Stabilization and its Discontents: Argentina’s Economic Restructuring in the 1990s

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Summary. — This paper assesses the Argentine stabilization and market reform strategies since 1989. We argue that Argentina may be penned in by its own success: exchange rate targeting quelled inflation but the resulting real appreciation has limited export and employment growth; microeconomic reforms raised efficiency but have threatened income distribution and hence political stability; exclusive styles of policy-making helped enact reform but have led to corruption and policy insensitivity and contributed to rising social discontent. We close by suggesting how a “second generation” of reforms could tackle these issues and spread the proceeds of reform to a wider segment of the Argentine public. © 1999 Elsevier Science Ltd. All rights reserved.

1. INTRODUCTION

Until not so long ago, Argentine economy minister Domingo Cavallo was fond of saying, “Argentina is Mexico two years later”. When, in late December, the shockwaves of the Mexican devaluation caused a fall in the Buenos Aires stockmarket and an upsurge in demand for US dollars, Cavallo changed his tune. “Argentina,” he said, “is not Mexico”. Latin American Weekly Report, January 12, 1995.

On July 26, 1996, Argentina’s flamboyant economics minister, Domingo Cavallo, was summarily removed from office by Argentina’s equally flamboyant President Carlos Menem. With the official announcement coming late on a Friday afternoon, markets had little time to react to the departure of an official who had been the architect, and self-styled guarantor, of the famed “Convertibility Plan” responsible for delivering Argentina from the throes of hyper-inflation. Yet as the next business week opened, the peso held its value and stocks actually rose. In the short-run, this favorable reaction signalled a positive assessment of Cavallo’s replacement by a low-key former Central Bank President with a market-reassuring economics Ph.D. from the University of Chicago. More fundamentally, it appeared that the country had made the transition from sole reliance on the credibility of just a handful of officials to a deeper faith in the macroeconomic laws now governing Argentina’s economy.

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But should Argentina be celebrating a sort of “end of history”—or at least its own history of erratic policy cycles, chronic macroeconomic instability, and prolonged bouts of social and political turmoil? While the Convertibility Plan purged the economy of inflation, and fostered a return to growth, particularly as pent-up demand surged through the economy during 1991–1994, there have also been some clear pitfalls to this strategy. Most obvious has been a sharp appreciation of the exchange rate, which has worked against the country’s full realization of its export potential and may make it difficult to sustain higher growth into the medium term. A major symptom of this dilemma is the precarious rate of unemployment, which in Buenos Aires had increased to around 13% by 1994 and then skyrocketed to 20% in the wake of Mexico’s 1994 peso crisis. While the labor market has improved since, much of the available work is now temporary, and underemployment remains a serious problem. Not surprisingly, social tensions are again running high in Argentina, with public concern over hyperinflation giving way to the fear of “hyperunemployment” and opposition politicians making gains in recent political contests.

In this essay, we assess the Argentine experiment and speculate on its future prospects. While the growth and inflation results may have been impressive, there are worrisome employment and distributional trends which are more than transitional costs related to market restructuring. Rather, they have resulted from the failure to coordinate micro and macro reforms, that is, to offset rigid management of fiscal and exchange rate policy under the Convertibility Plan with programs designed to help economic agents adjust to the additional simultaneous challenges of trade liberalization and privatization. As a result, Argentina needs what Michel Camdessus, the head of the International Monetary Fund (various years) (IMF) has termed a “second generation” of reforms, especially a more cohesive set of market-supporting strategies and far more attention to repairing the distributional stresses and political strains that have been part and parcel of Argentina’s contemporary political economy.

The remainder of this essay develops these arguments as follows. Section 2 analyzes and critiques the macroeconomic stabilization program that began with the implementation of Cavallo’s Convertibility Plan in 1991. We agree that, in light of the prevailing high inflation, there was little alternative to the Convertibility Plan when it was adopted, but argue that the resulting appreciation has likely dampened the potential for export and employment growth. Section 3 reviews the key microeconomic initiatives that were undertaken in conjunction with the convertibility stabilization plan and elaborates on the main dimensions of distributional stress (including underperforming labor markets, increasingly unequal household incomes, and growing disparities in the performance and asset base of small and large firms); we then review the politics of the reform process, noting that the Menem administration’s autocratic and insulated style of decision-making, especially when combined with the uneven distribution of benefits from new policies, has worked against the need to broaden the social base for reform. The conclusion sketches strategies to address today’s shortcomings, with specific attention on the macro, micro, institutional, and political dimensions.

2. MACROECONOMIC STABILIZATION: CONTEXT, STRATEGIES, AND OUTCOMES

Argentina has always been a country with moderate growth—believing that spectacular growth and riches are right around the corner. And when a good year comes, the Argentines say, “ah-ha, here comes the life we have been waiting for and so deserve”—Daniel Heyman, Staff Economist, UN Economic Commission for Latin America and the Caribbean, Buenos Aires.

(a) Inflation, convertibility, and growth

1989 marked a dramatic break with Argentina’s past. For the first time ever, a democratically elected president from one political party was succeeded by a democratically elected president from another party (McGuire, 1995, p. 200). Unfortunately, this positive political transition occurred in the midst of the country’s worst economic crisis; as newly elected President Carlos Menem took office in July, the monthly inflation rate soared to 197% (see Figure 1). Given the urgency of the crisis, the President reached beyond the working class and populist roots of his own Peronist backers in the Partido Justicialista (PJ) and sought
the support of business interests and the middle classes in the effort to tame skyrocketing prices.

At first, the Menem team moved gradually on the macroeconomic front, launching a “Bunge and Born Plan” named after the country’s largest transnational firm whose advisors had helped to design it. The moderately heterodox program, which relied on the same sort of price controls as had been implemented under Alfonsín’s Austral Plan, unraveled quickly when the government was forced to carry out a large step devaluation in December 1989. At this time, all price controls were eliminated, and the currency was allowed to float. Not surprisingly, inflation exploded once again in the first quarter of 1990; thereafter, inflation slowed, albeit to a still worrisome rate of 11% a month.

In January 1991, Domingo Cavallo was appointed as Economics Minister and soon launched the now famous Convertibility Plan. Passed quickly by the Argentine Congress into formal legislation, the Plan obliged the Central Bank to: (i) back up a fixed exchange rate by agreeing to convert national currency into foreign exchange at that rate; and (ii) calibrate the monetary base to the level of foreign currency assets. Like the approach that evolved in Mexico during 1987–94, a key assumption was that a fixed exchange rate, when coupled with import liberalization, would provide an effective control against domestic price hikes. More significantly, by removing discretion from monetary creation, convertibility sought to impose the sort of macroeconomic discipline once provided by the historic gold standard.

This new set of rules also enhanced the private sector’s influence over the economy: if local investors were displeased with the course of economic policy, the exodus of their resources via capital flight could trigger a destabilizing recession. To bring the private sector more firmly on board in facilitating the process of disinflation, the government initially asked leading companies to “voluntarily” engage in price restraint. As the currency gradually stabilized, so did prices. By May 1991, monthly inflation had tapered down to around 3% and by 1992, the monthly average was less than 1.5%. By 1994, annual inflation was less than 4%.

On the fiscal side, the Menem administration had inherited a public sector deficit that averaged 9% of GDP through the 1980s. Because the Convertibility Plan excluded the possibility of domestic credit creation, the central government was under intense pressure to keep its fiscal house in order. Fortunately, the Menem administration had moved, even prior to Convertibility, to eliminate tax evasion, improve tax administration and compliance, and curtail rampant public spendig. Legislative reform centered on increasing tax revenues on income, a sizeable increase in the value-added tax (from 13% to 18% – subsequently raised again to 21% in March 1995 as an “emergency measure” but never reduced as the “tequila crisis” subsided) and the construction of a regulatory framework for the privatization of state-owned companies and assets.

The impacts of these monetary and fiscal reforms on growth were initially positive. As can be seen in Figure 2, the first two years of the program prompted a buoyant recovery, with growth sustained at a slightly more moderate
pace in 1993–94. In regional terms, Argentina posted the second fastest growth rates for this period in Latin America, and the Argentine recipe was pronounced a success both at home and abroad. In light of the extreme policy swings and political economic decline that had characterized the country throughout the post-war era, it appeared that Argentina had finally turned a necessary corner.

(b) *All that glitters is not (the) gold (standard)*

Or had it? By late 1994, some investors and financial analysts were again expressing concern about Argentina, particularly with regard to the rising value of the peso. In the aftermath of hyperinflation, it is typical for price movements to take time to completely stabilize; in this case, it took until 1994 before domestic inflation fell more or less in line with international inflation.\(^9\) As a result, the real currency value steadily increased over the period, but especially in the earlier higher-inflation years. This pattern is evident in Figure 3, which shows the average annual real exchange rate.\(^10\) Discounting the upward surge in 1989—hyperinflation episodes are often associated with a sharp decline in the value of the local currency—we can see that, by 1993, Argentina’s real exchange rate had settled to about half of the value that it had held during most of the period following the 1982 debt crisis.\(^11\) While this level may be a misleading benchmark—the earlier period was characterized by high inflation, low growth, and significant uncertainty—the dramatic shift in the peso’s value did present a challenge to economic balance.\(^12\)

Indeed, both the rising value of the peso and the steady increase in GDP (and hence demand), were soon felt in the trade balance. In Argentina, export sales have often been a “vent for surplus” rather than a primary goal of domestic producers. As can be seen in Figure 4, exports were indeed briefly “crowded out” by the 1991–92 resurgence in demand within the domestic economy, and then grew moderately thereafter.\(^13\) What was most striking in the trade sector was the dramatic surge in imports: during 1990–94, the dollar value of imports swelled by more than 400%. The trade balance correspondingly moved from a US$8.6 billion surplus to a US$4.2 billion deficit, a shift on the order of 7% of GDP.

The medium-term sustainability of such large deficits depends on whether those investors...
who provide the offsetting capital flows believe that trade surpluses are likely in the future. If international investors are rational, the presence of a deficit may therefore be a sign of confidence; however, it is useful to recall that equally rational financiers may simply be taking advantage of high post-stabilization interest rates while maintaining a short position that will allow an easy exit. It is crucial, then, that deficit countries try to attract longer-term flows and to steer their enhanced supplies of foreign savings away from current consumption and toward the expansion of productive capacity.

What was the nature of financing and the investment/consumption balance in post-stabilization Argentina? Figure 5 indicates the dramatic, though uneven, increase in portfolio investment; the huge inflow in 1993 partly reflects a spate of privatizations of state-held companies, including the state-owned oil company, YPF (de la Balze, 1995, p. 93; Grosse and Yanes, 1996). Nonprivatization FDI increased modestly and there also seems to have been a substantial return of flight capital during this period.\(^{14}\) Overall, the pattern suggests a mix of both permanent and more short-term flows.

The government squirreled away a significant portion of the currency inflow, allowing reserves to increase dramatically through 1994. Part of the reason for this was that the government still needed to fully back the currency; as Williamson (Williamson, 1995, p. 9) notes, the Central Bank initially had full cover in terms of gross reserves but not in terms of net...
reserves (see Figure 6) and did not achieve the latter until 1992. After this, reserve accumulation continued, partly to provide for remonetization in the wake of falling inflation and the consequent increase in demand for real liquidity.

With regard to the investment/consumption balance, we should note that consumption upswings in the wake of stabilization may simply reflect consumer confidence in future income (Tanner, 1997). Still, investment increases, particularly in export capacity, are key to future trade surpluses. In Figure 7, we plot consumption, investment, and imports as a percentage of GDP. As can be seen, consumption was indeed on the upswing during 1990–94, increasing by nearly five percentage points over this period. Both the import and investment ratios however, rose even more dramatically, each increasing by about 10 percentage points during 1990–94.

While the import boom was worrisome, Figure 8 shows that imports of capital goods and accessories rose from around a third of total imports in 1990 to nearly 44% in 1994. Of course, consumer goods rose dramatically as well, going from below 10% of imports to nearly 25%; the relative loser in the import boom was intermediate goods; one reason may have been that final goods imports displaced old import-substitution industries, hurting firms which had been significant importers of parts for assembly.

In any case, investment was a key component of both GDP and import growth over the period. While some of the documented burst in

![Figure 6. International reserves in Argentina, 1982–97.](image)

![Figure 7. Consumption, investment, and imports as a percentage of GDP in Argentina, 1982–97.](image)
capital spending was due to pent-up demand—driven by low interest rates, a favorable exchange situation, and the need to rebuild capital stock—the government had clearly met its objectives of enhancing private investment. Still, some observers worried that the bulk of investment was devoted to the nontradeable sector, while others argued that low value-added agricultural products continued to dominate Argentina’s exports.

Meanwhile, as can be seen in Figure 9, the economic recovery did little to alleviate the sharp rise in unemployment, which hit 13% in Buenos Aires in late 1994. To some extent, increasing labor market dislocation reflected a positive development, as companies streamlined their operations in response to new liberal economic incentives, and labor productivity increased dramatically. But, in light of Argentina’s historically low levels of unemployment, and the context of economic boom that prevailed until 1995, the 1994 jump in the number of unemployed was both alarming and politically problematic.

By 1994, with unemployment rising, an appreciated peso dampening export growth, investment still below its 1980 level, and capital accumulation distorted toward nontradeables, some began to worry about the medium-term viability of the Argentine strategy. In December of that year, one multilateral banker observed that “there actually is no ‘model’ beyond..."
the adjustment plan which Cavallo introduced in 1991. Argentina should start thinking hard about what it will do next.\textsuperscript{22}

(c) The 1995 “crack” and beyond

Before Argentine policy makers had a chance to address these challenges, the Convertibility Plan itself had come under attack.\textsuperscript{23} In the first few months that followed the December 1994 Mexican currency crisis, over US$8 billion exited from Argentina, an amount equal to about 18% of all deposits in the domestic banking system. As Domingo Cavallo observed in August, 1995, “the fall in deposits between January and April was similar to that of the crack of 1929.”\textsuperscript{24} Publicly, the government reacted by holding a firm line on its quasi-gold standard; quietly, rules were bent to prevent a massive recession. The Convertibility Plan included a “loophole” which allowed the Central Bank to hold up to one-third of its assets as dollar-denominated government debt, and the bank moved quickly to purchase such debt in order to inject new dollars into the system. Previously steep reserve requirements in the private banking system were also cut by half, allowing for an expansion in liquidity.

The above measures helped to slow the decline in GDP, but investment and employment continued to plummet through 1995 (see Figure 10), with unemployment in Buenos Aires hitting 20.2% in May of that year. By the end of 1996, output had more or less recovered its pre-crisis level,\textsuperscript{25} but unemployment had declined by just 2–3 percentage points; moreover, permanent jobs actually fell by nearly 6% over the course of that year and the employment improvement came from a dramatic increase in temporary positions (EIU, 1997, p. 19).\textsuperscript{26} In 1997, GDP rose a startling 8.2%; while this was welcome news, a sizeable trade deficit resulted and the employment effects were relatively weak. Not until October 1997 did unemployment in Buenos Aires drop below 15% and national unemployment below 14% (see Figure 9), still above the pre-crisis level. Estimates suggest that half of the new jobs created were temporary, and many worry that both the composition of trade, with the biggest export increases in primary products with little value-added, and the yawning commercial deficits will constitute a bottleneck for future job creation.\textsuperscript{27} Portfolio investment also rebounded through 1996 and 1997; while this reassured some, it led others to wonder whether Argentina was again becoming vulnerable to the vagaries of international capital markets.

Still, the major achievement of this adjustment period was the maintenance of credibility: the government had (more or less) stuck with Convertibility and had been willing to suffer the employment consequences and other costs. Of course, the key policy issue is whether staying this particular course simply saddled Argentina with an “overvalued” exchange rate which leaves the country vulnerable to yet another crisis. In short, should Argentina have used the “cover” of the tequila crisis to devalue—and not having done so then, should it consider depreciation possibilities now?

The answers to these questions depend, in part, on whether the currency was or is actually overvalued. Argentine policy-makers naturally reject any notion that the peso is overvalued—as well they should since public statements to that effect by high officials are likely to trigger a stampede from the currency. These same policymakers argue that the currency was initially undervalued and further note that the exchange rate is validated by steady capital inflows. Moreover, they suggest, improving productivity by Argentine labor is superior to depreciation as a tool for achieving export competitiveness—and there has indeed been a significant increase in industrial output per worker, partly because of employment downsizing.\textsuperscript{28} These explanations would perhaps be more convincing if they did not resonate so closely with those recited by Mexican technocrats prior to that country’s 1994 crash; moreover, beyond the gamesmanship in which policy-makers are afraid of

Figure 10. Growth of real GDP, consumption, and investment in Argentina, 1982–97.
“talking down” the currency, lies a more serious debate about the behavior of the real exchange rate in a poststabilization economy.

As Dornbusch and Simonsen (1987) note, fixing the nominal exchange rate can cause real appreciation when inertial forces lead to a slow disinflation. If economic agents believe that the real appreciation will bring future problems, they are likely to step up current consumption, a trend which merely exacerbates the pressure on deficits and hence increases the likelihood of an eventual meltdown (Guidotti and Végh, 1997). Yet it is hard to know whether a high currency value (or even a consumption boom) are problems while one is still in the midst of stabilization: as Uribe (1997) suggests, real appreciation can occur even with flexible exchange rates, primarily because the inflation tax falls more heavily on nontradeable goods and its decline forces a shift in relative demand (and hence relative prices) away from tradeables. Thus, distinguishing whether appreciation is an equilibrium phenomenon which reflects a natural and positive course of events, or the result of a poor (and reversible) exchange rate policy, can be difficult.

Here, we take a simple approach based on the methodology developed by Goldfajn and Valdes (1996) in their study of currency appreciation episodes in 93 countries during 1960–94. Gathering monthly data on the Argentine exchange rate for the last 37 years (from January 1960 to August 1997), we calculated an “equilibrium” (or purchasing power parity) real exchange rate, as well as deviations from this equilibrium value. Our results suggest that the Argentine peso was modestly undervalued when Cavallo took office, but crossed a 25% appreciation threshold (above the equilibrium rate) less than two years later. Goldfajn and Valdes note that of the 71 cases they studied that crossed this threshold, less than 5% returned to within 5% of the equilibrium real exchange rate without a nominal devaluation; instead, most governments switched from a fixed to a floating rate, and in 90% of their cases, more than half of the movement back to equilibrium was done by currency depreciation and not price shifts. Since 1970, every time Argentina crossed this threshold for more than two months, the deviation from the real exchange rate continued to the point of a financial explosion. In the current episode, the threshold was crossed in a sustained fashion and this was subsequently followed by a modest downward trend; thus, the effect has been one of a financial “simmer,” rather than a full-blown crisis. While this may, to some degree, reflect equilibrium processes a la Uribe (1997)—and while “both theory and evidence suggest that real appreciation is an unavoidable product of lowering inflation” (Calvo and Végh, 1994, p. 44)—this is still a worrisome pattern.

One substitute for a flexible exchange rate would be a flexible labor market. If wages adjusted easily, as per theoretical models, then there might be no need to employ the relatively blunt tool of depreciation. But, as detailed below, progress on this microeconomic front has been erratic and thus the burden of adjustment has fallen heavily on employment. While some might argue that restoring the tool of depreciation would simply postpone necessary labor market flexibilization, seven years of footdragging in finalizing a comprehensive package of new labor market regulations does suggest a trend of strong resistance—and the changing political climate, which has begun to favor those more worried about labor incomes even as the ruling party may become more dependent on its union supporters, is probably not conducive to reform. In the meantime, Argentina has the worst of both worlds: its hands are tied by rigid exchange rate rules and labor market flexibilization remains stymied by political deadlock.

There is little doubt that Cavallo had little choice but to fix the peso against the dollar at the outset of his tenure as Economics Minister: in the wake of hyperinflation, the Convertibility Plan offered a highly visible and essential signal of the government’s commitment to fiscal and monetary discipline. It is also likely that depreciation in the context of the “tequila shock” would have squandered hard-won gains in public confidence. Over time, however, the Menem administration has perhaps hung too much of its credibility on the exchange rate anchor, and at the expense of cultivating a much broader range of confidence-enhancing signals within the country’s economic and political institutions. It is to these broader institutions that we now turn.

3. THE MICROECONOMIC SCENARIO: THE POLITICAL ECONOMY OF ADJUSTMENT

It is not so much a question of having confidence in the market, as it is of creating markets. (Bernardo
Kosakoff, Staff Economist, UN Economic Commis-
sion for Latin America and the Caribbean, Buenos
Aires)\textsuperscript{38}

… we support the model, but we do not want to be
buried by it. (Jorge Blanco Villegas, President of the
Unión Industrial Argentina)\textsuperscript{36}

(a) Microeconomic initiatives

So far, we have focused on the macroeco-
nomic stabilization strategy devised by the
Menem administration. Yet the government has
also been engaged in an ambitious program of
microeconomic reforms, including trade liber-
alization, privatization, and deregulation. In
this section, we review both the microeconomic
initiatives and the distributional stresses they, in
conjunction with the prevailing macroeconomic
strategy, have triggered. We then turn to the
politics of reform, focusing on the changing
benefits and costs of the administration’s style
of closed and autocratic decision-making.

(i) Trade liberalization

Like many Latin American countries since
the late 1980s, Argentina has pursued its trade
liberalization goals unilaterally, through the
multilateral Uruguay Round, and within a
subregional context (Berlinski, 1996; Tussie,
1996; Wise, 1998). In 1988, Argentina first
opened slowly with considerable pressure and
financial support from the multilaterals, build-
ing in part on the bilateral integration thrust
with Brazil that began in 1986. The reduction
of tariff and nontariff barriers was then escal-
ated in 1990–91 as Argentina followed in Me-
xico’s footsteps, seeking to link trade
liberalization with a fixed exchange rate as the
centerpiece of a stabilization strategy. At the
subregional level, Argentine officials have
committed to further liberalization and dereg-
ulation under the Mercosur customs union
(which includes Argentina, Brazil, Paraguay,
and Uruguay, and Chile and Bolivia as asso-
ciate members) that was launched on January
1, 1995 (Guira, 1997).

By April 1995, Argentina’s average tariff was
half of what it had been in October 1989, and
some progress had been made in reducing the
dispersion rate around the tariff (Artana and
Navajas, 1995, p. xiv).\textsuperscript{37} Meanwhile, one stan-
dard measure of openness—exports and im-
ports as a percentage of GDP—had risen from
less than 17\% in 1990 to over 30\% by 1996.\textsuperscript{38} As
Figure 4 indicated, the growth in this trade
ratio was lopsided: exports nearly doubled over
1990–95, but imports jumped fourfold over this
same time period.

While most economists would endorse Ar-
gentina’s increased trade and outward orienta-
tion as key to expanding growth and incomes
(Edwards, 1995, ch. 5), Argentina has expe-
renced an extended lag in the realization of
employment gains. While some of this is due to
exchange rate as well as labor market rigidity, it
is important to note that the country’s com-
mercial expansion has been dominated by low
value-added exports of agricultural and energy
products. Indeed, low value-added natural re-
source exports jumped from about 25\% of all
exports in 1989 to 34\% in 1994, suggesting the
limited progress that has been made in shifting
to the kinds of high value-added exports nec-
ecessary for triggering future income and job
growth (Edwards, 1997; Toulan and Guillén,
1997, p. 402). In regional terms, Argentina is
certainly not alone in facing this need to gen-
erate higher value-added economic activities,
which are essential for improving a given
country’s level of development. Policy-makers
have responded to this challenge by granting a
range of tax incentives to those producers who
can credibly demonstrate an increase in their
export capacity (de la Balze, 1995, pp. 117–
122). The lackluster response of higher value-
added exports to such policies appears to be a
matter of other crosscutting incentives which
favor production for the domestic market, es-
pecially the appreciated peso. In this sense,
there has been a lack of coordination between
micro and macroeconomic strategies.

Other structural factors have worked against
a trade-led reactivation of employment. The
top conglomerates in the main tradeable sectors
have indeed increased efficiency and consoli-
dated their assets and ties with foreign capital,
but in a highly capital-intensive and concen-
trated manner. By 1994, the 30 largest export-
ing firms controlled 55\% of all exports, and in
just four sectors (petroleum, foodstuffs, steel
products, and motor vehicles) (Toulan and
have not been the major employment genera-
tors: whereas the country’s 500 largest firms
accounted for about 30\% of GDP in 1994, these
top companies employed just 20\% of the
workforce. Meanwhile, during 1984–94, the
total number of manufacturing establishments
that employed 11–50 workers fell by 21\%, as
did the number of employees in these same
sized companies (FIEL, 1996, p. 140).
The basic problem is that most of the small and medium-sized firms that form the core of the country’s traditional industrial base lack full access to the technology, skills, and market information that would enable them to participate more fully in the new market economy. Since these firms have traditionally accounted for the majority of jobs created, the resulting squeeze has contributed directly to the growing unemployment challenge. A special difficulty has been the limited availability of reasonably priced credit with which to finance modernization: in late 1996, large companies in Argentina’s highly segmented credit markets reported paying 8–10% interest on business loans, while smaller firms paid between 15% and 30% interest. Equally important has been the lack of integrated ties between small and large firms, links which in East Asia and elsewhere have provided the large exporters with service inputs and flexibility and benefitted the small firms through increased demand.

Interestingly, one of the most important factors in Argentine export growth has not been liberalization per se but rather trade enhancement under the elaborate set of rules governing Mercosur, as well through special arrangements with Brazil in sectors such as autos. Partly as a result, the share of Argentine exports going to Brazil rose from 5.9% in 1985, to 11.5% in 1991 at the beginning of the Convertibility Program, to nearly 28% by 1996 (CEP, 1997, p. 54); indeed, the increase in Argentine exports to Brazil accounted for nearly two-thirds of the entire increase in exports during 1991–94, and the improvement in Argentina’s trade balance with Brazil accounted for a full third of the trade adjustment over the difficult 1995–96 period.

(ii) **Privatization**

By the late 1980s, it was estimated that Argentina’s approximately 400 state-owned companies accounted for 7% of domestic GDP and 21% of total gross investment. At the same time, the combined losses of the 13 largest public firms were US$4 billion in 1989, reflecting the extremely low levels of productivity within the government enterprise sector. With inflation running at 5000% that same year, and public opinion rebelling against the low quality of goods and services provided by state companies, the newly inaugurated Menem administration seized the opportunity to act against longheld preferences for state ownership in Argentina. Two laws were immediately passed in 1989, the Economic Emergency Law and the State Reform Law, which together enabled the government to quickly begin unloading state-held assets.

This legislation initially authorized the President to place trustees in charge of the state firms for up to one year, with the broad mandate to begin selling off as much as possible, and by whatever means necessary. Assets were rapidly sold across all economic sectors, including airlines, oil companies, steel, petrochemicals, insurance, banks, telecommunications, and postal services. The positive impact on the fiscal balance, particularly in the crucial years of 1991 and 1992, can be seen in Figure 11 (the huge privatization yield from the 1993 sale of the state oil company was not applied to the fiscal accounts for that year, which would have shown a large divergence between government revenues with and without privatization). The overall receipts have been impressive: during 1990–94 the federal government raised nearly US$10 billion in cash and
absorbed an even larger amount of public bonds from the market. Since this boom period, the pace of privatization has slowed considerably. The receipts for 1995–96 were approximately US$640 million, representing the sale of a handful of firms in the hydroelectric sector, and one large petrochemical enterprise.47

Given the context of high inflation, the urgent need to reduce the fiscal deficit, and the general public dissatisfaction with state firms, there is no doubt that the time had come for the Argentine state to shrink the government enterprise sector. Still, while the privatization process has been praised for placing Argentina in the vanguard of Latin America’s market reformers, public sentiment sees privatization as a main factor in the country’s high rates of unemployment.48 The data tell a slightly different story: because state firms have traditionally accounted for just 3–4% of the country’s total employment (de la Balze, 1995, pp. 88–89), any recessionary impact of privatization on the real economy may have as much to do with the pace and manner in which assets have been transferred from public to private hands, with the key being whether such transfers achieve the efficiency and productivity gains that can attract further investment and lay the groundwork for employment expansion and sustainable growth over the long-run.49

Recent research on the politics of privatization in Argentina suggests that while the successes of the privatization drive have been notable, so too have the failures (Chudnovsky et al., 1995; Saba and Manzetti, 1997). On the upside, the auction of assets ranging from ports to gas and petrochemical plants has attracted world class investors who, in conjunction with various local consortia, have introduced those standards, know-how, and technologies most conducive to increased competitiveness. In particular, the widespread privatization of Argentina’s public services holds strong potential for improving the quality of those nontradable inputs which are essential for supporting exports and growth.

On the downside, in its rush to balance the budget and produce some concrete results in the eyes of wary investors and inflation-weary voters, the government rode roughshod over some of the basic principles that have underpinned the privatization process elsewhere. For example, not all state firms went to the highest or most sophisticated bidder, and the barrage of sales in the early 1990s was made in the absence of a proper regulatory framework to prevent the emergence of costly private monopolies in such sectors as telecommunications and the airlines industry (Gelpern and Harrison, 1992).49 To date, foreign majority control of assets and technical expertise has been the rule, with domestic partners relegated mainly to the lower level administrative functions of privatized firms. But more to the point, the generous inducements offered thus far to foreign bidders and their Argentine partners have yet to foster a more dynamic pattern of production and investment geared toward the external market. In a survey of 28 privatized companies which represent nine different individual sectors, Chudnovsky et al. (1995, p. 99) found that

Figure 11. Fiscal performance in Argentina, 1990–97.
only two had adopted an outward export orientation (a meat-processing firm and a manufacturer of gear boxes), while the research and development activities of all but a handful of respondents were basically nil. The picture is more of oligopolistic rent-seeking than of dynamic enterprise—and the potential negative impacts for employment are clear.

(iii) Deregulation

The mass of regulatory reforms that have been legislated since July 1989 represents nothing short of a revolution. Across sectors, fiscal and administrative barriers to competition have been removed, and the Argentine economy is now a considerably more stable and cost-effective environment for conducting everyday business transactions (de la Balze, 1995, pp. 99–104). Moreover, while foreigners have been granted the same rights and treatment as national investors since 1979, sectoral restrictions and prior authorization procedures have been recently streamlined; indeed, Argentina’s FDI laws are now so liberal that inscription into the national Registry of Foreign Investments is optional (Agosín, 1995, p. 12).

The one area where deregulation has proceeded more erratically is within domestic labor markets. Admittedly, the President has shown great political acumen in maintaining organized labor’s backing while simultaneously dismantling a statist model that many of his own labor constituents within the Peronist Party (PJ) still hold dear. One cost has been an unwillingness to tackle various distortions in Argentina’s labor markets, most of which originated during the heyday of Peronism in the 1940s.

In theory, fuller wage/employment flexibility should speed up sectoral adjustments, allow for a more efficient allocation of resources, ameliorate unemployment, and relieve the pressure on the exchange rate (Pessino, 1997; World Bank, 1996a, p. 55). Unions and employers have not been completely rigid: de facto “flexibilization” strategies have included everything from the incorporation of productivity and work reorganization clauses into collective bargaining contracts; to the purchase by the unions of struggling firms in the represented sector; to union management of employee-owned stock of privatized state enterprises (Murillo, 1997, pp. 80–87). Yet union forces have resisted significant changes in official legislation, partly because they do not want to send the formal signal of free market surrender that business desires, and labor’s key role in the Menem coalition has allowed this sector to block reform. The result has been higher labor costs (including nonwage labor costs that run as high as 50% of gross wages in Argentina, as compared to 30% for the OECD countries) and continuing difficulties in hiring and dismissal, both of which have contributed to today’s high levels of un- and underemployment, and to the flight of some workers and producers into the informal economy.

The government has made some headway in legislating new rules on health insurance and workers’ compensation. The more difficult challenge has been a reduction in payroll taxes and the replacement of severance payments for dismissed workers by an unemployment insurance scheme based on individual capitalization accounts with payroll deductions. The severance issue is particularly important: since firms are required to provide one month’s wages for each year’s service in the event of a dismissal, they become extremely reluctant to hire. A 1995 law allowed for temporary employment but legislation proposed by President Menem in 1998, partly in response to union pressures, would “eviscerate” this act. The political opposition inching toward power is not likely to reverse this situation since much of their appeal is based on public concerns about the deterioration of wage and employment conditions. As a result, full labor market reform still seems far off.

Another pressure point in the regulatory reform process has been the government’s mixed record in constructing effective oversight mechanisms for newly privatized firms now providing such services as water/sewerage, telecommunications, natural gas, and electrical power. Again, the high presence of foreign investors in the privatization of public utilities (37% over 1992–95) reflects both the profitability conditions that were built into the transfer clauses and the captive nature of the domestic market (Chudnovsky et al., 1995, p. 40). The crucial role for public policy in overseeing the quality and price competitiveness of private service delivery under such circumstances has not been lost on the Menem administration.

Yet the regulatory bodies designed for this task have varied greatly in their effectiveness (Urbitzondo, 1997, pp. 13–28). At one end of the continuum are the gas (ENARGAS) and electricity (ENRE) commissions, which regulate numerous service providers, are funded...
autonomously, and fall under Congressional jurisdiction; at the other end are the telecommunications (CNT) and water/sewerage (ETOSS) commissions, which are the target of intense lobbying by 1–2 large firms, funded by revenues that sometimes carry questionable political ties, and are subject to frequent administrative interventions by the President and other local officials. The latter pattern has created lucrative opportunities for corruption, which sheds light on the numerous scandals that have surrounded the Menem administration since its inception (Saba and Manzetti, 1997).54

(b) Distributional outcomes in the reform process

While market reform inevitably creates winners and losers, it also holds out the promise of distributional improvements. In theory, liberal trade regimes can generate new demand for low-skilled labor; meanwhile, a reduction in the realm of government should deter rent-seeking and favoritism toward elites. In practice, however, most of Latin America’s market reformers have experienced distributional deterioration in the process of liberalization, marked by sizable transfers of wealth toward the top income deciles. Argentina is no exception.

Figure 12 illustrates the shift in income distribution over the course of the Convertibility program, (up until October 1997, the last period for which we have data), making use of a twice-a-year household survey collected for the Greater Buenos Aires area (which accounts for almost 40% of the population, and more than 50% of national GDP). We plot two measures of income distribution: the percent of income received by the top 20% of households relative to the bottom 40% of households, and the percent of income received by the top 10% relative to the bottom 10%. While there is some volatility, both measures show a pattern of worsening distribution over the course of the period.55

A detailed breakdown of the evolution of labor market trends since 1991 helps to explain some of this distributional worsening. By May 1993, the unemployment rate of blue-collar workers, those most likely to be at the bottom of the distributional hierarchy, was four times that of university-trained professionals. While part of the employment difficulties for less skilled workers were a result of the country’s rigid labor laws, another reason has been that the boom in nontradable sectors like financial services has favored workers with much higher skills.

Adding to the distributional problem has been a continuing concentration of assets on the business side. Even as the 1995 recession provoked higher unemployment and rising rates of bankruptcy throughout the economy, Argentina’s top 200 companies increased their sales and profits that same year by 11% and 30%, respectively.56 The restructuring of the financial system, particularly in the wake of the tequila shock, also resulted in asset concentration; while few banks went under in the midst of the 1995 crisis, many were absorbed by larger, more solvent banks and by late 1996, the

![Income Distribution in Argentina, 1990–97](image-url)
number of banks had fallen from over 200 to 148.57

Another distributional tension has arisen with regard to the relationship between the central government and the provinces. Until 1995, local governments had not been subjected to the same fiscal discipline as that imposed on the federal government. This was partly because the early period of growth generated a healthy increase in the local tax base.58 Moreover, provincial officials often forced province-owned banks, not subject to convertibility regulations, to extend credit. Finally, even in the midst of sharp cuts at the federal level, the central government actually increased its transfers to the provinces by nearly 2% of GDP during 1990–92. Overall, from 1990–95, federal resource transfers to the provinces more than doubled (Gibson and Calvo, 1997, p. 8). In the face of such largesse, local-level state reform was postponed.

When the 1995 recession hit and the federal surplus declined, however, provincial budgets quickly fell into a state of fiscal crisis. As the provincial deficit rose to US$3 billion in 1995 (slightly over 1% of GDP), the provinces finally quickened what had been an exceedingly slow pace in the realm of privatization; since provincial banks were a prime target for such privatization, the option to borrow locally was now foreclosed to provincial officials.59 With finances tightening, local officials postponed payments to suppliers, state employees, and pensioners (World Bank, 1996b). Social tension percolated, then exploded; in May 1997 alone, there were more than 40 incidents of local protest, including road blocks and clashes with the police.

In many other countries with similar distributional stresses, including Bolivia, Chile, and Mexico, governments have devised short-term “safety net” strategies to soften the pains of adjustment and win political support for reform (Graham, 1994). Because of the buoyant growth rates from 1991–94, the fiscal stringency imposed by the Convertibility Plan, and the “hands-off” management approach of the Cavallo team, the government rejected this sort of strategy; moreover, the fiscal aspects of the Convertibility Plan probably made distributional pressures more severe as the government became more dependent on the regressive VAT—which accounted for 45% of all taxes collected in 1996—to help cover the deficit (EIU, 1997, p. 13). In 1995, with recession and the full impact of economic restructuring sink-}

(c) The politics (and anti-politics) of reform

Until 1995, the Menem administration appeared to have accomplished the nearly impossible task of winning over one of the region’s most fiesty electorates, while at the same time launching the most far-reaching set of economic reforms in the country’s history. Despite the lack of a safety net strategy to garner political support for market adjustment, the alarming jump in unemployment in 1994, and the steep recession that followed from the Mexican crisis, the President won re-election to a second term in 1995. Yet in 1996, the ruling party lost the first open elections for the mayor of Buenos Aires and the country began to experience a string of militant general strikes. By early 1997, support for Menem in national public opinion polls had plummeted to just 10% and in October of that year, a coalition of opposition forces managed to defeat Menem’s party in mid-term Congressional elections.

Understanding Argentina’s political dynamics requires that we analyze, first, why Menem enjoyed such an extended period of support, and then why it evaporated. One oft-cited factor was simply the willingness of the public, in the wake of very high inflation, to tolerate austerity in exchange for price stability and the promise of future economic gains (Starr, 1997). Yet, as Corrales (1998) notes, high inflation is not necessarily a “trampoline to heaven”—the chaos of price hikes is as likely to breed conflict and more inflation as it is to create the implicit or explicit cooperation necessary to halt the price spiral. Of course, once the inflation slows and the evidence of success is in, the tolerance for austerity is likely to rise (at least for a while). Still, there were several key political tactics which also helped sustain some degree of support for reform.

The first was the masterful overhaul of Menem’s Partido Justicialista (PJ) such that the party’s mass base has expanded and diversified while the influence of traditional Peronist trade unions has diminished greatly.61 By exploiting the party’s weak rules for leadership turnover and its historically strong ties to the country’s
working classes, Menem seized the leadership role, replaced the PJ’s typically populist agenda with his own program of market reform, and was thereby able to draw a larger business and middle class segment into the party. He also managed to maintain organized labor’s loyalty in spite of its outright marginalization within the party, due most likely to the latter’s lack of other political alternatives.62

The second tactic involved playing off constituents in Argentina’s urban centers against their compatriots in the country’s less developed provinces. As noted above, the provinces had largely been spared the pain of fiscal adjustment until 1995, at which point the tequila shock forced the federal government’s hand. As Gibson and Calvo (Gibson and Calvo, 1997, p. 7) explain, “Peronism’s seeming invincibility at the polls...was due not to organized labor in the metropolis, but to its ties to clientelistic and traditional networks of power and mobilization in the periphery.” Hence, a winning electoral coalition was maintained nationally by the phasing of harsh adjustment measures to the regions at a much later point. As noted above, central government transfers to the provinces actually increased while the urban centers were subjected to a tight fiscal shock; moreover, during 1989–94, although the federal government workforce was cut by 77%, public sector employment in the provinces held steady. The force with which fiscal retrenchment is now hitting the regions, where public employment has traditionally been more of a mainstay, sheds light on why social protest has erupted later and with such vehemence in the periphery.

Finally, like many other heads-of-state in Latin America of the 1990s, Menem relied heavily on executive decrees in order to overcome lingering anti-market sentiments within Congress and the wider political arena (Teichman, 1997). Executive decrees have been utilized, for example, in the raising of taxes and the revision of tax laws, the modification of public and private contracts, the setting of the trade regime, and the structure of labor law—decisions which typically require broader input and consensus (López, 1997).63 The previous Alfonsin administration issued just eight decrees of “necessity and urgency” during its entire tenure; in contrast, between July 1989 and December 1993 more than 12,000 executive decrees and 308 decrees of “necessity and urgency” were passed, the latter comprising the core of the reform program (López, 1997, p. 15).

Given the measured success of these tactics, what explains the sharp drop in political support? In a recent study, Stokes (1996, p. 508) argues that an “inter temporal” response (“no pain, no gain”) to the sacrifices invoked by market adjustment can eventually shift to a “distributional” response (“my pain is your gain”) on the part of voters, even those who have been traumatized by hyperinflation:

...support for reforms began high among all classes and remained relatively high among the rich but declined notably among the poor...no one was willing to suffer catastrophic losses, such as unemployment, on the promise of future prosperity or with the excuse of ghosts of the past (Stokes, 1996, pp. 516–517).

The “distributional moment” has come in Argentina. The Radical Party victory in the June 1996 Mayoral election in Buenos Aires—where Menem’s party garnered only 18% of the vote—reflects the distinctly distributional mood that had settled in among urban voters worried over whether they would actually see some light at the end of the economic tunnel. The provinces followed suit in the October 1997 midterm elections, where the Peronists lost control of their majority standing in the lower house of the Chamber of Deputies.64 While this loss, in and of itself, has not seriously impaired Menem’s ability to govern (Perry, 1997), it is evident that Menem’s previous political tactics for garnering support have now run into difficulties.

The reworking of the Peronist party has worn thin, as the party’s traditional base constituency within organized labor is all but consumed with its own immediate economic survival. The arrival of market reform in the provinces has provoked a political backlash among those who thought they had escaped the inevitable pain of adjustment. The President’s strong reliance on legislative decrees has undermined executive legitimacy, as many of these earlier decisions have become shrouded in charges of corruption. Both the business and labor sectors have come to oppose an almost purely autocratic decision-making style, with points of conflict centering on Menem’s repeated circumvention of Congress, frequently in defiance of the Constitution, and his ready resort to other underhanded tactics, such as the stacking of the Supreme Court with members guaranteed to support executive-level policy directives.65

To its credit, the Menem team took command of a shipwrecked economy, imposed economic rationale on a society that had long
been accustomed to “storming the state,” and in the process secured the longest political honeymoon since the Peronist era. As effective as this style may have been for initiating and implementing market reforms, the successful consolidation of the reform process will require the development of technocratic expertise and political skills beyond just the Economics Ministry and the office of the executive. Meeting the challenges of distributional improvement and increased public accountability is now imperative for the next phase of market reform in Argentina.

4. CONCLUSION: THE NEXT PHASE FOR ARGENTINA

There is no relation between unemployment and economic policy. (Domingo Cavallo, Latin American Weekly Report, August 3, 1995).

What is this dollar to peso, one-to-one? The rest of Latin America is laughing at us... This has been an act of inhumanity over the last six years. They have destroyed the technical schools, destroyed education, destroyed the base of the future. They will be judged (Anonymous Businessman, Buenos Aires, July 1996).

Rodrik (1991) has sketched an analytical model of the reform process which provides a useful framework for assessing the medium-term sustainability of a program like Argentina’s. According to Rodrik: (a) reforms must be technically sound enough to produce the desired economic result and hence the basis for a new coalition; (b) technocrats must be sufficiently insulated so that short-term lobbying pressures can be withstood until the reform takes full effect; and (c) the “winners” from the reform effort—who may not have been an obvious interest group at the beginning of the process—must be persuaded or induced to develop a collective voice to maintain the new policy regime.

In our view, Argentina’s track record may be problematic on all three counts. With regard to technical coherence, the government’s ability to eliminate inflation and restore growth is testimony to both the design and implementation of Convertibility. But while these broad medium-term macroeconomic outcomes are positive, the strategy has discouraged investment in the production of manufactured exports and allowed market forces to breathe new life into sectors, such as services, that offer little to recuperate the tradeables sector; while privatization boosted the fiscal coffers over 1990–94, the subsequent fiscal deterioration in 1995 and 1996, and the only modest public sector recovery in 1997, suggest the continuing need for fiscal reform; while liberalization has generated a welcome increase in labor productivity, unemployment has lingered at depression-era levels and the effects on overall competitiveness have been quite mixed.

As for Rodrik’s second notion of insulating technocrats to filter out societal pressures during the initiation of market reforms, it appears that the Menem administration has gone overboard in two respects. First, by issuing more emergency presidential decrees than the total number issued by all constitutional presidents in the past 130 years (Teichman, 1997, p. 27), Menem secured his program, but also effectively silenced the kinds of debate and input that would now be useful as the reform program moves into the medium term. Second, hindsight has gradually shown that the Menem team was perhaps too friendly with, or not insulated enough, from Argentina’s powerful private sector conglomerates (e.g., Techint, Compañía del Plata and the Perez Companc Group), all of whom have benefitted disproportionately in the 1990s (Teichman, 1997, p. 31).

This excessive identification with wealthy interests, a seeming lack of concern about the employment and distributional consequences of reform, and an early determination to forego social policy has also done little for Rodrik’s third step: expanding the “winners” circle in Argentina in order to consolidate the political base. The Menem team rightly prides itself on having purged the country of its self-destructive populist past. Indeed, perhaps the most telling aspect of the October 1997 mid-term elections was the emphasis of the winning opposition candidates not on populist-style expansion but on the need for a second round of social and institutional reforms (especially anti-corruption initiatives) to correct for past shortcomings, and better facilitate the country’s adjustment to a market economy. Such a strategy however, has still not been articulated by those at the center of the official policy making apparatus.

Argentina, in short, needs a “second phase” or “second generation” of reforms at the level of the macroeconomy, the microeconomy, state institutions, and social policy. At the macroeconomic level, the two crucial issues are fiscal policy and exchange rate management. With
regard to the former, the Menem administration has made some important headway in increasing tax compliance, simplifying the tax structure, and modernizing the country’s budgetary process (Artana and Navajas, 1995). At the same time, however, Argentine fiscal spending in the 1990s has followed a procyclical pattern—expanding during the good times and abruptly contracting when bad times set in—just the reverse of what was needed, for example, during the 1995 economic downturn. Moreover, fiscal policy in the 1990s has clearly been manipulated for political purposes, most obviously in the provinces. A second phase fiscal reform requires that policy makers shift to a countercyclical strategy, decrease the reliance on the regressive VAT, tighten the administration and collection of increased direct taxes on income, and resist the excesses of political spending that marked the last two national elections.67

As for exchange rate policy, since the implementation of the Convertibility Plan in 1991, Argentina has defied conventional wisdom within the economic community which favors a more flexible approach to currency management (Corden, 1994 p. 304; Edwards, 1995). Despite the rigid policy options intrinsic to the currency board, growth and export rates have been more than respectable, and the recovery from the tequila shock more rapid than expected. Yet, given Argentina’s comparatively rich factor endowments and the continuing resistance to full flexibilization of the labor market, we are left to wonder whether the country could better maximize its economic potential through the adoption of a more flexible exchange rate strategy. In terms of a second-phase exchange rate policy, at least two additional points recommend a more flexible approach.

First, while strict fiscal policy enabled Argentine officials to survive the tequila crisis with the Convertibility Plan intact, this adjustment was facilitated by the bending of the rules on reserve requirements, and by the simultaneous expansion of Brazilian demand for Argentine products. Now, as the continued turmoil in Asian currency markets reverberates through the Southern Cone, the Brazilian economy has contracted, and forecasters have negatively adjusted their projections concerning Argentina’s current account balance and growth prospects. This leads into the second point: Convertibility’s two remaining stabilization tools, high interest rates and wage and employment compression, also seem less of an option in the current economic environment. Hence, it is at least worth contemplating a more flexible second phase exchange rate strategy—particularly since the seriousness of Argentina’s commitment to a market economy is now widely understood and need not be permanently tethered to one nominal value or even one particular sort of exchange rate regime.

On the microeconomic front, the important point is that market reform in and of itself is not a development strategy. As Chile found out the hard way in the early 1980s, market-supporting policies, including selective interventions, are needed to promote an outward orientation and a stronger foothold in international markets.68 Even in free-trading Mexico, which has had its own share of problems in implementing an outward-oriented development model based on higher value-added manufactured exports, there has never been any doubt as to the government’s intention to pursue such a strategy or its willingness to support such outward-oriented producers (Pastor and Wise, 1997, pp. 429–440).

In Argentina, a second phase will require that market reforms actually build toward an outward-oriented model. The specifics of such a strategy need not include a retreat from trade liberalization. Indeed, a confidence-enhancing second phase trade strategy would honor earlier commitments to trade openness—and we note with worry that Mercosur’s common external tariff has risen even as Argentina has used a “statistical tax” on imports to deter trade with nonMercosur partners.69 Of course, as projections for the country’s current account deficit over the next two years balloon above 4% of GDP,70 the temptation to raise tariffs further will persist. The best way to resist will be to implement other support measures.

This would include enhanced support for the small and medium-sized enterprise sector. Recent preliminary survey research suggests that smaller industrial firms have made some headway in shifting to an export-oriented mode of production, but also indicates that greater gains could be achieved with the help of a more assertive public policy framework to guide this economic restructuring (Robbio, 1997; Kosacoff and Ramos, 1997). Some support has been articulated in domestic legislation (FIEL, 1996), but this has been weakly implemented. What is crucial now is the fostering of horizontal and vertical links to larger firms; the provision of publicity, marketing, and technical
know-how; and the creation of better ties between education, job training, and employment expansion in these firms.

Meanwhile, public investment in infrastructure for productive purposes (railways, irrigation, industrial facilities) has dropped to historically low levels. The high concentration of public expenditure on current allocations in the 1990s has been especially detrimental to the country’s interior provinces, and has worked against the broader expansion and diversification of production in industrial activities. In a second phase, this deficit in productive investment must also be addressed, a task which will also necessitate determining the sources of new revenue.

The contours of labor market reform will also need to be settled. Since 1991, a series of piecemeal deregulatory laws have increasingly introduced flexibility, productivity, and other cost-cutting clauses into labor contracts. These measures have already forced major adjustments in Argentine labor markets in the 1990s, including various *ad hoc* arrangements that grant firms effective flexibility (Murillo, 1997, pp. 77–82). Yet the remaining gaps in labor market reform and the failure of politicians to push a comprehensive legislative package through the Congress has perpetuated a credibility problem, particularly from the standpoint of foreign investors. A second-phase labor market reform strategy demands that politicians finally take a stand and complete the labor reform agenda. Such an agenda need not follow the draconian and politically problematic union-busting measures, such as eliminating industry-level bargaining, as suggested in World Bank (World Bank, 1996a, p. 16); rather the goal should be to make hiring easier, partly by codifying the many changes that have already occurred as a result of incremental bargaining and *ad hoc* adjustments in domestic labor markets, and fix in place rules that can at least add more predictability to labor costs and relations.

The success of these macro and microeconomic second phase reforms will hinge on the extent to which a badly needed overhaul of the most relevant public sector institutions is carried out (Naim, 1995). While progress has been made in modernizing the state’s main economic institutions, other public entities such as the judiciary, the regulatory commissions, the social ministries, and provincial governments are still too easily permeated by corruption and outside interests. Thus, and with good cause, the Argentine public has continued to view state institutions with suspicion. One benchmark of the importance of institutional reform to the long-term success of market policies is the IMF’s remarkable 1997 offer to open a new line of credit for Argentina based on “good governance”.71 More to the point, during this second and more challenging phase of market reform, public institutions are crucial conduits for guaranteeing greater equality of economic opportunity and wider participation in the benefits of growth.

Finally, a word about social policy. As Argentina boasts the region’s highest per capita income (US$9,387),72 the most highly educated population, and relatively wide welfare coverage, the Menem administration was able to launch a first phase of market reform without resort to the safety-net compensation schemes that were adopted in poorer countries like Bolivia and Peru (Graham, 1994). Since 1991, however, the combined effect of the Convertibility stabilization program, government incentives which favor low value-added investments, and higher levels of market concentration—including of ownership, production, and exports (CEP, 1997)—has contributed to persistent poverty (Burki and Edwards, 1996, p. 8), and a worsening of distributional trends (see Figure 12). This could be tackled in the second reform phase through: (i) better targeting of social expenditures toward high-risk groups; and, (ii) a more concerted effort at encouraging the kinds of high value-added investments and concomittant educational training which would offer employment opportunities for a much broader segment of the Argentine population.

Building a more viable political coalition to push forward a credible set of second phase reforms is another matter. Despite some concern on the part of private sector analysts that the end of the Menem administration’s long reign would herald market instability, the unprecedented political competition witnessed in the October 1997 mid-term elections appears to have had the opposite effect. Not only did the results reflect an explicit commitment to policy continuity, the growing allegations of government corruption and infringement on civil rights prompted the public to vote for those who represented an end to the highly presidentialist and autocratic style of management that has been the hallmark of the entire Menem period.73 Opening the policy process up to more citizen involvement may generate a reform
agenda that is less ambitious, but a coalition that is capable of sustaining market reform into the longer-term (Graham, 1998); it could also provide some badly needed accountability checks that will induce policy-makers and political leaders to more closely harness market policies to the productive and distributive tasks for which they were originally designed.

NOTES


2. Statement made during authors’ interview on August 1, 1996, Buenos Aires.

3. Data sources for all figures are listed in Appendix A at the end of the text.

4. While progress on the macroeconomic front was gradual, the administration did move ahead on privatization, fiscal reform, and other measures that helped set the stage for the eventual stabilization. These are discussed in more detail later in the article.

5. Stabilization was made possible, in part, by the earlier “Plan BONEX” in which state debt was converted into 10-year, dollar-denominated bonds; this allowed the government to extend the maturity of public debt from less than one month to 10-years and to eliminate the quasi-fiscal deficit (a savings estimated to equal approximately 5% of GDP). Both outcomes made fiscal constraint easier to manage within the confines of the Convertibility Plan. See Rodríguez (1995) and Tanner and Sanguinetti (1996); for a nuanced account of policy-making during 1989–91, see Corrales (1997, 1998).

6. For a detailed look at the specific rules of the Convertibility Plan and currency board in Argentina, see Ades (1995). As we also note below, Argentina’s program differed from a more orthodox currency board in that the Convertibility Law permitted part of the monetary base to be covered by dollar-denominated Argentine Treasury bonds. This gave the government a bit of breathing room when the 1995 crisis hit.

7. For a general view of the role of capital mobility in Latin American development and stabilization, see Mahon (1996).


9. A model of how slow disinflation creates currency appreciation is available in Dornbusch (1995); alternative views, which stress how such appreciation might be an equilibrium phenomenon, are available in Calvo and Végh (1994) and Uribe (1997) and are explored later in the text.

10. As per the usual practice, declines in the real exchange rate imply increases in the domestic currency.

11. The effect of the exchange rate appreciation was tempered somewhat by the tax system. In 1992, the government decided to offer a “general reimbursement” on exports with the same added value scale structure as had been established for imports. Thus, wheat was exported with a subsidy of 2.5% and was imported at a duty of 2.5% (Cristini, 1996, p. 2.9). These mirrored tariffs and rebates ranged from 2.5% to 20%; the effect was a fiscal devaluation.

12. By the calculations we present below, the Argentine peso was at least 25% below its long-term equilibrium value through much of the 1980s and so at least half of the post-Convertibility appreciation reflected a normal process of recovery.

13. Likewise, Cristini (1996, p. 2.4) notes that the higher levels of exports from 1988–90 were due to both a decline in domestic activity and incentives to earn dollars. Models of macroeconomies with such export dynamics are offered in Arida and Bacha (1984) and Pastor (1987, ch. 5).

14. Argentine investors were estimated to have stashed nearly US$45 billion abroad by 1987, an amount equivalent to over 75% of the country’s external debt (Pastor, 1990). Since hyperinflation in the late 1980s induced the exodus of even more monies, there was ample flight capital to return home.

15. While the point is salient on a theoretical level, Tanner (1997) uses Granger-causality tests with only a two-year lag structure; this leaves open the possibility that his results simply record the impact of a consumption boom on output itself.
16. By 1996, intermediary goods had staged a modest comeback and capital goods fell to 41% of imports and consumption goods to 20%.

17. Chisari et al. (1996, p. 233) suggest that the very nature of relative prices channeled investment into the nontradable sector; see also Gerchunoff and Machinea (1995). Chudnovsky et al. (1996) argue that there was some investment expansion into tradables in 1993 and 1994, but the strongest investment was in Mercosur-related sectors (e.g., autos), reflecting the growing relationship with Brazil and the relative appreciation of the latter’s currency. Bielschowsky and Stumpo (1995, p. 159) note that FDI was also drawn primarily into nontradables, with the largest flows going toward services and petroleum (which is a mostly domestically-oriented industry in Argentina).

18. The main export products were also capital-intensive, implying that this growth was not conducive to the creation of new jobs. For a review of export performance and composition from the 1970s to 1990, see Bisang and Kosaco (1996); for a review of the contemporary period which suggests that there was essentially no export boom in manufactures, see Cristini (1996).

19. While we present unemployment figures for Buenos Aires and the provinces, we believe the former to be more reliable than the latter. The Ministry of Economics has recently stressed, however, the improvement in the national unemployment rate, which has been lower than the rate for Buenos Aires in the last several years. This shift coincides with a methodological improvement in the government’s labor market survey, which recorded the number of active job searchers in Buenos Aires but did not do so for the provinces and thereby tended to diminish the labor force divisor for the national series. See Ernesto Kritz, “Tribuna Abierta: ¿Qué hacer con las mediciones de empleo?,” Clarín (April 7, 1997).

20. Labor productivity reportedly rose by 4.1% per annum during 1990–95; see “Insufficient growth limits job creation,” CEPAL News, Vol. 27, No. 6 (June, 1997), p. 1. On the other hand, Argentine real wages grew by just 0.2% annually during 1990–95 (compared to 5.1% for Brazil and 4.4% for Chile), with the rising wage-productivity gap indicating one reason for the worsening distribution of income.

21. According to Pessino (1997), the unexpected severity of labor market adjustment was directly related to the higher relative price of labor with respect to capital in the aggregate, the simultaneous increase in the labor force and the shrinking of job opportunities, and virtually no change in long-outdated labor market regulations.


23. There was an earlier scare in November 1992, but the government stuck by the convertibility rules and, as Williamson notes (Williamson, 1995, p. 9), “the crisis passed rapidly.” Also see Starr (1997).


25. See Figure 2, as well as Charles Newberry, “Argentine growth pickup and lower rates seen,” Bloomberg Business News (December 26, 1996); another reason for the slow gain in employment was employer decisions to simply lengthen working hours (see “Argentina: Longer hours, not more jobs,” Latin American Weekly Report, March 11, 1997). Over the year, the financial system had also been shored up: in November 1996, bank deposits rose to US$53 billion, up sharply from the US$38 billion low of April 1995.

26. The problem of GDP growth without employment growth has become common to many Latin American reforms; see “Great reforms, nice growth, but where are the jobs?,” The Economist (March 21, 1998), pp. 37–38.

27. Oil, for example, rose 41% in value while raw materials went up by 21%. See “Growth of 6% forecast,” Latin American Economy and Business (LAEB-97-03). Meanwhile, exports of industrial manufactures actually fell by 1% (EIU, 1997, p. 29).

28. The December 1997 issue of Notas de la Economía Real from the Centro de Estudios para la Producción (Secretaría de Industria, Comercio, y Minería, Argentina) indicates that labor productivity (per hour) in industry improved a striking 38% during 1990–95. Figures in the October 1997 issue of Notas suggest that the gain in service sector productivity was probably about half that and some of the 1990s increase in both industrial and service sector simply reflects catch-up from the collapsed production and excessive employment of the 1980s.
29. For more on this “disequilibrium” view of the exchange rate, see Dornbusch et al. (1995).

30. Uribe’s model does fit the data, although it should be noted that consumption growth in Argentina was nearly 50% more than he predicted, suggesting that the process in Argentina reflects both equilibrium and disequilibrium (à la Dornbusch) processes; see also Calvo and Végh (1994) for a similar view. Felix (1995, p. 660) offers an entirely different explanation for the real appreciation, suggesting that trade liberalization dampened price increases in tradeables but exercised less discipline over prices in the highly cartelized nontradeable sector.

31. The actual procedure involves regressing the log of the real exchange rate on time (entered linearly and as a square) and using the result to obtain predicted values of the equilibrium rate (see Goldfajn and Valdes, 1996, p. 7). We did not use a multilateral, trade-weighted exchange figure and so we may be overstating the appreciation to the degree that the dollar fell in international value. It is interesting to note that the equilibrium value of the peso has been rising over time, implying that Argentine officials may be partially right when they point to the peso’s appreciation as a long-term and sustainable trend. This real adjustment is a very slow process however, and the movement of the actual rate has gone well beyond the long-term value.

32. Argentina has managed to generate some real depreciation without nominal devaluation; in 1996, inflation was only barely above zero which, given ongoing international inflation, produced a slight depreciation in real terms and the real exchange rate finally dipped below the 25% “risk” threshold in April 1997. If we generously assume that: (a) zero inflation continues, (b) international inflation stays at around 3%, and (c) the equilibrium currency value continues to drift upward, then the actual real exchange rate will arrive within 5% of its equilibrium value by the end of 2001. Waiting through that process, particularly in light of the high unemployment rates that have characterized contemporary Argentina, is not likely to be a comforting thought for most politicians.

33. For more on credibility, highly visible signals, and the Convertibility Plan, see Canavan and Tommasi (1996). On the politics of the Convertibility Plan, see Corrales (1997) and Starr (1997).

34. For a general discussion of the problems of exchange rate-based stabilization, see Reinhart and Végh (1996).

35. Statement made during authors’ interview on August 1, 1996, Buenos Aires.


37. The policy has been slightly more activist than the image; in 1993, for example, the government introduced restrictions and antidumping measures on the imports of some goods, hoping to shrink the growth in the trade deficit. See Tussie (1996) for further detail.

38. Measured as export, imports, and GDP in constant 1986 pesos, these figures derive from the data compiled by the Ministerio de Economía, República de Argentina. While other measures (such as in current pesos) will show different specific numbers, all reveal a general growth in trade as a percentage of GDP.

39. As of 1994, 99% of these companies employed less than 50 workers, and it is this group that accounts for 70% of all employment and 22% of GDP (FIEL, 1996, p. 14). Authors’ interviews with Bernardo Kosacoff at ECLAC and Omar Chisari, Director, Instituto de Economía, Universidad Argentina de la Empresa, August 1, 1996, Buenos Aires.

40. Authors’ interviews with eight members of the Confederación General de la Industria, a business chamber which represents all of the small and medium-sized firms in Argentina, July 26, 1996, Buenos Aires. Also see FIEL (1996).

41. Data taken from Table 8.1.2, exports, imports and balance, by economic region and principal countries, Statistical Yearbook Republic of Argentina, 1995 (CDROM), and Síntesis de la Economía Real, No. 9 (November 1997), from Centro de Estudio para la Producción, Buenos Aires.

42. Mercosur’s Common External Tariff now averages 17% and 80% of internal trade covered by the agreement has been liberalized. Major sectors such as autos and textiles have yet to be formally incorporated into the agreement, however, and the capital goods, informatics, and telecommunications sectors are still exempted from the CET (Nofal, 1997).

43. While auto producers within Mercosur have advanced quickly in modernizing their operations and increasing their export ratio, the “price” for this sophisticated system of protection has been the continued inability to compete effectively outside of the subregional market, not to mention higher auto costs
for consumers within the Mercosur bloc (Agosín, 1995; Chudnovsky et al., 1995).

44. Preliminary figures from Informe Económico, No. 24 (posted at http://www.mecon.ar) indicate that exports to the European Union declined 13% that year, exports to NAFTA countries declined 3%, and exports to Mercosur countries (primarily Brazil) increased 14%.


46. While the official numbers used in Figure 11 suggest that 1996 saw a modest primary deficit, newer cash basis numbers for the consolidated public sector indicate that such official figures may consistently overstate the balance by about 1–2% of GDP over 1991-96. According to the World Bank (1998), such a full accounting would reveal that the nonprivatization surplus was achieved only in 1993 and has since eroded sharply. The trends for both sets of figures are, however, similar to those in Figure 11 and thus the figure does afford a reasonable sense of changes over time.

47. These figures are reported in the INDEC (1997) Statistical Yearbook of the Argentine Republic, Vol. 13, pp. 480–483. The World Bank (1998, p. 6) reports that public enterprise expenditures were reduced from 11% of GDP in 1989 to 0.5% in 1995–96.


49. A study by Daniel Azpiazu found that 66 of Argentina’s 200 largest companies emerged out of the privatization program, with the 50 most profitable firms receiving 60% of all profits generated by the larger group of businesses; see “Big profits for privatized services,” Latin American Regional Reports—Southern Cone (March 4, 1997), p. 3. An earlier study by Fundación Capital, a private think-tank, found that just three privatized firms accounted for 40% of the total turnover of the 70 companies quoted on the Buenos Aires Stock Exchange (see “Argentina’s drift toward concentration,” Latin American Weekly Report, October 5, 1995).

50. Authors’ interview, Jaime Campos, Director of INVERTIR, August 7, 1996, Buenos Aires. Campos notes that these rules also make it more difficult to track new FDI flows into Argentina.

51. See also “Argentina: Longer hours, not more jobs,” Latin American Weekly Report (March 11, 1997).

52. Some estimates show that only 60% of the Argentine workforce is now formally registered (de la Balze, 1995, p. 108). More general information on the labor market provided in a speech by Felipe Frydman, Economics Attaché at the Embassy of Argentina, Washington, DC, “Argentina under the convertibility plan,” Johns Hopkins University, School of Advanced International Studies, November 13, 1996, Washington, DC.


54. According to Saba and Manzetti (1997, p. 363), “In less than four years the (Menem) administration suffered some 19 scandals resulting in 29 ministers and senior advisers being dismissed—with privatization scandals extremely prominent.”

55. At the same time, poverty rates fell steadily between the start of the program in 1991 and its 1994 peak (Petrecolla, 1995). Such improvements are common in the wake of hyperinflation, and can in fact be consistent with a relative worsening of income distribution. This pattern is usually politically acceptable, unless the absolute improvement is suddenly arrested, as it was in Argentina in late 1994. Data made available to the authors by the Argentine Instituto Nacional de Estadística y Censos (INDEC) indicate that the household poverty rate (in Gran Buenos Aires) rose from a decadal low of 11.9% in May 1994 to 20.1% in October 1996 (see also Beccaria, 1996); the poverty rates then fell by 1.3 percentage points in May 1997, which is the most recent period for which we were able to obtain data. This worsening of economic fortunes may help to explain the subsequent political rejection of Menem’s party in the 1997 elections.

56. Information on sales and profits in 1995 taken from “Big profits for privatized services,” Latin American Regional Reports—Southern Cone (March 4, 1997), p. 3. An earlier report also suggested that the biggest firms had seen their turnover increase even as the economy plummeted in the first half of 1995 (see “Argentina’s drift toward concentration,” Latin American Weekly Report, October 5, 1995). As for bankruptcies, there was a 26% increase in the number of firms filing for bankruptcy between first half 1994 and first half 1995; see “Going bust,” Latin American Weekly Report (August 3, 1995).
57. See EIU (EIU, 1997, p. 15); information also garnered from authors’ interview with Roberto Bouzas, FLACSO, July 30, 1996, Buenos Aires. See also Caprio et al. (1996) for a general discussion of the tequila shock and the financial system.

58. As Artana and Navajas (1995, p. vi) note, a turnover tax counts for 50% of provincial own-source revenues; half of the remainder stems from property taxes. Both revenue sources were boosted by the 1991–92 recovery.

59. According to the World Bank (1996b), “over a dozen provincial banks were privatized...social security systems were transferred to the streamlined national system, salaries were cut, and a number of redundant public employees were let go.” For more on the privatization of the provincial banks, see Banco Central de la República Argentina, Bulletin of Monetary and Financial Affairs (January–March 1996), pp. 13–14.


61. This point, as well as our elaboration on it, borrows from Levitsky (1997).

62. Levitsky and Way (1998) point to other factors, such as close personal ties between key labor leaders and Menem.

63. Corrales (1997, pp. 65–66) describes a more inclusive executive decision-making process, with stronger congressional oversight—an argument which we find lacking when the legislative track record is closely scrutinized.

64. “La gobernabilidad esta asegurada,” Clarín (October 28, 1997).


67. The idea of shifting away from VAT and toward income taxes is also suggested in World Bank (1998, p. 18).


69. “Economía elevaría a 3.5% la tasa estadística,” Clarín (May 2, 1997).


71. This included, for example, higher spending on health and education, an overhaul of the tax system, improved court practices and judicial independence, stronger guarantees on private property rights, and more transparency in government accounting. See Paul Lewis, “IMF Seeks Argentine Deal Linking Credit to Governing,” New York Times (July 15, 1997), p. D1.


73. In one incident, Alfredo Yábran, an entrepreneur who has often specifically benefitted from Menem’s policies and who was suspected of having ordered the murder of press photographer José Luis Cabezas, maintained close telephone contact with the head of the Justice Ministry who was supposedly investigating him.

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APPENDIX A — DATA SOURCES

Argentine monthly inflation, the real exchange rate (calculated as the nominal rate multiplied by the US wholesale price index, and then divided by the Argentine CPI), exports, imports, trade balance, capital flows and international reserves are from the International Monetary Fund’s International Financial Statistics.

Growth of real GDP, investment, and consumption, shares in GDP of investment, consumption, and imports, and unemployment rates from the Ministerio de Economía of Argentina (see http://www.mecon.ar and http://www.indec.mecon.ar). Fiscal performance data gathered from various issues of Informe Económico, as posted at http://www.mecon.ar; the 1995-97 figures as a percentage of GDP involve some estimation by the authors.

The unemployment figures are collected by the Instituto Nacional de Estadística y Censos (INDEC); INDEC is also the source for the distributional data in the text which was provided by special arrangement to the authors. Composition of imports and exports taken from INDEC, Statistical Yearbook Republic of Argentina, 1995 (CD-ROM version).