

BY ROBERT J. BARRO

## ARGENTINA'S CAVALLO MAY NOT PLAY THE HERO THIS TIME



**PUZZLING:**  
Cavallo saved the economy in 1991. But his new plan focuses on raising confidence without taking the tough steps required

In the early years of the 20th century, Argentina was one of the richest countries in the world. Then came many years of failed policies, and Argentina retreated to the status of a middle-income country. From 1913 to 1990, the average growth rate of per capita gross domestic product was only 0.6% per year.

Things changed in 1991, when Domingo Cavallo took over as Economy Minister. His reforms were pro-market and featured fixing the peso at 1-to-1 parity with the U.S. dollar. He also pushed trade liberalization and reforms of public finance and the banking system. Despite the recession of 1995, induced by the Mexican peso crisis, Argentine per capita GDP grew at an average rate of 4.8% during the Cavallo years, through 1996.

But Argentina recently took a turn for the worse. Per capita output has fallen by 3.2% per year since 1998. In March, 2001, President Fernando de la Rúa's new Economy Minister, Ricardo López Murphy, failed when a reasonable program of curtailing public spending hit a political roadblock. Now there is talk in the markets of default on Argentina's foreign debt.

Out of desperation, the President has turned to his political rival, Cavallo, to save the economy a second time. The initial reaction by many observers, including me, was positive. However, 2001 is not 1991, and Cavallo's proposals focus on confidence management without the brilliance and market orientation of 10 years ago.

**PAY IN CASH.** Cavallo's program can be understood as a reaction to two concerns, the size of the fiscal deficit and the overvaluation of the currency. Wary of the fate of López Murphy, Cavallo proposes to end the deficit not by trimming public outlays but by raising taxes. The main new revenue device is a levy on financial transactions through the banking system.

There are several problems with this approach. One is that the economy would actually benefit more from lower spending than from higher taxes. In fact, Argentina needs to boost its low level of investment by cutting the high tax rates on business income. Another problem is that the new tax will highly distort the financial system, pushing Argentines to use offshore banks and pay in cash.

Cavallo also seeks to ease worries about default on public debt by persuading corporations and banks to hold more government bonds. The payoff to the banks—if the central bank can be induced to ease its tough policy on reserve requirements—is that these bonds would count,

in part, as reserves. Unfortunately, this change could make banks riskier enterprises.

The appreciation of the peso—caused by the dollar link and the strength of the dollar—has made Argentinean goods and labor too expensive. The market reaction is for Argentina's prices and wages to fall, but this deflation takes time, and unemployment rises in the meantime. The challenge is to avoid the contraction without jeopardizing currency convertibility, the central pillar of the 1990s revival.

**ODD TIMING.** Cavallo's proposals tinker with convertibility without abandoning it. He tries to devalue without officially devaluing by enacting a sharp rise in import duties on consumer goods. The adverse consequences of this protectionism are well known, and the announcement that the tariffs are temporary is not reassuring.

Cavallo wants to replace the peso's link with the U.S. dollar with a tie to a 50-50 dollar/euro basket, but only after the euro appreciates to parity with the dollar. The inclusion of the euro is understandable because Argentina's trade with the euro zone has been comparable to its trade with the U.S. However, the timing is odd if, as President Bush just proposed in Quebec, we are headed for a Free Trade Area of the Americas. The idea of waiting for dollar-euro parity is also confusing. If Cavallo knows that the euro will appreciate, then he could solve Argentina's fiscal problems by speculating in the euro.

Cavallo's plan is especially puzzling because the fiscal deficit (2% to 3% of GDP) and deflation are not much different from previous years in which the economy was growing. The crisis really is one of confidence, but financial markets would be reassured more by a coherent plan for reform of state spending, rather than a short-term revenue fix by hiking taxes. Confidence also requires maintenance of dollar convertibility, but announcements of new kinds of pegs, combined with pressures on the central bank to ease, undermine this confidence. That is why interest rates in Argentina are so high.

I would have preferred a bolder plan: full dollarization of the Argentine economy, subject to negotiations with the U.S. to extend free-trade status to Argentina. This deal could also include compensation for conversion to the dollar.

Everyone needs heroes, and Cavallo was one of mine. Maybe the Cavallo of 2001 will turn around and help to turn around Argentina's economy. Maybe.

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