

Latin American Financial Crises and Recovery

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Although the financial crises that struck emerging market developing countries in the 1990s were all characterized by large and abrupt capital reversals, the causes of the conditions that first generated the capital inflows and then triggered the capital reversals were very different in Latin America than in Asia. In Asia savings and investment rates were extremely high and stable growth at double digit rates had become commonplace in conditions of stable prices and exchange rates with contained fiscal and external balances. Although it was questionable whether these countries actually needed additional financial resources from capital inflows, foreign investors were attracted by what appeared to be a successful long-term growth process with stable returns.

In Latin America, on the other hand, savings and investment rates had been persistently low, with chronic fiscal and external disequilibrium associated with hyperinflation and high exchange rate volatility. There was little in the actual performance of Latin America in the post-1980s debt crisis to attract foreign investors. Instead the inflow of external financial was induced by the structural adjustment policies that were introduced to deal with the aftermath of the 1980s debt crisis – the Brady Plan and the structural adjustment policies that accompanied it. It was the expectation of quick profits from the liberalization of these economies as they privatized state-owned companies and replaced import substitution with market-led liberalization and deregulation that brought capital inflows. But, the inflows were primarily into financial rather than real assets.

The fact that these capital inflows were soon reversed in the 1994-5 Tequila crisis in Mexico, the Brazilian exchange-rate crisis of 1999 and the Argentine crisis of 2001 can be seen as confirmation of the failure of the policies to provide sustainable recovery from the 1980's debt crisis. To date all three countries have avoided a third round of financial crisis, but with widely differing success. While Brazil and Mexico have persisted with modified versions of their previous policies, and have maintained price stability, this has come at the cost of a lower trend growth rate. Argentina, on the other hand has made a sharp break with its previous policies by defaulting on its foreign debt, and has seen a sharp increase in its trend growth rate and a recovery in employment, however with some evidence of emerging inflationary pressures and supply bottlenecks, especially in energy. The lessons to be drawn from Latin America must then be viewed in the context of the very different causes that attracted the inflows and their subsequent reversal, in particular the failure of post-crisis adjustment policies.

Policy-Induced Capital Inflows

After the declines in income growth that occurred as countries attempted to produce current account surpluses after 1982 large enough to meet outstanding debt service proved politically unacceptable, the Brady Plan shifted the focus of the resolution of the debt problem from policies to create large current account surpluses by reducing activity levels to policies that would allow Latin American countries to access the international capital markets in order to refinance their outstanding debt to commercial banks syndicates in the US and Europe by shifting it to the private sector institutional lenders in those countries.

Latin American countries were encouraged to introduce changes in their domestic policy framework to make them more attractive as destinations for international portfolio and direct investment flows. The primary objective of domestic stabilisation policies in addition to the elimination of inflation was thus the creation of conditions that would allow the countries to return to international capital markets to refinance their outstanding indebtedness and their existing levels of external deficits. The preferred avenue was via the stabilisation of exchange rates and rapid return to full convertibility of currencies at a targeted exchange rate or fluctuation band. Thus Mexico and Brazil introduced regimes with tight fluctuation bands and Argentina a fixed rate of exchange for the peso to the US dollar through the Convertibility Law. All experienced substantial real exchange rate appreciations.

These stable exchange rate regimes were supported by policies to introduce market-based resource allocation through reductions in the role of government in the economy through privatization of state-owned enterprises, deregulation of financial and goods markets, and the creation of primary government budget surpluses. Tight restriction on expansion of the domestic money supply were put in place and domestic markets were opened to competition from foreign imports to reinforce the price stabilisation policy.

The privatization of state-owned enterprises through direct sale or by floatation in domestic equity markets also served to draw the attention of foreign portfolio investors to what were to come to be known as “emerging equity markets”. Further financial market deregulation, capital account liberalisation and creation of domestic equity markets were introduced to encourage capital inflows to purchase domestic financial assets and provide foreign exchange to repay, and the opportunity to refinance debt.

The basic difference from the multitude of previous failed attempts to fight hyperinflation, and the major reason for the success of these policies in eliminating inflation so rapidly was that the rise in domestic incomes and consumption and imports, along with the decline in domestic export competitiveness that was caused by real or nominal exchange rate appreciation resulting from the use of an exchange rate anchor did not produce a balance of payments crisis because capital inflows were more than sufficient to cover the external deficits and caused reserves to increase and reinforce market perceptions of strength. Thus, it was the Brady Plan and the success of the

structural adjustment policies to open investment opportunities in conditions of low inflation that brought the capital inflows that would be produce the reversal and the crisis of the 1990s as the policies failed to deliver long-term increases in growth and profitability. A number of factors that were crucial to the success in fighting inflation were also important in preventing a return to sustained growth.

In most countries successful inflation reduction was accompanied by real appreciation of exchange rates, excessively high real interest rates and weak domestic demand that caused deterioration in external accounts and dampened incentives to invest to increase domestic productivity. Instead the capital inflows had little impact on domestic savings, and were primarily in portfolio assets rather than real assets.

Thus, although most Latin American countries introduced market-based stabilisation policies that achieved success in eliminating inflation and have been praised for introducing policies that produce good “macroeconomic fundamentals” they have not been able to harness trade as an engine of stable growth in per capita incomes.

The successful policies adopted to produce stability in macroeconomic fundamentals – low inflation, primary budget surpluses and control of the money supply, overlooked more traditional macro economic fundamentals such as high levels of aggregate demand, low real interest rates and competitive real exchange rates. As a result they created an overall macroeconomic environment that impeded the required structural changes at the micro level, and this failure has recreated difficulties at the macro level that appear to have undermined the sought after return to growth and financial stability. In addition, these changes at the macro level have made these economies less responsive to traditional stabilisation policies, and thus have tended to aggravate the response to crisis when it has occurred.

Five areas can be identified in which the structural adjustment policies undermined the stability of the macroeconomic fundamentals and the adjustment of the production structure. The first is the overvaluation of the exchange rate, the second is the high level of real interest rates, the third is the composition of the fiscal budget, the fourth the composition of the external account and the fifth the failure of adjustment of the industrial production structure to reduce the dependence of increased investment and increased export capacity on imported inputs.

Exchange Rates

Success in fighting inflation in the presence of a stable nominal exchange rate produces real exchange rate appreciation that in the presence of unilateral trade liberalisation makes it more difficult for domestic industry to respond to the new price and productivity structure after opening the domestic economy to global competition through trade. While overvaluation of the exchange rate is beneficial in reducing the price level of imported goods and creating competition for domestic producers, it also allows foreign importers to gain competitive advantage relative to domestic producers if domestic producers cannot adjust their cost and production structures rapidly while

foreign producers are simply faced with expanding output, which can be done rapidly in conditions of excess capacity.

Interest Rates

Tight monetary policies that were considered necessary to bring inflation under control, as well as the perceived need to provide attractive returns to external investors in order to ensure the capital inflows to refinance outstanding debt and to provide finance for the modernisation of domestic industry, produced nominal interest rates that were extremely high, and in conditions of rapidly falling inflation rates translated into extremely high real interest rates. Thus, on the one hand, domestic industry faced excessively high interest rates to finance restructuring, while banks, who during hyperinflation had ceased to provide credit to the private sector, found it more attractive to increase holdings of high yielding government securities, often financed by borrowing at cheaper external interest rates, or to take advantage of the deregulation of financial markets to offer credit to consumers. Business firms, facing a lack of domestic credit and extremely high domestic interest rates also were attracted to borrowing abroad at much lower rates of interest, creating increased foreign exchange exposure that was usually not hedged because of the confidence in exchange rate stability created by the elimination of inflation and the return of foreign capital inflows. The result was that domestic banks concentrated in financing government debt and provided virtually no lending to the private business sector, although consumer lending was expanded as a result of deregulation, while the private sector business financed production either from own funds or by borrowing at lower rates in foreign currency from abroad, creating implicit asset liability mismatches and increased financial fragility.

On the other hand, governments found themselves in the position of having to refinance and issue new debt at real interest rates that were far higher than real domestic growth rates, creating conditions in which reduction in the debt burden became impossible, irrespective of the restrictiveness of the government's financial policy. Indeed, the restrictive fiscal policy often only served to depress domestic activity and tax yields, thus increasing the size of the deficits to be financed, while it did little to reduce government borrowing costs that were set by international risk premia.

One of the basic reasons for implementing anti-inflation policies linked to exchange rate stability was that these policies would bring about a decline in interest rates and thus a decrease in financing costs that would provide support for investment. High interest rates were believed to be caused by a large inflation premium and the risks of exchange rate depreciation. Lower inflation would reduce the inflation premium and exchange rate stability would reduce exchange rate risk, bringing about a reduction in nominal interest rates that would provide a boost to domestic investment without any negative impact on external capital inflows. Indeed one of the main justifications for pegging the peso to the dollar under the Convertibility Law was the expectation that domestic interest rates would converge towards those prevailing in the US. However, the need to attract international capital and induce residents to maintain local currency deposits along with differential credit risks of Latin American financial institutions offset

much of the benefits of lower inflation and exchange rate stability.

Further, the deregulation of financial markets increased the costs of financial transactions in domestic credit markets disproportionately for small and intermediate businesses that did not benefit from the preferential access accorded to large businesses in international capital markets. The differential in interest rates and disparate financial costs contributed to the consolidation and concentration of private national economic groups in many countries in the region. The persistence of large interest rate differentials also generated inflows based on interest rate arbitrage similar to those that had been prevalent in Asia.

Government Expenditure

As a result of the resumption of external debt accumulation that was inherent in the success of the Brady Plan, a structural shift in the composition of government expenditures on current account occurred. First, rapid and unforeseen declines in inflation tended to increase labour costs as a share of government expenditures as wages adjusted less rapidly than commodity prices. At the same time the increasing debt burden and the failure of interest rates to fall increased the interest component of current government expenditures. With fiscal austerity measures aimed at balancing the budget, declining expenditures on goods and labour services were in many cases offset by the fall in income and thus tax yields and the increased interest service on outstanding debt due to the increased indebtedness and the higher real interest rates. This negative impact on the government finances was reinforced by the negative carry on the increased reserves due to the difference between the domestic interest rate paid on the bonds issued to sterilize the capital inflows, and the developed country short-term rate earned on the deposit of the reserves in dollars in New York.

External Account Balances

A similar shift occurred in the composition of the current account as the share of factor services increased relative to goods and services trade as a result of the increasing size of debt service payments. This shift was further reinforced by the fact that with global financial integration an increasing share of domestic government debt was being held either directly or indirectly by non-residents. In addition, the sharp increase in direct investment flows also increased non-resident claims on current account in the form of non-repatriated profits. Thus, just as the interest cost of government debt became an increasingly important component of government budgets, factor services became an increasingly important component of the current account balance for countries engaged in successful structural adjustment to conditions of hyperinflation.

Changed Response to Economic Policies

The return of substantial capital inflows and the shifts in the structure of internal and external account balances that resulted brought about an important change in the way these economies responded to traditional stabilisation policy measures. For example, in Argentina the rapid increase in the external deficit after stabilisation was not a cause for

policy concern since under its currency board system it was considered impossible for the central bank to provide financing for a fiscal or an external deficit. Instead an autonomous adjustment mechanism similar to that which was presumed to have existed under the gold standard was expected to operate. Any deficit on the external account that was not financed by the private sector would produce an outflow of foreign exchange reserves and thus a decline in the domestic money supply that would cause domestic wages and prices to fall, restoring external competitiveness, increasing exports and reducing imports until external balance was achieved. However, this automatic adjustment process can be severely disrupted if other factors determine the quantity of reserves, and other components of the external account dominate trade in goods and services. As a result of the liberalization and deregulation of domestic goods and financial markets after the introduction of the Convertibility Law in Argentina, private capital inflows more than offset the current account deficit. Indeed, up to the period of the Tequila crisis non-financial private sector inflows alone more than covered the current account deficit. Although the Central Bank did not finance the current account deficit, external creditors did, and as a consequence the constraint on domestic money supply growth was inoperative. Indeed, the flows were so large as to create impetus in the opposite direction. There was thus no automatic adjustment to assure external equilibrium.

There is an equivalent argument for the automatic adjustment of the fiscal balance since under the currency board system the central bank cannot monetize government debt unless it also acquires foreign exchange. Thus, when government fiscal receipts fail to cover its expenditures it must either increase taxation or reduce expenditures unless it can borrow from the private sector. Any of these responses should have the same general effect of reducing domestic demand and exercising downward pressure on wages and prices. This should cause imports to fall, exports to rise and external demand to expand sufficiently to offset the fall in internal demand. However, this adjustment mechanism can also become inoperative because of external capital flows. For the first half of the decade the government could count on revenues from the sale of state-owned property, and in the second on a captive market for government debt created by reform of the pension system and of the banking laws.

Thus as long as private sector lenders are willing to finance imbalances, the automatic adjustment mechanisms may not function as expected. It is often argued that no action should be taken to offset such flows since they are the expression of the private market – known as the Lawson Doctrine – nonetheless they offset the possibility of the market providing the automatic adjustment to external and internal imbalance that eventually produces financial crisis.

The build up of external and internal indebtedness that large private sector capital inflows create also means that there is a change in the way economies respond to Keynesian policy measures. By cutting government expenditures traditional Keynesian balance of payments adjustment policies aim to create a fiscal surplus that is reflected in a balance of payments surplus as declining incomes reduce imports and the resulting excess productive capacity is directed to increasing exports. But, when fiscal expenditures and external claims are dominated by debt service payments, policies that

influence income levels may have little impact on net internal and external balances. If the restrictive demand policies increase international risk premia because international investors view falling growth and profit rates as increasing the likelihood of exchange rate adjustment or of a reversal of stabilisation policy, the resulting increase in interest costs may more than offset any improvement in spending, leading to a deterioration in the accounts. The basic difficulty is that while government expenditure policy may influence imports and exports of goods and services, the debt service component of internal and external expenditure is determined by other factors such as international interest rates, the maturity structure of the debt and repayment patterns over which governments have little direct control.

Thus, while Mexico, Brazil and Argentina all managed to tame high or hyperinflation and enjoyed exchange rate stability, booming financial markets and rising foreign investment, by the middle of the 1990s they were also experiencing rising external and fiscal deficits, increasing external indebtedness and faltering growth performance. The underlying logic of the Washington Consensus that import substitution growth strategies could be replaced by eliminating inflation distortions and restoring the profitability of investment so that resources were more efficiently allocated, and by foreign direct investment creating a competitive export platform to eliminate the external constraint, proved to be mistaken.

Post-Crisis Recovery Experience in Brazil, Mexico and Argentina

There is one common characteristic of the recovery in all three countries – the crisis forced countries to abandon their exchange rate policies and thus the need for the highly restrictive money and fiscal policies that had been necessary to attract the external inflows needed to keep exchange rates stable or fixed. The possibility to relax policy provided an opening for recovery and higher growth that was experienced in all countries. However, both Brazil and Mexico took measures to restore their prior policy stance, although with nominally flexible exchange rates. Their expansions were thus short-lived and they were soon experiencing a return of capital inflows and exchange rate overvaluation in conditions of low trend growth. Argentina on the other hand chose policies to explicitly reject a return to externally financed growth and promoted growth with low interest rates and a policy of stabilization of the real exchange rate. It has experienced higher than trend growth on a sustained basis since 2002.

Brazil's 1999 Exchange rate crisis and recovery

In Brazil, the recovery was very short-lived as restrictive policies were quickly reintroduced. Cardoso's re-election campaign was run on the premise of maintaining control of inflation and it was assumed that price stability was linked to stability of the exchange rate. Thus, despite the deterioration of the external and fiscal balances, tight monetary and fiscal policy was maintained in order to generate the external capital inflows required to defend the Real in the face of rising unemployment and falling growth. Real interest rates that had averaged around 20 per cent in the period of the Real Plan shot up above 40 per cent in the last half of 1998. Unemployment rose from just

under 5 per cent in 1995 to over 8 per cent in 1998, while the growth rate fell from a Real Plan average of over 3 per cent to near zero in 1998. This policy was reinforced by a \$35 billion IMF support loan¹, which required maintaining current policies. Despite this “bullet proofing” attempt to convince financial markets to sustain their investments in Brazil, net capital movements fell from \$26 billion in 1997 to less than \$16 billion at the end of 1998 and foreign exchange reserves fell from nearly \$75 billion in April of 1998 to around \$36 billion in January 1999. Against a current account deficit running in excess of \$30 billion in 1997 and 1998 and without signs of improvement in either the fiscal or external balance, and with the successful re-election campaign over, the exchange rate band was abandoned in January of 1999. The result was extreme exchange rate uncertainty in which the Real surpassed 2 Reals to the US dollar and then stabilized. Against conventional expectations, the inflation pass-through was moderate and produced and allowed a permanent devaluation of the currency. When Arminio Fraga was appointed to head the central bank, he introduced a policy of guiding interest rates downward, while the government persisted in its policy of running primary surpluses. The result was a short-term spurt in growth in 2000 that was quickly reversed by the contractionary policies at the end of the Cardoso administration and the speculation surrounding the incoming Lula administration that largely adopted the policy stance of the outgoing government.

Real GDP Growth

1994 – Real Plan	5,33
1995	4,42
1996	2,15
1997	3,38
1998 Re-election Cardoso	0,04

¹ Mr Camdessus described the programme as combining “large up-front fiscal adjustment of over 3 percent of GDP with reforms of social security, public administration, public expenditure management, tax policy and revenue sharing that confront head-on the structural weaknesses that lie at the root of the public sector's financial difficulties. Within this framework of structural reforms, Brazil's three-year fiscal program targets primary surpluses of 2.6 percent of GDP in 1999, 2.8 percent in 2000, and 3 percent in 2001. The Brazilian authorities are also committed to further opening up the economy, ensuring firm monetary discipline and macroeconomic stability, and maintaining the current exchange rate regime, while reinforcing the exchange reserves and improving the competitiveness of the economy. The way is now open for the international community to provide financial support to Brazil that will enhance market confidence in the government's economic policies and help ensure the success of the country's program.

Official creditors, multilateral and bilateral, will provide support totaling more than \$41 billion over the next three years, roughly \$37 billion of which is available, if needed, in the next 12 months. I say “if needed” because this is a program which has an important precautionary character, and Brazil, of course, feels free to draw on the resources for their entirety or only in part. I believe that the soundness of Brazil's program and the authorities' commitment to it together with the strong support demonstrated by the official international community provide the conditions for Brazil's private creditors now to act to help ensure its success.

1999 Exchange Rate Crisis	0,25
2000	4,31
2001	1,31
2002 Election Lula	2,66
2003 First Lula Government	1,15
2004	5,71
2005	2,94
2006	3,70

External Capital Inflows

1994 T1	5.887,6450
1994 T2	4.234,6090
1994 T3	-1.193,4280
1994 T4	-236,6180
1995 T1	136,9580
1995 T2	5.400,5710
1995 T3	16.634,2000
1995 T4	6.923,7250
1996 T1	8.663,9542
1996 T2	8.219,2915
1996 T3	4.564,0731
1996 T4	12.520,7506
1997 T1	5.144,5046
1997 T2	8.233,9516
1997 T3	10.738,1684
1997 T4	1.683,7152
1998 T1	23.510,0762
1998 T2	13.329,8085
1998 T3	-16.676,0971
1998 T4	9.537,8648
1999 T1	-5.155,4805
1999 T2	15.650,9156
1999 T3	6.007,0547

1999 T4	816,6492
2000 T1	8.382,1089
2000 T2	-5.101,8779
2000 T3	7.528,9158
2000 T4	8.516,6545
2001 T1	7.914,6851
2001 T2	9.813,9158
2001 T3	7.619,0352
2001 T4	1.704,6243
2002 T1	4.685,6994
2002 T2	9.422,9977
2002 T3	-4.494,4461
2002 T4	-1.609,8249
2003 T1	4.156,8154
2003 T2	4.968,5900
2003 T3	918,6762
2003 T4	-4.933,1400
2004 T1	1.345,9124
2004 T2	-3.243,0883
2004 T3	-5.226,8313
2004 T4	-398,8621
2005 T1	7.692,1796
2005 T2	-3.325,4538
2005 T3	-8.239,4300
2005 T4	-5.591,3434

2006 T1	4.276,3027
2006 T2	1.624,7088
2006 T3	2.747,8742
2006 T4	7.678,3727
2007 T1	22.114,0498

The Recovery from the Mexican Crisis of 1994-5

Mexico, like Brazil had followed a policy of currency stability through an exchange rate band, and experienced capital inflows more than sufficient to cover its rising external and internal imbalances. At the end of 1994 just as the NAFTA treaty was being implemented, and following a period of modest economic growth, but with increasing political turmoil surrounding the change in government and the announcement of a revolutionary movement in the South, foreign investors loss confidence in the ability of the government to maintain its exchange rate policy. Short-term government liabilities could not be renewed and the peso collapsed. The IMF with the aid of the US and other governments produced one of the largest aid packages ever granted.²

² “The International Monetary Fund has approved an 18-month stand-by credit for Mexico of up to the equivalent of SDR 12,070.2 million (about US\$17.8 billion) in support of the Government's 1995-96 economic and financial programme. Of the total, SDR 5.259 million (about US\$7.8 billion) or 300 percent of Mexico's IMF quota¹ --is available immediately. As previously announced, the remaining SDR 6,810.3 million (about US\$10 billion) will be provided by the IMF to the extent that contributions of governments and central banks fall short of the targeted amount of US\$10 billion. This is the largest-ever financing package approved by the IMF for a member country, both in terms of the amount and the overall percentage of quota, 688.4 percent.

The program's specific objectives for 1995 are: (i) the reduction in the external current account deficit from 8 percent of GDP in 1994 to 4 percent of GDP in 1995, and to 3-3 1/2 percent of GDP in 1996; and (ii) a lowering of the annualized rate of inflation to around 9 percent in the fourth quarter of 1995, from more than 30 percent in the first quarter of the year. Economic activity is expected to decline in the first half of the year, as the effects of the change in relative prices and the financial adjustment work through the economy. However, it is expected to recover in the second half of the year as financial conditions stabilize. Real GDP should grow by around 1.5 percent for 1995 as a whole.

To achieve these goals, the program is centered on a policy of wage, price, and credit restraint supported by an improvement in the fiscal position. The revised 1995 budget for the nonfinancial public sector provides for a fiscal surplus of 0.5 percent of GDP (compared with a balanced position in 1994), and a primary surplus (the overall balance excluding interest obligations) of 3.4 percent for the year as a whole, compared with a primary surplus of 2.6 percent of GDP in 1994. The contribution of the public sector to the adjustment process is to be particularly large in the first half of 1995. Moreover, the authorities stand ready to strengthen the public finances through additional measures if necessary.

The fiscal tightening should help to achieve an early stabilization of financial and exchange markets, and the measures can be expected to boost savings and result in a substantial reduction in imports. In addition, an acceleration in export growth should result from the real depreciation of the currency.

The policy on wages and prices that has been formulated within the context of the Agreement of Unity to Overcome the Economic Emergency signed between the Government, the Bank of Mexico, and the labor and business sectors, will set the path for the evolution of wages and public sector price rises during 1995. This agreement implies a significant reduction in real wages on average and represents a major contribution

In exchange for the funding programme Mexico was required to implement a drastic adjustment package, similar to those seen in Asia after the 1997 crisis. Restrictive fiscal and monetary policy and wage controls formed the traditional structural adjustment policy. The result was a deep decline in output and employment of over 6%, and over 5%, respectively, with inflation shooting up to around 51% in 1995.

However, much like Brazil, the crisis was quickly reversed and the economy started to recover in the third quarter of 1995, and in 1996 GDP grew over 5% and by over 6% in 1997.

The immediate and most significant trigger was the fall in private expenditure i.e. private fixed investment and private consumption. The drop of the latter was due to a 13% (seasonally adjusted) decline of real wages. The reduction in government expenditure was also a contributing factor to the decrease of demand and output, but of lesser weight. On the other hand, non-oil exports responded quickly and robustly to the large depreciation of the peso, and the domestic receipts from oil exports also rose. The large improvement of the trade balance from the downward adjustment of imports and the growth of exports supported the level of demand and economic activity.

While the collapse in demand and output was partially offset by the growth of net exports, the growth of exports proved to be the single most important factor contributing to the recovery, with both oil and non-oil exports growing at a high rate. Eventually imports recovered, and the import coefficient also rose. The decline in government expenditure also reversed and offset its decline during the downswing -- the growth rate from the quarter prior to the crisis until the upper point of the recovery exceeded the rate of growth of GDP. Private expenditure, however, did not recover from its decline during the downswing, and both consumption and fixed investment were lower at the upper point of the recovery than they had been prior to the crisis (8% and 22% below, respectively).

Although employment was restored to its pre-crisis level, average real (manufacturing) wages did not recover. In fact they were 23% lower at the upper point of the recovery than in the quarter prior to the crisis.

on the part of labor to set the basis for a resumption of growth. Wage policy under the agreement provides for an increase of 7 percent in minimum and public sector wages, and an additional 3 percent through an income tax credit for workers with incomes of up to twice the minimum wage. Contractual wage negotiations will adhere to these guidelines and, in addition, will include productivity bonuses freely negotiated between labor and business. The pact also limits the increase in public sector tariffs during 1995 to about 10 percent, or about two thirds of the expected average rate of inflation. The price strategy will result in a revenue loss for the public sector (of about 0.6 percent of GDP) that will be compensated by other fiscal measures. The authorities recognize the need to address price distortions that may result from these measures in due course.

Credit policy will play a critical role in achieving the objectives of the program. The monetary program establishes a limit on the growth of net domestic assets of the Bank of Mexico of MexN \$10 billion in 1995, compared with MexN \$60 billion in 1994.”

The net additional demand generated by the government on the domestic market, deducting foreign interest payments, gives total government domestic expenditure (which is equal to government expenditure on goods and services, plus government transfers and wages, plus domestic interest payments). The deficit should refer to government expenditures over and above those financed with taxes levied on the population which in Mexico includes government revenues from ownership of the oil industry. Thus when a rise in the price of oil allows the government to increase domestic expenditure without changing the deficit, it will nonetheless create a net additional demand.

Thus, to see the impact of fiscal policy the government domestic deficit should be defined as the difference between government domestic expenditure and government domestic revenue. According to estimates made by Julio Lopez, during the both the eighties and nineties, Mexico has always maintained a positive, and relatively high, domestic deficit of around 17% of GDP in the first decade, and 6% in the 1990s. That is, thanks to the ownership of the oil industry the government has been able to exert an important positive influence on effective demand, thus stimulating employment and private profits. Also, revenues accruing from the oil industry have permitted Mexico to have a very low rate of taxation, which, obviously, has minimized social conflict.

Government expenditure and the domestic deficit fell until the third quarter of 1995 and from then onwards they both recovered remaining at a relatively high level during 1996. Finally, there is a tandem movement in the domestic deficit and total government expenditure. Indeed, the reductions of the former from a peak in the first quarter of 1996 did not provoke a fall in government expenditure, which further grew for two additional quarters --but now financed with the expansion of domestic government revenue ensuing from the recovery.

All in all, then, we can conclude that both the domestic deficit and total government expenditure played an important role in triggering the recovery, by sustaining the domestic demand and private profits when other components of domestic demand were dramatically falling. Of course, when the recovery had gathered momentum, other factors, e.g. the revival of private domestic expenditure, ensured its continuance.

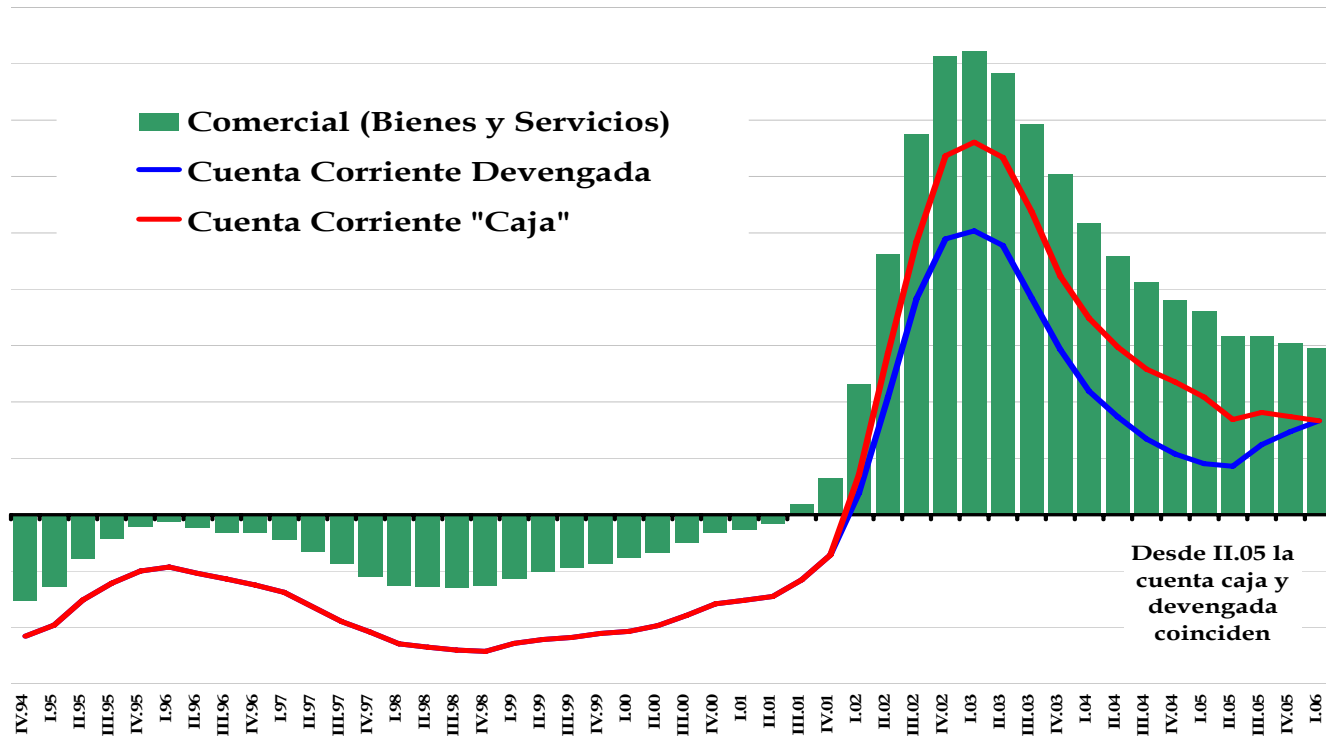
Was the increase in the domestic deficit the consequence of a deliberate counter-cyclical policy? I think that only to a minor extent. In fact, during a first stage (i.e., until 1995.III) the government tried to follow the orthodox receipt, and contracted its expenditure. But with the rise in oil prices and the devaluation there was no need to continue to cut expenditure, because the total budget was balanced. The rise of the price of oil along with the devaluation of the currency was then an important factor which explains the fiscal policy stance.

Argentina's Recovery from the 2001 Default

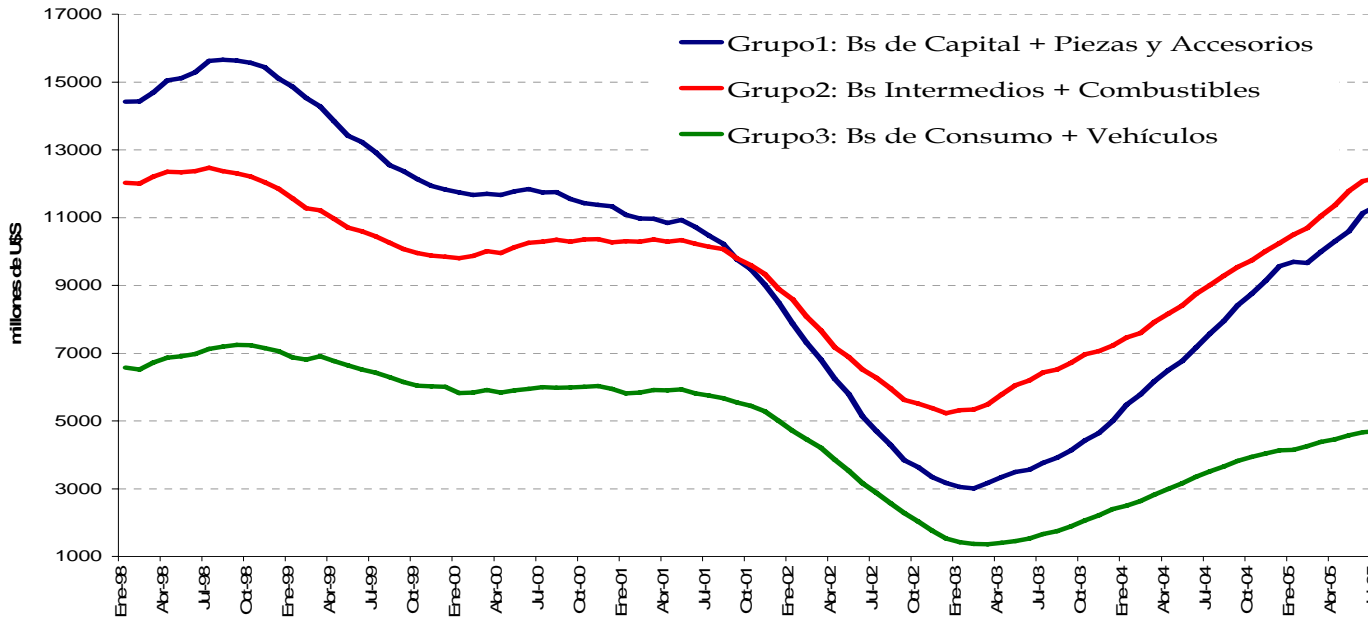
The political stalemate that followed the resignation of the government and the Christmas Eve default of Argentina's sovereign debt meant that there was little time for a formal change in economic policy. However, the elimination of the need to meet external and

internal debt service automatically created a less restrictive policy that was reinforced by the market-led devaluation of the exchange rate that followed the revocation of the Convertibility Law and the sharp increase in the terms of trade of Argentina's main agricultural exports. Thus, the initial response was a sharp increase in exports and a collapse in imports due to the deepening recession.

Cuenta Corriente Devengada y Caja (ult. 4 trim, en % del PIB)



Importaciones por Uso Económico



The newly elected government chose to concentrate on domestic recovery and thus did not seek a rapid conciliation with creditors. Rapid reconciliation with creditors had been supported by the Fund in order to allow Argentina to return to international capital markets to borrow to meet arrears in debt service. This had been the policy in the Brady solution and all subsequent crisis resolution. But, as argued above, this does not provide a real solution to the crisis, but simply uses additional borrowing to replace prior borrowing.

However, in the case of Argentina at the end of 2001 IMF had declined to continue to support the government program, following suggestions by the US Treasury Secretary Paul O'Neill that the past history of IMF supported bailouts of debtor countries has created moral hazard amongst creditors who had come to believe in an IMF guarantee on emerging market debt. He also argued that the threat of contagion producing systemic instability in international capital markets that had been used to justify IMF support was more theoretical than real. As a result, not only did the IMF withdraw support, it failed to provide support for the Argentine recovery program as had been the case of Brazil and Mexico.

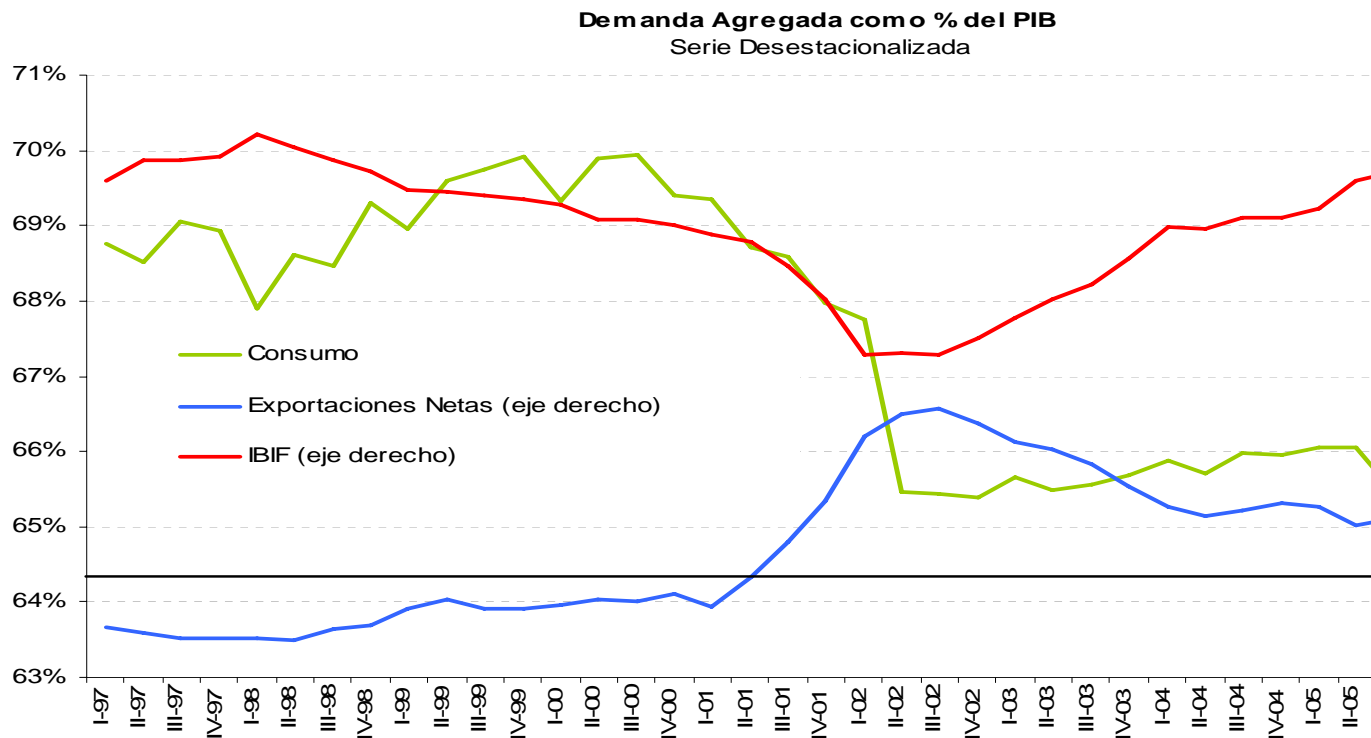
Instead, the government argued that only by returning to sustained growth could Argentina make a credible commitment to sustainable debt repayment. Thus, the question at issue between the government and the IMF was whether the new government's surplus target would be one that maximized the probability of sustained growth (and thus implicitly also maximized the amounts received by creditors) or whether the surplus target would be one that maximized the amounts received by creditors (and thus implicitly jeopardized domestic growth and maximized the risk of another default and rescheduling in the short period). In response to the Fund's insistence on the latter stance Argentina noted that while the Fund's new strategy of market resolution was supposed to remove the moral hazard guarantee created by a Fund bailout, by supporting a policy that

favoured the interests of the creditors, the Fund was still creating moral hazard, only now at the expense of Argentine citizens who are being asked to forego growth in order to repay debt at 100 per cent of its face value.

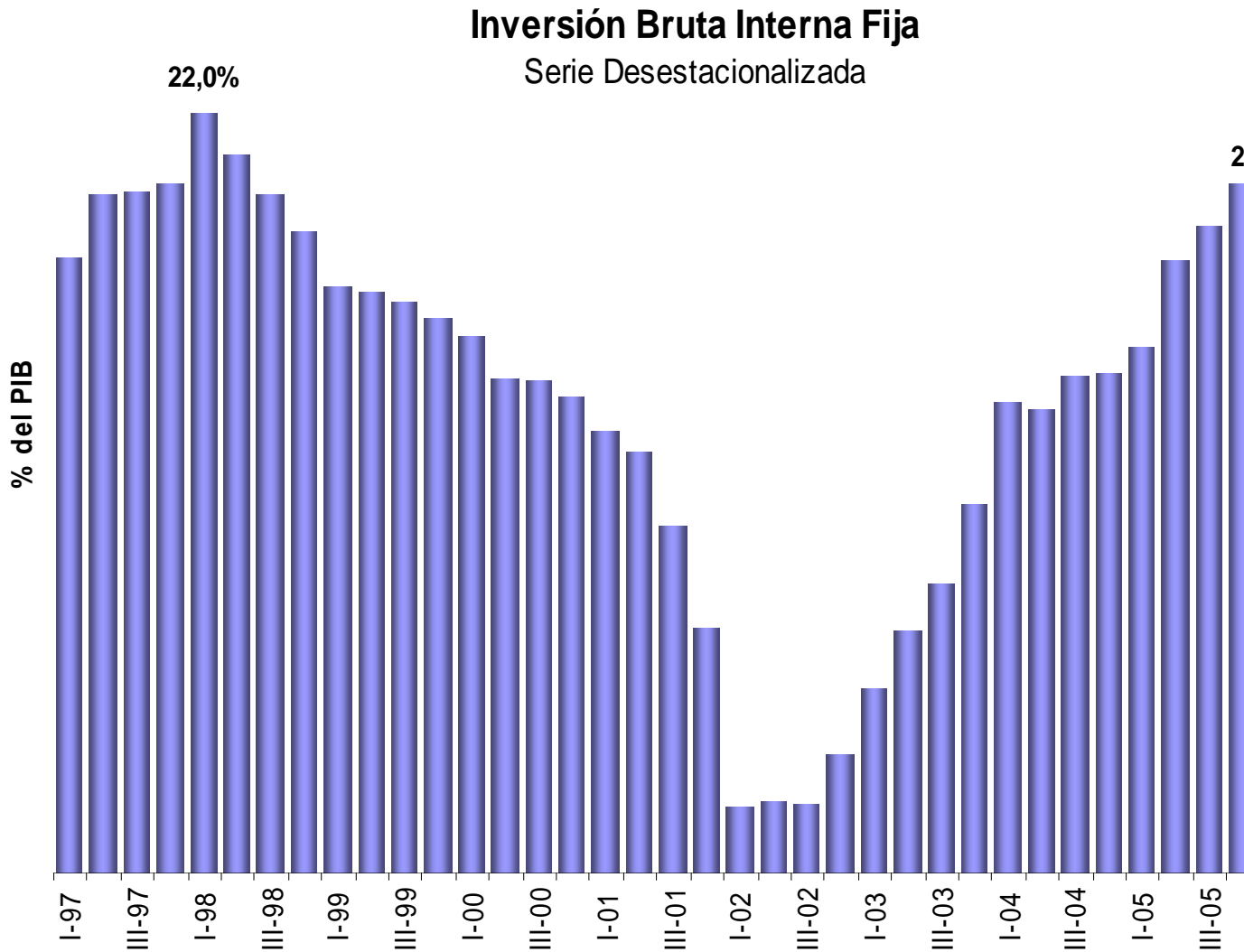
Indeed, a high Fund official has confirmed that because of the Fund's position as a preferred creditor to Argentina it was required to give priority to the interests of the private creditors. He argued that if the IMF did not participate in the debt restructuring process then its position as a privileged creditor could be questioned and this would cause irreparable damage to the ability of the IMF to lend. As a result, he argued that the Fund must be involved in determining the fiscal policy of the debtor because it makes no sense to follow a policy that leaves the determination of fiscal stance above and beyond what is necessary to meet the debt service to the multinational lenders to the debtor and the private creditors independent of the IMF since it is the IMF that judges the sustainability of the debt restructuring that is reached with the private creditors.

The government argued that a surplus of 3 per cent of GDP along with a restructuring package repaying approximately 25 percent of the debt would satisfy the requirement of producing sustained growth. Argentina eventually repaid all of its outstanding borrowings to the IMF in order to maintain its policy autonomy. At the same time, the government refused to use tight monetary policy to return to foreign markets, instead using a policy of negative real interest rates to support the restructuring of the financial system and investment.

While net exports provided the initial impetus to the recovery of demand and the creation of internal liquidity and the increase in tax yields due to a tax on exports, internal demand soon became the driving force behind the recovery.

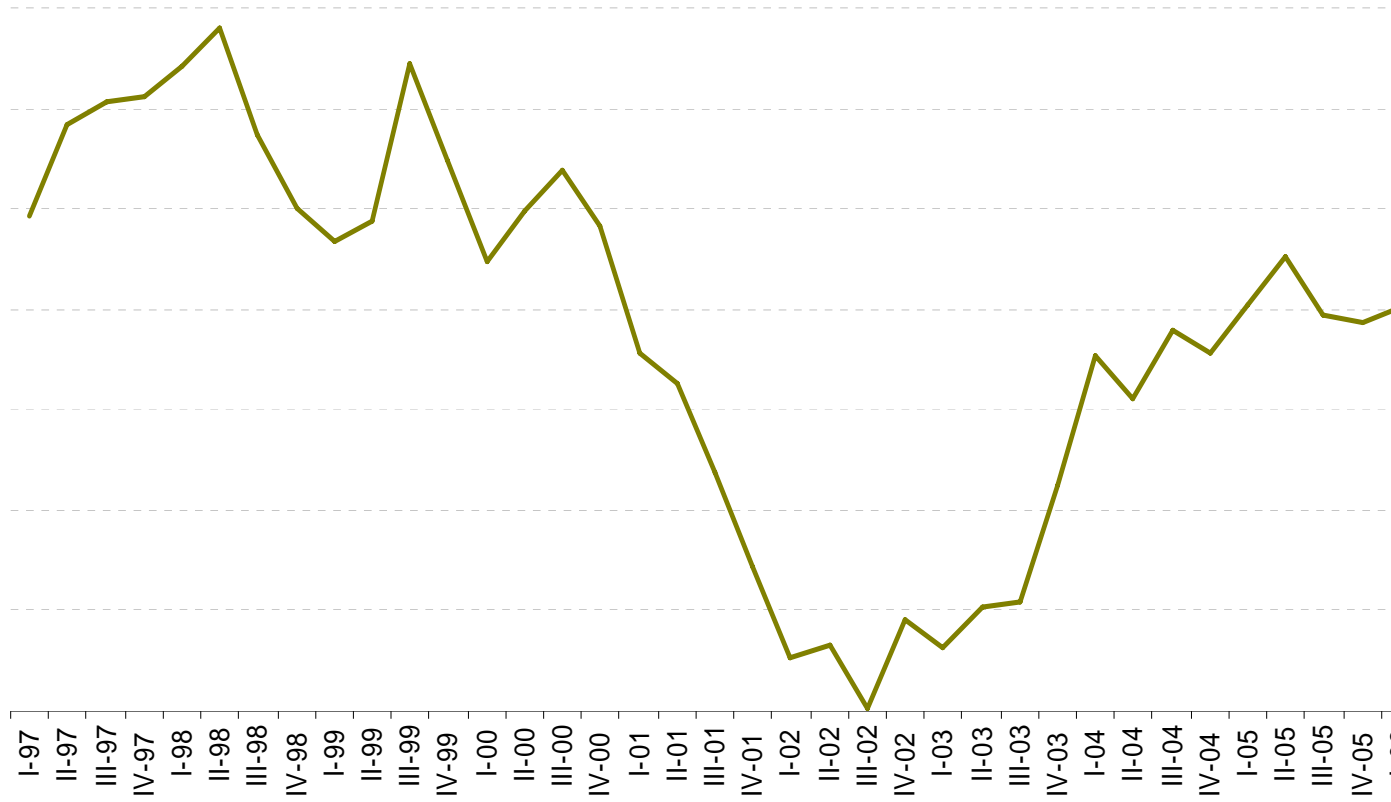


In particular, investment recovered sharply, and the decline in



national income of nearly 11 per cent in 2002 was followed by an expansion of over 8 percent in 2003 (peaking at an annual quarter on quarter rate of over 16 percent in the second quarter of 2003). In a response similar to that of the Brazilian economy in 1999, removing the fixed exchange rate target allowed highly restrictive policies to be relaxed.

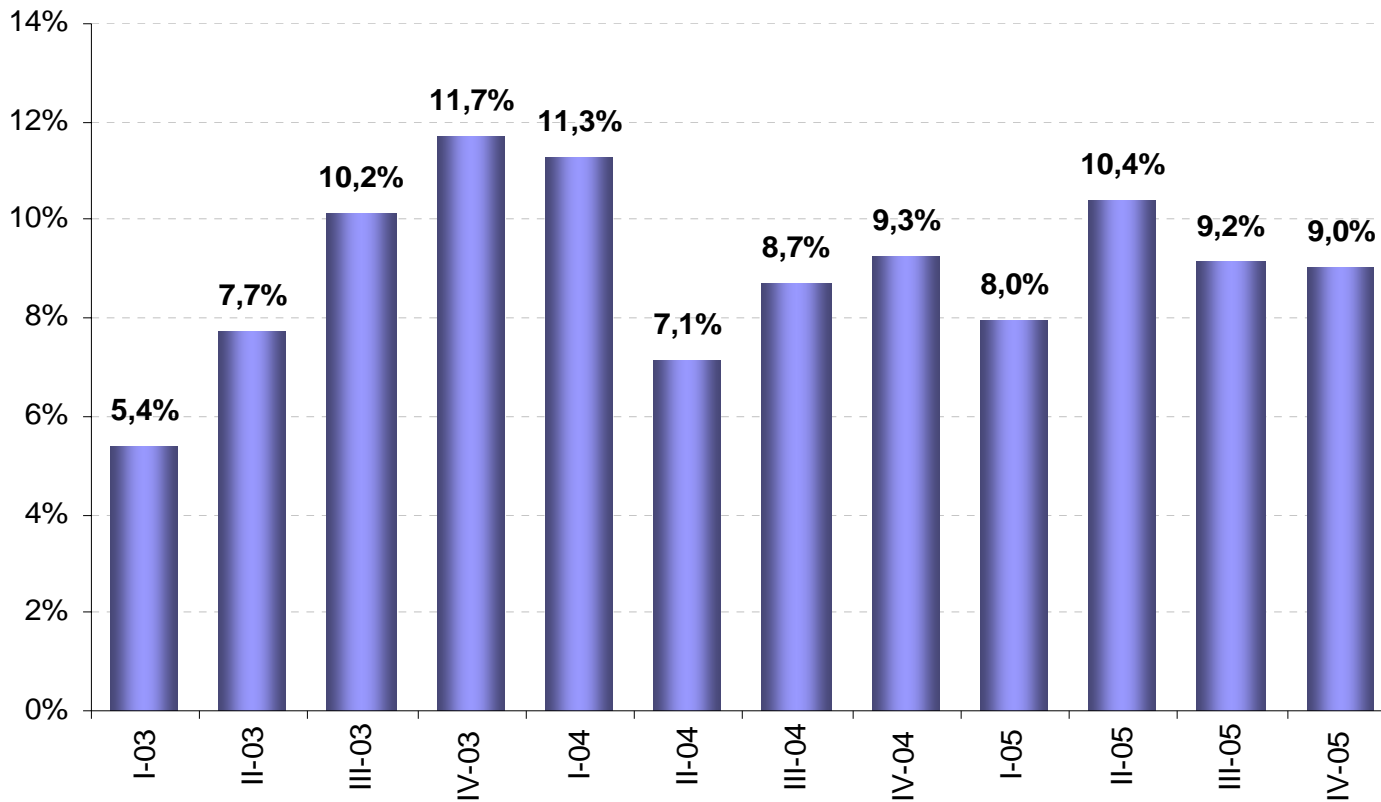
Equipo Durable como % de la IBIF (a precios de 1993)



The recovery in economic activity dates from the last quarter of 2002 when output increased by a modest 1.2 per cent over the third quarter. However the recovery has not been as smooth and sustained as indicated by the annual growth rates either when calculated on a year on year basis, or by annual rates calculated on the basis of comparison with the same quarter a year earlier. These annualized rates have been positive since 2003.

PIB

Tasas de Variación Interanual



A particular characteristic of the recovery has been the stability of nominal salaries in the private sector (around 50 per cent of total employment) that remained negative in real terms until around 2004, when real increases were enjoyed. However, the public sector is still showing negative performance with relation to the pre-crisis period. This does much to explain the stagnant behaviour of consumption expenditures. Despite the rising levels of employment, the reduction in the poverty ratio and the gini coefficient, the recovery has largely been to increase profits in the agro-business and manufacturing sectors at the expense of wages. As inflation is starting to resurface, this represent a potential hazard to the continuation of recovery.

Thus, the positive Argentine recovery can be traced to the decision to forgo a return to policies of external savings financed investment and flexible exchange rates without capital controls. Indeed, although it was warned that it would never be able to borrow in international capital markets after the restructuring agreement, Argentina has found it necessary to introduce Chilean style controls on capital inflows.

Financiamiento de la inversión por origen del ahorro

