

Deficit Spending Got Argentina into This Mess

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The people of Argentina have suffered enormously from political mismanagement of their once-robust economy during most of the past 80 years. The current crisis again is mainly due to politicians who continued to borrow on the international capital market to finance large and growing budget deficits.

In 1991, to tame its tendency to finance public spending by printing pesos, Argentina introduced convertibility of its peso into dollars at a fixed one-to-one exchange rate. Hyperinflation was rampant in the 1970s and '80s, and prices increased by more than 1,000% in both 1989 and 1990. Monetary mischief and destructive government intervention reduced Argentina's economy to Third World levels, as its per-capita income sank from among the 10 highest in the world in the 1920s, to about 80th in 1990.

Convertibility controlled the issue of pesos and hyperinflation and stabilized the economy. By 1995, prices were rising at less than 2% per year. I, and many others, concluded that Argentina was on the path to sustained growth. But convertibility did not eliminate the tendency for the provincial and central governments to spend much more than they collected in taxes.

Spending by these governments grew to more than 30% of gross domestic product--a much bigger fraction than that of its neighbor Chile and a large share for a nation at Argentina's level of development with an ineffective tax system. These budget deficits were hidden during the first half of the 1990s by revenues from the sale of government companies.

After privatization revenue evaporated, the government financed the budget gap by borrowing dollars on the international market. In recent years, this debt grew to about \$150 billion as deficits exceeded 4% of the country's GDP. The deficits were financed mainly with dollar-denominated debt, and additional borrowing was needed just to pay interest and roll over expiring debt. When further borrowing became impossible, Argentina defaulted, ended convertibility of pesos into dollars, and froze most deposits at banks. The default will temporarily ease budgetary problems by eliminating interest payments from the budget and the need to refinance debt. The banking system is in shambles, and many depositors effectively have lost their savings.

Some critics blame Argentina's problems on the speed and extent of its free-market reforms inspired by the so-called neo-liberalism, or Chicago-style economics, of the early 1990s. However, Argentina did extremely well after 1991: Even including the bad recent years, its real GDP prior to the devaluation grew by more than 4% per year. This beats Brazil's growth and that of most other Latin American countries.

Argentina, however, did not reform its economy as much as its neighbor Chile, which ranked 17th, vs. Argentina's 39th position, on the index of economic freedom compiled by The Wall Street Journal and the Heritage Foundation. Argentina has higher trade barriers, more rigid labor markets with stronger unions, and a larger government sector than Chile, which has not experienced a major financial or economic crisis.

Others attribute Argentina's collapse to convertibility because the fixed exchange rate raised the cost of its goods on world markets as the dollar gained in value in the 1990s. Clearly, Argentina could have benefited by floating the peso earlier, perhaps in 1999, when Brazil devalued. However, I do not believe an overvalued peso was the major contributor to Argentina's current economic difficulties. Exports account only for some 10% of the nation's GDP and rose as the dollar appreciated.

One recent Finance Minister, Ricardo Lopez Murphy, a former student of mine at the University of Chicago, lasted only 14 days because he tried to cut spending and raise taxes to close the budget gap. While printing more pesos and a little inflation will ease these budgetary problems, the end of convertibility will allow the government to return to its bad habits of financing spending with the printing press.

The International Monetary Fund and the U.S. should not rescue financial institutions holding bad Argentina debt. Indeed, the expectation of an international bailout probably encouraged lending that was not justified. Perhaps Argentina should receive aid after instituting reforms that reduce spending and improve the tax structure, but the populist steps so far taken by recently appointed President Eduardo Duhalde are not encouraging. Nor is his record as Governor of Buenos Aires state from 1991-99; Duhalde ran large deficits and greatly expanded the public payroll.

Violence and other protests continue to erupt as Argentinians voice their displeasure with politicians. The nation is beginning to lose its most valuable asset--educated and skilled citizens. Emigration will turn from a trickle to a rapid flow, and those who remain will continue to stash billions abroad unless Argentina's central and provincial governments quickly get their financial houses in order.