

Argentina's Structural Reforms of the 1990s

Argentina experienced serious economic and financial difficulties in the 1980s. Hyperinflation in 1989–90 finally elicited the necessary political consensus for reform. Despite areas of concern, structural reforms implemented in the 1990s have set Argentina on the path to sustained growth.

Pedro Pou

THE ARGENTINE economy fared badly during the 1980s when the first debt crisis was in full swing. Growth of real output stagnated, financial markets collapsed, prices rose as the currency steadily depreciated, and capital fled the country in pursuit of safer havens. Most public enterprises were running large deficits, and the external debt kept mounting. The central government, hampered by low tax collections and desperate for revenues, turned to the central bank for finance through the taxation of deposits and money creation. Inflation, which had risen gradually over the previous three decades, soared—reaching average annual rates of 2,600 percent in 1989 and 1990. In the face of these developments, the banking system practically disappeared. Although it tried a number of times to bring inflation under control, the central government was unable either to balance its budget or to escape its reliance on inflationary financing. The hyperinflation of 1989 and 1990 finally provided the impetus for reform, which began with the Convertibility Plan of 1991.

Trade liberalization, tax reforms

The reforms of the 1990s also included financial system reforms, liberalization of trade and the capital account, and far-reaching public sector reforms.

The removal of most restrictions on trade and capital movements significantly opened the Argentine economy. The government eliminated export taxes and most quantitative restrictions on imports, reduced import duties, and established free entry and exit of portfolio and direct investment. Public sector reform, which substantially reduced the scope of the public sector, entailed privatizing almost all of the major public enterprises and had three main results. Public subsidies to the enterprises were reduced or eliminated; the enterprises' efficiency and provision of services improved dramatically; and funds became available to cover a substantial part of the government deficit while other reforms, including of the tax system, were under way.

Tax reforms increased consumption and income taxes and gradually eliminated many of the more distortionary taxes (such as the one on exports). New and stronger laws increased the government's ability to control tax evasion, while accelerated economic growth increased public revenues. The public pay-as-you-go pension system was replaced by a system combining public transfers and private capitalization. Although the private pension system was optional for current workers, the majority switched to it. The government also reduced most industrial subsidies and encouraged the entry of new, often



Pedro Pou is Governor of the Central Bank of Argentina.

international, firms into the local market. These measures resulted in a dramatic change in the composition and prices of goods available to the public. The cumulative effect of the reforms was to enable the country to return to voluntary financing of its external public debt, which had been rescheduled under the Brady Plan (named after the then U.S. Treasury Secretary, Nicholas Brady).

Financial system reforms

Reform of the financial system has been a continuous process, with two benchmark developments: the Convertibility Law of 1991 and the Central Bank Charter of 1992. The convertibility law fixed the exchange rate at one Argentine peso per U.S. dollar, eliminated indexing, and required the central bank to back two-thirds of the monetary base with international reserves. These rules converted the central bank into a form of currency board (a monetary arrangement in which domestic currency can be issued only in exchange for a specified foreign currency at a fixed rate, limiting the board's discretion to create money by extending credit to the government or the banking system), eliminating the possibility of inflationary financing of the government deficit.

The Central Bank Charter made the central bank independent of the executive and legislative branches and set as its principal goal that of maintaining the value of the domestic currency. Also, by providing for the presidential appointment of a standing central bank president and directors, it intentionally made their removal difficult. Under the charter, the central bank is prohibited from financing provincial or municipal governments, public firms, or the private non-financial sector. It can back the monetary base up to one-third with dollar-denominated Argentine central government securities evaluated at market prices, but its holdings of these securities may not grow more than 10 percent a year.

Banking regulations

Banking regulations increased competition between banks and ensured the safety of individual banks and of the banking system. Restrictions on the entry of foreign banks and on the opening of new branches of domestic banks were removed. Beginning in September 1991, capital requirements were implemented with an initial rate of 3 percent; these were gradually increased until they reached 11.5 percent in January 1995, substantially above the 8 percent Basel Committee on Banking Supervision's recommendation for industrial countries. Reserve requirements were set high, on average: 40 percent (later 43 percent) on checking and savings deposits and 0 percent (later 3 percent) on time deposits. Because of concern about moral hazard, deposit insurance was eliminated, and the currency board restrictions on monetary policy stipulated in the Central Bank Charter and the Convertibility Law curtailed the role of the central bank as a lender of last resort. These measures strongly limited the safety net available to banks, reducing moral hazard in the financial system.

The run on deposits during the Tequila crisis in early 1995—which followed Mexico's devaluation of its currency at the end of 1994—generated a systemwide decline in deposits of 18 percent over five months, which had severe repercussions for liquidity in the banking system. This decline was an important test for the authorities and led them to revise bank regulations significantly. They created two trust funds: one to help privatize provincial banks and the other to aid in the restructuring or merger of troubled private banks. The central bank's ability to extend rediscount operations with financial institutions under extraordinary circumstances was increased through a change in the Financial Institutions Law that gave substantial powers to the central bank to restructure troubled banks. The amendment allowed the central bank to divide the assets and liabilities of a troubled bank into a "good" bank to be sold and a "bad" one (comprising the nonperforming assets of the original bank) to be liquidated, which it achieved by transferring the "bad" bank's nonperforming assets—plus cash provided by the deposit insurance agency—to the bank or group of banks absorbing its deposits.

To enhance depositor confidence in the banking system, the central bank set up a limited program of mandatory private deposit insurance in April 1995 with an initial limit of \$20,000 per depositor, later raised to \$30,000. In another step designed to provide liquidity, the central bank opened contingent repurchase agreements with 13 private international banks that can be triggered at its discretion. Recently, this contingent repurchase facility has been enhanced by a line of credit with the World Bank and the Inter-American Development Bank for a total of \$1 billion, which becomes available if the private repurchase facility is triggered and the central bank is required to meet margin calls because of declines in the prices of public securities.

Since 1995, bank regulations have been further revised to impose more regulatory and market discipline on banks. First, banks are now supervised under a CAMEL system—capital, assets, management, earnings, and liabilities, where each aspect is assessed on a scale of 1 to 5, and an overall rating for each bank is then expressed as an average of these scores, similar to that used by the Office of the Comptroller of the Currency in the United States—and a BASIC system—bonds, external auditing, supervision, information, and credit rating. All banks are inspected on site by the superintendency at least every 18 months and banks with difficulties, more often. Second, traditional reserve requirements have been replaced by remunerated liquidity requirements, which are based on the residual time to maturity of deposits and other bank liabilities. The requirements have a decreasing rate that starts at 20 percent for liabilities due in less than 90 days and reaches 0 percent for liabilities due in one year or longer. Only 20 percent of these requirements need to be channeled through the central bank. The rest can be invested in a wide range of very safe and liquid international assets. Minimum capital requirements are based on counterparty risk, interest rate risk, and market risk for the trading portfolio. Total

capital requirements are the sum of the three requirements. Counterparty risk along Basel lines is further adjusted by the bank's CAMEL rating and by loan interest rate spreads over intermediation costs (as a proxy for risk premiums). Following the Asian crisis of 1997–98, a rule (the so-called anti-bubble rule) was introduced that increases the capital requirement for new mortgage loans when a nationwide real estate price index surpasses certain thresholds. Standardized procedures for the origination of home mortgages were introduced in 1998 to facilitate loan securitization.

As a further measure of bank reform, between 1991 and August 1999, the number of banks in the financial system declined from 167, of which 35 were public, to 119, of which 16 are public, primarily as a result of mergers or closures following the Tequila crisis. In addition, 16 small government-owned banks, mainly provincial, and the National Mortgage Bank were privatized.

Payment system reforms

Before the reforms of the mid-1990s, payments were effected through 84 clearinghouses, which were inefficiently operated. In 1995, the central bank and the banking associations established a working group that generated widespread reform through the adoption of new technologies. The system today consists of a real-time gross settlement system managed by the central bank, an automated large-value clearinghouse, and two automated low-value clearinghouses.

Monetization advanced rapidly, and by 1999 M3* was over 30 percent of GDP. This broad measure of money includes the monetary base plus both peso and dollar deposits and thus gives a measure of the size of the financial system. Deposits per bank employee rose from \$96,000 in private institutions (\$69,000 in public institutions) in March 1991 to \$877,000 in private institutions (\$729,000 in public ones) in August 1999, and spreads have declined significantly. Since the Financial Institutions Law took effect, 16 banks have been restructured, and in only 2 of these restructurings did the depositors suffer losses. The success of the reform is highlighted by the fact that although the Asian, Russian, and Brazilian crises increased Argentina's country risk, caused dramatic declines in asset prices, and precipitated a recession, they did not precipitate either international or domestic capital flight from the banking system.

Ongoing reforms

The reforms of the 1990s were extremely successful in bringing the economy back to a sustained growth path. GDP growth averaged 4.7 percent in 1991–99 notwithstanding two recessions. During 1992–99, the value of exports increased by 8.2 percent a year on average, and the volume by 9.4 percent a year, while employment increased by 12 percent.

Two areas in which reforms are continuing are the public sector deficit at the national and provincial levels and the sharing of revenues between the national government and the provinces. Although the public sector deficit grew during

1999, in part because of the recession, congress has recently passed three measures to address this problem. The Law of Fiscal Responsibility mandates a reduction in the federal deficit over the next three years until a balanced budget is reached in 2003. A tax reform law increased the tax rates on incomes, personal net worth, and a number of consumer products. The third measure is related to financing provincial governments that continue to depend on taxes raised at the federal level, while the municipalities depend on taxes raised at the provincial level. A system needs to be developed that improves the balance, at each level of government, between the political benefits of public services and the political costs of raising revenues. A step has been taken in this direction with a recent agreement that established a ceiling on future federal revenues to be shared with the provinces. Federal tax revenues that exceed this ceiling will all go to the federal government.

The labor market, deeply affected by the structural reforms of the 1990s, is another area in which the government is committed to further reforms. Argentina's unemployment rate remains high (14.3 percent in 1999), especially by historical standards (it averaged 4–5 percent during the 1980s and 7.3 percent in 1990). Following the opening of the economy and the privatization of public sector firms, capital imports increased dramatically and new capital-intensive technologies were introduced. The rigidities of labor market institutions (such as centralized bargaining, high severance costs, and high wage taxes) have impeded the necessary adjustments in labor demand. On the one hand, although some progress has been made in labor market flexibility and wage tax reductions, the remaining rigidities limit the ability of labor markets to adapt to the restructuring of the industrial sector. On the other hand, the introduction of new technologies implies changes in the labor force skills that will be in demand. Education will play a crucial role in helping the labor force adapt to changes in labor demand.

Some concerns remain

Although much progress has been made in establishing the basis for a sound financial system, there are a number of ongoing concerns. Argentina's country risk premium remains high and variable. The financial sector is still small by international standards and is expected to continue growing more rapidly than output; thus, care needs to be taken to maintain the stability of the system. Financial innovation, if too rapid, can weaken the regulatory framework and requires continuous monitoring. Small and medium-sized companies are the main sources of employment and output, and more needs to be done to improve their access to the system's financial resources without impairing loan portfolio quality. The expected growth of the financial system, as well as administrative and technological innovation, will further reduce intermediation spreads and help Argentina achieve its objectives.

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