

The International Financial Architecture issues in Argentina

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Introduction

It seems difficult to find any country more deeply involved in the IFA (International Financial Architecture) motivations and issues than Argentina. There should be a natural attraction in this country for international steps that could contribute to the stabilization of the financial markets. However, no discussion has taken place in the country so far and rarely any mention of the IFA initiatives and meetings can be found. On the other hand, driven by present orientations, the participation of the former Argentine Government in the IFA initiatives tended to be passive and conservative. This seemingly paradoxical situation is related to the Convertibility regime prevailing in Argentina.

The Convertibility regime

Throughout the first half of the nineties, Argentina underwent an impressive process of reforms following market-friendly guidelines. This process involved the privatization of a large proportion of state-owned

enterprises, as well as both trade and financial openness.

At the same time, the country emerged from a period of extreme instability of prices, which had led to two brief hyperinflationary episodes in 1989 and 1990. Price stabilization was concurrent with a strong recovery in economic growth. However, less desirable results were also attained; in the same period, unemployment grew significantly and inequality deepened.

One of the main structural reforms was the opening of the economy to international trade flows. Notable inroads in this direction were already in existence since 1988. But, in the early nineties, the previous gradual approach was abandoned and the opening process greatly accelerated.

Several norms constituted the legal pillars of the structural reform process. The State Reform Act (August 1989) established the legal bases for the privatization of state-owned enterprises and allowed, for that purpose, the use of debt – equity swap mechanisms. Second, in order to improve the

performance of public accounts, the Economic Emergency Act (September 1989) suspended several subsidy mechanisms, such as those that were implicit in the industrial and regional promotion regimes. This law also established equal treatment for foreign and domestic capital invested domestically in production activities. In

SUMMARY

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This seemingly paradoxical situation is related to the Convertibility regime prevailing in Argentina. The paper explores the features of the economic performance, the pattern of public discussion and the motivations of Government positions. The conclusion stresses that the participation of the Argentine Government in the IFA initiatives tended to be passive and conservative

this way, prior approval for any direct foreign investment was no longer necessary. In addition, in November 1991, a Deregulation Decree eliminated a wide set of regulations encompassing diverse economic activities.

The most important legal instrument of the stabilization process was the Convertibility Act approved by Congress in March 1991, which established a fixed peso-dollar exchange rate and validated contracts denominated in any foreign currency. It also stipulated that the Central Bank had to back 100% of the monetary base with foreign reserves. It is also important to mention that the new Central Bank Charter (September 1992) established the independence of the Central Bank.

In practice, the Convertibility Law (reinforced by the new Central Bank Charter) transformed the Central Bank into a currency board and completed the deregulation of the capital account of the balance of payments. So, since early 1991 both trade and capital flows were fully liberalized.

Growing Dollarization

Despite the high credibility enjoyed by the exchange rate commitment private sector savers have showed preference for dollar denominated deposits while banks hedged balance sheets against exchange rate risk by offering dollar denominated credits. Consequently, as from the early steps of the Convertibility regime there was a persistent trend towards a growing proportion of dollar denominated assets and liabilities in the local banking system. This proportion grew to around 60% this year. The dollarization of private sector assets is perceived as a hedge against the risk of devaluation and it has also contributed to stabilization of local portfolios. This role was particularly important after the Asian and Russia-Brazilian crises. While there was a dramatic run from local deposits in the crisis that followed the Mexican devaluation, total deposits in the banking system did not fall in 1998-99. On the other hand, the exchange risk burden rests not only on foreign investors, banks, and big firms indebted abroad, but also on numerous local bank debtors with peso denominated income. This undoubtedly contributes to the extenuation of the claim in favor of the fixed parity continuity.

The accentuated financial globalization of the Argentine economy

The Convertibility regime succinctly described above is an extremely rigid setting. The rigidity does not follow exclusively from the legal rules, but also from the actual behavior of real markets. For instance, the flexibility of the real exchange rate vis-à-vis negative external shocks would require a significant downward flexibility of domestic non-tradable goods prices. Actually, significant nominal deflation has taken place neither in the 1995 deep recession nor in 1998-99, in spite of the significant flexibility of low-skill hourly wages (unemployment elasticity is approximately -2).

Growing External Gap

The Convertibility regime setting determines two features of the macroeconomic performance. First, there is a growing external gap. The combination of trade opening with an appreciated exchange rate has resulted in a chronic trade balance deficit. The trade balance reaches equilibrium only under conditions of deep recession (as in 1995 and, more recently, in mid-1999) or with an exceptionally strong external demand (from Brazil) combined with high international commodity prices (as in 1995-96). The trade deficit together with the growing structural deficit in the factor services account generate a rising current account deficit. To reach a positive rate of growth the economy requires substantial net capital inflows. To sustain any positive rate of growth the economy requires increasing external capital inflows.

Strong External Influence on Performance

Secondly, the volatility of the international financial conditions confronted by the country is mechanically transmitted to the domestic activity and employment levels. The correlation between national performance and international capital markets behavior is a common characteristic of the emerging market economies, as was dramatically illustrated by the recent events. In the Argentine case the correlation is accentuated by the Convertibility regime which lacks any significant monetary and nominal flexibility to compensate for external impulses of both signs. In the first half of the nineties domestic demand boomed which was led by capital inflows and consumption. After the

Mexican devaluation, the Argentine economy was most significantly affected by the Tequila effect with the second deepest regional recession (after Mexico) and a jump in unemployment from 12% to 18%. A second surge in capital inflows led an acceleration of growth in 1996-97 and unemployment fell to 12%. The external impulse slowed down after October 1997, together with the rate of growth. The activity trend turned again to recession in the third quarter of 1998, after the Russian-Brazilian crisis (but well before Brazilian devaluation in January 1999). In mid-1999 the Argentine economy shows one of the deepest recessions in the region (only Ecuador and Venezuela rank under Argentina) while the unemployment rate is rising from 14.5% reported in April 1999.

The currency board regime plays its intended role as an automatic stabilizer of external accounts. But in the Convertibility regime, the deepest recessions left the current account with a substantial deficit (i.e. 12 billion dollars projected for 1999) and a very high unemployment rate. These features weighed in on the con side of international investors' perceptions and tend to detract from its pro side. The Argentine version of the currency board is far from dissipating the risk of default.

International investor's analysts have to express opinions and bet on the risk of default and on the permanence of the Convertibility regime. Multiple-equilibrium situations and self-fulfilling prophecies are not unusual in the present setting of international financial markets. Default and/or the abandonment of the Convertibility regime is one of the potential outcomes in the Argentine case.

Reduced Relevance of Domestic Factors

One difference between the Argentine game and other emerging market games lies in the reduced relative relevance of domestic economic factors. Given the mentioned features of the macroeconomic performance, the factors which count most for sustainability are external. These factors comprise, for instance, the main external circumstances affecting the trade balance prospects: export commodity prices and Brazilian demand for Argentine imports. But, fundamentals contribute only partially to the formation of players' conjectures. Given that the bulk of the financial needs originate in debt rollover and factor services account deficit, the most important

conjecture for each individual player refers to the future behavior of the international financial market with respect to the country, i.e. the behavior of other players. The signals regarding the trade balance prospects - as other signals - are worth mainly by their expected influence on the financial market's future behavior.

Dollar as national currency?

In the search for credibility signals the government announced in early 1999 that it was considering adopting the dollar as the national currency. The main intention of the announcement was to signal the government willingness to exhaust the reserves of the Central Bank if faced with a run. This *de facto* full dollarization of the economy could in no case be implemented only by selling all Central Bank reserves, but it would also require massive intervention in banking contracts. Even in this case, the process would involve serious risks of financial disruption. Financial market analysts did not focus on the instrumentation difficulties and risks, but concentrated their analyses on the changes in performance and prospects of the supposedly fully dollarized Argentine economy. The majority verdict says that even if the devaluation risk is eliminated by the currency substitution, default risk remains unchanged because external solvency does not depend on the currency denomination of domestic transactions.

The International Financial Architecture (IFA) issues

One conclusion follows from the above discussion: it seems difficult to find any country more deeply involved in the IFA motivations and issues than Argentina. There should be a natural attraction in this country for international steps that could contribute to the stabilization of the financial markets. Argentine performance could undoubtedly benefit from a more stable financial environment and also from the development and implementation of national regulatory measures intended to smoothing the private capital inflows, while preserving the free access to financial markets. Interest, engagement and explicit positions should then be expected from the government, political parties and other organizations of the civil society as well as an active discussion in economic forums and the media.

However, rarely any mention of the IFA initiatives and meetings can be found. While economists' opinions are abundant in Argentine newspapers, IFA issues receive almost no attention. No discussion has taken place so far and no political or social representative has even advanced a comment. It is legitimate to suspect that a large majority of them did not have notice of IFA existence.

The government actively participated in the G22 initiative and took well-defined positions in other forums. For instance, through the statement of the president of the Central Bank before the 52nd meeting of the IMF Interim Committee. But the government showed no interest in disseminating information about the IFA existence, development and issues. There are not accessible documents about Argentine official positions and no information has been made public about Argentine presentations in the IMF and other multilateral and international forums.

The mentioned facts configure a seemingly paradoxical situation from which we can suggest some hypotheses.

The civil society organizations, political parties, and analysts

It was already mentioned that an acute dependency on external capital inflows is the original sin of the Convertibility regime. Sustainability and growth expectations fluctuated throughout the nineties driven by both good and bad news. The contagion of the Mexican crisis contradicted the initial expectations of persistently high capital inflows and revealed their volatility. But, at the same time, booming commodity prices and the Brazilian Real plan represented good news. Helped by the positive real shock and an 11 billion dollar rescue package, the Convertibility regime survived the Tequila effect. The combination of a favorable real external environment and the same success of the rescue operation gave strength to optimistic expectations and a new surge in private capital inflows. Both lasted until the Asian crisis. From then on optimism dissipated, capital inflows declined and the country risk premium rose persistently with relatively high peaks marked by the Russia-Brazilian crisis and the Brazilian devaluation.

The Future of the Convertibility Regime

On no occasion throughout the agitated history of the Convertibility regime, its withdrawal has ever received public discussion. Although some criticism is expressed from time to time, no significant political or social representative has taken a position favoring the change of the regime. Similarly, few economists express criticism, they do not even focus their analysis on the difficulties embodied in the regime. In the public arena, the Convertibility regime is taken as a given and as an inalterable natural state of facts. On the other hand, some influential economists strongly advocate the regime. Their arguments do not disregard the negative evidence, but they find the regime virtues in the discipline it imposes to government and society. With enough time, those virtues are expected to fructify in competitiveness, exports and sustainable growth.

Sector interests help to explain this situation. Banks, big firms indebted abroad, foreign owned firms, and financial intermediaries are intimately interested in continuity. Domestic credit dollarization vastly extends this interest. Analyses and opinions are not immune to those influences.

Thus, most of the public attitudes, opinions and silences are driven more by fear than by conviction. Critical opinions and the analysis of the Convertibility regime drawbacks run the risk of being labeled as "devaluationist" and doomed to intellectual and political isolation.

Most of the issues related to the IFA fit in the same pattern. The establishment conceives the regime as a full integration between the domestic and the international financial markets and shows concern and resentment in front of any suggestion about capital flow restrictions of any kind. Politicians and other civil society actors generally do not worry about issues in which they are not able to build publicly exposed positions. Nor are specialized analysts attracted by issues whose analysis dangerously refers to the pros and cons of the Convertibility regime.

The Government

The above considerations apply to the government's public positions. Government officials are pushed by the circumstances to defend the Convertibility regime more enthusiastically than anybody else. This is the sine

qua non credibility signal. The government is not inclined to disseminate information and promote the discussion on issues that call attention to the international financial market's volatility and to the Convertibility regime weaknesses. Besides, any attitude that could be suspected of heterodoxy with regards to free capital flows could undermine credibility.

International Forums

The Argentine positions in international forums can be traced back to the Central Bank President's statement before the 52nd meeting of the IMF Interim Committee. With regard to exchange rate regimes, the statement emphatically defends the currency board regime as an alternative to flexible exchange rate regimes. The arguments are based more on criticizing flexible exchange rates than on currency board regime virtues. On issues related to "involving the private sector" (risk sharing and procedures to distribute the burden of crisis resolution) the Argentine Government essentially called for caution in promoting innovations. The initiatives regarding the international standards on financial surveillance and transparency are strongly supported, as well as the establishment of contingent credit lines. The Government is in favor of an amendment to the Articles of Agreement of the IMF in order to make full capital account liberalization mandatory for member countries. The Government "sees some merit" in including in the new set of rules price-based provisions allowing for temporary restrictions to capital transactions to mitigate the consequences of excessive surges in inflows and argue against restrictions on outflows "often attempted to conceal domestic weaknesses."

In conclusion, the Argentine government's participation in IFA initiatives seems to be oriented by the conviction that Argentina's regime represents the best possible arrangement to deal with the problems showed by the international

financial markets. The government sees the roots of recent crises in structural deficiencies in many emerging-market countries and in macroeconomic imbalances in others, while the Argentine economy suffers passively from those external sources of financial contagion. The government supports making full capital account liberalization mandatory and is very cautious with respect to international measures that could conflict with the positions of private financial investors. Driven by these orientations, the participation of the Argentine government in the IFA initiatives tends to be passive and conservative.

Perspectives

Presidential elections will take place on October 24 and the elected president will take office on December 10. Electoral polls indicate with a high probability the triumph of the main opposition political party - the Alianza. This would be an important change after ten years of continuous Menem administration. While government policies would surely experience significant changes in many aspects, the same can not be expected with respect to the main orientations of economic policy. With the exception of a few

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political groups of minor importance, all the programs and candidates are committed to the continuity of the Convertibility regime. Therefore, the strong contextual forces driving government policies and positions - as commented above - will, after October 24, make significant changes in the local scenario unlikely. However, taking into account the ideological composition of the Alianza, more active and less conservative government participation in IFA initiatives might be expected.

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