



65 | The fiscal adjustment after the 2001-02 crisis in Argentina

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After the crisis of the convertibility regime, Argentina experienced a significant adjustment in the public and external accounts, passing from “twin deficits” to “twin surpluses” within a brief period.

In contrast, the policy measures and the efforts developed to gain control over the results of the public accounts had been self-defeating in the long 40-month recessive period that ended in the default, financial crisis, and devaluation. In a previous Policy Brief² we explained the vicious macroeconomic circle leading to this result. Basically, in the midst of a recession triggered by a huge increase in the country-risk premium as a contagion of the South East Asian, Russian, and Brazilian crises of 1997-98, fiscal austerity measures reinforced the declining trend in aggregate demand, thus increasing the concerns over the sustainability of the monetary regime based on the hard peg of the peso to the US dollar. The negative expectations prevented the country-risk premium and the interest rates from falling.

In other words, the transmission mechanisms that would supposedly steer fiscal austerity to economic recovery were not working and the effect of contractionary measures on aggregate expenditures happened to be, as should have been expected, contractionary. In turn, both factors – high interest rates and recession – had negative consequences on the fiscal accounts and on the dynamics of the public debt, closing the circle.

The pre-crisis scenario revealed four major macroeconomic disequilibria: ER appreciation (and consequently, a deficit in the current account of the balance of payments); very high levels of country-risk premium and interest rates (depressing overall aggregate investment and expenditures); a significant deficit in the fiscal accounts (and consequently, a swiftly rising public debt); and recession (with massive unemployment, associated with ER appreciation and the recession).

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² Damill, M., R. Frenkel, and M. Rapetti (2012): Fiscal Austerity in a Financial Trap: The Agonic Years of the Convertibility Regime in Argentina, Policy Brief available at: <http://www.itf.org.ar>.



The pre-crisis macroeconomic policy setting can be summarized in two main orientations: on the one hand, fiscal adjustment measures (plus some attempts at public debt restructuring) aimed at restoring the “confidence of markets” and, on the other hand, changes in labor market regulations for the purpose of making wages “more flexible”. As was suggested above, the first orientation would cause a decline in the country-risk premium and then in interest rates. The second one would supposedly induce a decline in domestic wages and prices. Therefore, they would jointly correct the two major price distortions of the period (huge interest rates and an appreciated RER), while triggering the mechanisms for the economic recovery.

However, they failed to do so. The fiscal adjustment measures only deepened the recession and contributed to consolidating the negative expectations regarding the sustainability of the monetary regime, and the labor market measures did not trigger a nominal deflation.³

From 1998 on, the main counterpart of the current account deficit (that is, the Rest of the World surplus) was the fiscal deficit, as can be seen in Graph 1. But this factor does not imply that fiscal austerity measures will automatically correct the external sector imbalance. Accountability warrants that the sum of sectoral surpluses (or deficits) has to be zero by necessity, but this in no way can guarantee what the effects of measures conceived to reduce the deficit of one of the aggregate sectors will be.

Additionally, some rigidities of the macroeconomic regime made the correction difficult. Graph 2 shows the result of the Capital and Financial Account of the Balance of Payments by sector (private and public). It can clearly be seen that the net private capital inflows declined substantially after the 1998 Russian crisis, while the public sector managed to sustain its access to foreign funds until 2001 despite very high interest rates. In this way, the public sector contributed to preserving the level of foreign reserves and domestic liquidity over a long period in spite of deteriorating private expectations. A more successful fiscal adjustment in the period would probably have brought the economy to lower levels of foreign reserves and domestic liquidity and, hence, to a deeper recession (as a consequence of reduced net capital inflows to the public sector). An economic recovery was essential to restore the public finances, but a recovery was also unfeasible as a consequence of the strong ER appreciation. The conclusion is that both problems, the fiscal imbalance and the ER appreciation, had to be faced jointly and solved by correcting the main price distortions of the economy and thus lead the economy out of the recession.

³ In spite of the recession and the soaring unemployment levels, the deflation in the latter days of the regime was almost imperceptible as an aggregate phenomenon. From an orthodox perspective, it was argued that the labor market reforms were insufficient and the Argentine labor market was very rigid. However, we have estimated the unemployment-elasticity of real wages for the period and found similar values to those registered in other economies, like the US, so that the idea of particularly rigid wages in the Argentine case would appear to be incorrect. Two other features of this “second mechanism” should be stressed. Firstly, to operate, the unemployment rates should have been high over a long period, which would have contributed negatively to expectations. Secondly, had a price deflation taken place, the value of debts in real terms would have risen, thus increasing the financial fragility of debtors and of the economy, in general.



The main characteristics of the recovery phase

recovery of GDP that began in the first half of 2002 had a brief first phase during which the aggregate demand barely rose and every internal component of domestic expenditure (private consumption, public consumption, and investment) continued to shrink, as happened during the previous depression but at a slower pace. Therefore, it was not the domestic demand that stopped the decline in the level of activity. The expansive factors were mainly the international trade variables, exports and imports, and especially the latter. The local production began to match an increasing proportion of the aggregate demand. Import substitution particularly favored the manufacturing sector. But after this brief initial stage, the activity level recovery was led by the increase in the domestic demand components, especially by investment – which grew at a yearly rate of nearly 40 percent between 2002 and 2004 – and by private consumption.

Although the contribution of external factors to the recovery is undeniable (in particular the high prices of some exported commodities) a substantial part of the expansion's dynamism was derived from internal demand sources.

Note that the consumption and investment recovery took place in a context of accentuated credit rationing, both external and internal. The investment recovery was financed by higher profits retained by firms, although the 'wealth effect' resulting from the significant external assets holdings of the private resident sector surely contributed as well. The value of these assets increased in pesos with the exchange depreciation and also rose in relation to the prices of domestic assets, such as real estate and land. This factor also fed the recovery of the private consumption expenditure.

External and fiscal adjustment

The adjustment experienced by the external sector took place to a great extent before the devaluation, as Graph 1 shows, where the improvement in the current account (equal to the "Rest of the World surplus" with the sign inverted) can be seen from 1998.



Actually, the abrupt contraction in the activity level that characterized the end of the convertibility generated a significant trade surplus. The trade balance exhibited a deficit surpassing 3 billion dollars in 1998. It then rapidly decreased and turned into a surplus owing to a drastic reduction in the volume of imports. After the devaluation of the peso, the external adjustment deepened. In 2002 the positive balance exceeded 17 billion dollars and remained over 16 billion in 2003 (and over 12 billion in 2004 and 2005) in spite of the fast recovery of the activity level and, hence, of the volume and total value of imports. The trade surplus caused the change of sign in the current account balance. Between the post-crisis period and the debt restructuring of 2005, it showed positive results even when taking into account the interests accrued by the debt in default.

As Table 1 illustrates, a strong adjustment in the public accounts also took place, together with the external adjustment process we have just mentioned.

The improvement in the global result of the Consolidated Public Sector reached between 2001 and 2005 was equivalent to 7.6% of GDP. This result went from a global deficit of 5.6% of GDP in 2001 to a surplus equivalent to 1.9% in 2005.

What factors can explain the adjustment in the fiscal cash flow? About a third was derived from an improvement in the provinces' balance sheets (2.5% of GDP). This improvement came from the increase in tax collection facilitated by the economic recovery and the rise in nominal prices, together with the restraint in expenditure.

The global result of the National Public Sector improved by 5% of GDP, more than 70% of which can be explained by the favorable change in the primary result (+3.6% of GDP). The contraction in interest payments basically resulted from the default of the sovereign debt, and the debt restructuring of 2005 accounts for the rest (-1.4% of GDP).

The rise in the primary surplus of the National Public Sector can mainly be explained by the increase in tax revenues (+5.3% of GDP). Interestingly, although the receipts from traditional taxes such as the VAT and income tax rose significantly, they did not increase substantially when measured as a proportion of GDP. Between 2001 and 2005 they increased by 1.5% of GDP as a whole.

Note that the tax on exports item mostly explains the rise in tax revenues (+2.3% of GDP). Soybean and soy derivatives generated almost one half of the taxes on exports. By re-establishing taxes on exports, the government was able to capture part of the income effects of the devaluation of the peso.

In other words, the public sector captured part of the effect that the devaluation had on the profitability of the tradable goods sector and also benefited



from the high prices of some of the exportable goods, such as soybeans and oil. The tax on financial operations established in 2001 also contributed to the increase in tax collection (+0.4% of GDP).

Let's also consider the interest payments on the public debt. As Table 1 shows, this flow passed from representing almost 4% of GDP in 2001 to 2.4% in 2005.⁴ Table 2 presents the abrupt decline in the burden of interest payments on tax collection.

However, the fiscal effects of the suspension of part of the debt services payments in the period 2001-04 and the debt restructuring of 2005 were much higher than that shown in the figures of Table 1 for instance. These effects cannot be measured precisely because a significant amount of new debt was issued after the debt payments had been suspended. We have estimated, however, that the amount of interests on the 2004 public debt, the year before the restructuring, valued at the 2004 exchange rate, would have represented between 9% and 11% of GDP. This is approximately equivalent to one half of the total tax collection of the year. These payments would certainly have been incompatible with economic recovery. In fact, a crucial aspect of the fiscal financial vulnerability resulted from the extremely high proportion of debt denominated in foreign currency, with the consequent exposure to the impacts of the exchange rate variations. The 2002 substantial exchange rate depreciation would have had a harsh impact on the public sector's financial equilibrium. Taking this aspect into account, we could say that the payments suspension and the following debt restructuring produced a considerable amount of fiscal savings – either measured in domestic currency or as a proportion of GDP.

Nevertheless, the most important effect of the default and the end of the convertibility regime was the reestablishment of the effectiveness of the instruments of macroeconomic policy, which were crucially important to guiding the economy out of the abyss generated by the final collapse of the convertibility regime.

⁴ After the 2005 public debt restructuring, the amount of interest payments increased but still reached levels well below those observed before the crisis.



Table 1
Fiscal adjustment: Results of the Consolidated Public Sector
(As a percentage of GDP)

Concept	2001	2005	Variation (2005-2001)
Tax receipts	13,8%	19,2%	5,3%
Taxes on exports	0,0%	2,3%	2,3%
Financial tax (*)	1,1%	1,5%	0,4%
VAT	3,1%	3,5%	0,4%
Income tax	2,5%	3,6%	1,1%
Other taxes (**)	5,3%	6,7%	1,4%
Other receipts	5,0%	4,5%	-0,5%
Total receipts	18,8%	23,8%	5,0%
Total expenditures	22,0%	22,0%	0,0%
Primary expenditures	12,1%	14,9%	2,9%
Exp. of the Social Security System	6,1%	4,7%	-1,4%
Interest services	3,8%	2,4%	-1,4%
Primary result	0,5%	4,2%	3,6%
Total result of the NPS	-3,2%	1,8%	5,0%
Provinces (***)	-2,4%	0,2%	2,5%
Total result of the CPS	-5,6%	1,9%	7,6%

(*) Tax on bank debits and credits.

(**) Includes taxes shared with provinces, which are included as expenditures in the Primary expenditures item as transfers to provinces.

(***) Including the City of Buenos Aires.

Source: Authors' calculations based on Ministry of Economy data.



Table 2
Total public interest payments, Tax collection-GDP ratio
and Sovereign risk premium (in percentages)

Year	Tax collection as a percentage of GDP (1)	Average interest rate on public debt (2)	Interest payments / tax collection ratio (3)	Sovereign risk premium (annual average)
1991	18.8	n/d	5.5	9.6
1992	20.8	6.6	8.3	6.9
1993	21.3	5.0	6.0	4.9
1994	21.1	5.5	6.9	5.9
1995	20.9	6.1	9.2	12.4
1996	19.6	5.8	9.7	6.5
1997	21.0	6.7	10.9	3.3
1998	21.4	7.6	12.2	5.8
1999	21.4	8.3	15.9	7.2
2000	21.9	8.9	18.5	11.5
2001	21.0	9.4	23.4	14.8
2002	19.2	5.2	13.3	--
2003	23.1	1.9	9.6	--

(1) Includes Security System receipts.

(2) Calculated as a ratio between interest payment in period t and debt at the end of t-1.

(3) Tax receipts include those from the social security system.

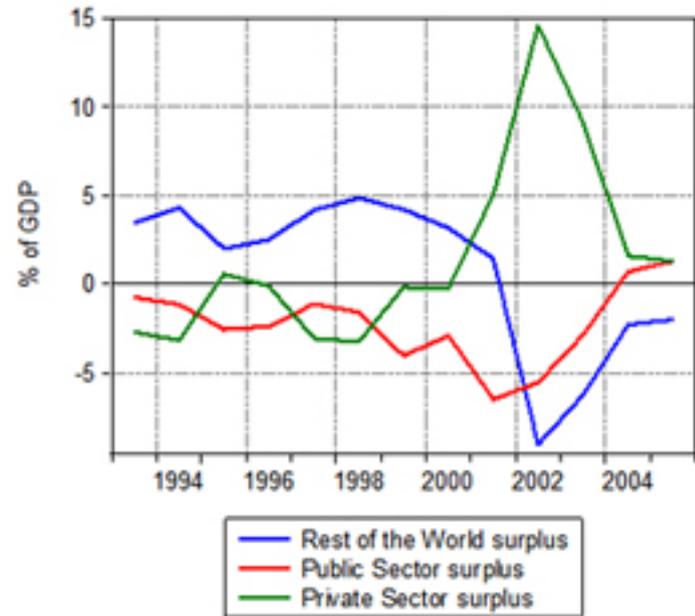
Source: Authors' calculations based on Ministry of Economy data.



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Graph 1

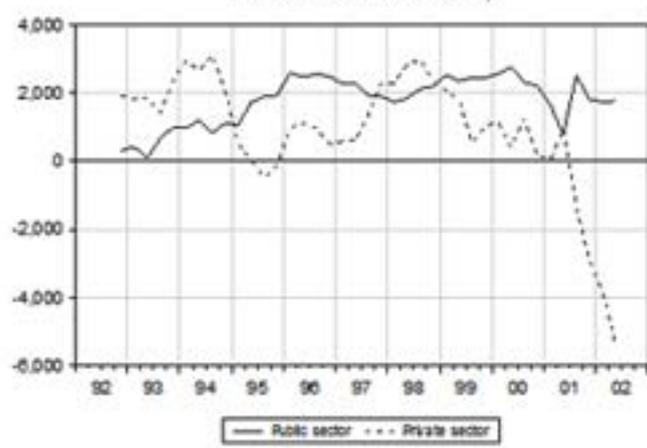
Aggregate surpluses by sector (% of GDP)



Source: Authors' calculations based on Ministry of Economy data.

Graph 2

Balance of payments: Net capital inflows by sector
(moving averages of four quarters
in millions of US current dollars)



Source: Authors' calculations based on Ministry of Economy data.