Adios, Peso?

By ROBERT J. BARRO

After decades of poor economic policies, Argentina's economy minister, Domingo Cavallo, implemented pro-market economic reforms in 1991. The economy functioned well during his first tenure, which ended in 1996, continuing through 1998. Since then, it has contracted for more than two years, and financial markets have become increasingly apprehensive about Argentina's public finances. The International Monetary Fund's acceleration of $1.2 billion in financing will have little effect. In any event, the important issues concern Argentine domestic policies, not additional IMF money.

When Mr. Cavallo was reappointed economy minister in March, many observers, including me, were optimistic that he would restore Argentina to economic soundness. However, the initial proposals were disappointing-a new tax on financial transactions, duties and subsidies on foreign trade, tinkering with the currency board-and financial markets were not impressed. Missing was a commitment to curb government spending and, thereby, achieve fiscal balance.

The situation changed recently with the implementation of the zero-deficit law, which promises a quick elimination of fiscal deficits by drastic cuts in public expenditures. This law, a remarkable political achievement, dramatically raises the chances for Argentina to weather the current economic storm without any form of default or devaluation. Yet this fiscal achievement has not yet received the credit that it deserves from the markets, or from most commentators.

Since 1991, Argentina has been operating under two key principles for the public sector. The first is "Do not devalue," enshrined in the convertibility law, which created a type of currency board that fixed the value of the peso at $1. Reinforcement comes from the widespread dollarization of the economy. Here, most short-term benefits from devaluation and inflation are eliminated. In fact, the many dollar obligations of banks and companies imply that devaluation would cause a spate of bankruptcies. Hence, the usual temptation to devalue and inflate does not exist, and this absence of temptation strengthens the credibility of the convertibility law.

Most Argentines also know that a failure of the currency board would imply the loss of external discipline for monetary policy. Without this, the country would likely return to the high and variable inflation that existed before 1991.

The second principle is "Do not default." Obligations to bondholders are regarded as contracts that a serious country always honors. So, just as holders of Argentine money can count on one peso being worth $1, holders of Argentine bonds can be confident of receiving a contracted stream of payments. Argentina does not regard reneging on debt as a satisfactory way out of its current problems.

The fiscal deficit, although not exceptionally high as a ratin of GDP. has fostered international speculation that Argentina's core principles would be violated. In particular, the high interest rates have exacerbated fiscal problems. This situation makes public-sector default more likely, even if the currency convertibility remains in place. lb counter this speculation and to ease fiscal pressures, Mr. Cavallo has now introduced a third principle for government: "Do not borrow."

The zero-deficit law limits public outlays over each quarter to prospective receipts. Some of the adjustments in expenditties will even occur on a month-to-month basis. Thus, the government will not have to borrow on net from the financial markets and will "only" have to roll over outstanding bonds as they come due.

The size of the spending reductions is much greater than that proposed in March by the previous economy minister, Ricardo Lopez Murphy, ousted because of political opposition to his spending cuts. More remarkably, the present decreases in spending apply primarily to the most politically sensitive and recalcitrant parts of the budget: wages and pensions. It seems that a lot can be accomplished politically in an atmosphere of economic crisis.

Domingo Cavallo

Admittedly, there is a sense in which a continually balanced budget is not ideal. Much better would be the option to borrow during bad times, and to run corresponding surpluses in good times. This "tax-smoothing" approach is, however, much less important at present than the restoration of fiscal credibility. Perhaps later-when credibility is in place-Argentina can balance its budget over periods longer than a quarter or a month. For now, the principle of continual budget balance is the right way to go.

It would have been better if Mr. Cavallo had implemented the new principle in March. Sharp cutbacks in spending may have been politically feasible then, but he seemed to underestimate the seriousness of the fiscal situation. In my view, however, late is better than never.

The form of the convertibility law is another matter. Last spring, Mr. Cavallo moved to replace the U.S. dollar with a 50-50 dollar-euro basket as an anchor for the peso. However, this provision becomes effective only if the euro first appreciates to parity with the dollar. The last part confuses me, because no one has any idea whether the euro will appreciate relative to the dollar. Abstracting from this, I found understandable the inclusion of the euro in the basket, because Argentina's trade with the euro area is larger than that with the U.S. So, if one were just starting to build a currency board, the 50-50 basket might be superior to the pure dollar.

But one is not starting from scratch The simple and clear convertibility law has been a pillar of Argentina's enhanced credibility during most of the '90s. Maintaining this credibility is more imp&ant than attaining a somewhat better form of currency basket. Instead of changing tile basket, my preference would be to opt for a full dollarization that included the USC 'of U.S. dollar bills in Argentina.

Better still would be to negotiate with the U.S. to combine full dollarization with a free-trade agreement, and with compensation for Argentina's conversion to the dollar. These policies require support from Washington for freer trade and for other sound economic reforms. The U.S. would clearly benefit-partly from expanded trade, and partly from havingto deal with fewer international financial crises.

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