A Simple Answer for Argentina: Follow Chile's Example

By Sebastian Edwards,

Argentina's fifth president in just over a month has survived longer than any of his three predecessors did. But whether Eduardo Duhalde will complete his term, which ends in 2003, is far from certain. The social unrest and violence that began more than a month ago continues unabated, portending disaster for Mr. Duhalde unless he does something radical to improve economic circumstances. Without growth Mr. Duhalde's days may be numbered.

Argentina's challenges are fundamentally political, rather than economic. The country's slow-motion collapse showed how hard it is to change the status quo in a relatively wealthy and closed society, even when the economic perils are clear. But the depth of the crisis now presents an opportunity to achieve what was not possible when things were more stable. No one expects Mr. Duhalde to do so out of ideology, but he would be smart to do so for political survival.

Despite the grim outlook, Mr. Duhalde's government has one great advantage: Just across the Andes there is a model of success where this all happened before. Almost two decades ago -- in June 1982 -- Chile faced a crisis hauntingly similar to Argentina's today. The peso, which for several years had been pegged to the dollar under an implicit currency-board arrangement, was devalued by 78%.

Firms and households that had borrowed massively in dollars could not pay their debts, the banks failed, and there was a huge default of private external debt. This hit eight years after Chile had initiated, under the leadership of the free-market economists known as the "Chicago-boys", a reform program that made the economy relatively more open to competition, privatized many state enterprises, and deregulated some markets.

When the Chilean economy collapsed in 1982, many observers blamed the reforms and claimed that a free-market system could not be implemented in a small developing country. In Chile then -- as in Argentina now -- the post-crisis reaction was to flirt with populism. In the period from 1982-84 the government hiked import tariffs, increased regulation and implemented industrial policies to subsidize domestic producers.

The results were dismal. After two years, the economy remained flat on its back, unemployment was rising, and inflation was spinning out of control.
Despite the military government's grip, popular dissatisfaction was growing, and the country's business leaders and political elite were also restless.

Such was the protracted misery when, in early 1985 Hernan Buchi was appointed finance minister and launched a major debt-restructuring program and a deepening of market reforms. Over the next four years GDP growth averaged 7.3% annually. Unemployment declined to 6%.

The Chilean recovery program made encouraging investment its cornerstone. A fiscal reform implemented in 1985 reduced taxes on retained corporate earnings to 10% from 46% and sharply lowered current government expenditures. By maintaining an overall fiscal balance, the government avoided unsustainable pressures on the exchange rate. Between 1985 and 1988 investment grew better than 12% annually, contributing to the recovery and subsequent GDP explosion.

The adoption of sound monetary policy and the credibility it brought was another fundamental cog in the Chilean wheel of success. Argentina lost its monetary credibility last May, when President Fernando de la Rua dismissed Central Bank Governor Pedro Pou because he refused to tinker with the country's convertibility law, which anchored the peso to the dollar. Reinstating Mr. Pou immediately as Central Bank governor would remedy a major injustice and go a long way towards assuring the public and the market.

Argentina's banking sector must be re-capitalized. It won't be easy as the recent violations of contracts and property rights -- including the mandated de-dollarization of debts of up to $100,000 -- are likely to keep private investors away. Still, the Chilean experience is instructive. There the government played an important role in repairing the financial system by following two basic principles. First, it refused to bail out owners. Rather, its cash infusions made it the owner of the banks. It then turned around and rapidly sold its stake in those re-capitalized banks, making sure that the new ownership was dispersed -- over 100,000 people became new shareholders -- and that the new banking environment was competitive. It also upgraded bank supervision to make it more modern and efficient.

Trade liberalization was another key to the Chilean miracle. The Duhalde government has made the mistake of following the pre-1985 Chilean model by raising import tariffs. The former Governor of Buenos Aires and new Minister of Foreign Affairs, Carlos Ruckauf, has stated that his main goal is to strengthen the ties with Brazil and the protectionist customs union known as Mercosur.

As the economy continues to languish though, one can only hope that Mr. Duhalde will recognize the costs of protectionism and adopt the latter-day
Chilean model of reducing import barriers. When import tariffs were cut by almost one-half in 1985, it improved life for Chilean consumers and helped generate an export revolution by making domestic producers more competitive.

Naysayers will argue that Chile reformed its economy under the guidance of a military government, making its model inapplicable to Argentina. I disagree. The fact that an authoritarian government does not face elections does not mean that economic reformers have a free hand within a dictatorship. Reformers have to convince the military -- which usually have nationalistic, state-centered views -- that their policies are appropriate. Dictators also demand results -- usually in the form of higher growth -- because they too seek to maintain some degree of legitimacy.

The democratic structure in Argentina makes the need for bold reform even more urgent. A leader willing to confront special interests would be rewarded with growth and enormous popularity. Without growth it's hard to see how Mr. Duhalde can survive politically. He can raise his chances for success if he implements social assistance programs aimed at helping the unemployed and the poor in the short-run, as Chile did in the mid-1980s.

The gravity of the Argentine crisis should not be underestimated but it is not hopeless. A pragmatic reform program will re-ignite growth and achieve social stability. The alternative is more frustration, suffering and chaos.

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