

Managing the Indian Economy: Lessons from Argentina

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Indian politicians can learn a lot from their counterparts in Argentina. The country's exchange rate management has become a case study for many developing countries. Even though Argentina has been in recession for quite sometime now, it has steadfastly held on to what is called the Currency Board system of exchange rate management. In this article, we summarize Argentina's experiences in managing its economy and the lessons India can learn from them.

Argentina had been one of the richest countries in the world till the 1930s, thanks to its strengths in agriculture. Thereafter, poor government policies and a failure to develop a strong industrial base led to a continuing decline. By the early 1990s, Argentina had been written off as a basket case. Huge fiscal deficits, hyper inflation and government controls had eroded the country's competitiveness significantly. In early 1990, for instance, inflation crossed 20,000%. High import barriers protected inefficient industries and militant trade unions constantly pressed for more wages. The 'austral' plan launched in 1985 failed, after an initial spell of optimism, as it focused on administrative controls rather than structural measures like elimination of the fiscal deficit.

In April 1991, a new government led by Carlos Menem decided it was time for radical measures. The policy initiatives were led by Domingo Cavallo, a Harvard trained economist. Cavallo introduced the Convertibility Act which pegged the austral, at 10,000 to the dollar. (Now, a new currency the peso is pegged at one to the dollar). The Act stipulated that the country's monetary base would be backed by gold and foreign currency reserves. This meant that any downward pressure on the Argentine currency would be dealt with only by contracting the domestic money supply. Domestic money supply could be increased only if dollars flowed in. Consequently, the question of printing money to bridge the fiscal deficit, did not arise. This created a strong in built pressure for maintaining monetary discipline. The fiscal deficit was cut from about 9% of GDP in the 1980s to 5% in 1990 to 1.8% in 1991. By the last quarter of 1992, the government in fact recorded a budget surplus, a consequence of more tax revenues, privatization receipts and a sharp cut in subsidies. The government aggressively privatized the telephone network, the state airline, two television stations, over 10,000 km of road network and some railway lines. The average import tariffs were cut from 40% in the late 1980s to 9% by 1992. Quantitative restrictions were lifted on all items except cars.

The remarkable thing about Argentina's reform process was unprecedented public support. For his tough measures, Cavallo actually became Argentina's most popular politician. Of course, Cavallo's success in curbing inflation was the main contributory factor. With the currency pegged, one problem which Argentina faced was loss of export competitiveness when other currencies depreciated. When industrialists approached him to complain, Cavallo told them bluntly to focus on productivity, efficiency and innovation, instead of artificial props such as

devaluation. He made it clear that the peg was there to stay.

Argentina's currency board system seemed to face a crisis when the Brazilian real fell sharply in early 1999. The soaring dollar also did not help. An overvalued currency vis a vis other currencies in the region and high interest rates (because of the strong linkage to the high interest rates then prevailing in the US) slowed down the economy. As government spending increased to cope with the recession, the fiscal deficit reached 3.8% of GDP in 1999. The country's commitment to the Currency Board however, remained unwavering. As the Economist remarked, "Argentina's currency board system of automatic monetary control can be a strait jacket on the economy. But few see change as even practicable, given how many deposits, loans and contracts are in dollars. And not even the gloomiest industrialist wants to try."

In recent times, the government of Fernando la Rúa has been struggling to put an end to the recession which has been going on for almost three years now. The government has cut spending and taken various steps to attract foreign investment. The president has now pulled out his last trump card, by inviting Cavallo to return as the economy minister. Cavallo has sprung into action announcing plans for changes in taxes and import tariffs, reform of the state bureaucracy and labour laws and further cuts in government spending. He has defied the rules of the Mercosur trading group (consisting of Brazil, Argentina, Uruguay and Paraguay) by deciding to cut tariffs on capital goods and increase duties on consumer goods. Cavallo has also reiterated that the peg is there to stay. This statement is credible as according to rough estimates two thirds of personal loans and 93% of government debt are already denominated in foreign currencies. The main worry today is that political instability (The economy minister has been changed twice in a month) may put downward pressure on the peso, leading to a further increase in interest rates. That would worsen the recession further.

True, Argentina is facing problems today. But then, it is likely to emerge all the stronger. Under difficult conditions, industries are working hard to shed flab and improve their competitiveness. Unlike India, time is not being wasted discussing what should be the 'correct' exchange rate. Nor is time being spent lobbying for further cuts in interest rates, which in Argentina are market determined in the real sense of the word. Argentina's determination to cut fiscal deficit is also more genuine than is the case in India. We must remember that with all its problems, the fiscal deficit in Argentina is today only about 2.5% of GDP. In India, if we eliminate dubious accounting practices, (such as not considering NSC deposits as part of government debt), and include the deficits of the states, as we logically should, the fiscal deficit would easily cross 10%. India can also learn a lot from Argentina about privatization. After almost 10 years of reform, privatization is essentially a farce in our country. We can learn a lot from Argentina's aggressive approach in this context.

Thus, Argentina has several lessons for us. This important Latin American country has demonstrated a political will to implementing economic reforms, so badly lacking in India. Unfortunately, the Indian public knows more about Argentine skills in football rather than in management of the economy!

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