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Chapter Title: Avenues and Obstacles to Growth

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6   Avenues and Obstacles
            to Growth

In late 1987 the government introduced a new stabilization program that was
aimed at shoring up what was left of the 1985 Austral Plan. As shown in figure
6.1, inflation in the post-stabilization period had passed from a comfortable 3–4
percent per month to an uncomfortable 6–7 percent, before moving in October
1987 into the exotic range: 20 percent inflation for consumer prices and 30
percent for wholesale prices. As were previous stabilizations, this one was
doomed because it did not come to grips with fiscal necessities and the need to
meet fundamental conditions for sustainable growth.

The government's dramatic loss in the congressional elections of 1987
showed the strength of the new Argentine democracy, but it also left the
government critically weakened. The hope for resumption of sustained
growth, with moderate inflation, was yet one more step further away. In this
chapter we investigate which policies and what environment would be
conducive to growth. Our conclusions, not surprisingly, are fundamentally
pessimistic. The external environment continues to be unfavorable. The debt
overhang requires large resource transfers abroad, and these transfers are
made more difficult by very unfavorable terms of trade.

The domestic economic outlook is no more encouraging: the deficit
continues to be too large, taxation remains inefficient, political and economic
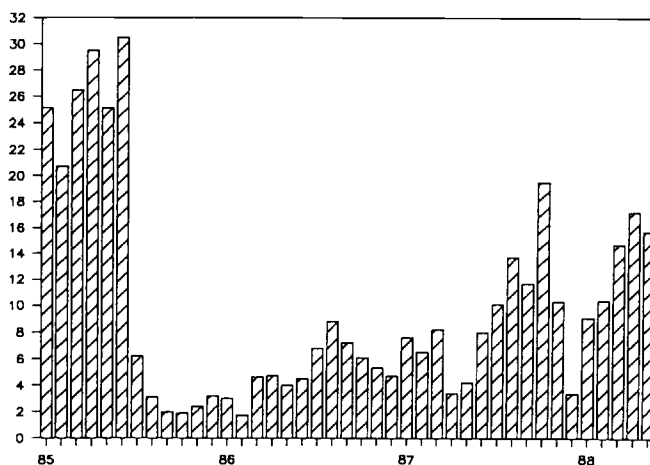stability are lacking, and, as a result, capital formation is altogether

Fig. 6.1   Inflation since 1985 (CPI, percent per month)

inadequate. The hyperinflation of 1985 shocked Argentineans into accepting a policy directed toward national economic reconstruction. The tragedy today is that the steady decline of living standards and erosion of economic stability which Argentina has experienced for more than a decade continues unabated. Gradualism may not offer an escape from the predicament. Argentina is learning slowly and painfully to introduce realism into public sector decisions within a democratic context, an experience that is entirely new.

6.1   Conditions for Economic Progress

In 1929 Argentina was among the seven richest countries in the world. Today, the living standard has fallen far below that in advanced countries and, unlike in most other countries, is still declining. The extent of decline revealed by estimates of official GDP may overstate the actual decline because of a large and growing underground economy. But the fact of continuing and significant decline is unquestionable.

The main requirements for a resumption of sustainable growth are three-fold:

- increased and sustained stability (institutional, financial, and political);
- increased investment, both in the private and public sectors; and
- improved resource utilization and increased efficiency throughout the economy.

We now develop each of these requirements in more detail. But it is essential to point out at the beginning that their separation is artificial, since the various elements are significantly interdependent. To give an example, budget problems are responsible for financial instability, and financial instability is one of the explanations for low investment. But low investment also contributes to budget instability because it implies low growth.

6.2   Investment, Saving, and Debt

A vast literature on growth, in advanced and in developing countries, supports the idea that capital accumulation is one of the most important sources of growth. Capital accumulation increases potential output directly, but it also tends to be a vehicle for technical progress. Capital accumulation is important in both the private and public sectors. Public sector enterprises need to expand capacity not only with respect to infrastructure (for example, in telecommunications), but also in more traditional industries which happen to be located in the public sector.

6.2.1   A Model

We can consider a stylized model of the growth process in an open economy in order to highlight the critical restrictions and tradeoffs.[1] We start by

fixing the target rate of output growth. Next we use the link between growth and investment shown by the ICOR (incremental capital output ratio). The ICOR gives us the *net* investment required (as a fraction of GDP) to support the target growth in output. In addition, there is the investment required to offset capital depreciation. The gross investment requirement (θ) is:

$$(1) \qquad\qquad I/Y = \theta = \alpha y + \delta,$$

where I and Y denote real gross investment and real GDP, respectively, y is the growth rate of output, and δ is the fraction of GDP that needs to be invested to offset capital depreciation. The ICOR is denoted by the coefficient α.

Next we consider the financing of growth. Net external liabilities will increase (as a fraction of GDP) due to debt service plus the noninterest current account deficit which is equal to the ratio of consumption and gross investment to GDP less unity:

$$(2) \qquad\qquad b_t = \Phi\, b_{t-1} + (\theta + c - 1),$$

where b and c are the ratio of debt and consumption to GDP, and the term $\Phi = (1 + r)/(1 + y)$, representing the ratio of the interest factor $(1 + r)$ to the growth factor $(1 + y)$.

Equation (2) highlights an important point. Taking the investment requirement as given, growth and an improving debt ratio may not be compatible. Specifically, suppose, as do Selowsky and van der Tak (1986), that the level of consumption grows more slowly than GDP so that the consumption ratio declines and the saving ratio increases over time. Thus even if the real interest rate exceeds the growth rate so that $\Phi > 1$, the rising saving ratio can dominate and the debt/income ratio will eventually stabilize and then decline.

Such is the force of compound interest that as the saving rate rises, it first is able to finance all of the required investment and then interest payments, and ultimately an ever-increasing trade surplus, which finances debt amortization. The interesting question concerns the time path of the saving rate, the current account, and the debt/GDP ratio when a country embarks on an investment strategy that yields sustained growth. Table 6.1 reports simulations of this model with parameters adapted to the case of Argentina.

Table 6.1   Sustained Growth Scenarios

	Scenario A			Scenario B		
Year	s	Financing/GDP	Debt/GDP	s	Financing/GDP	Debt/GDP
1986	15.6	0.5	70.0	15.6	0.5	70.0
1987	16.8	9.4	77.2	16.4	9.8	77.6
1990	20.4	6.9	92.7	18.8	8.6	96.9
1995	26.0	1.9	97.7	22.7	6.1	116.4
2000	31.3	−4.4	74.8	26.4	2.8	119.0

In the simulations, the initial debt/GDP ratio is set at $b = 0.7$, and the consumption ratio is $c = 0.844$, as it was in 1986. The world real interest rate is $r = 0.06$. The simulations assume a target output growth rate of 3 percent which implies a gross investment requirement of 22 percent. This is arrived at by assuming depreciation of 13 percent and an ICOR of 3.[2] To place these numbers in perspective, we note that growth in Argentina in 1979–80 averaged 2.3 percent, while the ratio of gross investment to GDP averaged 21.8 percent. Thus a gross investment requirement of 22 percent is certainly not unrealistically high.

We now explore the time path of the debt/GDP ratio under two alternative consumption scenarios:

- Scenario A: Per capita consumption is maintained constant. With population growth assumed to be 1.5 percent per year, consumption thus grows at 1.5 percent while GDP grows at 3 percent.
- Scenario B: Per capita consumption grows at 0.5 percent per year. Even in this case, consumption growth falls short of the growth of GDP so that the saving rate rises over time.

Table 6.1 summarizes the results of simulations under the two scenarios. The column labelled s shows the ratio of national saving to GDP. The financing/GDP ratio represents the current account deficit.

Both scenarios show that growth is compatible with a reduction in the ratio of debt to income, but the reduction occurs only very far in the future, beyond the year 2000.[3] What is the recipe for growth with debt reduction? The model highlights three critical elements:

1. There is an increase in the investment ratio which supports the growth process. The model has no room for investment plans, so the critical question of why firms would want to invest goes unanswered. With respect to public sector investment, there is the unanswered question of financing the increase in budget deficits.
2. The increase in investment (without a compensating increase in saving) initially generates an increase in the current account deficit. Borrowing finances not only interest payments but also a trade deficit. The availability of external finance to cover an *increase* in the trade deficit is thus a critical feature of the early stage of accelerated growth. This goes far beyond the "new money" in present concerted lending programs which only covers part of the interest bill.
3. The saving rate rises throughout and reaches Korean levels in fifteen years. The increasing saving ratio assures that the current account deficit shrinks to zero and eventually becomes a surplus that helps reduce the debt/GDP ratio. Figure 6.2 shows the simulation of the debt/GDP ratio for the two scenarios.
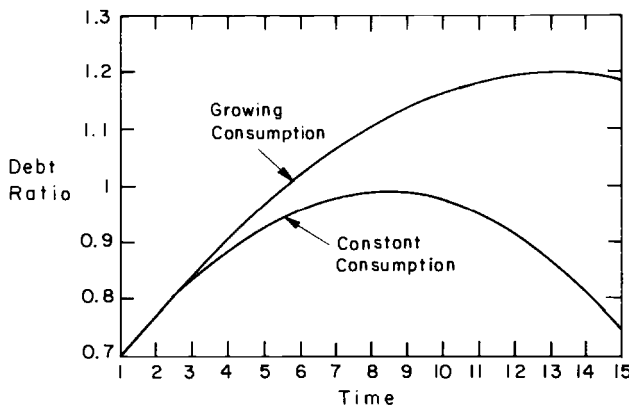
Fig. 6.2   The debt/GDP ratio: Alternative scenarios

There is no doubt that such a development path is conceivable. Korea, in fact, followed exactly this path.[4] In the case of Argentina, however, there is considerable skepticism regarding each of the three points. An increase in investment is unlikely unless a much more stable business environment develops. But even if private or public investment increased spontaneously to start the growth process, there is absolutely no reason to believe that the external financing required for growth would become available. But without external financing of the large trade deficits that come at the beginning of the growth process, growth cannot get underway. Thus the external constraint is binding and bars growth from the outset. Finally, unless the saving rate increases over time and eventually exceeds the investment rate, the development of trade surpluses to pay interest and even amortization is impossible.

If external financing is the constraint, the model suggests an alternative strategy: start off the growth process with an increase in the domestic saving rate, i.e., with a reduction in per capita consumption. The increased availability of resources now finances the required increase in investment without causing the trade balance to deteriorate. But this recipe brings into play the following difficulty: Can the cut in consumption be readily translated into an external surplus? This may not be possible if investment has a significant import content. If this is impossible, there will be a recession and a foreign exchange shortage.

Suppose that the problem of resource flexibility does not arise. What might a growth program look like? If we assume that the initial reduction in the consumption ratio is sufficient to finance the increased investment and that the investment requirement is 22 percent, or twice the 1986 level, a reduction in the consumption ratio by 10 percentage points or some

reduction in the consumption ratio along with a suspension of debt service is required. Suspension of debt service would imply that the noninterest current account is balanced $(1 = c + \theta)$, so extra resources would become available for investment. In this case, the consumption ratio would need to fall by only 6.4 percentage points. But, as a counterpart, the debt/income ratio would be rising. The evolution of the debt ratio over time would depend on how the consumption ratio behaves.

We can distinguish two possibilities. In one case, consumption and output grow at the same rate, so the consumption ratio is constant. The noninterest current account never improves and, as a result, the debt/GDP ratio steadily increases. Effectively, the country has repudiated its debts and used the flexibility provided by abandoning debt service, along with an initial cut in consumption, to embark on growth. The alternative is, once again, a path where consumption grows less rapidly than output. Hence the saving rate increases over time, the noninterest surplus improves, and, ultimately, the debt/GDP ratio stabilizes and starts declining. Compared to the scenarios in table 6.1, the strategy of an initial reduction in consumption involves a smaller financing requirement and hence, throughout, a lower ratio of debt to GDP.

6.2.2 Creditors' Preferences

We have looked so far at alternative growth strategies defined in terms of a desirable path of consumption. Another perspective is that of the creditors, who are concerned with creditworthiness as measured by the debt/GDP ratio and naturally want to minimize new money commitments.

Creditors would certainly think that home-financed growth is an excellent idea, but they would also believe that the increase in the debt/income ratio should be kept to a minimum. Table 6.2 shows the recent debt facts. The rising debt/GDP ratio and the rising level of debt would certainly lead creditors to emphasize adjustment paths with debt reduction.

Creditors might, for example, recommend a focus on the debt ratio rather than on the growth of that ratio. According to their type of plan, the consumption ratio would be allowed to increase only if the debt/GDP ratio

Table 6.2   **The External Debt (in billions of $U.S. and as a percentage of GDP)**

	1981	1982	1983	1984	1985	1986
Total external debt	35.8	43.6	45.1	46.6	48.1	51.7
Debt of the public sector (%)	55.8	65.6	70.3	77.0	85.2	85.5
Debt to official creditors (%)	7.9	6.4	15.5	11.2	16.8	20.5
Debt/GDP ratio	63.1	75.9	73.5	71.1	74.4	73.7
Interest/GDP ratio	6.8	8.6	8.8	8.5	7.9	6.6
Resource gap (% of GDP)	1.5	-3.4	-4.4	-5.0	-6.8	-2.6
Investment/GDP ratio	19.5	16.4	14.2	12.4	10.6	11.9

Source: World Bank and IMF.

fell below the target level. In this scenario, much of the growth translates immediately into trade surpluses and thus would serve debt reduction.

Such an adjustment process is clearly implicit in the IMF Staff Report of July 1987 on Argentina. This report envisages a reduction in the ratio of debt to GDP from 70 to 55 percent during 1987–92. The current account deficit is expected to fall from 3.5 percent of GDP in 1986 to just above 1 percent by 1992. Essential to this outlook, as always, is the assumption that budget balancing provides the increase in saving and that an investment and an export boom are the engines of growth.

A more plausible route is suggested by table 6.3. Argentina in 1984–86 was running large trade surpluses that were sufficient to pay up to half of its interest liabilities. This suggests the possibility of abandoning the policy of resource transfers, with the increase in investment financed by suspending the trade surpluses rather than by an initial increase in saving.

6.2.3   Debt Service Alternatives

There are two different ways in which a suspension of the resource transfer might work. One is an outright repudiation or suspension of debt service. The alternative is a moratorium or debt write-down such as has been urged by Rodriguez (1986a, 1986b, 1986c), among others. In this case, resources in the budget that can be used for home investment become available. The suspension of payments abroad dispenses with the need for a large trade surplus and hence provides the resources from the supply side to step up growth.

A more attractive opportunity seeks a compromise between the interests of creditors and the requirement that resources be available for investment and growth. Such a program might take the following form. The government engages in a comprehensive fiscal reform that entails an improvement in public sector spending programs, a major tax reform to generate revenue, and a restructuring of the external debt service process. The domestic effort centers on eliminating the budget deficit and raising national saving. External creditors would receive half the interest payments in Australs, having the right to use them to make any investment in the economy, with the sole restriction that the resources cannot be repatriated. The remaining half of the interest payments would be suspended pending reconstruction of the economy.

Table 6.3   **Investment and Resource Transfers (as a percentage of GDP)**

Period	Investment	Noninterest Current Account Surplus
1970–81	21.2	1.6
1982–86	11.9	4.7

Source: World Bank.

The part of the debt under suspension would accumulate real interest at a rate equal to the growth rate of per capita real income, i.e., per capita real GDP growth adjusted for changes in the terms of trade. Thus external debt service is, in part, recycled into the economy, suspending the external transfer problem. The rest is suspended to free budget resources for investment and to dispense with inflationary finance. If the program succeeds in reconstructing the economy, creditors fully benefit from the increased ability to pay. Creditors have an interest in such a program because the current arrangement offers a lesser chance of ever recovering the credits. The reason is that the current process of debt collection destroys financial stability and bars investment. As a result, there is no mechanism to enhance the ability (hence, willingness) to pay.

A focus on the transfer problem helps in understanding the links among the budget, debt service, inflation, and the lack of investment. A domestic budget effort is, of course, indispensable. Much of the inflation problem is one of fiscal laxity and the inefficiency of government. The budget problem is not exclusively a reflection of the external debt. But a restructuring of the external debt can and certainly should be part of a reconstruction effort. Reconstruction has three features. First, there is a need for real resources for investment. These become available by budget correction and by recycling external interest payments into the economy. Second, there is a need to stop inflationary finance. The suspension of trade surpluses helps because it means a reduction in the real exchange rate and hence relief in the budget. Most of the correction, though, must come from an improvement in the budget such that foreign creditors are paid with the revenue from outright taxation (or increased public sector efficiency and expenditure cuts) rather than with the revenue from the inflation tax. Third, the credibility of the program is enhanced by a formula for capitalization of external interest geared to an ability to pay rather than to an exogenous and possibly excessively high world real interest rate.

We conclude this section by summarizing the main message: there is a tight link between growth and external debt service. Unless the domestic saving rate can be raised, more debt service means less growth. As we shall see presently, more debt service also means less financial, economic, and political stability.

6.3   Efficiency of Resource Allocation

Increased efficiency in resource allocation is an important complement to higher rates of investment in raising the sustainable growth of output. More efficient resource utilization simply means that a given factor input produces a higher level of output. In Argentina the experience with productivity growth is exceptionally poor. This is brought out in table 6.4, which shows

Table 6.4   Sources of Growth (average annual percentage rate)

Period	GDP	Capital	Labor	Residual
1960–65	4.6	3.5	1.6	2.0
1965–70	3.5	4.3	3.5	−0.8
1970–75	3.8	4.5	3.6	−0.2
1975–80	1.8	4.1	1.8	−1.0
1980–86	−0.3	1.1	1.6	−3.1

Note: The estimates for 1960–80 come from Elias (1982), where capital and labor growth are quality adjusted. The 1980–86 data are reported in McCarthy (1987). The residual is obtained by weighting the factor inputs by their distributive shares. McCarthy assumes a labor share of 47 percent.

estimates of the sources of growth in real GDP for the past twenty-five years. The striking fact in this table is the extraordinarily low contribution of growth to total factor productivity.

By comparison, Korea, certainly one of the strong performers among developing countries, achieved an average GDP growth rate of 8.2 percent in 1963–83. Of that growth, nearly half was due to growth in total factor productivity.[5] Only in the early 1960s did Argentina come close to that performance. What reasons for this poor performance on the productivity front can be given?

One reason for poor productivity growth is the inefficient trade regime, which leads to a continuing high level of protection and to variability in key relative prices. A more trade-oriented development strategy would draw resources into more efficient uses. Sturzenegger (1986) has studied the antitrade bias of protection and the implicit import tax. Table 6.5 reports various measures of distortions in relative prices.

The table brings out the strong bias against trade implicit in the protectionist structure: the domestic relative price of exportables in terms of importables is about one-half the world price ratio. There is thus a powerful incentive operating against exporting and in favor of import substitution, which in itself represents highly inefficient resource allocation. The inefficiency is, of course, compounded by the limited scale of the market,

Table 6.5   Antitrade Bias and Implicit Import Tax, 1960–84

	1960–69	1970–79	1980–84
Export tax[a]	11.9	14.1	10.0
Anti-export bias[b]	48.2	56.9	44.4
Implicit import tax[c]	63.7	51.5	96.6

Source: Sturzenegger (1986).

[a]Export tax revenue as a fraction of exports.

[b]Ratio of domestic to external terms of trade.

[c]Ratio of import to world prices.

which prevents important scale economies and limits competitive pressures on pricing. The inward-looking production structure and lack of competition likewise stand in the way of exposure to and adoption of foreign technology.

The systematic antitrade bias is only one of the respects in which resources are inefficiently utilized. The high variability of relative prices is another example. Between 1976 and 1980 the average tariff rate on imports declined from 55 percent to only 22 percent. By 1982 it had increased to 27 percent, and in December 1985 it stood at 37 percent. Half the tariff positions had duties in excess of 30 percent. In 1982 licensing applied to only 13.5 percent of imports. By 1985 it reached 46.6 percent of all the tariff positions.[6]

Another example of variability in policies is the extreme variation in the real exchange rate documented in earlier chapters. For instance, the real exchange rate for "traditional" (agro-based) manufactured exports declined from an index level of 100 in 1976 to 54 by 1980, and was back up to 99 by 1983; for "nontraditional" manufactured exports the real exchange rate fell to 50 in 1980 and returned to 87 by 1983.

The same variability can be found in real interest rates. Figure 6.3 shows the monthly real interest rate for the past eight years. Episodes with extremely high real rates, such as in 1980–81 and in 1985–86, alternate with periods of extremely low real rates, as in mid-1982. In other periods real rates are simply variable, fluctuating between positive and negative, as in 1984–85. Such a situation inevitably leads to short horizons and speculation on near-term relative prices rather than to long-run efficient use of resources.
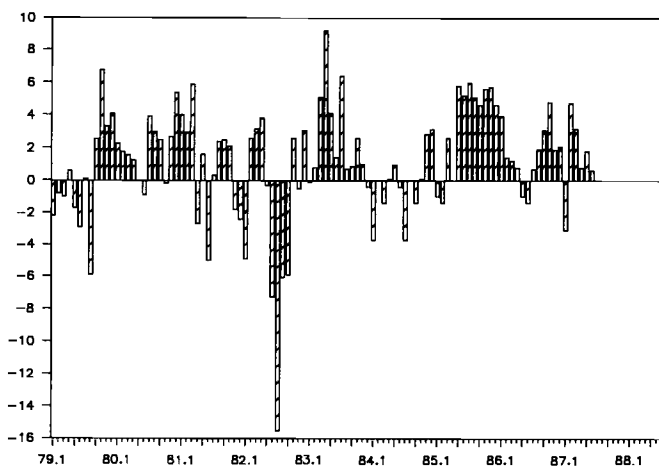

Fig. 6.3   The active real interest rate (percent per month)

A discussion of efficiency in resource utilization cannot avoid mention of the public sector, where resources are being used in a highly inefficient manner. In part this is the result of militant unions, in part the legacy of military patronage, and in part it is endemic to public sector enterprises. Whatever the primary explanation for the current state of affairs, Argentina has much to gain from a trimmer and more efficient public sector.

6.4   Budget Deficits and Financial Instability

The third problem area is stability of institutions and policies. The lack of stability can be measured by any number of variables: the wide swings in economic philosophy of those in power, ranging from Peronism to Alsogoray; the short average tenure of finance ministers; and the variability in the level of output (as shown in figure 6.4, for example) for the manufacturing sector. However, the most immediate indicator of underlying instability is the inflation rate. During the past twenty years, Argentine inflation has always been high, and most of the time a sharp acceleration is just around the corner. As a result, economic actors are always concerned with the possibility of inflation and with the shift in politics and economic policies that will occur when inflation gets out of hand. In practice, inflation uncertainty means short horizons for production decisions and a concentration on liquidity and inflation hedging. The economic structure that results emphasizes finance at the expense of production.

The inflation problem is, of course, a direct outgrowth of persistent budget deficits. The budget deficit today is substantially financed (except for the
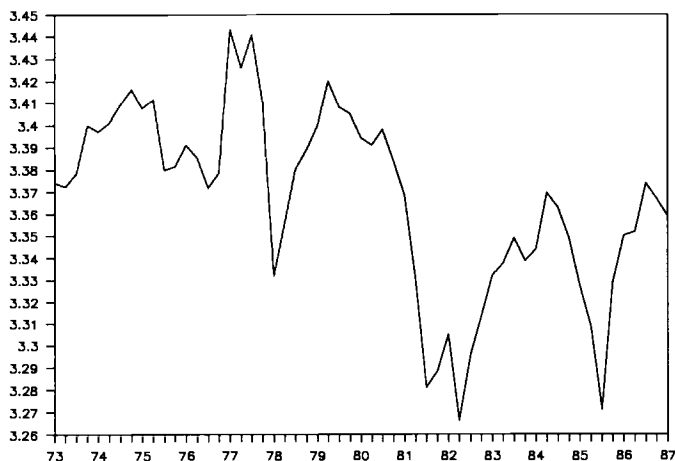

Fig. 6.4   Real GDP in manufacturing (logarithm, 1970 Australs)

new money portion coming from foreign creditors) by printing money. Occasionally, deficits are financed by domestic debt, now denominated in dollars. But the very high interest rates—well above 20 percent on dollar bonds in late 1987—discourage this channel of financing. Thus the inflation tax, rather than ordinary taxes, finances the government's outlays. This raises two questions. First, why is it so difficult to shift from an inflation tax to ordinary taxation? After all, the inflation tax is highly regressive, so changing the tax structure should be politically attractive. Second, why is it so difficult to contain government outlays?

Table 5.3 above has already shown the budget deficit calculated using IMF/BCRA measures. Other measures, such as those prepared by FIEL, are more comprehensive and show even larger deficits. We have already noted the existence of a wide range of deficit measures and the fact that public discussion has not settled on any particular measurement. The difficulties are chiefly coverage (central government, all levels of government, etc.), the inclusion of particular accounts (treatment of public sector enterprise investment, Central Bank losses, Central Bank discounts), and the distinction between budget and cash bases. Even so, various sources do portray roughly equivalent fluctuations in the budget, and hence we can focus on any one measure to make the point that there are large and persistent deficits. These deficits require financing, and that financing, as other sources have now dried up, increasingly takes the form of printing money.

We concentrate here on two central points in the budget situation: the appalling record on enforcement of tax collection, and the outlays in the budget that result from financial instability or policy mistakes.

Tax fraud is so common in Argentina that it is almost considered a citizen's right. Income tax collection in 1985 accounted for less than 1 percent of GDP! Some idea of the extraordinary degree of evasion is given by a report of the Ministry of the Economy: in a country of more than 30 million inhabitants, only one and a half million were registered taxpayers. Of those registered, less than one-third filed a return and less than 1 percent of those registered declared any tax liabilities due. Worse, 84 percent of the total revenue from income and value-added taxes was paid by 6 percent of the registered taxpayers. Thus one must ask why those 29,081 Argentine households and firms do pay when nobody else does.[7]

In 1985–86 the government made considerable progress in collecting taxes. Unfortunately, most of the additional tax collection was of an emergency variety. There were new taxes on imports and exports, increases in real public utility rates, and increased taxation of those who had already paid. The role of public utility rates as a source of revenue is particularly problematic. The political and inflationary effect of changes in utility rates makes them targets for politicization. As a consequence, rates tend to fall behind in real terms, giving rise to deficits and hence inflationary deficit

finance. When the time comes to restore the budget and the real value of utility rates, this results in a major inflationary shock. Essential in public finance is to index rates once and for all, and to put rate decisions at arm's length from the budget and political process.

Establishment and enforcement of a broad-based, efficient tax system is the most urgent task. With a broad-based tax system applying low rates to a large body of taxpayers, the extreme inequity and inefficiency of the present system can be reduced. At the same time, there would be significant room for collecting more tax revenue without adverse supply-side effects.

With regard to outlays, we want to emphasize two categories directly related to past policy mistakes. One is the large external interest bill which reflects in part the fact that the government increasingly "nationalized" the external debt from 1981 on. This occurred partly as a means of stopping capital outflows when the government took over from the private sector external loans that had not yet matured but which private borrowers wanted to pay off in anticipation of depreciation. In part the debt was nationalized in the course of financial market problems. By now more than 85 percent of the external debt is a burden on the budget, but there is no significant offset in terms of revenues. As a result of this debt nationalization, there are extra outlays amounting to 5–6 percent of GDP which the government must finance.

Moreover, every time the real exchange rate is depreciated, the ratio of debt service to GDP increases and so does the budget deficit. A 15 percent real depreciation, for example, raises the budget deficit by 1 percent of GDP.[8] Thus, once more, external debt and adjustments to ensure continued debt service play an important part in keeping macroeconomic instability alive.

The other element in the budget that is directly due to past policy mistakes appears in the quasi-fiscal deficit. Specifically, in 1981–84 in the aftermath of the Martinez de Hoz overvaluation, the government had to pay out extraordinary sums as the result of exchange rate guarantees. On average, 10 percent of GDP was paid out in those years to cover bets lost by the public sector! Needless to say, financing of these losses is an important element in the buildup of inflation after 1982.

The correction of budget deficits is essential because the current situation has two clear implications. First, high and rising inflation is always just around the corner. That possibility discourages any long-term investment and assures the public that holding assets abroad remains the best investment. The resulting speculation against the currency puts pressure on the exchange rate, forcing the monetary authorities to produce high real interest rates. The high real rates in turn discourage productive investment, aggravate bankruptcy problems, and worsen the budget by their adverse effects on activity. When the unreasonable fiscal position is routinely compensated for by tight money, normalcy is simply impossible. Exactly the opposite pattern

is required: tight fiscal policy to raise saving, and easy money to finance domestic investment and reduce the risk of business bankruptcies.

6.5   External Constraints to Growth

Most of Argentina's economic problems are homemade, but not all. The external environment has been exceptionally unfavorable in recent years. These poor external conditions have reduced the flexibility for policymakers, making adjustment more inflationary.

The U.S. policy mix of 1981–85, with record real interest rates, a massive dollar appreciation, and a sharp decline in commodity prices, was an important part of the Argentine debt crisis. The magnitude and persistence of these very poor policies were especially damaging to countries such as Argentina, where debts are in dollars and mostly geared to short-term market rates and where there is a significant concentration on commodities on the export side. Without this external shock, there certainly would have been a debt crisis, but the increase in indebtedness would have been far less, as we already saw in chapter 3.

The outstanding feature of the poor external environment was, of course, the credit rationing and the short-leash approach that was introduced in the aftermath of the Mexican debt crisis of 1982. The concerted-lending approach not only proved cumbersome, but it also focused attention on financial aspects at the expense of long-run growth considerations. Debt negotiations kept policymakers in a perpetual state of emergency. IMF conditionality, oriented to quarterly targets, distracted all attention away from long-run policy reform toward balance sheet tricks and emergency taxation.

The environment has been unfavorable in other respects, too. The terms of trade have deteriorated sharply since the early 1980s. As a result, there has been a need for more depreciation of the currency, which in turn has meant a worsening of the budget, more inflation, and a reduced standard of living.

The terms of trade deterioration shown in table 6.6 and figure 6.5 reflects in part the decline in world agricultural prices, especially for those products of interest to Argentina. Wheat prices in dollars today, for example, are 30 percent below their 1981–85 levels, and the same is true for an index of food products in world trade. The dramatic decline in the real price of food

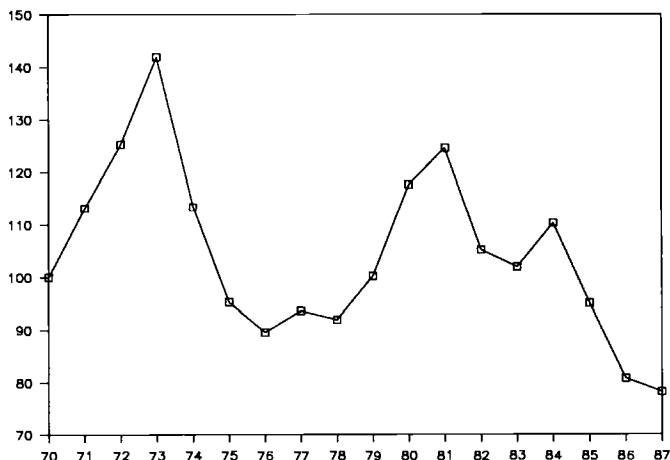| Table 6.6	Terms of Trade (index 1970 = 100)			
	1970–74	119	1985	95
	1975–79	94	1986	81
	1980–84	112	1987	78
	1984	110		

Source: World Bank.

Fig. 6.5   The terms of trade: 1970–87 (Index 1970 = 100)

reflects the rapid growth in agricultural productivity and the increasing self-sufficiency of traditional importing countries. But it also reflects the agricultural support policies of industrial countries. The policies of the European Common Market, in particular, are costly for Argentina. As a case in point, when Spain joined the common market, the diversion of trade caused Argentina to lose a traditional buyer of Argentine wheat. The U.S. drought of 1988 gave a reprieve by sharply raising export prices for Argentine agricultural products. It remains to be seen whether policymakers can appropriate some of this windfall for budget correction rather than dissipate it in further macroeconomic instability and premature debt service.

For manufactured exports, the news is no better. Although the world economy grew at a significant pace over the past five years, competition among newly industrialized countries has been intense. Morever, protection in the industrialized countries' markets has been increasing. The growth of protection, in turn, has served to discourage investment in nontraditional exports.

6.6   Concluding Remarks

In July 1986 Brazil and Argentina signed agreements to initiate a limited free trade regime. This is the only bright spot on the external side, but it is also an event with the potential to overshadow even the debt problem in its scope and promise.

For the time being, the agreement covers only specific sectors. But there is no question that if it is expanded to unrestricted free trade, the implications

for Argentina would be dramatically positive. The size of the market would increase fivefold.[9] Firms could specialize in products for which they have the greatest comparative advantage, and thus reap major scale economies. The increase in competition in the home market would give consumers a major increase in real income. Free trade with Brazil (unlike unilateral trade liberalization) offers a plausible strategy for reaping massive gains from trade without the immediate risk of a serious destruction of industry. An opening to Brazil might be one of the very few means available to Argentina for reversing the steadily declining standard of living.

We have argued in this chapter that poor economic performance in Argentina is the result of a number of interdependent factors: debt, inefficiency, poor public finance, and an adverse external environment. There is little scope for bootstrapping the country out of this predicament. Even a moratorium is unlikely to set off a process of sustained growth. The hyperinflation woke up the national conscience and gave the government a brief moment in which to achieve some consolidation. But the change in policies and opportunities was not sufficiently large and durable to reverse the drift back into poor performance. The Austral Plan of 1985 gave a powerful boost to confidence in economic management, as shown in figure 6.6. The gain in approval after stabilization in May 1985 exceeds 30 percent! But since then, public approval of economic management has declined below the prestabilization levels. Thus, political support for change has been dissipated.

It is clear today that a turnaround in public finance, financial stability, and investment simply will not happen except as a byproduct of an extraordinary event. The world macroeconomy is unlikely to offer much good news. That
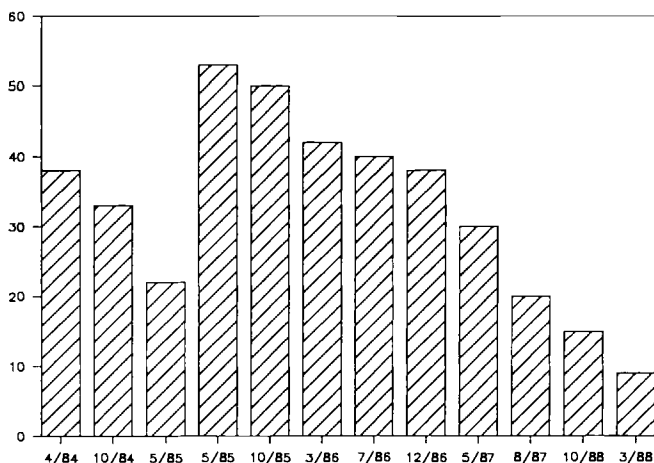
Fig. 6.6   Public opinion poll rating approval of economic management
Source: Gallup Poll.

leaves the free trade option with Brazil as one of the few cards policymakers have left to play. A major fiscal reform, widening the tax base and achieving public sector efficiency, restructuring of the external debt service, and a new initiative in trade policies form a program that can reconstruct Argentina. Such a program now requires urgent attention.

In concluding we draw on Carlos Díaz Alejandro's (1988) words to balance the widespread skepticism about Argentina's economic future:

> Paradoxically, the troubles of the 1970s in Argentina may have set the bases for political conditions allowing steadier and more efficient economic policies. . . . Perhaps swords and furnaces will be put away, and quieter hours may come. Under conditions of reasonable political stability, the unsinkable Argentine economy could recover from the catastrophes of the late 1970s and the early 1980s, including a high external debt for which so little growth can be shown. Abundant food stuffs and energy resources, plus an industry which, whatever its past costs, has shown itself capable of exporting, provide solid foundations for a growth which may or may not keep up with those of Australia and Brazil, but which assure a good life to all Argentines.

Appendixes

Appendix A
Price Dynamics Under a Tablita Regime

In this appendix, we sketch a model of inflation dynamics under a Martinez de Hoz–style program. The essential linkages are purchasing power parity for traded goods and integration of the capital market. The former implies that prices of traded goods are determined by the exchange rate:

(A.1) $$P_T = e$$

and that interest rates are set by the world market with an adjustment for the rate of depreciation:

(A.2) $$i = i^* + \lambda$$

where i^* is the international interest rate and λ is the rate of depreciation.

The real exchange rate is defined as $R = P_N/e$, which is the ratio of home goods to traded goods prices. Let π denote the rate of inflation of home goods prices and λ the rate of traded goods price inflation. From the