Argentina and Latin America: The future path

Domingo F. Cavallo

Domingo F. Cavallo was Argentina’s Minister of Economy and Public Works from 1991 until 1996, He also served as Argentina’s Minister of Foreign Relations. His many honors include being Minister of the Year, Economist of the Year Man of the Year; all awarded by major economic and finance organizations. He is currently a visiting professor in the Stern School of Business at New York University, Honorary President of Fundacion Mediterranea, and Correspondent Member of the Royal Academy of Moral and Political Sciences of Spain. He holds a Ph.D. from Harvard University and a doctorate in economics from Cordoba National University.

How did Argentina's economy spiral downward so fast, after racking up such impressive gains in most of the '90s? Domingo Cavallo answered this question and expressed his concern for the future of Argentina in his address to the Global Executive Forum.

From 1991 to 1998 a convertibility law was in effect, which pegged the peso to the dollar and legalized the use of foreign currencies in local contracts. "Argintines used the dollar as a way to protect their savings at a time of high inflation and hyper-interest," said Cavallo. "Also, real estate transactions and contracts were written in dollars. Convertibility opened up markets and led to an expansion of the GDP and exports.

"The '90s was a very good decade for Argentina, especially when compared to the lackluster '80s," said Cavallo. "In the '80s, GDP growth was 1.5 percent; from 1990 to 1998, it was 4.6 percent. Exports, too, grew in this period, from 4.4 percent to 7.9 percent, and productivity growth went from 1.2 percent in the previous two decades to 4.3 percent.

In fact, in the '90s, Argentina outshone Brazil which had a GDP growth rate of only 2.7 percent and productivity growth stagnant at 0.2 percent.

So what went wrong?

"The current recession started mid 1998. It was caused by a squeezing of bank credit due to excessive spending and borrowing by the provinces in '97 and '98 at high interest rates that couldn't be repaid." It was intensified by external factors such as the devaluation of Brazil's real, the subsequent depreciation of the euro and the continued weakening of the global economy.

What finally sent the economy over the edge was pesification. "In an attempt to eliminate currency over valuation, the new government in 2002, headed by President Duhalde, decided to freeze deposits in banks, banning the use of savings for payments through bank transfers and mandating the conversion of dollars into pesos. The peso's peg to the dollar was eliminated and the peso was allowed to float. A huge devaluation of the peso followed."

Assets of citizens and pension funds plummeted; investors' ability to fund projects dried up along with their confidence in the system. "Pesification brought an end to convertibility and the devaluation deepened the recession. But it failed to resolve the insolvency situations derived from debts contracted under foreign law, which cannot be pesified.

"Now, people are angry; they want their money back in dollars, not pesos. Savings are going abroad to protect against inflation, leaving banks without the ability to extend credit; consequently there is no
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financing for cars or mortgages. Wages are low; unemployment and poverty are high. And without convertibility there is neither investment nor stability.

"Pesification is hurting the energy sector, preventing new investment because the government wants exporters of crude oil to take their proceeds in pesos. It's also making the operation of these companies a lot more difficult."

Said Cavallo, "We're much worse off now than we were last year."

There are social consequences to pesification. "But Duhalde knows how to find political solutions. Heads of families are getting unemployment compensation of 150 pesos a month, which is less than US$50. But almost 2 million people are getting this money and that's sort of a social safety net."

To get the economy up and running again, "the Supreme Court needs to reinstate the rule of law by unfreezing deposits and revoking pesification. Unfortunately, the legislative and executive branches have impeached the Supreme Court; there was a procedure in place for doing this. Now the Court does not want to make any decisions while under impeachment.

"We need a new elected government to recreate conditions conducive to growth and eradicate corruption, inefficiency and political favoritism.

"Corruption is a complex problem in Argentina, and it is encouraged by the kind of federalism that exists," said Cavallo. "The federal government collects the taxes, then shares the taxes with the provinces. The provinces are not accountable for their spending, so they use the tax money to buy political support." To eliminate or reduce this corruption, "the local governments have to be given more responsibility to collect their own taxes and to be accountable to the taxpayers for their spending."

Argentina's problems are affecting Brazil, and "if a crisis like the one in Argentina develops in Brazil, all of Latin America will be affected because our political and economic institutions are weak and unstable.

"Mexico will be okay because it has a strong institutional anchor in NAFTA and the United States. Chile will be okay because it is using the world as an anchor via its bilateral and multilateral trade agreements. I think that is the methodology all of South America should use."

Argentina's immediate challenge, Cavallo wrote in a recent paper, "is to rebuild its monetary institutions as to reassure savers that their financial wealth will be protected from arbitrary changes in the rules of the game."