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## THE POLITICS OF DEPRESSION

**Pedro Lacoste and Martín Lousteau**

### EXECUTIVE SUMMARY

Faced with a recession that has persisted for more than three years, the Argentinean government still has not managed to find a solution. Not only has this recession exacerbated social problems in Argentina, but it has also led to a major political crisis. Both the ruling Alliance and the image of the president have been severely weakened, and they have just been defeated in legislative election in which the main opposition party has maintained majority in the Senate and has become the first minority in the lower chamber. The recession is raising doubts about the extent to which the current administration will be able to continue to govern, just as the failure to respond to the economic situation is slowly changing the opinions of some political representatives and power groups regarding convertibility and the country's ability to fulfill its debt payments.

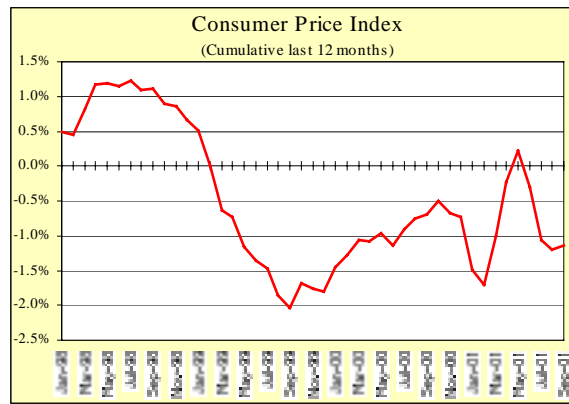
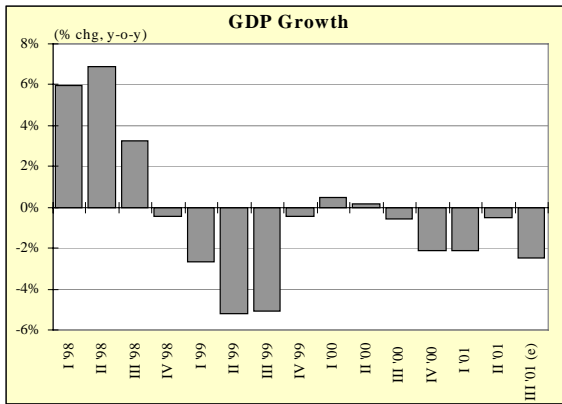
### CRITICAL ISSUES

Argentina is facing a three-fold challenge. First, the recession that began in the third quarter of 1998 has evolved into a depression, evidenced not only by its persistence but also by the attitude of domestic consumers and investors. It has also had a profound effect on tax revenues, which in Argentina are very procyclical. As a result, the issues of the public debt and creditworthiness have been placed at the center of attention. At the same time, the unfavorable economic climate has highlighted the social problems, which resulted from the sweeping economic reforms imposed on the country in the early 1990s. The coming survey of households will probably show an unemployment rate of 19%, three times the country's historical figure, and nearly 30% of all households living below the poverty level.

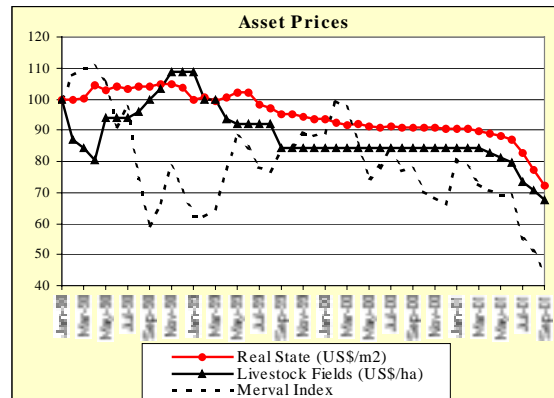
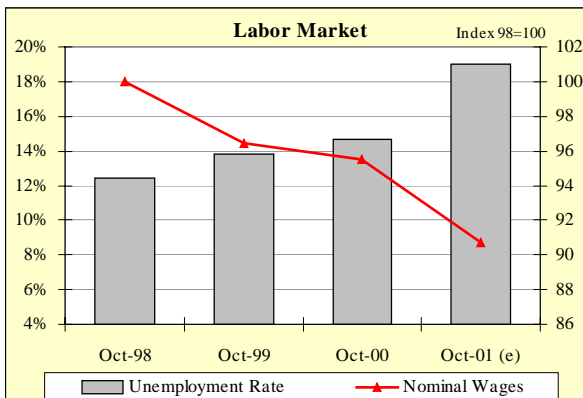
Given the severe shortage of economic policy instruments (a by-product of convertibility and other reforms), the government is forced to cope with both the skepticism of the international financial community when trying to obtain financing from abroad (on which Argentina heavily relies) and the deteriorated social dynamics at home. The lack of progress has given rise to a widespread political crisis, with a ruling Alliance that has undergone many changes and break-ups, and a president who, by law, maintains his legitimacy but in practice sees it impaired. On recent congressional elections, the Peronist Party was able to keep its majority in the upper chamber and to become the first minority in the lower chamber, which will make things more difficult for De la Rúa in the next two years of his mandate. The main opposition party won seventeen out of 24 provinces, with a margin of 17% nationwide over the governing Alliance.

### ESSENTIAL BACKGROUND: ECONOMIC DEPRESSION

What began in 1998 as an apparent recession sparked by external shocks developed over time into an outright depression, characterized by a decline in economic activity and significant price deflation for twelve straight quarters.

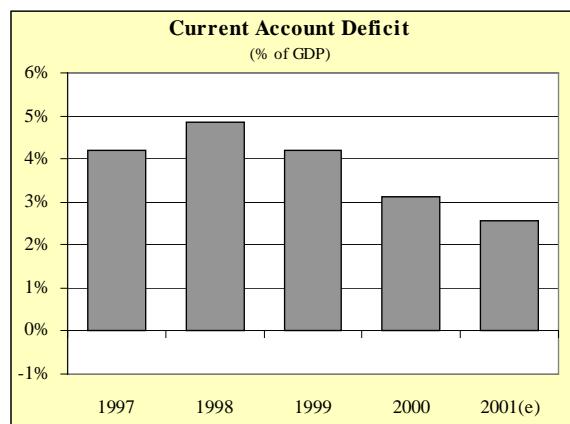
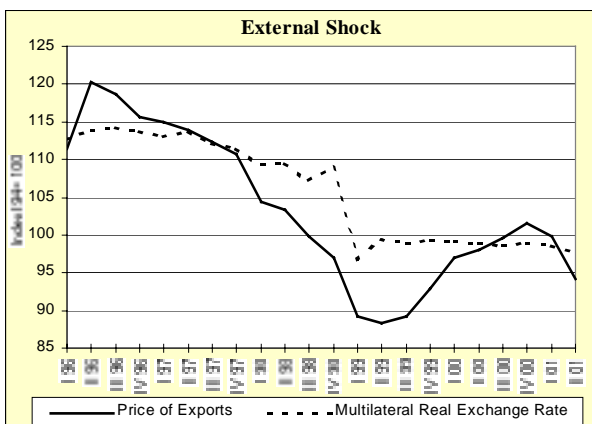


Labor prices and various asset prices were also affected by this downward trend, a common characteristic of depression.



How did the economy in Argentina reach such crisis proportions? The answer to this question is linked to two factors: adverse external shocks and failed attempts to respond to them.

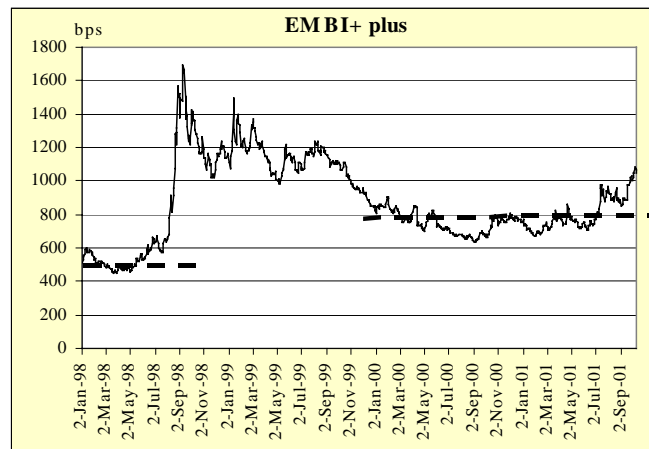
The Asian crisis of 1997 triggered an ongoing and sustained drop in the price of commodities produced in Argentina, which led to the onset of a major trade shock. At the same time, the value of the dollar (and the peso as a result of convertibility) was increasing sharply against other currencies throughout the world, which is exactly the opposite of what reduced export prices needed. The final coup de grace occurred in Brazil, a country that accounts for about 27% of Argentina's international trade, in January 1999, with the maxi-devaluation of the Brazilian real.



During this time, the country was also affected by the financial shock that followed Russia's default, which had structural consequences on the emerging debt market. Since then, many funds designed to invest on



less liquid markets such as emerging economies had to be reduced or closed altogether. Some estimates indicate that these hedge funds, which represented 40% of the liquidity of the emerging debt, today account for only 10%. This situation is reflected in wider spreads, which can be seen in the changes to the Emerging Markets Bond Index (EMBI) produced by JPMorgan:

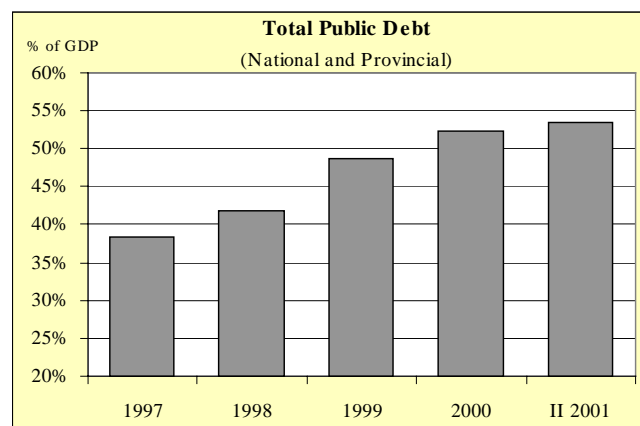


The logic behind convertibility implies that, given the problem of competitiveness, an adjustment is made by lowering prices. The problem is that the deflationary process is not immediate but rather slow and painful. Investment and consumption plunge into a downward spiral from which it is difficult to escape. The former shrinks as a result of the lack of profit in the trade sectors, and the latter falls in light of the fact that lower salaries and higher unemployment affect not only consumers' disposable income but also their readiness to spend.

The various economic cabinets, which held power after 1998, misdiagnosed the situation in Argentina. They assumed that the main problem was fiscal and overlooked the sharp decline in competitiveness. Based on their diagnosis, they increased taxes and lowered public spending, which threw the economy even deeper into recession. The supposed "virtuous cycle" that was expected to result from tighter fiscal policies triggering lower financing costs through lower interest rates never materialized, partly because the capital markets had changed significantly and partly because the ongoing depression underscored the uncertainty of Argentina's economic prospects.

## CURRENT SITUATION: FINANCIAL, SOCIAL, AND POLITICAL CONCERNS

The persistent economic depression gave rise to problems on three different fronts: financial, social, and political. First, Argentina's credit standing became increasingly uncertain. Although the national public debt/Gross Domestic Product (GDP) ratio is at an acceptable level, its rate of growth is raising concerns.



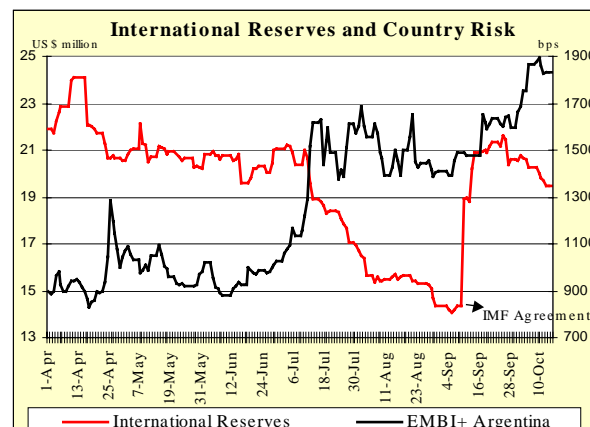
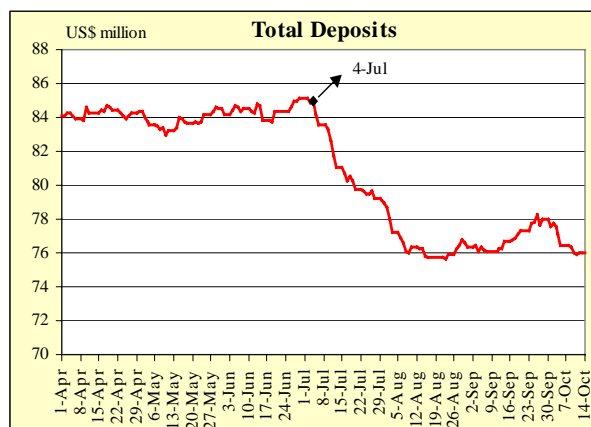
To solve this problem, Argentina needs to grow at a steady pace, but the country seems to lack the economic policy instruments needed to achieve economic growth. Convertibility practically eliminates

exchange rate and monetary policy. On the other hand, the transition cost related to the over-ambitious switch from a pay-as-you-go system of social security towards an individual capitalization accounts one and the need for adjustment based on the uncertainty of the country's creditworthiness limit the fiscal policy's range of action.

At the beginning of his term in March 2001, the current Minister of the Economy, Domingo Cavallo, sought to alleviate some of these problems. He suggested the possibility of introducing the euro as part of convertibility, a measure that will only be implemented when this currency and the US dollar reach parity. With this tool, not only was he trying to cushion the future impact of imported inflation or deflation (a by-product of the changing market value of the dollar) but also to provide immediate support for the country's competitive ability by introducing a dual exchange rate system. Since the peso will eventually be equivalent to the arithmetic average of the dollar and the euro, the amount of this calculation is being used in the meantime, but only for foreign trade operations. Therefore, the resulting depreciation is around 5%.

In order to increase the amount of credit available in the private sector, the Central Bank eased its policy somewhat regarding cash reserves and Treasury funding, while in some sectors industry-based competitiveness programs were attempted, which included reducing distortive taxes and relaxing labor conditions for the industries most severely affected by the appreciation of the peso.

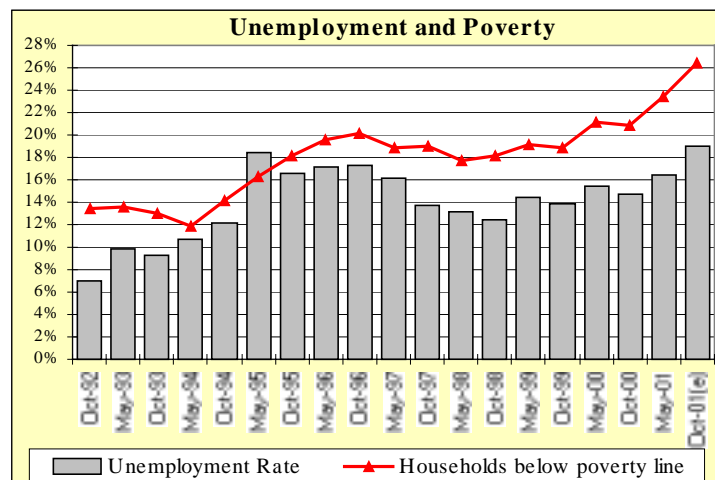
The problem with introducing flexibility measures into rigid models is that the end result is generally a middle ground that satisfies neither the supporters of the *status quo* nor the proponents of change. Cavallo's solution was no exception to this rule. It was too timid in its intent to revitalize the economy, and too bold for those who felt that nothing needed to change. The mega-swap of debt carried out in early June was perhaps the clearest indication of this reality. Too many expectations were raised and everyone was disappointed. The result was a financial run of enormous magnitude that began in early July.



The government's response was to step up constraints by moving toward the zero deficit rule, whereby primary public spending becomes a direct function of the revenues collected. By doing this move the economic team was trying to build strength from weakness: realizing that financing to the public sector from both abroad and locally was almost null, it tried to create a confidence shock by betting one more time in the story of the virtuous cycle to be triggered by fiscal prudence. This led the government to reduce salaries and retirement pensions by 13% in the third quarter of the year. But that was not enough, so they started to accumulate arrears in payments to suppliers and on transfers to provincial governments. Therefore, the zero fiscal deficit rule that was supposed to be on an accrual basis switched to a cash basis and resulted in the worst possible scenario. It further aggravated the collapse on the chain of payments in the economy, without triggering confidence because of the growing short-term debt that the government is building with provinces, suppliers, and even pensioners.

The liquidity shortage shock that hit the country in July and August, combined with the ultra-restrictive fiscal policy aimed at zero deficit, are not the best solution for coping with an economic depression. The economic implosion is therefore deepening, which leads us to question the social and political feasibility of the entire situation.

In terms of the social situation, growing difficulties are apparent. A country which has historically had good social indicators is now forced to come to grips with a sustained unemployment rate close to 20% and a poverty rate that grows with each new household survey.



The current social situation is the result of two distinct factors. First, the dizzying speed at which the economy was transformed in the early 1990s vindicated the inefficient production system of previous decades and led to an increase in unemployment (even at times when the country was growing at an annual rate of 7.9%). In recent years, with a decline in economic activity, this structural factor of unemployment and poverty has been worsened by the economic climate. The prevailing social discontent is a by-product of both the challenging circumstances and the absence of any indication that this trend will change: In the eyes of the public, the tendency towards a greater risk of remaining unemployed, problems re-entering the job market, the uncertain employment situation, and lower base salaries has become too difficult to reverse.

The only possible outcome of this entire process is a deteriorating political situation. De La Rúa's approval ratings, which were around 60% at the beginning of his term, are currently at 10%. This rating carries a great deal of weight in a presidential regime like that of Argentina's, since it represents the legitimacy in practice (as opposed to legitimacy by law) of the person at the helm of the Executive branch. Thus, the institutional weakness, which the president has suffered since early on in his term and has only gotten worse, is not offset by any personal strength on his part.

It is important to note, that the Alliance, a merger between the Radical and Frepaso Parties, is an association of heterogeneous political figures and arenas, particularly with regard to its vision of economic order and its method of policy-making, which dates back to the 1990s. At that time, when the opposition could be personified in the figure of then President Menem, internal differences went unnoticed. However, when it became necessary to make decisions about governing the country (i.e., finally putting into practice the divergent political ideas), the differences began to be apparent and were later underscored, as decisions accepted reluctantly by some internal sectors also failed to solve the existing problems.

Thus, within a period of one and one-half years of coalition rule, this group lost first its Vice-President, Carlos Álvarez, a Frepasista who resigned in protest to his own government's response to a bribery scandal in the Senate; and then, eighteen of its 121 deputies, who, in dissent, opted to form new parliamentary blocks and/or new political groups. The Alliance's internal disarray is such that, in the recent held legislative elections, the coalition's official candidates in the three main districts were among the strongest critics of the current administration, especially against the economic policy. The government lost the first minority in the lower chamber and could not stop the Peronists from keeping a majority in the Senate. This will become a major weakness for the Executive branch compared to the past two years. Let us recall that enjoying at least one chamber's first minority is crucial because of how the laws are passed. When the Executive branch sends an initiative to Congress, it chooses as the originating chamber the one where it can impose the direction of voting. It does not matter if in the process the other chamber introduces modifications to the bill. Once the modified project is sent back to the originating chamber, the latter can insist on the original version by passing it with the appropriate support. The government used this mechanism more than once to neutralize the weight of the Peronist majority in the Senate, however,

not anymore.

## LIKELY SCENARIOS

### 1- The Short-Term

The latest financial crisis was halted only in the wake of the agreement with the International Monetary Fund (IMF), which triggered an additional US\$5 billion for Argentina. This agreement, in which the US Treasury played a very active role, included a reference seeking the sustainability of the Argentinean economy, a direct reference to the country's debt problem. It is unclear whether Washington and Buenos Aires are thinking along the same lines. Although the run on deposits quieted down following the agreement, country risk is still high, an indication of bondholders' doubts regarding Argentina's ability to repay as well as doubts about the US decision to contribute with sufficient guarantees to ensure that a conversion is voluntary and successful by lowering the average rate paid by Argentina. The country, therefore, remains vulnerable, and any adverse event could again trigger an outflow of deposits and a loss of reserves.

At this stage, it is important to recall the most important features of the recent congressional elections. As expected, the Peronist Party won, but it nonetheless was not able to catch all the votes from people disappointed with the Alliance. Neither has been able to live up to expectations of the Republic of Equality Party (ARI-the recently new founded party by the charismatic Lilita Carrio), as it was short of defeating the Alliance in the capital district and far from the second place obtained by Alfonsín in Buenos Aires. In a way, the ARI failed to grasp the angry vote that preferred to express itself through blank and null votes, although was able to put itself in the third place. Perhaps Lilita Carrio has been affected by the frustrated experiences of Graciela Fernandez Mejjide and Chacho Alvarez from the Frepaso, who showed a mediatic appeal by their transparency and anticorruption stance during the '90s but failed to transform them into a government program once they got the Executive responsibilities. Other than some increase of leftist parties, no politician was able to draw from the angry vote, causing a big amount of blank votes and null votes that nationwide add up to around 22%, compared to just 6% in previous ones.

Congress Elections			
	1997	1999	2001
Blank	4.7%	4.4%	9.3%
Null	1.6%	1.0%	12.4%
Total	6.3%	5.4%	21.7%

The bottom line is that Peronism is barely able to keep its historical levels nationwide but with no clear leadership, the Alliance has lost half of the votes in just two years, and the ARI is unable to channel all the anger caused by the four-year-old depression, which went to the "angry vote" through blank and null. As a consequence of the Peronist clear triumph, the primary for 2003 presidential elections among the Peronists has started and Duhalde is now on board along with Ruckauf, De la Sota, and Reutemann. This event in the main opposition party, plus the fragmentation that voters have shown, is the most important asset of a very weak president. The following questions are ones that the president must address:

How to deal with a severe economic depression, with his popularity plummeting from 60% two years ago to just 10% today, and with both chambers of Congress in the hands of the opposition? How to reach a zero fiscal deficit when tax collections are falling at a 10% annual rate, without exchange rate or monetary policy tools? And, to make things worse, how to deal with a coalition that made him president but is falling apart, with its leaders blaming the Minister of Economy as the person responsible for a congressional election defeat? No easy answers of course, but we will attempt to draw some likely trends for the short-term:

**No surprises:** the president is not a friend of the unexpected, neither is he willing to accept pressure. He will not fire Cavallo, neither will he change the main underpinnings of his economic policy. Priority will be given to deal with the galloping depression by announcing timid measures to reactivate tax benefits, lower reserve requirements on deposits, provincial debt exchange seeking interest rate relief, and some trade policy measures. They will not look as a turning point but as more gradualism.

**Dollarization:** the president will not make the move to dollarize the economy, but he would be willing to



show gradual steps in that direction and to reaffirm his commitment to the 1 to 1 exchange rate.

A cabinet reshuffle will happen soon and the new one will look more like the Radical Party than before, but of radicals close to the president and who would be helpful to regain the control of the party.

Trying to build a coalition with Peronist governors: the issue of co-participation and provincial debt restructuring is next on the agenda and will help to perceived how each party's negotiation stance has been affected by the election, and the new political map. The most powerful governors on the Peronist Party will be playing a very delicate balance: not to destroy governability that would only help the contenders for 2003 with no executive responsibilities (Duhalde and Carrió) and to avoid being too close to an unpopular president running an unpopular economic program.

## **2- The Medium-Term**

Scenario 1: Success of the current economic policy (probability 15%).

The government succeeds in maintaining the zero deficit scheme and imposing the adjustment for the following year during budget negotiations. In the first quarter of 2002, strong signs of voluntary rescheduling of debt along with greater international support would be required. The clearing up of uncertainty and the freeing up of fiscal resources enable the country to resume a course of sustained growth. Exchange-rate parity is maintained and the possibility of dollarization, aimed at strengthening confidence to promote a closer partnership with the United States, is not ruled out.

Scenario 1			
Probability = 15%	2001	2002	2003
Var. % GNP	-2.5%	2.0%	4.0%

In the political arena, the president surrounds himself by an homogeneous and very "De la Ruista" cabinet, with the possibility of support coming from part of the Peronist Party (mainly ex president Menem and perhaps people close to de la Sota).

Scenario 2: The "muddling through" continues (probability 35%).

The authorities do not manage to put the economy on the right track. In this case, measures similar to those already tried out will be taken, and a new call for international support will be made, which will not be enough to disrupt the vicious cycle in which Argentina finds itself. Efforts to maintain convertibility continue, but a less voluntary form of debt rescheduling could take place. Country risk remains high, a sign of poor creditworthiness, and financial runs like those experienced recently could be repeated.

Scenario 2			
Probability = 35%	2001	2002	2003
Var. % GNP	-2.5%	-1.0%	1.0%

As the economy fails to recover, the government could opt to include more prominent opposition figures in the administration. As this process fails to produce positive results, the chances of this scenario resulting in one of the two described below increase.

Scenario 3: New focus for economic policy (probability 35%).

The government is too weakened to survive without assistance. An appeal is made for a broader coalition, with the Peronists playing a fundamental role. In this scenario, the replacement of Cavallo by a figure having a greater consensus is not ruled out, at a time when serious questions are being raised about the public debt and convertibility. An attempt is made to move toward a system that includes floating exchange rates and debt rescheduling in the most orderly way possible. The result of this

scenario will depend on the strength of the political consensus, which will determine the possibility of negotiating for new support at the international level.

Scenario 3			
Probability = 35%	2001	2002	2003
Var. % GNP	-2.5%	-2.0%	5.0%

Scenario 4: The economic and political situation reaches new crisis levels (probability 15%).

This is a worsening of the preceding scenario, in which the decline in the president's governance capabilities leads to his resignation sometime thereafter. In this case, the legislative assembly must elect a successor from among the governors, senators, and deputies to fill the office for the remainder of the current four-year term.

Scenario 4			
Probability = 15%	2001	2002	2003
Var. % GNP	-2.5%	-5.0%	-2.0%

On the economic front, a financial crisis of tremendous magnitude would take place, including devaluation and default in the midst of great confusion, and, most likely, the de facto dollarization of the Argentinean economy.