank accounts could be voluntarily converted into dollar deposits. The national reserves at that moment sufficed to exchange all the money supply; that is to say, there were enough dollar reserves to back every peso in circulation at that date. Therefore, people could turn their cash into dollars banknotes if they wished. By virtue of their legal rights, Argentineans could decide whether to keep their pesos or exchange them for American currency -it was by no means a "dollarizing blow by the Right".

How would then the Central and Provincial Governments manage to pay their dollar expenses if tax revenues were not enough?

Any possible deficit would be covered by means of the LECOP, a treasury bond meant to replace all other quasi-money issued by provincial governments. LECOPs functioned as a new type of non-convertible currency whose value was not backed by the peso or the dollar. Unlimited issuances of LECOPs would certainly lower their value, but this type of devaluation would not be violating the convertibility law. In any case, the depreciation of LECOPs would only affect those on the public-sector payroll. Private-sector workers in turn could have negotiated with their employers how much of the salary would be paid in dollars and how much in LECOPs. This could have meant some sort of flexibility for wages and would have spared the economy from the overall deterioration caused through devaluation.

In practice, all pesos would have voluntarily been replaced with dollars, and the bi-monetary system would have continued to operate with dollars and non-convertible floating LECOPs.

This alternative resembled President Rodríguez Sáa idea of introducing the “Argentino”, a type of currency, which would work in the same fashion of LECOPs. According to his words, the plan was to issue 10bn argentinos throughout 2002 in order to absorb approximately 3 bn LECOPs and other provincial quasi-currencies in circulation at that time. The Argentino would have certainly lost value vis à vis the dollar, but such depreciation would have been definitely much lower than the eventual devaluation of the peso derived from the forced pesofication of the economy. Furthermore, if the debt restructuring process had been achieved and the interest bill had been halved, the zero deficit goals would have been met and the issuance of argentinos could have been discontinued.

But my personal impression is that as soon as President Rodríguez Sáa chose not to revoke convertibility, pro-devaluation-and-pesofication lobbies pressed to have him replaced using the same methods applied a few days earlier with Fernando De la Rúa.

I am persuaded that such measures as devaluation and pesofication were not actually urged by the prevailing circumstances; on the contrary, they were the motive behind the Institutional Coup, which started on December 19th and finished when Adolfo Rodríguez Sáa resigned, on December 30th, only 10 days after Fernando De la Rúa’s own resignation.

I also believe that the decision to devalue the currency and pesofy the economy was aimed at redistributing wealth and income in favor of heavily indebted provinces and companies, and to the detriment of savers and workers. These measures only helped to aggravate the financial crisis and the debt situation, and eventually represented a very high cost that translated into a dramatic GDP fall and increased levels of poverty and unemployment.

Was devaluation necessary to boost exports and promote imports substitution?

No, it was not. Exports grew during the 1990s due to the increased productivity achieved thanks to high levels of investment. The devaluation of the peso itself has not brought any additional expansion in terms of volume. The higher value of exports experienced after the devaluation is due to higher prices not bigger volumes. In fact, the current performance of exports is similar to that of the previous decade. On the other hand, exports taxes will have an increasingly negative effect on all investment directed at traditional exporting industries.

Regarding the production of tradable goods in general and imports substitutes in particular, the “convergence factor” coupled with the competitiveness plan and the 2002-2003 depreciation of the dollar vis à vis the euro would have provided a natural protection factor. In any case, it would have been also necessary to insist on a system of safeguards that prevented the unlimited competition from Brazilian imports favored by the free trade agreement with that country and the sharp depreciation of the Real. To me, these measures prove more consistent and permanent than a devaluation to boost competitiveness.

This is so, because, no matter how sharp the depreciation of the currency, devaluation effects are always transitory.

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Lecture 10
Rebuilding the Latin American Consensus

From the end of the eighties to the end of the nineties a consensus on how to reorganize the national economies of the region emerged in Latin America. Although the establishment in Washington and its critics like to call it "the Washington Consensus", I contend it was a true "Latin American Consensus" generated by the exhaustion of the import substitution growth strategy and the lessons of the debt crisis of the eighties.

Although the reorganization of the economies was implemented with varied degrees of coverage and deepness in different countries, today Latin American economies have in common some important features that significantly contrast to the kind of economic structure and organization present in the mid eighties.

As a matter of fact, most Latin American economies have been able to cure chronic inflation, erosive stagflation and virulent hyperinflation, three related diseases that in different doses had infected the region until the early nineties. The success in fighting inflation brought about the necessary popular support for the accompanying reforms, at least at the time the reform packages were launched.

Nowadays, most Latin American economies can show increased private sector participation, more competitive markets, and smaller public sectors, which besides function under stricter budget constraints.

Finally, most Latin American economies are today both more open to foreign trade and investment and have received, at least for some years, larger inflows of foreign capital than in previous decades.

Chile is the only one economy that reached rapid and fairly stable growth. Argentina reached also rapid growth in the early 1990s, which lasted eight years, afterwards it went into a very deep crisis and its economy now looks completely disorganized. Brazil and Mexico looked a bit more institutionally stable than Argentina, but their growth performance since the beginning of the nineties was mediocre at best.

Except for Chile, in most other Latin American economies, income distribution worsened and extreme poverty not only did not diminish, but even also increased. As a consequence, democracies are weakening and governments face increasing difficulties to maintain popular support for the policies they choose to implement, no matter their ideological tint. The political picture is completely opposite to that that emerged at the beginning of the reform processes, when governments were able to defeat inflation.

Those that argue that the direction of the reform process implemented by the Latin American Consensus of the nineties was fundamentally wrong propose a reversal of the reforms. If this opinion prevails there will be increasing Statism and Isolation and that trend will sooner or later reintroduce inflation in the economies. The social consequences will be even worst than those of the previous reforms.

I sustain that the direction of the reforms embodied in the Latin American Consensus of the nineties was right but in many countries the reforms were incomplete and superficial, particularly in its intent to increase and mobilize domestic savings and to open investment opportunities accessible to all kinds of entrepreneurs, not only to the old and big firms. They were also incomplete and superficial in relation with the planning and operation of the public sector that in most cases did not focus its effort in providing security, justice, education and public health.

The Latin American Consensus of the nineties needs to be reborn and rebuilt. It should be revived in its commitment to reform both the Market and the State. But it should also be rebuilt in the sense of emphasizing the inclusiveness of the Market and the transparency and democratization of the State.

Market reforms for more inclusive growth

The key for making growth more inclusive is to reorganize the markets through the simplest and clearest rules possible rather than through discretionary interventions of the State on a case-by-case basis.

Monopolies created and enforced by the State should disappear and natural monopolies should be regulated in such a way that the risk of the capturing of the regulators by the monopolists is minimized.

Further privatizations should only be conducted after the monopolies have been broken or effective regulations have already been enacted and the agencies responsible for enforcing them are able to operate with exclusive focus in the general interest of society. That is to say, the appropriate checks and balances for the well functioning of the natural monopolies should be in place, before starting a new privatization wave.

Tax and labor regulations should be simple and minimal for the new and small enterprises, as to encourage entrance of the informal businesses into the formal economy.

The registration of assets and the protection of the property rights of those operating previously in the informal economy should be the backbone of the strategy to include the maximum number of workers and small proprietors into the formal market economy.

The use of electronic and plastic money and the facilities offered by the Information Technology make it possible a rapid process of formalization of the informal economy that could not have been imagined just ten years ago.

Credit should be available not only for the old and big businesses but also for all households and the new and small enterprises. This will only happen to the extent that the process of formalization of the informal economy takes place simultaneously with an effective process of mobilization of increased domestic savings and with a financial intermediation system that encourages domestic lending of the available financial resources.

A tax system based on a uniform Value Added Tax, a progressive Personal Income Tax at the Federal level, and Sales and Property Taxes at the local level should generate the tax revenue necessary to finance government expenditures.

The Government Budget should be balanced over the business cycle making room for deficit financing at times of recession with the cumulated surpluses during the boom years.

Macro policies, mainly fiscal policy, will be available for dampening the business cycle only if the country is able to accumulate financial wealth during boom years.

Monetary policy will only become a counter cyclical policy tool once the currency is trusted by the people. For that to happen it may take a long period of time if the economy has a long experience of inflationary outbursts.

Monetary Regimes in Latin America

There is no such a thing as an optimal currency regime for Latin American economies. As it usually happens in relation to most political and economic institutions, the best rules of the game depend on every country specific historical circumstances. The best that theory can do to help institution building in emerging economies is to point out the risks associated with the acknowledged distortions in each type of second-best solution.

A currency regime is an essential part of the institutional base of any economy. If an emerging economy is unable to create a good currency regime, it will lack the financial and capital markets that are essential for the financing of productive investment. With those limitations it will be difficult for such an economy to simultaneously achieve stability and growth.

A good currency regime has to provide at least one currency to efficiently fulfill the following roles: a means of exchange for every kind of market transaction (spot, future, domestic, foreign) and a store of value. No doubt, the best currency regime for a national economy is that of the US today or that of the UK at the time of the British Empire. One currency, the Dollar today (or the Sterling prior to WWI) is accepted worldwide for every kind of transaction and is considered a secure store of value. Nowadays, only Europe, as a Monetary Union and eventually Japan if it finally decided to internationalize the Yen, are in a position to create such a currency regime. In the three cases, the currency permits the existence of spot and future markets of every imaginable kind, while long term interest rates are close to some concept of a ”natural rate,” reflecting long term expectations of price stability.

To open the door to the best solution for emerging economies, a future International Monetary System should offer them the opportunity of becoming full members of a monetary union that will meet the conditions identified by Nobel Laureate Robert Mundell for optimum monetary areas.

Nowadays, countries, which are eligible to become members of the European Union, enjoy the prospect of joining the euro. However, this is not the case for emerging economies that mostly trade with the US or Japan, because none of these two leading nations have demonstrated any intention of letting their national currency regimes evolve into larger Monetary Unions. In an ideal world, a good way to move in the direction of building a better International Monetary System that would increase the prospects of stability and growth for the global economy, would be to have the US and Japan demonstrate a willingness to use their currencies as the base for enlarged monetary unions that would offer to their developing country commercial partners the possibility of adopting the best possible currency regime. Yet, so far, the re are no signals that the US and Japan endorse the idea.

The second best currency regime for emerging economies would involve the use of a domestic currency different from those used in foreign transactions, or simply adopting the Dollar, the Euro or the Yen for domestic transactions. Countries will find significant advantages in using one of the three above mentioned foreign currencies in domestic transactions if two conditions apply: they trade heavily with one of the three monetary areas; and a long history of inflation has prevented the creation of future markets and long term financial contracts. Foreign currencies such as those previously described will dominate inflationary expectations and will allow for the creation of future markets that cannot develop in an inflationary environment.

This means that long-term interest rates will be much lower than otherwise. The one important constraint emerging economies may need to cope with relates to the lack of a central bank that may act as a lender of last resort. Notwithstanding, the relevance of this limitation deserves further analysis given the fact that whenever the domestic currency is not credible enough, a central bank' chances of providing lending of last resort is very limited. In such a context, when a financial crisis looms there is usually demand for the foreign currency. Thus, increasing the supply of the domestic currency only feeds hyperinflation. This explains why Panama, Ecuador and El Salvador have already adopted the Dollar as their currency, and why it is likely that other economies in Central America and the Caribbean pursue the same course in the future.

When the "second best" currency regime, so to speak, includes a domestic currency, the economy involved has to define two main features: the degree of convertibility between the domestic and the foreign currency, and the degree of flexibility of the rate of exchange. In case that the financial history and behavior of the country allows it to have a currency regime that combines the maximum of convertibility with the maximum of exchange rate flexibility, then there is no doubt that that particular economy should choose full convertibility and a free float for the national currency. The UK, Switzerland, Canada, Australia, New Zealand, Singapore and a few other economies chose that path long ago.

The typical dilemma for an emerging economy that has had a long experience of persistent inflation, and even worse, hyperinflation is how to deal with the trade off between convertibility of the domestic currency and flexibility of the exchange rate. The degree of convertibility needs to be somewhat restricted so that the Central Bank has some capacity to conduct an independent monetary policy through the flexibility of the exchange rate. Otherwise everybody would use the foreign currency for most domestic transactions, particularly those involving long-term contracts. The typical restriction to convertibility that is commonly imposed involves prohibiting financial institutions to accept foreign currency deposits from residents and prohibiting residents to lend domestically in the foreign currency. In economies that have long been exposed to periods of inflation this limitation to convertibility may generate the flight of domestic savings. Hence, the constraint is normally accompanied by some additional restrictions on the transfer abroad of residents' funds.

These restrictions may impose significant distortions on the economy, particularly if residents interpret them as the government leaving the door open for the imposition of a future capital levy through sudden devaluation and inflation. These distortions will be reflected in high long term interest rates or simply the inexistence of long term savings and financing. This is one of the reasons why some emerging economies may prefer, at least for a while, to sacrifice exchange rate flexibility but to grant full convertibility to their domestic currency by managing it through a currency board. This was the case of most economies in the world between 1870 and 1930, at the time of the Gold Standard, as well as Malaysia and Singapore immediately after independence, Argentina from1991 until the end of 2001, and Hong Kong from 1983 to the present.

The challenge is, however, to minimize the risk that the sacrifice of exchange rate flexibility in favor of full convertibility end up in the catastrophic way that it did in the case of countries participating in the Gold Standard in the thirties and of Argentina in 2002. The emerging economies that choose full convertibility should exit the fixed exchange rate as soon as a persistent inflow of foreign capital calls for an appreciation of the domestic currency. That should be taken as an indicator that the economy is ready to combine full convertibility of the currency with free floating of the exchange rate. This is what Singapore did in the early 1970s.

Full convertibility, however, is not always the most convenient solution. Emerging economies that have had a history of inflation but at the same time consider it too risky to sacrifice exchange rate flexibility, particularly if they are prone to suffer severe external shocks, should probably try other institutional arrangements in order to lower long term interest rates and encourage medium and long term savings and financing. Chile, and to some extent Brazil and Mexico, have successfully used financial indexation as an alternative to full convertibility. Notwithstanding, whatever the mechanism used to remove the distortions created by the lack of full convertibility, crises will be unavoidable if there is not enough fiscal discipline, particularly, in the case of emerging economies that have a long history of inflation.

Trade liberalization and economic integration

National economies should actively negotiate removal of trade barriers within the WTO and should not make unilateral concessions unless they are necessary to generate significant welfare gains within the national economy.

Regional integration should only be pursued to the extent that it is part of a project of political and economic integration soundly grounded in geography and history and supported by the people.

In any case, regional integration processes should emphasize physical integration and include at least some minimal doses of monetary and financial coordination as to avoid sudden monetary and financial disruptions of trade and investment flows.

If the level of productivity and income of the involved countries is initially very different, resource transferences oriented to facilitate the process of economic and social convergence should be negotiated.

Reform of the State

So far, the main reforms of the State that took place in most Latin American Economies consisted mainly in a downsizing of the Public Sector associated with the process of privatization of state owned enterprises, the change from a pay as you go system to a capitalization Social Security System and the end of the inflationary financing of Public Sector deficits by Central Banks. These reforms, even though were not always implemented in the best possible way, did help to increase the degree of transparency and accountability of the State.

But many more reforms are needed, particularly in countries with a Federal System. The reforms implemented in the Central Governments were not always accompanied by similar reforms in the provinces or local states, and when these could get access to bank credit or external financing they contributed to the process of unsustainable indebtness in a way that made fiscal policy completely pro-cyclical. This was particularly the case in Brazil and Argentina. So reforms that introduce transparency and accountability in local governments are very necessary.

In some countries significant portions of the Judiciary, the Police and the Armed Forces have been captured by organized crime or have been made part of "organized corruption". There are some evidences that even though the old style corruption associated with rent seeking in closed economies and obscure management of state owned enterprises was reduced, at the same time, "organized corruption" associated with the management of social programs and the security or defense forces was increased.

The corruption of the security and defense forces is probably associated with the aggravation of drug traffic. The aggravation of corruption in the organization and management of social programs is a consequence of the shift in the composition of the sources of financing of obscure politics: as the state owned enterprises reduced their role as suppliers of funds, social programs took their place, with the terrible effect of discrediting the mechanisms that should provide social safety nets for the undesired consequences of economic reforms.

The main deficit of the Latin American Consensus of the nineties originates in its almost exclusive economic focus when the democracies of Latin America were still very imperfect and needed at least as much reform as that of the economies of the region. I consider Roberto Mangabeira Unger's proposal for a re-energized democracy very relevant and creative, but they would not work if the economic reforms of the nineties were reversed.

A reversal of the economic reforms of the nineties, for example the re-nationalization of privatized state owned companies and the closing of the economies will not help but endanger the process of political democratization of Society and the State, because it will only recreate old Latin American corporate state politics, which was even worse than the still very imperfect liberal politics of today. But a deepening of the reform in the direction of making them more socially inclusive could help a lot to make democracy more effective in removing "organized corruption" from the institutions of the State and broadening the participation of the people in political and economic development.