

Don't Cry Yet for Argentina's President De la Rúa

by Carlos Alfredo Rodriguez

BUENOS AIRES: After ten years of democratic rule under President Carlos Menem, Argentina's transition to its new president, Fernando De la Rúa, has been swift and smooth. The ease of change from Peronist rule to the center/left Alianza signals Argentina's democratic maturity. Stability prevails in financial markets; country risk fell 300 basis points between July and the day De la Rúa assumed power; industrial production grew 14.9% in the second half of last year.

Policy continuity eased this change of regime. Sensibly, the new government maintained "Convertibility", the local name for a Currency Board system that sets a 1:1 exchange rate between the peso and the US dollar. Yet despite this, De la Rúa's government denounces President Menem's economic legacy, claiming that fiscal irresponsibility had nearly incited a run on the banks and currency. That catastrophic assessment led the new government to enact a tax package which hiked taxes on middle income wage earners and exempted earnings from dividends or interest. Tax evaders were offered deals to repay overdue taxes.

Nothing angers paying taxpayers more than having their taxes raised while shirkers get special breaks. Economists, although they praised the idea of balancing the budget, sharply criticized the means. Moreover, persistent effort to blame everything bad in Argentina on Menem's administration boomeranged: people viewed it as a smokescreen for a lack of leadership.

Such finger-pointing has a price. During the new government's first three months, trends in industrial production, services, construction, consumption and, worst of all, tax collection reversed. Although nominal GDP was expected to be 2% higher (in annual terms) in the first quarter of 2000, nominal tax collection fell by 1.5 %, exposing the inadequacies of De la Rúa's tax package.

Government economists now accept that recovery will be slow, but expect improvements due to lower interest rates and higher exports, even though both may only be the result of ongoing slowdown. The banking sector, indeed, is showing excess liquidity as a result of a fall in demand for credit. To counteract this, a reduction in bank reserve requirements is expected, although this cuts against the rules of Convertibility and cause a fall in international reserves.

The financial system, still strong thanks to Convertibility and a buoyant global economy, favor recovery – but a later recovery. Nothing, however, indicates that Argentina will grow again at the 5% to 8% rates of the 1990's.

For growth and investment to improve, Argentina needs a long term strategy for integration in the world trading system which pushes productivity up. Mercosur, the regional trading pact of which Argentina is a member, served as a growth engine in the 1990's, seems insufficient to the task now. President De la Rúa cannot take Argentina out of Mercosur, yet the country cannot live permanently within it. This paradox demands a solution: muddling through will not attract investment or induce appropriate scale in new export projects. Investors need to know whether they must compete with Brazil alone or the whole world.

Under prevailing conditions, Argentina cannot compete globally. To do so requires labor market deregulation and tax reform. High employment costs and nominal tax rates promote small scale enterprises that only thrive on black market employment and tax evasion. With much industry operating at small scale, it is no surprise that many firms cannot compete internationally.

De la Rúa has not been completely idle here. A proposed Labor Reform Law is now being considered by the Peronist controlled Senate. While the proposed law does not kill all the distortions favored by unions, it is clearly a step in the right direction and may be accepted by the Peronists. Legislative approval will help De la Rúa recover lost momentum and perhaps encourage new investments.

Unfortunately, De la Rúa botched other competitiveness initiatives. Despite 14% joblessness, unemployment taxes were increased last December after three years of cuts by Menem. A law promoting small enterprises (so long as they remain small!) only increases the bias against large scale operations embedded in Argentina's high tax rates and strict labor market regulations. Reforms of the opposite sort are needed in an economy plagued by unemployment and low productivity.

Other Menem era reforms are also under threat. Privatization of much of the Social Security System was

one influential change wrought by President Menem. Some members of the ruling administration now want to allow people to voluntarily switch back to the state system, bringing with them contributions made during their years in the private capitalization system. Because the state system is based on redistribution, those extra funds are likely to be spent immediately, risking bankruptcy of the system for a second time.

President De la Rúa's worse problem is not this or that policy, but his tendency to send contradictory messages that confuse markets. In his state of the nation address he promised to increase competition in the economy, yet in the same week suspended an 'open sky' airline agreement reached with the US by the Menem administration. Perversely, he did so to defend the monopoly of a now privatized national airline which is 85% owned by foreigners.

President De la Rúa's first four months weakened Argentina's economy. His misfortunes do not seem to be ideologically motivated, but are based on an inability to see the conflicts intrinsic within his policy initiatives. Hope, however, is not lost. It took President Menem two years to find his footing and act boldly; he then delivered a death blow to inflation by implementing Convertibility in 1991. No test of that magnitude faces President De la Rúa – at least not yet. What he needs to do is abandon the politics of blame and get on with implementing a coordinated policy package designed to lift Argentina's international competitiveness.