Argentina: A Poster Child for the Failure of Liberalized Policies?

Interview with Lance Taylor

This fall, Argentina needed to be bailed out by the International Monetary Fund to avoid financial crisis. But Argentina has been the poster child for liberalized economics policies, including pegging its peso to the U.S. dollar and completely liberalizing the flow of capital. Economist Lance Taylor, long an expert on development economies, discusses what went wrong in Argentina and the state of the debate about how effective international development policies have been.

Q We had the threat of a serious international financial crisis again this summer, precipitated by troubles in Argentina. Only emergency loans to the nation by the International Monetary Fund seem to be warding off a crisis. Yet Argentina in many

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Challenge, vol. 44, no. 6, November/December 2001, pp. 28–44.
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ISSN 0577–5132 / 2001 $9.50 + 0.00.

ways was the poster child for liberalized policies about capital flows and a firm currency. Is this an indication that those free-market liberal economic policies have failed?

A. Yes. Argentina has clearly failed, in my view. It clearly had failed three or four years ago. The history is that in the early 1990s Argentina had an anti-inflation program based on freezing the exchange rate. Basically, it tied the peso one-to-one to the U.S. dollar and set up a so-called currency board. This essentially means that the money supply within the country and the supply of credit to firms are tied directly to international reserves. So if the country gets capital inflows, the supply of money and credit increases, leading, as it did until around 1996 or 1997, to a substantial investment boom. If capital flows out, however, the opposite occurs.

Q. Explain how this works. Is the money supply tied to international reserves?

A. If there is a capital flow into a country, it means that people outside the country are buying some kind of security that people within the country are issuing—in most cases, that security is a government bond. The money to buy that security cannot be used immediately when it comes into the country because it is in dollars or yen or francs, so immediately this capital inflow in the form of foreign currency goes into reserves. The Argentines had set up their banking system in such a way that those reserves would automatically translate into an increase in money and credit. So in terms of their monetary policy, they are highly dependent on movements of capital across the border.

Q. What was the alleged benefit of that?

A. The alleged benefit was that it was an anti-inflation program. They wrote into the law that there would be a one-to-one

peg between the U.S. dollar and the Argentine peso, which meant that the government could no longer break its promise to maintain the value of the peso by boosting the money supply or cutting interest rates and causing inflation.

Q Didn't Argentina do pretty well for five or six years?

A. This package was instituted in 1991. It did reasonably well up to the Mexican crisis in 1994–95, then there was a slowdown. There was a short pickup afterward, but since 1997 or so, it has all been downhill. One aspect of this type of anti-inflation policy, which is also seen in Turkey and many other places, is that when you peg the exchange rate, the internal price level does not stop rising immediately. So there is an increase in domestic prices relative to foreign prices, which makes the country more and more noncompetitive. For a long time, until the Brazilians stabilized their currency in the mid-1990s, Argentina was living off Brazilian overvaluation.

Q. Please explain that.

A. It worked in the sense that the Argentines had stipulated the currency peg, whereas Brazil still had an inflationary process under way and its currency was becoming steadily overvalued. Finally, the Brazilians froze the inflation, and then their currency began to depreciate. While the Brazilian currency was overly strong, Argentine industry was benefiting. Its exports were relatively inexpensive. That came to an end and Argentina went into a slump.

Q Is that the precipitating factor for the slump that it is in now?

A. There were several precipitating factors. One was the shift in valuation between the peso and the Brazilian real. Another was the

tequila crisis, which slowed capital inflows. There was finally the recognition that the Argentine peso was becoming increasingly overvalued. At the same time, because the peso was so strong, the country was running a major trade deficit, which meant that it became highly dependent on capital inflows. It has not been able to get substantially new or fresh money since 1997 or 1998, and now it is in a terrible mess.

Q. How do you explain how the international markets have reacted to what is going on in Argentina?

A. The Argentines have to convince the world to lend them another $10 billion or $15 billion every year, and in an economy the size of Argentina, that is a lot of money. They now have to pay unusually high interest rates, which means that a lot of people are afraid that Argentina is simply going to default or devalue, or both.

Q. Would the policy instituted in 1991 inevitably lead to a situation like this, in your view?

A. The way it was set up, yes. It was an effective means of stabilizing inflation in a Latin American context—that is, freezing the exchange rate and making strong promises about how the exchange rate will stay frozen for a while and getting capital inflows so they could pay for imports during the stabilization period. But ultimately, they really tied their hands in two ways: first, by insisting on writing this currency peg into the law so it is quite a legal issue and hassle to try to change it, and second, by setting up this crazy banking system, the currency board system, which essentially said they abdicated control over monetary policy. So, they went too far. In the mid-1990s, there was some talk about backing away and relaxing a little bit and becoming more sensible, but for political reasons, that did not work out.

Q. What would you have preferred to see them do?

A. I think the Brazilians really did it more sensibly in that they did not completely tie the real to the dollar; they have allowed room for depreciation of the currency. And they have maintained some control over monetary policy. Also, Argentina completely liberalized the capital account—that is, eliminated regulations on capital flows—and opened up the trade account rather strongly, which raises other kinds of threats they have not been able to deal with either.

Q. Is the Brazilian capital account totally liberalized or equally liberalized?

A. It is in principle equally liberalized, but Brazil has had a longer history of capital market controls, and if the Brazilians have any sense, they will probably go back in that direction. But that remains to be seen.

Q. So you think that in many respects complete capital liberalization can be dangerous?

A. It is both capital account and current account liberalization (the free trade of goods and services) and the interactions between them that can be dangerous. That is the broad history of developing countries into the mid-1980s and early 1990s. They have liberalized both sides of the balance of payments, that is, the current account and the capital account. The interactions between them can very easily be destabilizing and also do not seem to do very much for growth.

Q. What is the evidence on that, in general? Obviously the Clinton administration was virtually gung-ho in favor of capital account liberalization, which, for our readers' sake, essen-

tially means capital can flow in and out of a country without regulation.

A. That is right. There are various forms in which financial capital can cross borders. One is direct foreign investment and another is portfolio investment, for example, when pension or mutual funds invest in shares of companies. The Clinton administration together with the International Monetary Fund and the World Bank pushed a lot of countries in the direction of capital account liberalization. Also, as I said, there was almost simultaneous liberalization of the current account—removal of tariffs, barriers, and import quotas, export subsidies, that kind of thing.

Q. Do you think that as a result there was a lot of hot money that would leave Asia on a moment's notice, and that accounted for the severity of the financial crisis in 1997?

A. Yes. Hot money can take various forms. In the Asian countries, for example, there was a lot of bank lending, and in other contexts you have a lot of bond sales, which is what happened in Russia with government bonds. But one way or another, that money is all short term and can go in and out easily unless you have some controls. That was at the root of many of the crises.

Q. When you say that capital liberalization has failed, that there is no strong evidence that it has contributed to growth, on what do you base that statement?

A. I would base it on research projects I have been running, which have undertaken country studies trying to trace the implications of both capital and current account liberalization.

Q. Is this in Latin America or around the world?

A. There is one book about Latin America and another project under way that focuses more on the socialist economies and Asia. Perceived economic theory tells you that capital account liberal-

ization should be helpful because it brings new resources into the country and generally frees up markets. However, in practice, as you have said, the money tends to be hot money, to move in and out quite rapidly. The most successful case of capital account liberalization is China, but that is only partial, and the money they are getting is direct foreign investment rather than portfolio money, some of which at least goes into productive activity. But that is not the case in many other countries.

Q Can you give a couple of examples where capital account liberalization has failed to produce rapid growth?

A. We have already talked about Argentina.

Q. Let us talk about Argentina then, and go on to others. The idea in Argentina, I assume, was that this investment would lead to a more diversified economic base or at least an economic base that was healthier and modernized.

A. I guess that was the idea. In the Latin American countries at the turn of the 1990s, the major policy objective was to stabilize inflation, which had been ongoing for many decades.

Q The ultimate idea in stabilizing inflation is, I assume, to encourage broad-based capital investment and for markets to do their magic.

A. That is obviously true, but the immediate policy objective was inflation stabilization. And that was only made possible with the fixed exchange rate and the fact that in the early 1990s, Latin America for the first time became a desirable place for people to put money. So the capital inflows they received, which were basically portfolio inflows—a lot of which were tied to privatizations that were going on at the same time—provided the money to raise imports so they could drive down prices and

maintain the exchange rate. That is how it worked. The secondary objective, the ultimate objective, as you say, was to try to build a basis for sustained economic growth. But here you get other complications. Exchange rates tend to appreciate for the reasons I indicated: The money comes in, and the nominal exchange rate is fixed, and prices continue to increase. So the real exchange rate appreciates, which makes you less trade competi-

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tive, which means the balance of payments in your current account gets bigger, which means you really get de-industrialization. At the same time, in many cases interest rates went up because foreign investors were still a bit afraid that the anti-inflation strategy might not last. In the Brazilian case, the government was issuing a lot of debt and felt it had to maintain high interest rates so people would hold the government debt. So you get a combination of a strong currency, high interest rates, and money coming in and out, and that is just not a good base for any kind of industrialization or long-term growth process.

Q. Has there been a similar experience in Asia?

A. The experiences in Asia were different in the sense that they did not have an inflation problem, and the Southeast and East Asian countries had been growing fairly rapidly in the 1980s and 1990s. In part, again, problems were caused by the exchange rate. The history is that after the Plaza Accord of 1985, the dollar declined against the yen. Because they were tied to the dollar, many of the Asian currencies depreciated. They had an export boom, which overshot, and then an investment boom. But then they also liberalized the capital accounts, and money

rushed in. Internal rates of return were pretty high, they had fixed exchange rates, and you could place money in, let us say, Thailand and get something like 10, 15, or 20 percent returns. You could borrow abroad at around 5 percent as long as people expected the exchange rate would hold. That is a pretty big margin.

Q. Is Argentina essentially a commodity-based economy?

A. Not completely. Argentina had an import-substituting industrialization phase, and, in fact, its machine tool sector was pretty good.

Q. Why did that fail?

A. That failed for the same reasons we have been talking about. It had some degree of protection, and if you take away the protection and appreciate the exchange rate at the same time, that is just a sure recipe for de-industrialization.

Q. But did the economists who were influential at that time believe the import-substitution model was not working?

A. It was really one economist who set the Argentine strategy, Domingo Cavallo. He was opposed to the import-substitution strategy, or thought that it had run out of steam, and that they had to do something else.

Q. Was there some evidence to support his view?

A. That is a very complicated question. I would like to answer it with a little history. If we look at the general economic trajectory of countries since World War II, which is an appropriate place to start, roughly from 1950 to 1970 was the so-called Golden Age, when both developing and developed countries were growing quite rapidly and trade was expanding quite rapidly. Then, for a variety of reasons that are still being debated, this Golden

Age period came to an end. The developed countries, in effect, went into a slump, which was worsened by the oil shock and by a burst of inflation in the 1970s. In the 1970s the developing countries, to a certain extent, outperformed the developed countries for a couple of reasons. One is that real interest rates were low in international markets. So a couple of dozen developing countries, including Argentina, Brazil, Mexico, and Korea, could borrow at negative real interest rates, which they proceeded to do. In the commodity-exporting countries, commodity prices were high through the 1970s but then began to tail off. So when the 1980s came along, there is a sharp decline in commodity prices and a sharp increase in real interest rates.

The developed countries, in effect, went into a slump, which was worsened by the oil shock and by a burst of inflation in the 1970s.

Q. So those key conditions were entirely reversed?

A. These conditions were entirely reversed, and you get this so-called lost decade of growth in the major Latin American countries, sub-Saharan Africa, and a good chunk of Asia. Korea came within a hair's breadth of folding but did not.

Q. When was that?

A. That was when everybody else did, in 1982–83. Korea was very close to a debt crisis but managed to get additional funds, then saw its own export boom dissipate in the 1990s because of this price realignment I mentioned earlier.

Q. So, we are in the 1980s.

A. The reason for this long detour is that the defining strategy through the 1970s and into the 1980s was import substitution.

The economies went bad largely for the reasons mentioned above, but import substitution was largely blamed. Given the ideological change in the world and the fallen Soviet Union and a lot of other things, import substitution became discredited. That opened the way theologically for the liberalization policies that kicked in in the late 1980s and early 1990s.

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Q. So basically you are saying that the causes of lost growth in the 1980s are ambiguous.

A. Yes. But the other thing that happened in the late 1980s and 1990s was that all countries became dependent on the Bretton Woods institutions for support.

Q. Those being the International Monetary Fund and the World Bank?

A. Right. They were all highly dependent on these institutions for money to keep themselves afloat, and that forced the hand of many policymakers.

Q In other words, the IMF and the World Bank both essentially pushed liberalization of markets and strong currencies?

A. They did not anticipate the strong currencies. The main thing they pushed was liberalization of markets. Then when they got worried about stabilization, they pushed for austerity—government austerity.

Q. Which often exacerbated the situation, I presume?

A. It certainly did not help on the effective demand side, but if you look at the data from these country studies that I mentioned

and ask what happened, let us say, to the public sector, the private sector, and the external sector, you would see that the policies did not work. There was some increase in exports but less than anticipated, in part because of exchange-rate appreciation. Also, imports went up at least as much as exports, so you did not get any big push from the external sector on balance. The government was supposed to swing into austerity but, in fact, the general fiscal stance of most countries was neutral. If you look at the private sector, there was a drop in private-sector saving and a consumption boom.

Q. What period are we talking about?

A. We are talking about a good chunk of the late 1980s and early 1990s, up to the present, in fact.

Q. By conventional measures of growth, the impact was positive in some of these countries, however.

A. The impact was positive only in the sense that a few countries, Argentina again being a good example, or Mexico prior to the crisis, had consumption-led booms for a few years. Basically, they started importing a lot more than they used to. But you had de-industrialization or reduction in activity of the traded goods sectors, or stable, essentially flat performance in traded goods sectors, and a boom in nontraded goods and services—which is OK, it creates jobs. But they tend to be low-end jobs at the same time as you are losing high-end jobs in trading goods.

Q What alternative policies would you recommend?

A. If you want to go back in the direction of some kind of autonomous growth path, I think the key step is the imposition of some kind of capital controls. You can argue that import substitution went too far in the sense that tariffs were really crazily high, but you also have to go somehow toward directed supports to domestic producers in an intelligent way. They may be

domestic producers of industrial goods or agricultural goods or services, I do not know. But some kind of directed public policy for local production activity seems to be essential.

Q. Is there any chance, given the power of the Bretton Woods institutions, as you call them, that that could happen?

A. I think that is going to depend to a large extent on what happens globally. That is, if the United States economy, say, recovers vigorously next year, there is less chance. As a leading manufacturer, as a leading productive economy, it has a vested interest in pushing free trade. As a leading financial economy, it has a vested interest in pushing liberalized free capital markets since it can make money on both sides. So, if the United States recovers strongly and reasserts its hegemonic power, which held during the 1990s, I do not think there is any room whatsoever for developing countries to adopt the necessary policies. On the other hand, if the U.S. economy slumps fairly seriously, which I personally think is the more likely alternative, that would create room for developing and transition economies to try to pursue more autonomous policies.

Q. Why? Would the IMF and the World Bank be less resolute?

A. The IMF and the World Bank are resolute in the sense that they are being backed by the leading power in the world. There are plenty of people around the world who are willing to espouse alternative points of view—even the Japanese, for example. If some large, relatively closed economies were to go back in the direction of more autonomous policies, I think they could probably get away with it.

Q. There are recent claims by the World Bank that, despite criticism, their policies have been quite beneficial in reducing

inequality, at least between nations, if not within nations. What is the evidence on that?

A. That is just not true. Again let us go back to the history that we were discussing. Let me give you a little methodological caveat, and then let me say what I want to say. There is a question of how you measure individual countries; that is, do you take countries themselves as units of observation, or do you weight them by population, or do you try to say something about what is going on with distribution both across and within countries? The last thing is very difficult to do, and nobody really tries to do it. If you take countries as the units of observation, according to Angus Madison, who is the major figure in doing these types of international comparisons, the income spread in 1970, for example, between the richest and poorest countries was on the order of thirteen to one. If you look now, it is something like nineteen to one. So there has been a perceptible widening of the gap between the richest and the poorest countries, in part because the richest countries have grown in positive per capita terms, and in part because the poorest countries, notably sub-Saharan Africa, have had negative per capita income growth, due to the end of the commodity boom in the 1970s.

Q. You are saying the prima facie evidence is quite clear on this?

A. The prima facie evidence is quite clear if you take countries as the unit of observation. If you weight countries by population, that means essentially that you give India and China very high weights in the calculation, and then global inequality has probably deteriorated somewhat. But remember, China and India grew using non-IMF policies.

Q A lot of people credit India's growth to liberalized policies—reductions of tariffs and opening trade and so forth.

A. But that argument also does not fly. You can argue about

when India began to liberalize, but you can make the best case that the big shift was in the 1990s. India grew pretty rapidly prior to 1990, largely because of heavy public investment in infrastructure and a fairly expansionary fiscal stance. In pre- and post-1990, there has been a slight deterioration in growth performance, and poverty—certainly poverty as measured by household income—has not declined, and many people would argue that it has increased.

Q. And what about the record on poverty? How bad is it, or is it not as bad as people like me think it is?

A. This is another whole analytical can of worms about poverty. If you just look at income poverty and say that a poverty line is a $1 a day or $2 a day, or something like that, there has been a little bit of poverty reduction worldwide, proportionally. As countries grow, and there has been positive growth at a low rate in per capita terms, poverty tends to go down. But there has been nothing dramatic anywhere, with the possible exception of a few countries that have grown quite rapidly, like Costa Rica and the Dominican Republic, two open but small economies.

Q. What about the reduction of poverty in China?

A. Reduction of poverty in China has been quite dramatic in urban areas because urban China, the eastern urban fringe of China, has been growing very rapidly. There has been much less reduction in rural areas.

Q. And what about India?

A. It declined in the 1980s and stabilized in the 1990s.

Q. Is the claim of the demonstrators from Seattle to Genoa valid?

A. I think so. The way to reduce poverty most directly is to grow more rapidly, and then you do other things like increasing wages and providing better social services. Basically, the experi-

ence during this liberalization period, which again began sometime in the mid-1980s/early 1990s, is not satisfactory. Countries have not grown and poverty has not gone down significantly in most cases.

Q The argument generally is that these "silly" protestors do not understand how important economic growth is to poverty reduction. What you are saying is that the Bretton Woods institutions have not been very good at stimulating economic growth.

A. There are some working papers out of the World Bank by David Dollar and various coauthors that make a two-phased argument. One is that the kind of policies recommended by the Bretton Woods institutions increase economic growth. Step two is that economic growth reduces poverty. Now step two is in fact correct: In a sustained period of growth, poverty tends to go down. On the other hand, the argument that the kinds of policies that these guys are recommending actually increase the rate of growth is just not supported.

Q. And how do they make the claim? How do they support it?

A. They support it in the following way. Again, it is a relatively old theme in the Bretton Woods institutions. What they are doing is looking at cross-country regression studies. That is, you take a bunch of countries and put economic growth, measured one way or another, as a dependent variable, and then you have a number of independent variables, which include various kinds of policies and degrees of economic openness. And given that kind of data set, if you are willing to play around with it enough, it is not difficult to come up with some kind of regression equation that would give you the results you want. Actually I sat down this morning and made a list. The World Bank has been doing this kind of regression analysis at least since

1983. It issued a paper in 1983 called "Price Distortions and Growth in Developing Countries," which tried to show that if you got rid of your price distortions, you would grow faster. It was absolutely fallacious, as several critics rapidly pointed out. But before those critics had a chance to do their work, that particular paper had been featured in the bank's 1983 *World Development Report*, got a special page in the *Economist*, and so on. So they come out with this bad set of equations, they get shot down, but the fact that they are heavily criticized just does not show up. In 1991 in the *World Development Report*, the same thing occurred: Market-friendly policies are good, what remains is to put these ideas into practice worldwide. A lot of dubious regressions were behind the claims. If you look at tables in the appendix, less than half of them were statistically significant, and a lot of them had the wrong sign, as far as the bank is concerned. You got a similar story in 1993 with the so-called East Asian miracle, where a lot of cross-country econometrics was used to show that interventionist policies in import substituting and export promotion policies did not play a role in East Asian growth, and that is simply wrong. In 2000–2001 you get the David Dollar cross-country regressions, which have also been heavily criticized on methodological grounds. The evidence supporting the Bank's assertions about the effectiveness of its preferred policies is just not there, but it still keeps on saying that they work.

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