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by Allan H. Meltzer

Testimony before the Committee on Financial Structure,
Subcommittee on International Monetary Policy and Trade
U.S. House of Representatives

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Argentina and the IMF

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Argentina is now suffering from a deep and prolonged social and economic crisis. Its roots are political as well as economic. The political system seems unable to develop a coherent, consistent plan to solve or improve either Argentina's current position or its longer-term structural problems.

The need for a plan or program to restore growth in output and employment without renewing inflation cannot have escaped the leadership. They have received this message from President Bush, Secretary O'Neill, the IMF and others, including me. Without a plan that begins to resolve the current liquidity, financial, economic and human problems, there cannot be a resolution of the crisis. Additional financial assistance from the international financial institutions, led by the IMF, cannot solve Argentina's problems unless Argentina adopts a coherent, consistent plan.

Argentina had three fundamental problems that brought it to its current, deplorable position with massive loss of wealth and increase in misery. First, its debt could not continue to grow and be serviced by Argentina's economy and exports. Astute observers recognized publicly more than a year ago (and privately as early as 1999) that Argentina's foreign currency denominated debt was unsustainable. Second, Argentina's budget deficit increased its debt and undermined its monetary policy. The convertibility law tied the peso to the dollar and permitted unrestricted convertibility at a fixed exchange rate. This arrangement could not cope with an unsustainable debt on one side and an overvalued exchange rate on the other. The appreciation of the dollar and the depreciation of the Brazilian real made Argentina an unattractive place for investment and a costly place to buy. Third, Argentina made many reforms in the early 1990s, but it did not develop a budget policy or pass a fiscal responsibility law that controlled provincial spending. And it did not remove some of the structural impediments to growth.

The current Argentine government has not proposed a coherent, consistent plan. Some of the actions it has taken are piecemeal efforts to solve a particular problem without regard for the larger consequences. For example, the monetary authorities did not have enough dollars to convert peso deposits into dollars, as required by its monetary regime, so the government decreed that all dollar deposits had to be converted into peso deposits at 1.4 pesos per dollar. This increased the potential money supply by about 30%, raising concerns about inflation. To assure the public that they would not lose from inflation, the government suggested indexing peso deposits to inflation. As inflation increased, the government or the central bank would print more money.

This policy would lead to hyperinflation. Argentine citizens have had such miserable monetary and economic experience for the past fifty years that they understand better than most the links between the central bank's printing press and inflation. Their response is to run from the peso before the inflation reduces the value of their money. This response further drives down the value of the peso, raising Argentine costs and prices. Unions, anticipating inflation, have asked for a 40% increase in wages.

The economy is collapsing. Construction activity in January was 44% below year earlier levels. Because bank deposits were frozen, January supermarket sales were 30% lower than December. The unemployment rate is above 20% and rising as the economy sinks. The government announced that it does not have enough money to pay the wages of government workers.

No one can fail to be concerned with and distressed by the fate of the Argentine public. People are fleeing the country. Lifetime savings are threatened, and bankruptcy and joblessness are high and rising. A decade after suffering the chaos that accompanied hyperinflation, people suffer from renewed economic collapse.

What can the IMF and other international institutions do? What should they do? The IMF has not ignored Argentina. In March 2000 it offered a $7.2 billion loan. In January 2001, when the sustainability of Argentina's debt was very much in doubt, it offered $7 billion more as part of a $20 billion official package. In August 2001, it advanced an additional $5 billion to prevent a banking and currency run. It should be clear to all that more money without policy changes did not work. The IMF announced new negotiations last week.

Would more money now help Argentina or its people? Until Argentina has a credible, coherent plan, the public has no reason to want to hold pesos. Giving money now would give the Argentine government money to support its exchange rate and its budget. That's another way of saying that holders of Argentine pesos would be able to get dollars on more favorable terms and the Argentine government could maintain a larger budget deficit and avoid pressures to establish fiscal responsibility. This is not just conjecture. It is a description of what happened to much of the aid Argentine received in the last two years.

I favor assistance to Argentina once it has adopted a coherent, consistent plan. Such a plan is needed to ensure that the money advanced to Argentina is not used to support an exchange rate peg or slide, to sustain budget deficits, or to permit creditors to avoid losses. That's how additional support would be used in the absence of a plan that the government adopts and implements.

In December 2001, Adam Lerrick and I discussed these issues with members of the Argentine government and with those who were then in opposition but are now in government. There are seven problems that have to be addressed. Some are interrelated.

(1) External debt has to be reduced to a sustainable level. The debt is now in default. It has to be renegotiated.

(2) Argentina needs a credible exchange rate regime to replace the present blocked exchange system of currency controls.

(3) No exchange rate regime can remain credible or be sustained unless the monetary system produces low inflation or stable prices. The government must make the central bank independent and adopt a rule that prevents the central bank from printing money to finance the budget deficit.

(4) A stable fiscal regime, with budgets close to balance sustains credibility of the monetary system and exchange rate stability. The fiscal system should also encourage efficient use of resources to increase living standards, and the government should adopt a fiscal responsibility law applicable at all levels of government. Many of Argentina's fiscal problems result from excessive spending by the provinces financed by the central government.

(5) Adjustment of the Argentine monetary and exchange rate system should avoid asset and liability mismatch. Argentina's current government has wiped out the capital in the banking system and crippled the payments system.

(6) Any policy today must convey unpleasant news. It should also convey some good news by reducing the 21% value added tax as much as possible to stimulate private spending and to shift spending from informal to organized markets.

(7) There is a pressing need for liquidity. Adam Lerrick and I proposed a way to reconcile an increase in liquidity and spending with safety and soundness of the financial system. The government adopted a version of this proposal.

The Argentine crisis affects not just the IMF. It poses a challenge for the World Bank, with 8 to 10% of its outstanding loans to Argentina, and the Inter-American Development Bank, with 20% of its loans to Argentina. An Argentine default on these debts would severely impact the capital of these institutions. The lesson from this problem should not be to send more money. It should be to reform these financial institutions.

In summary, I support the IMF's current program. It is a major step forward from the open-handed bailouts of the 1990s. The new policy is exceedingly painful for Argentina because the government has failed to make adjustments and reforms necessary for growth. Financial support is wasted when the economic structure is unsound. I urge members of this committee to support the important steps toward reform that Secretary O'Neill and Managing Director Koehler have underway. I urge them to continue with their effort to reward performance and to insist that promises must be kept.