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Editor's Summary

For much of the 1990s, Argentina seemed to offer one of Latin America's best hopes for a great leap forward in economic development. Argentina had gone further than any other country (perhaps save Chile) in putting into place most of the standard economic reforms. Not only did those new policies bring down inflation and stabilize financial markets, but they also delivered unexpectedly high growth, first in the early years of the decade and then again after the region was shaken by Mexico's 1994–95 collapse. Add to that the perennial reasons for hope about Argentina—a rich endowment of natural resources, an educated labor force—and the economy seemed to present the necessary ingredients for success.

Alas, how naïve those hopes seem today. In half a decade Argentina went from great hope to great disappointment. Sorting out what went wrong is crucial not just for Argentines, but for anyone thinking about economic development in Latin America. That is why the editors of *Economía* chose to devote part of this issue to a symposium on the Argentine crisis.

Cynics might argue that this is just one more in a long list of Argentine disappointments. The country, after all, had a per capita income only slightly below those of Canada and Australia in the early twentieth century. Looking at the current crisis in the perspective of history is precisely what Gerardo della Paolera and Alan Taylor do, and their conclusions are not encouraging. They argue that Argentina has long oscillated between "periods of very loose floating and periods of more or less hard pegs" and that the causes of today's mess are similar to those behind previous crises stretching back to the nineteenth century. One collapse (both of output and the exchange rate) happened as long ago as 1890, on the heels of the great

Baring Crash. Another in 1914. Yet another in 1929, when what della Paolera and Taylor term Argentina's first currency board came crashing down. They argue that the parallels between 1929 and 2001 are closest. What both episodes have in common is that local banks crashed along with the currency. Indeed, banking problems may be the root cause of the demise of the two hard peg experiments.

The strength of a currency board lies in the full backing of the monetary base with international reserves. Its inherent weakness is that not all money is base money: a run on the banks can be self-fulfilling even with full backing of base money. The extent of this risk was not recognized in post-1991 Argentina, the authors maintain. Minimizing the risk requires that bank balance sheets be kept as clean as possible. It also requires adherence to the rules of the currency board, in particular avoiding Central Bank financing to the government or to commercial banks. In the run up to both the 1929 and the 2001 crashes, della Paolera and Taylor argue, both of these principles were violated.

The recent currency board was flawed in that not all reserves were actual dollars. A portion of the total could be held in government dollar-denominated bonds. The problem was exacerbated in April 2001, when the government placed U.S.$2 billion of government bonds with local banks and allowed the banks to use those bonds to meet up to 18 percent of the liquidity requirement. This both reduced the liquidity of the financial system and exposed banks to the risk of government default (which would soon materialize). Furthermore, a rapidly shrinking economy placed strains on bank portfolios. All these developments made a bank crisis increasingly likely. In the event of a crisis, dollar claims on the financial system would exceed dollars actually available by a wide margin. A haircut or a devaluation would become inevitable. No wonder depositors began shifting out of peso assets and out of the banking system altogether.

One could view the local banks as victims in this process, but della Paolera and Taylor see them, most controversially, as accomplices practiced in the art of gaucho banking. Bankers agreed to the bond swaps, which amounted to a temporary bailout of the government, betting that this would increase the likelihood of a government bailout of the banks—through pesification and rediscounting, for example. In this view, politicians and bankers were cronies, in 2001 as well as in 1929. Discussant Soledad Martínez Pería disagrees, arguing that the government coerced banks into the so-called megaswap: if the post-tequila experience of 1994–95 (when several banks were allowed to fail) was a precedent, then local banks could not rationally have been betting on a bailout.

The paper by Augusto de la Torre, Eduardo Levy Yeyati, and Sergio Schmukler also focuses on the links between the currency board and financial stability. They argue that the roots of the crisis lie not in mistakes made at the last minute, but in the underlying weaknesses of Argentina's monetary regime. Their conclusion: "the benefits of hard pegs have been much overstated."

Optimists claimed that such an irrevocable peg, which by its very nature placed tight limits on how many pesos could be printed, would have many beneficial side effects in Argentina. Savers, now enjoying a stable peso and the dollar as a legal store of value, would increase their trust in local financial institutions; federal and provincial politicians, understanding that money financing was no longer an alternative, would do away with unsustainable deficits; employers and workers, realizing that the occasional devaluation could no longer do the job of restoring competitiveness, would begin to write more flexible labor contracts.

In the early years of convertibility, exports grew and capital flows were abundant, and the economy saw a boom in financial intermediation and much financial deepening. With rising revenues, fiscal deficits and public debt seemed under control. The optimists seemed to be right. Starting in the late 1990s, however, a sequence of adverse external shocks sent Argentina into what the authors term a currency-debt-growth trap: "the currency was overvalued, growth was faltering and debt was hard to service." At this point it became clear that the currency board had failed to deliver on some of its promises: there was little nominal flexibility in wages and government spending, so that adjustment was bound to be painful, with much unemployment and low growth. With the economy and tax revenue stalling and with a sharp real depreciation looking increasingly likely, public debt dynamics threatened to become unsustainable. Finally, local banks with large dollar liabilities and mostly risky assets (loans to nontradables producers and to the Argentine public sector) began to look increasingly wobbly, precipitating a slow-motion run by depositors.

The currency board was by design hard to exit. This, argue de la Torre, Levy Yeyati, and Schmukler, proved to be more of a weakness than a strength. When the peg came under pressure, the Argentine government could only "redouble the bet" by encouraging even greater dollarization of debt and deposits. This signaled toughness, but also desperation. It also meant that when devaluation finally came, its costs would be astronomical: with the lion's share of bank loans and public debt denominated in dollars, outright default or (the more polite but equivalent) generalized rewriting of contracts were the only options.

One policy conclusion is that no exchange rate regime is complete without an exit strategy. De la Torre, Levy Yeyati, and Schmukler argue for what they call dollarization with pesification at the margin: converting all bank deposits to boost confidence and stem the run, while consolidating the provincial quasi-monies (very common in Argentina by then) into a new currency that would float against the dollar and in which new wage and financial contracts could be written.

Another policy conclusion is that Argentine bank regulation, while generally strict, underestimated the risk of loans to nontradables producers: "This risk arises from the simple fact that debtors in the nontradables sector cannot denominate their debts in terms of nontradables or hedge when contracting debts in terms of tradables." They are left exposed when the relative price of nontradables falls, as it must in any macroeconomic adjustment, regardless of the nominal exchange rate regime in place. The solution proposed by de la Torre, Levy Yeyati, and Schmukler involves establishing tougher loan classification and provisioning criteria for this sector and giving it a higher weight when measuring capital requirements.

The third paper on Argentina, by Sebastián Galiani, Daniel Heymann, and Mariano Tommasi, also views convertibility as a risky bet that did not pay off. One risk, again, has to do with choosing a system that had very high exit costs. Running the risk seemed sensible in 1991, the authors argue: the costs of monetary and exchange rate discretion were known to be high in Argentina, while the costs of abandoning discretion were uncertain and likely to be far into the future.

Stabilization made structural reform possible, and such reform brought hopes of efficiency gains and much higher incomes in the future. Such hopes, argue Galiani, Heymann, and Tommasi, were overblown. Too much optimism helped early on: feeling wealthy, consumers and investors spent more, and they financed the increase by borrowing abroad. The resulting capital inflows helped growth and also propped up the real value of the peso. The dollar value of GDP rose sharply. The initial optimism seemed to be self-fulfilling.

When shocks came and the situation deteriorated, mistaken expectations and high exit costs interacted to make the situation especially difficult to manage. After the Asian and Russian crises, capital flows stopped and export prices fell. The Brazilian devaluation of early 1999 drastically reduced demand from that country. What was the sustainable level of Argentine dollar GDP on which consumers, investors, and political leaders should base their decisions? Since a sudden devaluation was ruled out, the authorities had no choice but to argue that an abrupt fall in dollar GDP was also out of the question. To make this claim credible, they had to redouble the bet, encouraging further dollarization of liabilities. On this point, Galiani, Heymann, and Tommasi and the authors of the earlier paper are fully in agreement.

Regardless of the effects on public confidence, such a policy entailed fiscal risks. Measured at prevailing relative prices, the ratio of public debt to GDP seemed prudent. If no abrupt change in relative prices seemed possible, then why push for fiscal austerity? Coupled with an unwieldy political economy of fiscal decisions, the fiscal policy was not obviously irresponsible, but it was not particularly prudent or risk averse, either.

In the end, low growth and lagging exports undermined credibility to an extent that no amount of governmental chest-thumping could offset. Galiani, Heymann, and Tommasi here usefully allude to the work of Drazen and Masson on the credibility of policies versus the credibility of policymakers. Acting tough and insisting all was fine may have caused investors to conclude that policymakers were tough and committed to defending the value of the peso. At the same time, however, the real overvaluation kept rising and tax revenues kept falling. This eventually convinced investors that even a very tough policymaker at some point would abandon the peg, default, or both. A run on the banks and the final collapse could not be very far away.

The three papers on Argentina are rich and nuanced. All three suggest that convertibility was vulnerable in ways that were not recognized in time. In particular, changes in relative prices—which have to occur in response to shocks regardless of the exchange rate regime in place—left a highly dollarized banking system and a government with much dollar debt exposed to risks they ultimately could not bear. Argentina also suffered from extreme bad luck. After the 1995 tequila crisis, external conditions soon improved, making a quick recovery possible. After the 1998–99 shocks, things just kept getting worse. Whether an alternative economic policy could have saved Argentina is a question scholars will debate for many years.

But the world does not begin or end at the River Plate. The fourth paper in this volume casts a wider net, focusing on the distributional consequences of privatization in four countries in the region: Bolivia, Mexico, Nicaragua, and—again—Argentina. The subject could hardly be more topical: privatization is becoming politically contentious in several countries, with newspapers reporting public disenchantment over price rises and job losses in privatized enterprises.

The paper by David McKenzie and Dilip Mookherjee summarizes the evidence of large-scale studies conducted in the four countries. A first concern is with the effects of privatization on the price of and access to public services, and hence on the welfare of consumers. Contrary to public perceptions, they find that there is no clear pattern, with prices going down after privatization in half of the cases studied. Moreover, even when prices went up, access improved, with the greatest gains in access concentrated among consumers in the bottom half of the income distribution. (An exception to this was the failed concession of a municipal water firm in Cochabamba, Bolivia.) The net effect tended to be beneficial for welfare (measured as the change in consumer surplus) and for measured poverty. In addition, there is much anecdotal evidence of improved service quality, which would strengthen the conclusion that the effect of privatization on consumers was mostly positive.

Even if consumers gained, what about workers? Layoffs have been a concern, not only for their direct effect on unemployment, but also for their indirect effect on average wages. Here the evidence is more mixed. Job contractions were large as a share of firm employment but not necessarily as a share of the labor force, since many of the industries involved are quite capital intensive. The figures are 0.13 percent of the labor force for Bolivia, 1.0 percent for Mexico, 2.0 percent for Argentina, and a much larger figure for Nicaragua, which was in the midst of the transition away from a failed quasi-socialist experiment. In the two countries where the cutbacks were largest, a significant share of the laid off workers was eventually rehired in the same sector (45–50 percent within one year in Mexico and 80–90 percent within four years in Argentina). There is no clear evidence of the effect of the layoffs on wages, but the authors conjecture that the effect could not have been large in Argentina, Bolivia, and Mexico, given the small labor reallocation in those countries.

Finally, privatization had clearly beneficial fiscal effects. To the extent that reducing the losses at state enterprises allowed governments to reduce debt and expensive interest payments, cut back on the inflation tax (which hits the poorest citizens most heavily), and reallocate expenditure away from firm subsidies and toward social programs, the effects on poverty and inequality can also be beneficial.

Poverty and how to alleviate it is the subject of the last paper in the volume, by Francisco H. G. Ferreira and Phillippe G. Leite. The Millennium Development Goals (MDG), adopted by the member states of the United Nations in September 2002, set up ambitious targets, the most publicized of which is to halve by 2015 the number of people who live on less than one dollar a day. Other goals range from the specific and measurable (increasing net enrollment in primary education) to the outright flabby (developing a global partnership for development). The paper uses microeconomic simulations to assess whether and how one country, Brazil, can attain eight concrete targets having to do with poverty, educational enrollment, and gender equality in schools and the labor force.

A key question is whether reductions in poverty should be attained by increases in growth or changes in distribution. Ferreira and Leite conclude that "for a country as unequal as Brazil, the MDG poverty reduction target could be attained through a modest reduction in inequality, but it would require a growth rate well above the recent historical average if the Lorenz curve remained unchanged." Doing so would be fiscally expensive if that redistribution were to be accomplished through a universal lump-sum transfer. Highly targeted interventions appear to be called for.

The paper also asks how well certain programs might do in attaining the poverty reduction goals. An expansion in schooling alone appears unlikely to reduce poverty very much, since marginal returns to schooling are low for people who have little education to begin with. A conditional cash-transfer program, like *Progresa* in Mexico or *Bolsa Escola* in Brazil, might do better, but it is unlikely on its own to cut poverty enough by 2015. The simulations suggest, however, that an expanded *Bolsa Escola* program (covering secondary schooling), coupled with an ongoing expansion in enrollments at the pace recorded in the 1990s, would enable Brazil to reduce the number of poor sufficiently to meet the millennium goals.

I conclude, as usual, with some acknowledgments. This sixth issue of *Economía* contains papers presented at the Panel Meeting held in Madrid on 12 October 2002, alongside the annual meeting of the Latin American and Caribbean Economic Association. The Centro de Estudios Monetarios y Financieros (CEMFI) and its director, Rafael Repullo, proved to be efficient and gracious hosts. Financial support for this issue of *Economía* was provided by the David Rockefeller Center for Latin American Studies at Harvard University. We are very grateful to all.