

Lessons from the stabilization process in Argentina, 1990-1996

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Hyperinflation exploded in 1989. It was the final stage of a chronic inflationary process that began in 1945 and lasted 45 years. From the beginning of the century until the end of World War II, Argentina had been characterized by stable prices. Internal prices only reflected fluctuations related to events in the world economy, such as the two world wars and the Great Depression of the 1930's.

After 1945 the combination of industrial protectionism, redistribution of income based on increased wages, and growing state intervention in the economy touched off the inflationary process shown in table 1. After so many years of inflation, there is a general consensus among economists about the mechanics of this process. A persistent fiscal deficit, increasingly financed by monetary emission, caused more and more frequent devaluations of the local currency. The acceleration of inflation resulted from the demonetization of the economy as the public tried to avoid the inflation tax.

During the last decade of this period of chronic and growing inflation, the social and economic costs of inflation became evident. In the 1980s the economy, increasingly disoriented by inflation, declined at a rate of 1% per year. Employment continued to grow 1.6% per year but the 2.6% average annual decline in the productivity of the employed was the clearest evidence that only unproductive activities were expanding. This was especially the case of the public sector but it also existed in the private sector which continued to be strongly protected from foreign competition and involved in financial speculation. Government expenditure during the 1980s represented, on average, 33% of GDP, while the fiscal deficit was about 5% of GDP.

In spite of the fact that the currency was strongly undervalued during the whole decade, exports grew at a rate of only 3% annually and imports contracted at a rate of approximately 7% annually.

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Table 1
Argentine Inflation by Decade
(annual rates of change in the consumer price index)

<i>Period</i>	<i>Average</i>	<i>Maximum</i>	<i>Minimum</i>
1920-1929	-1.7	17.1	-15.9
1930-1939	-0.3	13.0	-13.9
1940-1949	10.6	31.1	-0.3
1950-1959	30.3	111.6	3.7
1960-1969	23.3	31.9	7.6
1970-1979	132.9	444.0	13.6
1980-1989	750.4	4923.3	87.6

Source: INDEC

The year 1989 was catastrophic. Government expenditure reached 35.6% of GDP and the fiscal deficit climbed to 7.6% of GDP. From December to December inflation almost reached 5,000%; at the peak of March 1989 - March 1990 it was over 20,000%. Gross domestic product fell more than 6% and imports fell 21% that year. The government could not ignore the strong public demand for the price stability that had been absent for 45 years.

The stabilization plan

In 1990 the government began to completely overhaul the organization of the Argentine economy. It included (a) comprehensive liberalization of foreign trade and capital movements, (b) the privatization of public enterprises and the deregulation of the economy, (c) reduction of the bureaucratic apparatus of the public sector and the reconstruction of the tax system, and (d) the creation of a new monetary system.

Table 2
The Argentine Stabilization in Numbers
 (decade of the 1980s and 1989 through 1997)

	80 to 89	89	90	91	92	93	94	95	96	97
Annual Inflation rate	750.4	4,923.3 (20,266) ¹	1,343.9	84.0	17.5	7.4	3.9	1.6	0.1	0.1
GDP growth (annual %)	-1.1	-7.0	-1.3	10.5	10.3	6.3	8.5	-4.6	4.4	8.0 ⁴
Export growth (annual %)	3.0	4.9	29.0	-3.0	2.1	7.2	20.8	32.4	13.4	7.0
Import growth (annual %)	-6.7	-21.0	-3.0	103.0	79.7	12.8	28.6	-6.8	18.3	26.0
Current Account of the Balance of Payments (% of GDP)	-2.4	-1.7	3.3	-0.2	-2.4	-2.7	-3.3	-0.9	-1.3	-3.1
Public spending (% of GDP)	33.1	35.6	29.8	29.3	28.7	28.4	27.2	27.0	27.0	26.8
Budget deficit (-) (% of GDP)	-5.8	-7.6	-2.3	-0.3	0.2	1.2	0.1	-1.0	-2.1	-1.4
Foreign reserves (billions of dollars)	3.1	3.8	4.0	9.0	12.4	17.4	17.9	18.5	21.5	22.6
Employment growth (%)	1.6	1.0	1.1	4.3	2.7	1.3	-0.2	-2.6	3.1	5.0
Productivity per person employed (Index 1980=100)	100 ²	76.6	74.2	79.5	85.6	89.9	97.9	95.2	99.3	102.1
Share of household below the line of poverty (Total Greater Buenos Aires)	26.2 ³	29.0	29.5	19.0	14.4	13.3	13.0	17.2	19.9	18.8

Sources: Secretaría de Programación Económica/ B.C.R.A

Notes: 1. March 1990 with respect to March 1989; 2. Corresponds to the year 1980; 3. Average for years 1988 and 1989; 4. Estimated

Government expenditure fell drastically from 35.6% of GDP in 1989 to 29.8% in 1990, and continued to fall to 27% of GDP by 1995. The fiscal deficit also decreased sharply from 7.6% of GDP in 1989 to 2.3% in 1990, and from 1991 onwards it fluctuated around 0%, accompanying the economic cycle.

The prices of goods and services began to be freely determined in competitive and open markets. As of April 1991 the public could freely choose the currency used in all financial and commercial transactions. Among the alternatives was the convertible *peso*, which came with the transformation of the Central Bank into a virtual Currency Board. The Central Bank must back each *peso* in circulation with an equivalent amount or gold or foreign exchange, permitting holders of *pesos* to exchange, at any moment, one *peso* for one American dollar.

The same law that created this monetary system included the prohibition of indexation clauses or any other monetary alterations in the terms of contracts. Wage agreements resulting from collective bargaining had to be accompanied by agreements on productivity.

The desinflationary process was continuous and sustained: inflation fell from 1,344% in 1990 to 84% in 1991, 17.5% in 1992, 7.4% in 1993, 3.9% in 1994, 1.6% in 1995 and 0% in the twelve-month period between June 1995 and June 1996.

Table 3
The Recession After the Mexican Crisis

	1994	1995				1996				1997	
		I	II	III	IV	I	II	III	IV	I	II
Inflation (annual %)	3.9	4.8	4.2	2.7	1.8	0.4	-0.2	0.1	0.3	0.4	0.7
GDP growth (annual %)	8.5	2.7	-5.2	-8.1	-7.0	-3.2	4.8	6.7	9.2	8.2	7.8
Export growth (%) ¹	20.8	48.5	47.6	23.9	13.8	4.4	4.5	21.9	24.0	18.0	6.0
Import growth (%) ¹	28.6	6.6	-10.3	-12.9	-9.0	-4.3	20.4	33.7	24.5	29.4	30.4
Trade balance (billions of dollars)	-4.2	-0.3	1.9	0.7	0.0	0.1	1.3	0.3	0.0	-0.8	-0.5
Current Account Balance of Payments (billions of dollars)	-9.4	-1.8	0.8	-0.2	-1.3	-1.4	0.1	-0.9	-1.7	-2.4	-1.5
Foreign reserves (billions of dollars)	17.9	12.5	15.0	14.2	18.5	18.2	20.0	18.4	21.5	19.8	21.4
Bank deposits (billions)	44.9	38.9	38.4	39.7	41.7	47.8	50.1	51.0	53.5	56.7	62.3
Unemployment (%)	12.2 ²		18.4		16.4		17.1		17.3		16.1
Persons employed ('000)	10,609		10,307		10,348		10,343		10,542		10,861

Sources: Secretaría de Programación Económica/ BCRA/ ADEBA

Notes: 1. Change from the same period of the previous year; 2. October 1994

The new monetary system encouraged a strong increase in the external reserves that back the monetary liabilities of the Central Bank. Reserves went from 3.8 billion dollars at the end of 1989 to 17.9 billion at the end of 1994. This trend was reversed when the fall in the level of confidence following the devaluation of the Mexican *peso* led to capital flight from Argentina: by the end of March 1995 reserves had fallen to 12.5 billion dollars. But the policies adopted to face the crisis reestablished confidence: by the end of June 1996, reserves had already surpassed 20 billion dollars.

Between 1991 and 1994 the gross domestic product grew at an average annual rate of 7.7%. However, due to capital flight, after the second quarter of 1995 the economy entered a period of

recession. The recession lasted a year and in the second quarter of 1996 the economy was already showing signs of a recovery at an annual rate of 3%.

Exports, virtually stagnant in the previous decade, grew vigorously during the period of the stabilization. Imports, which had grown much more than exports until 1994, shrank during 1995 with the onset of the recession.

Despite the strong increase in the GDP, employment grew relatively slowly, and suffered a decline during the recession that began in 1995. The poor performance of the economy in relation to employment is explained by the substantial increase in worker productivity which, by mid-1996 had reached the level of 1980. The rapid growth of the economy during the period permitted the transformation of numerous low-productivity or unproductive activities that had been artificially created during the decade of the 1980s into productive efforts. However, this was not sufficient to employ all of the growing labor force. Thus, beginning in 1992 the unemployment rate increased and reached a peak of 18.4% of the active population in May 1995. Since then, there has been a slight decrease in unemployment. The survey of May 1996 recorded a rate of 17%, still three times higher than that of the 1980's.

The percentage of households below the poverty line (an average of 26% in the late 1980s which had risen to 29% in the period of hyperinflation) fell to 13% in 1994 but went up to 17% during the recession of 1995.

In July of 1996, with the appearance of a fiscal deficit during the first half of the year that was greater than had been expected (approximately 2% of GDP), a discussion began about measures to contain government expenditure and increases in some taxes in order to reach a balanced budget during 1997. The reappearance of the fiscal deficit in the second half of 1994 was caused by automatic increases in social security expenditure, as well as in the elimination or reduction of economically distorting taxes, especially payroll taxes, that had been implemented to encourage increased productivity and employment.

Beginning in early 1995, facing the risk of running out of financing, evident since the onset of the Mexican crisis, the government was able to limit social security expenditure. In July 1996 these restrictive measures were reinforced, limiting family allowances and the expenses of the health system for the elderly. Regarding taxes, the April 1995 increase in the value added tax from 18 to 21 percent to face the Mexican crisis was maintained. Recently, a proposal to increase tax collection by eliminating exemptions from several taxes has been presented to Congress.

But beyond these fiscal adjustments, the reduction and eventual elimination of the deficit will result from economic recovery. This has already been demonstrated by the effect on tax revenue in July 1996 of the 3% increase in output between the second quarter of 1995 and the second quarter of 1996. In fact, in July 1996, the highest historical level of tax collection for any July was attained (also the third highest monthly level of tax collection on record).

Finally, a strong reduction in expenditure and the fiscal deficit of the provinces is already being observed due to the adjustments that they were obligated to carry out in response to the flight of

deposits that affected provincial state banks since the beginning of 1995. Those institutions had continued to provide financing to their respective governments, running counter to the restrictions imposed by the Convertibility Law on the Central Bank and the national treasury. Forced by the lack of financing and encouraged by the conditional support of the federal government, most of the provinces decided to privatize their banks and public companies, as well as to reform the social security systems for their employees.

The combination of the sharp increase in bank deposits that occurred after the effects of the Mexican crisis had subsided and the accumulation of contributions to the new pension funds reflect an increasing trend in domestic savings that is already being transformed into medium and long term credit offered at moderate interest rates. Mortgage credits for housing, absent for decades in Argentina, promise to become the driving force for the construction sector. This could touch off a substantial increase in employment, as in Chile after 1984.

Lessons of the Argentine experience

The main lesson of the Argentine stabilization experience is that the elimination of inflation is possible even when an economy has been flogged by that disease for decades. It is not true that in Latin American economies it is necessary to accept annual inflation rates of around 10%, even after many years of searching for stability.

Another important conclusion of the Argentine experience is that the fiscal adjustment, understood as a reduction of the government expenditure, as well as the reduction and the elimination of budget deficits are the keys to stabilization after decades of instability, the origins of which are mainly found in the monetary financing of persistent fiscal deficits.

For a society in economic chaos due to inflation, the imposition of basic discipline on both the private and public sectors is of special importance. External and internal competition -achieved through the opening of the economy, deregulation and the privatization of public companies- is an excellent disciplining mechanism for the private sector. The budget is the disciplining mechanism for the public sector. In order to achieve the transparency necessary for the markets and the budget to function efficiently, the monetary system is the key.

The success of stabilization in Argentina is neither due to the quantitative control of the national currency, nor due to fixing its value in terms of the dollar because, in a strict sense, these two monetary policy rules were not applied. What the government offered the public was freedom to choose the currency to be used in its transactions and for its savings. In practice, the choice was given among the American dollar, that the public had already transformed into its currency during hyperinflation, and the convertible *peso* that began to be offered by the Central Bank. In accordance with the Convertibility Law, this currency should be at least as stable as the dollar. For this reason, from the outset its creation was limited to the quantity that could be backed by the gold and foreign currency reserves in the Central Bank. Freedom of choice of the currency to use, not necessarily limited to the *peso* and the US dollar, sustained the prohibition on monetary

corrections or indexation clauses in contracts. This was very important to the elimination of all vestiges of inflationary inertia in the system.

Stability in the value of the *peso* in relation to the dollar was not an obstacle for a healthy expansion of exports, much greater than that of the previous decade when the Argentine currency had been grossly undervalued. And it was not necessary to devalue the *peso* in order to reduce the deficit in the Current Account of the Balance of Payments, which in 1994 reached 3.3% of GDP but fell drastically to just 0.9% in 1995.

The stability of the *peso* was vital to encouraging public officials as well as private entrepreneurs to pay greater attention to the real determinants of external competitiveness: economically distorting regulations and taxes, as well as factor productivity.

The increase in the rates of investment and productivity explain the impressive economic growth during the stabilization period. The increase in the unemployment rate could not have been avoided by allowing higher inflation. With the exception of the year of recession, aggregate demand was constantly expanding and tending towards an overheating of the economy. The causes of unemployment can be found in the institutional rigidities in the labor market and the low levels of productivity of the 1980s. In the case of both problems, the transparency attained with price stability creates a much more adequate environment conducive to improving the quality of the public policy debate and of the labor negotiations that are necessary to overcome them.