Argentina: The current inflationary crisis



Domingo Cavallo

Former Minister of Economy of Argentina

Solange Monteiro, Buenos Aires

ARGENTINA'S FORMER ECONOMY MINISTER, Domingo Cavallo, is well known for implementing Argentina's convertibility plan, which fixed parity for the dollar and the peso between 1991 and 2001 during the Carlos Menem administration. He has also been reviled for creating the *corralito*, which prevented savers from withdrawing all of their money from bank accounts when convertibility was showing signs of exhaustion. Today a senior fellow in international affairs at Yale University, he is an expert on economic development and on financial crises and is a consultant to businesses and governments. He suggests that to fight unemployment European countries should replace the payroll tax with a value-added tax. He also believes that Brazil has been too slow in making reforms, and he has a dim view of the prospects for Mercosur.

***The Brazilian Economy*— As a consultant, have you advised the European countries most affected by the economic crisis? What are you recommending?**

Domingo Cavallo—I did not advise any governments directly but I have expressed my opinions. I argued that they need to preserve the integrity of the euro, because no country should rebuild its national currency because that would mean destroying the contractual basis of the economy, and would reinstate inflation and uncertainty. We suffered from that in Argentina, and we are still suffering. I suggested cutting payroll taxes and replacing them with the value added tax (VAT) or any other that does not discourage hiring. Spain has announced that it will reduce payroll taxes a little in 2014 but only very timidly. I think this policy should be pursued much more vigorously not only in Spain but also in other countries suffering from high unemployment.

Keeping the euro is important. In Argentina, when the economy stabilized, we allowed the dollar to be used like the Argentinian peso as currency for transactions and contracts, and there was a lot of financial intermediation in dollars. When the government that took power in 2002 decided to abandon the peso-dollar parity, the consequences were very serious. The problem today in Argentina in the energy sector has to do with that, because at that time energy prices were fixed in dollars and in relation to investment

and energy production costs. When prices were converted into pesos and then controlled, the costs increased because of the exchange rate devaluation but prices were not increased. Then all investment in the energy sector froze and demand for energy increased tremendously because prices were controlled. Now we have a huge energy deficit. It is a serious situation for a country which until 2001 was exporting electricity, gas, and oil.

"The best system in effect today is Peru's. There you can use the nuevo sol or the dollar, and this gives the country a big advantage: it has very low inflation, and enough exchange rate flexibility that the value of the nuevo sol adapts to external shocks."

Has any European country reduced payroll taxes, making it up with a higher VAT?

Ironically, even before the crisis, Germany had adopted such a policy on a small scale. It's almost a natural idea for countries that care about the competitiveness of their economies. This idea should be adopted to address the crisis, especially the unemployment in Spain, Portugal, Ireland, Greece, and Italy.

Is it possible to measure the impact of this policy in Germany?

Germany has never lost competitiveness—instead it has been winning it—but I think not so much because of this tax measure but because of a rise in productivity and a very prudent wage policy that did not increase unit labor costs. Other countries that had more generous wage policies were unable to increase productivity and efficiency by investing as Germany did.

Do you see any similarities between the economic imbalances that can now be seen in European countries and what happened in Argentina when you were minister?

The origin of productivity imbalances is completely different. In Argentina, our loss of competitiveness was caused by deteriorating terms of trade. Between 1998 and 2002 export prices in Argentina went down because the dollar was a strong currency … .In 1994 China unified its exchange rates and depreciated the yuan. Then the Mexican peso was devalued in 1997 and so were almost all the Asian currencies. In 1998 the Russian ruble was devalued, and in 1999 the Brazilian real. And during 1999, 2000, 2001, the euro recorded a slow devaluation. This implied an overvaluation of the Argentine peso. However, Argentina's competitiveness, coming from productivity and the quality of investment, registered an impressive increase. From 1990 to 2000 Argentine's exports grew almost twice as much as Brazil's.

Has the dollar-peso parity stimulated the quest for increased productivity?

In the 1990s there was a lot of investment, and above all it was efficient. Investments were oriented to increase productivity, which greatly improved transportation infrastructure, especially ports; industry was equipped with modern machines and advanced technology was adopted. Every automobile factory that now is producing at full capacity was installed in Argentina at that time. Agricultural productivity also increased impressively. The loss of competitiveness due to appreciation of the dollar should have reversed itself, and it happened starting in March 2002 with the fall in the value of

the currency. It was not necessary to devalue as Argentina did. Even with the devaluation of the peso, had they not converted contracts in dollars to pesos, the crisis might have been relatively short. In Greece, the situation is different. There were increases in salaries and in public and private spending. The quality of life improved but it was based on the indebtedness of households, businesses, and government, as well as on a transfer of funds from Europe. There was no increase in productivity. After several years, they realized that their labor cost was much higher than in Germany. The same happened to a lesser extent in Spain and Italy. They began to have access to cheap debt. With this they expanded infrastructure, with some very good projects but also exaggerated luxuries. That kind of excessive indebtedness did not happen in Argentina. At the time of the crisis in 2001, public debt was lower even than in Brazil, less than 50% of GDP. The indebtedness of households and companies was not so high either.

"The appropriate monetary system for open emerging economies is one in which national currencies coexist with foreign currencies that may also be used as legal tender, because that way there is full convertibility of the currency without the downside of a currency board."

Some experts argue that adoption of a currency board is only successful in a small country with a procyclical dynamic, which was not the case in Argentina. Do you agree with this view?

What Argentina had was a bi-monetary system [in which the US dollar circulated as legal tender alongside the Argentine peso]. Actually for an economy with international exchanges as diverse as Argentina's, we should have had a system with three or four currencies, allowing intermediations in euros or dollars. I think the best system in effect today is Peru's. There you can use the nuevo sol or the dollar, and this gives the country a big advantage: it has very low inflation, and enough exchange rate flexibility that the value of the nuevo sol adapts to external shocks . . . . The substitution between U.S. dollars and nuevos soles is quite large and, for example, when there is a global excess liquidity of dollars, it does not lead to an extreme appreciation of the nuevo sol. In contrast, in a country that only has a national currency, excess liquidity of dollars and high interest rates in dollars cause the national currency to appreciate excessively, which brings about loss of external competitiveness. I believe that the more appropriate monetary system for open emerging economies is one in which national currencies coexist with foreign currencies that may also be used as legal tender, because that way there is full convertibility of the currency without the downside of a currency board.

Even with its macroeconomic management condemned, Argentina has continued to grow in the Nestor and Cristina Kirchner administrations—average growth was 7% over the last five years. How is that?

Very simple. First, when they came to power Argentina had a lot of investment and production capacity, and had greatly increased productivity. What was missing in 2001 and 2002 was foreign demand because of the appreciation of the dollar and the

world recession. Even so, Argentina's exports continued to grow faster than Brazil's. When the exchange rate depreciated, soybean prices and exports soared. This was an extraordinary benefit for Argentina, which allowed the government to charge high taxes on exports, something Brazil and other countries did not do. Also, the devaluation greatly reduced wages so that the government could give nominal wage increases, and control energy and transportation prices. But all this has paralyzed investments. Today Argentina is finding it harder to grow because it has many bottlenecks in key sectors of the economy. The Kirchner administration took advantage of the capability already installed and turned to a protectionist industrial policy, increasing import restrictions. There was some investment in this new phase of import substitution, but now industry as a whole is not competitive in terms of prices and quality products; the old problems of import substitution policies of the 1970s and 1980s have reemerged. Another important factor was inflation: in the beginning it supported the construction industry because people prefer to buy land and houses rather than save. But there were no new investments in gas, electricity, transport, oil .... Although the economy has grown; it lost a huge opportunity to grow on a sustainable basis with stability. Had fiscal and monetary management not been disruptive since the Duhalde administration, Argentina's economy today would have been a lot like that of Canada or Australia.

"The Argentine government is a mix of characters that act disconnected and are not professionally prepared for the responsibility they have."

What would you do currently to contain inflation in Argentina?

Today, a minister could not resolve the situation. Neither could the central bank governor. That will only happen with a president that inspires confidence, credibility. Kirchner can no longer correct the course of the economy. Nobody believes her, inside or outside Argentina. Today there is no economic team; there is no central bank governor. The Argentine government is a mix of characters that act disconnected and are not professionally prepared for the responsibility they have.

What should the economic team of a new government do?

At once, I would remove all the barriers the government has imposed on the foreign exchange market and foreign trade, and seek full integration of Argentina with the world, seeking a negotiated solution to recover foreign and domestic creditworthiness. It is essential that Argentina no longer lies about inflation and commits to having price indices calculated by an independent institution. With a program of liberalization of the Argentine economy and a president willing to give full autonomy to the Central Bank and to advocate for keeping inflation low and for inflation targeting—in that context it is possible to lower inflation. But before or during this process, there will be a recession. The government that seeks such a stabilization policy will have to have political support. That's because suppressing inflation, the need for a large devaluation, and the recovery of utilities prices will require a tight monetary policy that will at first necessarily cause a recession.

Recession and inflationary explosion may happen before a new government takes over

because of the Duhalde and Kirchner policies of the last 10 years, which had also been realized between 1972 and 1975, when Perón returned to Argentina. At that time, prices were controlled, the exchange rate was fixed, public spending was increased to stimulate the economy, and it was financed with large deficits. In June 1975, there was a package which included devaluation of the peso by 150% and doubling of prices for utilities, transportation, and fuels. The unions went on a general strike and demanded nominal wage increases that were of the same magnitude as the devaluation and increase in utility prices, and inflation rose from 30% a year—similar to today—to 150% a year . . . .

"One thing I have never understood is why the real interest rate—the rate for borrowers—is so high in Brazil. For me that is strange, given the number of banks in the country. When there is competition in the financial system, interest rate spreads should decrease."

Today, in Latin America Argentina is not the only country tolerating inflation. What should be the fate of Venezuela, for example?

Among the countries where there are nationalist, isolationist, very populist, very interventionist policies, some have monetary and fiscal prudence imposed by their monetary regimes. That is the case of Ecuador and Bolivia. These countries are able to maintain a better international image than those that have more tolerance for inflation . . . . [In Argentina and Venezuela] inflationary disorder is great and will have to be reversed—but it will be difficult to reverse if these two nations do not radically change the way their economies are organized.

Today, in Brazil, there is real concern about inflation, low growth, and external competitiveness. Where has Brazil failed?

Brazil has not moved fast enough on microeconomic reforms including fiscal, tax, and regulatory reforms that are essential to increase productivity. The good thing is that Brazil has maintained the direction of reforms made so far. The bad, or not so good, is that it has never made reforms fast enough. Brazil looks like Colombia, which chooses to reform gradually. But Colombians have an economy that has not accumulated all the inefficiencies and distortions that Brazil has accumulated . . . The tax system in Brazil is very costly for businesses, and tax evasion and informality prevent companies from accessing credit to invest and modernize. The best way to encourage companies to be creative and grow is to simplify the regulations and tax system . . . One thing I have never understood is why the real interest rate—the rate for borrowers—is so high in Brazil. For me that is strange, given the number of banks in the country. When there is competition in the financial system, interest rate spreads should decrease.

Mercosur could contribute to the strengthening of our regional economies, at least on a commercial level. How do you see the future of Mercosur?

I think Mercosur functioned only for five years, from 1994 to 1999—when Brazil had managed to stabilize its economy with the Real Plan and Argentina had its convertibility plan working, During that period, Europe looked at Mercosur as something admirable, it

wanted to negotiate free trade agreements, and in Brazil and in Argentina there was talk of a deal with the U.S. But Mercosur began to run into difficulties after the Brazilian *real* was devalued because obviously this meant a negative blow to Argentina. Still, there was a climate of dialogue and understanding until the 2001 crisis, when Argentina began to impose trade barriers. That was the end for Mercosur. When President Lula took office there was still an unprecedented opportunity to reverse this situation. The currencies of both countries were devalued and if at that time the Argentine government and central bank had imitated Brazil's monetary policy, both currencies would have appreciated at the same pace and created a healthy climate of monetary integration between Brazil and Argentina. Instead, Argentina insisted on containing the appreciation of the peso, bought a lot of reserves, raised barriers to trade, and when inflation increased and there was capital outflow, imposed exchange controls. Today in practice Mercosur does not exist, especially with the incorporation of Venezuela, which is an invitation to finish it. What we have to think about in the next year or maybe in the next decade is to improve what remains of Mercosur as a good free trade area. I find it unthinkable that the bloc could become a customs union.

"Had fiscal and monetary management not been disruptive since the Duhalde administration, Argentina's economy today would have been a lot like that of Canada or Australia."

IBRE ECONOMIC OUTLOOK

The Brazilian economy and macroeconomic scenarios

The Brazilian Institute of Economics (IBRE) Economic Outlook provides statistics, projections and analysis of the Brazilian economy:

- Economic activity
- IBRE business and consumer surveys
- Employment and income
- Inflation and monetary policy
- Fiscal policy
- External sector and trade
- International outlook
- IBRE focus

To know more, go to:
www.fgv.br/ibre
or call
(55-21) 3799-6799 and (55-11) 3799-3500

FGV
IBRE

