

KEYNOTE ADDRESS

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The situation in Argentina is so difficult that we are suffering shocks every minute; we get confused in every circumstance. Thank you, Jack, for your invitation and for the opportunity to speak with you at this important meeting.

I will present a diagnosis of the current crisis, and, if I can, discuss the prospects for recovery. This is more difficult to address nowadays given the difficulty we face.

The current Argentine crisis can be traced back to two sources. First, at the end of the 1990s we suffered several external shocks. As a point of departure, keep in mind that Argentina, as an economy, is very intensive in three things. We are very rich in natural resources, and we produce mainly commodities. Second, we have very close economic ties with our neighbors. We depend a lot on the behavior of our neighbors because they are our main customers. Third, we used a lot of external savings during a long period of time. These were the three main features of our economy.

Why is it important to have this in mind? It is important because we suffered an external shock—and the external shock was higher than everybody believed in the beginning for the following reasons.

First of all, we suffered Asian shock, and the Asian shock was linked to the fall in the price of commodities. Second, we suffered the Russian shock, and that increased the spread for all emerging countries. Third, as a consequence of the Asian and Russian shocks, and because of inconsistent internal policies, we suffered the Brazilian shock. The Brazilian shock was very important for us because Brazil's large economy is very integrated with Argentinas. The fourth shock is the overvaluation of the dollar against other currencies, mainly the euro.

When we refer to external shocks, sometimes we are not clear enough in explaining what that means for us. One way to understand the effect of external shocks is to think that a price—the external price for us—has fallen. That is, commodity prices in dollars fall, the price of Brazilian gross domestic product (GDP) and level of prices falls, the prices of Chile's and Uruguay's products fall, and the spread—the cost of our indebtedness—increases. I ask you to keep this in mind while I address how this affects our economy.

We have problems because our internal policies were inconsistent. We made mistakes. To clarify the kind of mistakes we made during the nineties, I want to give you some information about our monetary framework. We have, since the beginning of the nineties, a currency board.

The currency board was very useful in Argentina in reforming our monetary and financial system after we suffered a long period of very high inflation. First, since the end of the Second World War until the middle of the seventies, we suffered high inflation. Then, since the middle of the seventies to the end of the eighties, we suffered mega-inflation, something much bigger than high inflation. We had triple-digit inflation.

After that, we had two hyperinflations. The first reached 5,000 percent per year at the end of Mr. Alfonsín's government. The second reached 21,000 percent per year when Mr. Menem's first three economic plans failed. During that period, we erased from our currency thirteen zeros. Each zero is equivalent to a 1,000 percent devaluation. We used devaluation as much as we could; we tried to prove if it's useful, but we went beyond the experience of other countries. For that reason our domestic currency almost disappeared. You need some sense of humor to be able to withstand these waves of difficulties.

The economic currency almost disappeared. We had an M1 of almost 1 percent of GDP. Under these circumstances we implemented a monetary system that was useful for the recovery of the monetary system and the financial system, but it was extremely rigid if we suffered a real shock. It was very good in dealing with monetary shocks but very bad in dealing with real shocks. This system is a very old system—we had one at the end of the nineteenth century and it has four main requirements.

First, you have to be very careful with your fiscal policy. You must have a surplus almost every year to await the bad moments. Your insurance must be to have a surplus when the situation is normal in order to prepare a cushion for the bad moments, for the rainy days.

We were not able to deliver that during the nineties. During the nineties, when we had very good periods, we didn't save enough. We were not careful. We never made very large mistakes, and we didn't have a very large deficit. We had small deficits, but a small deficit is not the right recipe when you have a currency board. When you have a currency board, you need room for maneuvering. You need some space to adjust because the monetary system will not let you do the work as in other countries.

Second, in this system you need to replace the flexibility that you do not have in the exchange rate mechanism with flexibility in other parts of the economic system. That means labor flexibility and bankruptcy law, but it also means something that is more important than any other thing. Everything that can go up has to be able to go down. We have upward mobility in our public expenditure, but when we faced the crisis, we discovered that the downward mobility in public expenditure was not available. And that is a very important part of understanding the problem. It's not labor flexibility, and it's not entrepreneurial flexibility: you need public expenditure flexibility. You need to know that from the beginning. And this is not the issue of solvency. This is a different issue.

The third point, very related to this conference, is that you need a very strong financial system. Fortunately, there we did the best part of our job. We built very strong financial institutions. They have been strong enough to withstand a withdrawal of deposits of more than 15 percent and they are alive. They are almost ready to withstand an earthquake. But not two or

three. The problem is not withstanding one shock or one earthquake. The problem is, we are having one earthquake per month. And the financial system will not be able to withstand this if we are not able to reverse course.

The fourth requirement of our monetary system is openness. An economy with a currency needs a high degree of openness. You need to cushion the business cycle sending abroad the recessions. The current account has to be a very important cushion in the business cycle. If we are very open that will fulfill that requirement. Argentina, unfortunately, is not very open. Is one of the most closed economies in the world. This comes from a long period of import-substitution, and our opening in the nineties was an important one but not enough to deal with this type of system.

I hope to have communicated to you why we have this system. Indeed, this system has a lot of problems, but, remember, we had hyperinflation before. Another thing that is difficult to see in other countries is the degree of currency substitution. For example, in Argentina at the end of the eighties and the beginning of the nineties, the degree of currency substitution was extreme, not only as a store of value and not only as a unit of account. We used dollars also for transactions. Small-denomination currency bills were used for transactions. For that reason, using another monetary system is not easy. The idea of floating in Argentina is a very difficult one. I am not sure we will have a stable demand for money, but that is another discussion.

Why did we fail? I mentioned the debt problem, but I want to refer to something that is very important and possibly very difficult to understand. Public expenditure grew 100 percent in the nineties. The GDP, in real terms, grew something like 40 percent. The inflation implicit in our export price was 3 percent during this period. If your numerator grows by 45 percent and your public expenditure grows by 100 percent, you will suffer a crisis sooner rather than later. And the crisis happened when the external environment turned against us, when we didn't have any more public assets to sell. We don't have any more access to indebtedness, and we suffered the economic crisis. And the economic crisis is a problem not only of public solvency, it's a problem of competitiveness, it's a problem of labor and employment, it's a problem of investment, it's a problem of export growth.

But, in any case, you cannot explain the Argentine crisis if you refer only to these aspects. We have a third factor that affects us a lot. The third factor was a crisis of credibility and confidence that was linked to the deposit withdrawals we suffered mainly during July and August. The crisis of confidence happened for several reasons. One of them may be related to the discussion in Argentina about the idea that one of the ways to address our difficulties was to declare a moratorium on our public debt. Half of our debt is in the internal market. In the assets of the banking system, you have bonds—the deposits that are the liabilities of our banking system. And their owners (the depositors) heard that somebody thought that the solution to our problem was not to pay the debt. If you don't pay the asset, you will not be able to pay the liabilities. And that was important at the beginning of the bank run—the idea that the public sector debt was too large in the internal market. Why is this so? When the external financial markets closed, we maintained the deficit and issued a lot of debt in the internal market and that created the cause of the problem I mentioned.

Finally, a very important factor is the fragmentation of power, or the problem of governability. Argentina has a coalition government, and the coalition melted down. When the coalition melted down, the government lost the ability to deal with the very difficult crisis, a very difficult external environment, a very difficult process of adjusting to the mistakes of the past decade, a regional situation that was difficult, and, as we have seen in the papers before, less capital flowing to emerging countries. If you have such a large crisis in a very weak government, you know the outcome. The outcome is the crisis we are facing now.

What are the prospects for recovery? After what I've explained, it's difficult to think that we will have a recovery soon. But let me put together my thoughts regarding what is necessary to address our difficulties. I think that to have room for overcoming our difficulties, we need mainly three things. First, we have to restore credibility and confidence, and that means restoring governability and all the power in a very fragmented government. Without this type of coalition and power, it is very difficult to reverse the crisis of confidence. Second, we need an improvement in our external parameters because without that the problem of adjusting to such an adverse situation will be a very difficult one. Our income per capita is falling, we are in deflation for the last four years, our GDP is falling for the last forty months, and without an external improvement our recovery is a very difficult outcome.

Finally, we will have to do our internal adjustment and that means two things. First, we must reverse some of the mistakes of the nineties, and, second, we must strengthen our institutions. That is the key for the future. We need to strengthen our institutions. And when I mention institutions, the first and most important institution in a decentralized economy is property rights. Without very clear and defined property rights, without the idea of respect for the rules of the game, it is impossible to create the environment needed to attract an investment, not only for an inflow of capital but to retain domestic capital. I hope I have helped you understand why we are in such a mess, and I ask you to join me in praying for my country.