

ARGENTINA'S ECONOMIC CRISIS

HEARING
BEFORE THE
SUBCOMMITTEE ON
INTERNATIONAL TRADE AND FINANCE
OF THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
ONE HUNDRED SEVENTH CONGRESS

SECOND SESSION

ON

THE CAUSES OF ARGENTINA'S POLITICAL AND ECONOMIC UPHEAVAL,
AND THE POLICY CHANGES NECESSARY TO CORRECT THOSE PROBLEMS;
WHETHER THE ADMINISTRATION AND THE INTERNATIONAL MONETARY FUND
HAVE RESPONDED CORRECTLY; AND A REVIEW OF ARGENTINA'S FINANCIAL
CRISIS ON UNITED STATES BUSINESSES

FEBRUARY 28, 2002

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C O N T E N T S

THURSDAY, FEBRUARY 28, 2002

	Page
Opening statement of Senator Bayh	1
Opening statements, comments, or prepared statements of:	
Senator Hagel	3
Prepared statement	31
Senator Miller	4

WITNESSES

John B. Taylor, Under Secretary for International Affairs, U.S. Department of the Treasury	4
Prepared statement	31
Michael Mussa, Senior Fellow, Institute for International Economics	14
Prepared statement	34
Response to written question of Senator Johnson	39
Peter Hakim, President, Inter-American Dialogue	16
Prepared statement	35
William J. Haener, President and Chief Executive Officer, CMS Gas Trans- mission Company	18
Prepared statement	36

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Crying With Argentina by Paul Krugman, dated January 1, 2002	40
Chronology of Events by J.F. Hornbeck	41

ARGENTINA'S ECONOMIC CRISIS

THURSDAY, FEBRUARY 28, 2002

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON INTERNATIONAL TRADE AND FINANCE,
Washington, DC.

The Subcommittee met at 2:30 p.m. in room SD-538 of the Dirksen Senate Office Building, Senator Evan Bayh (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR EVAN BAYH

Senator BAYH. Thank you all for coming. I am pleased to call this meeting of the Subcommittee on International Trade and Finance to order.

I would like to say that Senator Hagel is on his way, my Ranking Member. I want to thank him for his interest in this issue. We have a good bipartisan relationship and a good working relationship here in the Subcommittee, so I am grateful to him. We will afford him the opportunity to make his opening comments when he arrives. The same thing for any other Members of the Subcommittee who may appear.

I want to thank our witnesses for being with us today. I know that you are very busy and there are many other things you could be doing. So, I appreciate your taking the time to be with us today.

Also to members of the public, and members of the press who are here with us to inform the public, this is an important topic affecting not only Argentina, but also the rest of Latin America and significant United States interests, as well.

Today's hearing will explore the causes of Argentina's economic and financial disintegration, the consequences for United States businesses in our economy, as well as the consequences, economic and otherwise, for other South American nations. We will also explore what can be done to stabilize the situation on a sustainable basis. And the role of the Breton Woods Institutions and the U.S. Government, if any, in addressing the current crisis.

We have here with us today four distinguished witnesses. We are going to begin with John Taylor.

John, thank you for being with us, once again I should say. John is the Under Secretary of the Treasury for International Affairs. He will be our first witness and will explain the Bush Administration's policy towards Argentina.

I am going to just introduce the other three witnesses briefly and make some opening comments, and then turn to you.

With us is Dr. Michael Mussa. I hope that I have pronounced that correctly. He is a Former Chief Economist at the International Monetary Fund, and currently a Senior Fellow at the Institute for International Economics. He will comment on the IMF's handling of Argentina, and the Fund's effectiveness in dealing with economic crises like the one confronting that country.

In addition, we have Peter Hakim, who is President of the Inter-American Dialogue. Peter will provide testimony on the causes of Argentina's crisis, the potential for political contagion, and the implications of the Argentine situation for the rest of the emerging market world.

Last—but by no means, least—we have William Haener, President and CEO of CMS Gas Transmission Company. This company is one of the most significant American investors in Argentina. Mr. Haener will give us the American business sector perspective on Argentina's economic crisis.

I want to thank you all for being with us today.

A few brief comments of my own, and then Mr. Taylor, we will turn to you.

Argentina is the third most populous nation in South America. It historically has among the highest standards of living in that Continent. Over the last decade, Argentina has received substantial foreign financial assistance. Total external debt now stands at \$128.5 billion. This includes \$23 billion in loans from U.S. financial institutions, and \$14.5 billion in direct foreign investment from U.S.-owned companies.

The International Monetary Fund has provided \$22 billion in assistance during the last several years. And the World Bank has provided \$8.6 billion of assistance in the last several years. So the external financial support has been significant in recent years.

Yet, today Argentina is in a precarious state. Its economy is at a virtual standstill. It has defaulted on its external debt. Its currency value has been cut virtually in half, and political turmoil and social unrest are pervasive.

Many have suggested that this crisis was precipitated by several factors. Among other things, chronic profligate government spending at both the state and local levels; a fiscal relationship between the central government and the states which encourages unsustainable fiscal policies by the latter, with consequences disastrous for the former; an inefficient tax collections system—it is my understanding that roughly one-half of taxes owed are actually paid in Argentina—a formerly overvalued currency, and unsustainable borrowing to cover deficits which created crushing interest payments with consequences that are now obvious.

If possible, some of the recent attempts to address the situation have given cause for even greater pessimism. Decisions undermining the sanctity of Argentine contracts, the rule of law, and the fairness of the bankruptcy provisions make new foreign direct investment or private sector loans highly problematic.

A recent surge in the money supply suggests attempts to monetize the debt, and a possible return to hyperinflation. The past pledges of reform have been announced, but not implemented and therefore have been of little consequence, except to undermine the credibility of future pronouncements. For example, the Fiscal Re-

sponsibility Act of September 1999, and the Zero Deficit Law of July 2001, are examples of such past pronouncements of promised restructuring of the relationship between the central government and the states addressing the fiscal situation of both that were announced and yet not implemented to any significant degree.

I want to emphasize that no one likes this situation. No one benefits from the misery and impoverishment of a great nation.

It has been suggested by some, that unless we find a way to usher in and implement—and I want to underline “implement”—true sustainable reform, that virulent anti-Americanism, protectionism, and threats to Argentina’s democracy, may be in store. Obviously, we do not want that. It is not in America’s interest, Latin America’s interest, or anyone’s interest. But it raises the question, and in some ways the conundrum of “what can be done?”

I am personally inclined toward engagement. I have always favored something that Larry Sommers once said about the forward defense of America’s economic interests through proactive policies. And indeed, America and the multilateral institutions that we support, have played a constructive role in the past and stand ready to do so again.

But given the past record of Argentina’s failure to reform, substantial skepticism is warranted. Reforms must be sustainable, and implemented, not just announced. Otherwise, further assistance will merely perpetuate the disastrous policies which have led us to this crisis and, in so doing, postpone the day of genuine recovery for the Argentine people and others with an interest in that great country.

I look forward to hearing from my colleague, Senator Hagel, and from our witnesses, as we explore what the ramifications of this situation are and what can be done to improve the current state of affairs.

Having said that, Senator Hagel, I would like to welcome you. I said before you arrived, I have appreciated our close personal friendship and good working relationship on this Subcommittee, and I want to thank you again today for your interest in this subject and helping us put the hearing together and would welcome an opening statement.

COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I am appreciative, I think as we all are, that you would focus on this. This is an appropriate area not just of jurisdiction but of interest and responsibility of this Committee, the Congress, and our country.

So, thank you.

I have a brief statement that I would ask to be inserted into the record, Mr. Chairman.

Senator BAYH. By all means.

Senator HAGEL. And I look forward to hearing from our distinguished witnesses.

Mr. Secretary, welcome.

Secretary TAYLOR. Thank you.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Senator BAYH. That was commendably brief, Senator.

[Laughter.]

You set a standard to which all of us can aspire. But thank you, Chuck.

John, before I introduce you, our friend and colleague, Senator Miller has just arrived. Zell, thank you for your interest in this subject. I would give you at this time the opportunity to make an opening statement if you are interested in doing that.

COMMENT OF SENATOR ZELL MILLER

Senator MILLER. I think we would get more out of listening to Mr. Taylor, but thank you.

Senator BAYH. You even did better than Chuck.

[Laughter.]

We have a healthy bidding going on here. This is going to help us all.

Thank you, Senator Miller.

Senator HAGEL. Well, if we have one more come in, it will be two seconds.

[Laughter.]

Senator BAYH. I was going to say, he may just say "ditto" and turn it over.

John B. Taylor, as I mentioned, is the Under Secretary of the Treasury for International Affairs. As Under Secretary, Mr. Taylor serves as the principal advisor to the Secretary of the Treasury on international economic and financial issues. He heads the development and implementation of policies in the areas of international finance, trade, investment, economic development, international debt, and the U.S. participation in the International Monetary Fund, the World Bank, the Inter-American Development Bank, and several other institutions.

Mr. Taylor has extensive previous Government experience, as well as an extensive background in academia.

John, we welcome you again and we look forward to benefiting from your testimony. Thank you for joining us.

**STATEMENT OF JOHN B. TAYLOR
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY**

Secretary TAYLOR. Thank you very much, Mr. Chairman, Senator Hagel, and Senator Miller for putting this hearing together and for inviting me to testify. It is a very important subject, as you indicated in your opening remarks.

I want to begin by saying that I agree with you, the people of Argentina are facing very difficult times right now. President Bush has made it clear on a number of occasions that Argentina is a close friend and an ally, and that we want the Argentine economy to grow. We want it to become an engine of growth for its people and for the whole hemisphere.

My written testimony covers events in Argentina during the 1990's leading up to the current time, as well as the recent IMF program and recent United States policy.

I would like to submit that written testimony for the record and highlight a few issues, if I might.

Senator BAYH. Without objection.

Secretary TAYLOR. To begin to understand the current situation, I think it is actually helpful to go back to the early 1990's when the government of Argentina undertook a series of very impressive economic reforms. These reforms had to do with monetary policy, fiscal policy, international trade, and regulation. Perhaps the most dramatic one was the monetary policy change which enabled the inflation rate in Argentina to come down from over 3,000 percent a year, to nearly zero. Fiscal policy was also brought under better control. A significant privatization program was started which drew many foreign investors into Argentina. Moreover, a number of international trade barriers were reduced.

Not only did these reforms bring about a much lower and more benign inflation rate, they increased economic growth. Economic growth in the 1980's in Argentina was near zero, and it rose to over 4 percent in the early 1990's. I would also note, looking at the components of GDP, that investment and exports grew particularly rapidly during this period. So those economic reforms did some real good. They were intended to be market oriented, and as I indicated the results were impressive.

However, in the late 1990's a number of policy setbacks and external shocks sharply reduced the economic growth rate in Argentina, and ultimately lead to the financial crisis that we are talking about today.

If you look closely at the spending numbers and the debt numbers, and the deficit numbers, it is clear that the debt began to grow more rapidly, raising concerns about sustainability. Risk premia started to increase; and of course that caused interest rates to rise, slowing economic growth even further.

This was compounded by a persistent deflation. Prices actually fell for a number of years in a row. With depreciating currencies in Europe and Brazil, it raised competitiveness problems in Argentina as well.

I also think it is important to note that persistent expectations of depreciation of the peso during this period tended to raise interest rates in Argentina to levels higher than they would be elsewhere. In particular, higher on peso loans than on dollar loans.

As we move toward the end of last year, it became clear that efforts to deal with these problems through the budget were not working. People increasingly viewed the government's debt as unsustainable, and in November of last year in fact the government announced that it wanted to restructure the debt.

As that restructuring was underway, uncertainty about its impact on the banks holding that debt began to lead to large deposit withdrawals. To stop those withdrawals, the government imposed restrictions on the ability of people to withdraw their deposits from banks. That occurred first in December. After those restrictions were imposed, significant social and political protests took place. They turned violent, and the President at that time, President de la Rúa, resigned.

As we move to the present, it is clear that those restrictions, and a number of other things, have caused economic circumstances in Argentina to deteriorate. With restrictions on deposits, the payment system does not function as it normally does, and it creates

great shortages of liquidity compounding the problems as we have seen in the last few months.

Argentina is beginning to remove these restrictions; and just recently, it was made possible for people to withdraw the full monthly salary of their payments, for example, the full monthly salary from the banks. But ultimately, it is going to be up to the government of Argentina, as you have indicated, Mr. Chairman, to find ways to make economic growth more sustainable, and to make the policies that do that. Indeed, the implementation of the policies is very important.

We have been in very close contact in the United States Government with the economic team in Argentina. In fact, there have been contacts at all levels. We are following closely what they are doing. The Economics Minister visited Washington on February 12, and met with Secretary O'Neill. A good set of meetings. They also met with the International Monetary Fund at that time.

We are encouraged with the steps that Argentina is taking to deal with these problems, and as you indicated in your opening remarks, Mr. Chairman, in the last few days they proceeded to negotiate and establish an agreement with the Provinces that has the goal of making the budget more sustainable and ultimately economic policy more sustainable.

So let me leave it right there, Mr. Chairman. I would be happy to answer any questions you or your colleagues may have.

Senator BAYH. Thank you very much, Secretary Taylor.

Let me begin where you ended up by the pronouncement yesterday of the new agreement with the Provinces. As I understand it, it would call on the provincial governments to reduce their deficits by around 60 percent, and that the central government would absorb the outstanding debt of the local providences.

Having been a governor, I can tell you, cutting a deficit by 60 percent is a hard thing to do. And so since it is my job to ask the hard questions, we had a program along these lines announced in September 1999, the Fiscal Responsibility Law, which promised restructuring and more fiscal restraint. We had another zero deficit law enacted in July 2001.

What would give you reason to believe that this pronouncement would be any more successful in actually being implemented than its predecessors, given the political difficulty at the state level of actually carrying this through?

Secretary TAYLOR. With respect to the first part of the question, on the 60 percent reduction, part of the agreement also has, as you say, the national government dealing with the debt of the provincial governments, and that reduces the interest payments and therefore has an impact on expenditures in that way. So that will be part of the way in which the goals of deficit reduction are reached. Although, you are quite right that is a large reduction.

With respect to implementation, I think with all of the efforts to move policy reforms through, there are steps that countries must take. This is an agreement which involved signatures, agreements that are written, ultimately as I understand it, and of course the information is still very fresh, there will be legislation needed, and there will be more documents put into place. But I think the good thing here is that there is a start on dealing with an issue which

the government of Argentina itself has recognized as important to deal with, and so the efforts in the last few days are showing that there is progress.

You are correct though, Mr. Chairman, to emphasize implementation with respect to all changes in economic policy.

Senator BAYH. So, you are encouraged by the effort, but it is fair to say that signatures and documents and even enactments are one thing, however, what really matters is the implementation of those steps.

Secretary TAYLOR. Yes, sir.

Senator BAYH. What about the recent reports that the money supply has been increasing? Is that troubling to you given the past record of hyperinflation in Argentina? Is there a possible attempt to monetize the way out of this problem?

Secretary TAYLOR. I do not see that. I certainly hope that that is not the case.

The central bank has made it very clear that they want to limit the amount of money creation. The central bank governor who was actually just officially confirmed yesterday in his job, unanimously I understand, is taking efforts to keep the money growth low and consistent with price stability, eventually.

So at this point in time, it seems to me that they have been very clear about the monetary side of the program and intend to limit the growth of money—certainly to prevent the kind of hyperinflation that occurred in the past.

As I indicated in my opening remarks, one of the really great successes in Argentina in the early 1990's was to end that hyperinflation. I think that has been one of the most popular things in Argentina during the 1990's, to get rid of that inflation. It was very popular.

Senator BAYH. If I could put one thing on your radar screen.

Secretary TAYLOR. Yes.

Senator BAYH. I was referring to a report, dated February 26. George, I hope I am pronouncing his name correctly, Tedesco, the Deputy Minister for the Economy, said, to use his term, "emissions from the central bank" were responsible for what he called, a sharp increase in the money circulation. And so that caught my attention, given the history of the situation.

Secretary TAYLOR. Certainly. If you look at the money statistics, there are going to be movements up and down. And remember, I think it is also important to keep in mind that during the last year and a half, the money statistics in Argentina have been coming down, down. That is that liquidity problem we referred to at the beginning. It is one of the reasons that they have had deflation.

So an increase in liquidity in Argentina is important to take place. That is how you get some growth again. The important thing is to have that increase in liquidity associated with keeping inflation in check, and I see no evidence that the central bank has not kept that in mind with respect to any money supply increases that are being reported.

Senator BAYH. Well, that is reassuring. This report went on to say that the central bank had already injected at least 1.3 billion pesos into the economy this month alone, and that it had already printed nearly three-quarters of the two-and-a-half billion pesos

that it said would be its limit for the year. That is what caught my attention, but I am glad to see you are focusing on this, and if you are reassured, I am reassured.

Secretary TAYLOR. It is a good fraction of the total amount for the year, that is for sure. That does not mean that the amount for the year is going to be exceeded; and it does not mean that that increase in liquidity at this time is improper.

Senator BAYH. Thank you, Mr. Secretary.

My time has expired.

Senator Hagel.

Senator HAGEL. Mr. Chairman, thank you.

You mentioned, Mr. Secretary, in your overview a number of factors that led to this crisis in Argentina. And you referenced, of course as always, one of the consequences of exports' trade, and I would be interested in getting your sense of what you think this current crisis in Argentina may have on the Mercusor Free Trade Agreement that we are trying to work our way along in the general universe of trade agreements and trade for not just Argentina but Latin America and how it affects us.

Secretary TAYLOR. Well, I think it is very important that we do move ahead on these trade agreements. The events in Argentina, as I look at them, they indicate the importance of having policies that keep both strong. And free trade policies will do that.

Throughout the 1990's, as trade barriers were removed in Argentina, exports grew very rapidly and that benefited the economy. It was not until the last few years that things started to be difficult for economic growth.

If you look at the data carefully, you see there are benefits to Argentina, and any country for that matter, for greater opening of markets and reduction of trade barriers. So that is the objective and the facts.

I think your question also may raise the idea that the crisis itself, perhaps making people question certain types of policies, will make them question free trade agreements. There is no reason for that kind of questioning to occur. As I think I tried to indicate in my opening remarks, it was the opening in the market oriented policies that led to strong growth in Argentina. And it was moving back from some of those, some of the fiscal discipline, that led to the problems.

The message I see, and I hope the message that is received by everyone looking carefully, is that this is a reason to try to have more free trade agreements so that you can establish the conditions for strong economic growth.

Senator HAGEL. Do you know if that is an area the Secretary touched upon in his meetings earlier this month?

Secretary TAYLOR. He has always touched on the importance of open markets and free trade. I cannot report on exactly what has taken place in any particular meeting, but I would say that in many discussions that we have had over the months since we have been here, with Argentina—and again in other countries—the idea of free trade, promoting trade, open markets, comes up so much because it is so important, it would be very strange to have a meeting on economic policy or a discussion without talking about the importance of this.

Senator HAGEL. But I mean specific issues related to Argentina. I know we all support free trade—fair trade.

Secretary TAYLOR. Just one example I guess I would give is: Last August there was a particular effort to have some trade talks in Argentina, and USTR conducted some trade talks at the subcabinet level that involved Argentina and the other Mercusor countries along with the United States, of course, as a possibility for moving toward these free trade agreements. So that is an example of what took place. But with respect to very recent meetings with the Secretary, I cannot really speak to that.

Senator HAGEL. Thank you.

Do you know what we are doing, if we are doing anything, in regard to stressing the importance of the convertibility of currency for the free currency convertibility in Argentina?

Secretary TAYLOR. What we have indicated is that it is important to have a unified exchange rate in that sense of convertibility. And Argentina has moved since the start of this year toward a more unified exchange rate.

The word “convertibility” sometimes conveys the idea of the convertibility law that was in place in Argentina starting in the early 1990’s. That has a somewhat different meaning and refers to that one-to-one peso peg, and the currency award that was in place.

They now have decided to have a floating exchange rate, a flexible exchange rate, and that coupled with the good control on money that Senator Bayh asked about, will lead to low inflation just like the Convertibility Law did.

Senator HAGEL. And we continue to stress that point with them?

Secretary TAYLOR. Stressing the importance of price stability and low inflation, certainly.

Senator HAGEL. Thank you.

Senator BAYH. Thank you, Senator Hagel.

Senator Miller.

Senator MILLER. Mr. Secretary, I would like to get your thoughts on the future of foreign-owned banks in Argentina. We know that a number of them, like Citibank and Morgan and Chase have had to shoulder some losses after the peso devaluation. We know about the protests in Buenos Aires against foreign-owned banks. What is the situation there? Is there a possibility that some U.S. banks just simply write off their losses, and withdraw? What do you see the future to be?

Secretary TAYLOR. Well, we have been in close contact with a lot of foreign banks in Argentina, and have had a lot of discussions, and they have a difficult time in the current situation with the revaluation of the currency and the other problems with the economy. The economy is not growing and it is tough to do business in that situation.

I cannot help but ultimately be optimistic though. This is a country with so much potential. It opened up its financial sectors in a way that ultimately will pay off and be very healthy. But right now there are some restructurings that have to take place. There is some revaluations. That means that the banks and others who are creditors, will have to make some adjustments.

We have always emphasized that that should be fair. Treat people fair whether they are foreign or domestic regardless of what

country the investment is coming from. But I think once Argentina is able to get over these payments' problems and restructuring problems, that the future will be good.

Senator MILLER. What about U.S. exports? What do I tell my Georgia computer and electronics companies that are our State's leading exporters to Argentina. What should I say to them about what to expect in the next few months?

Secretary TAYLOR. The next few months are going to be difficult, as the last few months have been, but I think we see some signs for improvement. And there are still a lot of unresolved questions which people in Argentina are asking us all the time about how the debt will be restructured. How will payments be made? But again I do not know exactly what the business is that you might be discussing something with.

Different businesses are faring in different ways. The exchange rate change itself has caused these revaluations which affected different businesses in different ways.

So, I would say in terms of talking to your exporters from your State to ask them to be patient. Ask them to demand fair treatment. Remind them that there is an investment treaty in place, a bilateral investment treaty in place, if it is a foreign investment issue, and to be in touch with people like me, and others in the U.S. Government.

Senator MILLER. Thank you.

Senator BAYH. Mr. Secretary, we are going to have a second round. I have three more questions, and then that exhausts my questions for you today.

Let me say that I am delighted to hear of your optimism.

I am reminded of something that a well-known economist, Lester Thoreau from MIT, I saw a speech that he gave back in the early 1980's when there was a lot of pessimism about the U.S. economic situation, and he was asked his general state of mind about the U.S. economy. He described himself as an "intellectual pessimist but an emotional optimist." The more he analyzed the problems, the more it was hard to see how they would be resolved, but he just knew they would be. And hopefully that will be the case here with Argentina, as well.

I am glad to hear about your optimism. Can you tell us a little bit about your meetings with the new Minister of Economics? There were some suggestions in the press that the figure of \$22 to \$23 billion of additional IMF assistance was just floated. If true, can you give us any idea of how that figure was derived?

Secretary TAYLOR. No, I cannot give you any idea of how that figure was derived. I personally have not been given—

Senator BAYH. It appeared in the press.

Secretary TAYLOR. —figures like that. Perhaps it appeared in the press. When Minister Rems Lenicov came to the United States, it was a very good meeting. He met with Secretary O'Neill. He met with the IMF. But the particular numbers you are talking about here are just in the newspaper as far as I know.

Senator BAYH. So, you do not believe everything you read in the press?

[Laughter.]

I do not expect you to comment on that, Mr. Secretary.

I have two other questions. First, in the interests of fairness let me present the other side of the fiscal argument. I read with interest the other evening a paper by I think the Harvard economist Jeffrey Sachs—you may be familiar with this distinguished gentleman. Let me just quote from his paper. He says: “Contrary to that widespread view”—which I incorporated in my opening statement about fiscal problems being one of the root causes of the current crisis—“Argentina’s public sector is not grotesquely bloated or wasteful. For a country of Argentina’s GDP, the share of government consumption, Federal Government expenditures, and total government expenditure is actually at the low end.”

I read this with some surprise. Do you have a reaction to the professor’s statement about Argentina’s public sector being actually fairly modest in size for a country of that GDP? I had always heard to the contrary.

Secretary TAYLOR. Yes. The measures of spending as a share of GDP are exactly what is indicated there. What is needed in terms of the budget is making the expenditures come in line with the revenues. There are all sorts of decisions a country can make about expenditures, of course, but the important thing here is to get things in line.

Senator BAYH. So if the government is modest in size but the revenues are even more modest, that is the problem?

Secretary TAYLOR. Yes.

Senator BAYH. Very good. I intend to contact the professor at some point, and I will ask him how he arrived at this.

Let me just offer my own opinion. If so, then possibly we face as much of a political difficulty as an economic or fiscal one. The decisions to redress the fiscal imbalance are very difficult, and that requires real political fortitude. Perhaps that is one of the major problems that we face in this circumstance. Would you care to comment on that observation?

Secretary TAYLOR. I agree. In a way, the economic goals, or the economic policies are straightforward. They have worked in other countries that have adopted them. That is, a monetary policy to have a low inflation; a fiscal policy that keeps the revenues in line with expenditures and keeps the debt from becoming unsustainable; a trade policy which is oriented to its open markets; a regulatory policy with low regulation and privatization activities.

So those are all easy things to say. But, Senator, as you indicate, getting those through a political system is sometimes very difficult. I think you are seeing that in Argentina right now.

And maybe just a comment on your reference to my optimism, I see in a way the gains that can be achieved by getting the right policies. I am just an optimist because I see eventually people will realize that and will find a way to get these things through the political system.

But I recognize, and as my realism comes into play for just the reasons you indicate, that it is difficult politically to do. But as I indicated, we had a good visit from Minister Rems Lenicov, and he had a good meeting with Secretary O’Neill. He knows the things that need to be done, and that is the reason we can be optimistic.

Senator BAYH. I am glad to hear it. Thank you, Mr. Secretary.
Senator Hagel, other questions?

Senator HAGEL. Yes, Mr. Chairman, thank you.

Mr. Secretary, are we doing anything to encourage the Argentine government to amend its recent law which allows for nonpayment to creditors of up to 6 months? Even though it is my understanding that those companies may have that capital, but they have that 6 month period. We, as you know, have American corporations who have provided services and goods and who are affected by this. I would be interested in your thoughts on what we are doing or not doing about that.

Secretary TAYLOR. We are making every effort to find out about issues like that. Then when we find out about them, to convey our concerns to Argentina, to the relevant authorities.

There are a number of things that have occurred like the one you are mentioning as part of this effort to reconcile the gaps that have occurred because of the revaluation of the currency.

It is very difficult. Someone, in general, has to make some adjustments to that. It should be fair in a sense that not one party, creditors or debtors, should take the large bulk of that. It should be done in a way that is fair and that will get things back on course again. So, we have expressed the views very strongly. It is a very high priority for us that this adjustment be done fairly and even-handedly.

Senator HAGEL. You, I note from your written testimony, started to get into the current IMF negotiations, and the Chairman asked you a question about it. Would you care to just give us a quick status on those IMF negotiations and how we feel they are going, and if they are going in the right direction?

Secretary TAYLOR. I think they are going in the right direction. The economic team came up and met with the IMF on February 12. They exchanged information about the situation.

Once the economic team went back to Argentina, they have been in touch with the IMF and the IMF has been very clear about the nature of the things that would be required for sustainability. Sustainability is essential for an IMF program. As Chairman Bayh indicated, you cannot lend into unsustainable situations. You have to lend into sustainable situations.

I think the IMF is in good discussions with Argentina and we, as shareholders in the IMF, keep in close contact and try to track what is happening, and I think it is going well. I am not sure when the next formal interaction such as a mission will take place, but I hope it is very soon.

Senator HAGEL. So generally you were of the opinion that what is happening in those negotiations and the IMF's participation is helpful and productive and they are doing the right thing?

Secretary TAYLOR. Yes. I think the exchange of information, the perspective that people giving advice can contribute to people at the IMF is helpful. I think there are people in Argentina from the central bank to the economics ministry who recognize that.

Senator HAGEL. Thank you.

I thank you very much, Mr. Chairman.

Senator BAYH. Thank you, Senator Hagel.

Senator Miller.

Senator MILLER. Mr. Secretary, one of the factors that has been cited as a cause of Argentina's persistent budget problems has been

the relationship between the Federal Government and the provinces. It is almost as if they have an incentive to run deficits. Do you think that President Duhalde's reforms adequately address that issue? And I guess also, the hard question, do you think that President Duhalde has the political capital to bring about these reforms? They are pretty painful reforms, as Senator Bayh mentioned in his earlier statement.

Secretary TAYLOR. I think that the economic reforms have to deal with a relationship between the national government and the provinces. They have started along a route to do that. The details are coming out. But again as I indicated before, there is progress being shown on this very difficult problem. And, yes, it has to be addressed. We know in our Federal system the relationships between the Federal Government and the States are essential to get right, or you can create fiscal problems.

Brazil, just in the last few years in the 1990's, went through some major adjustments by the national government that relates to the local governments and the provincial governments, state governments. So it is very important to get in place.

I see the discussions that are taking place, and there are agreements that are being negotiated, and it seems to me that the progress is there. But we need to look at it carefully as everyone else does, as the people in Argentina do.

So, I think I should probably leave my answer to your question there. You did ask about the political ability to carry things through, and all I can say is it seems to me that it should be clear, and it is becoming clear about what should take place. And if the interests in the Argentine people are clear on how beneficial a growing economy will be, then I think that will help the political parties come together. But I cannot really attest to the particular capital, the political capital that you were asking about. Sorry.

Senator MILLER. Thank you.

Senator BAYH. Mr. Secretary, thank you very much. We appreciate your presence so much and look forward to working with you.

Secretary TAYLOR. Thank you.

Senator BAYH. Thank you to our next panel of witnesses. We have three very distinguished guests that we are looking forward to hearing from.

Michael Mussa—I hope I am pronouncing that correctly—is a Senior Fellow at the Institute for International Economics. Mr. Mussa has previously served as Economic Counsellor and Director of the Department of Research at the International Monetary Fund for a decade from 1991 to 2001, where he was responsible for advising the management of the Fund and the Fund's executive board on broad issues of economic policy and providing analysis on ongoing developments in the world community.

Michael, thank you for joining us.

Next, we will hear from Peter Hakim. Peter, I hope I pronounced that correctly.

Mr. HAKIM. Perfectly.

Senator BAYH. As someone whose last name is often mispronounced, I always do my best.

Peter is President of the Inter-American Dialogue, a Washington-based center for policy analysis and exchange on Western Hemi-

sphere relations. He writes regularly for *The Christian Science Monitor*. He was the Vice President of the Inter-American Foundation, a U.S. Government foundation that supports grassroots development projects in Latin America. Previously, he managed the International Resource and Environmental Program at the Ford Foundation, and worked for the Foundation in South America.

Last, but not least, we will hear from William Haener.

Mr. HAENER. That is correct, Senator.

Senator BAYH. Mr. Haener is the President and Chief Executive Officer of CMS Gas Transmission Company, one of the largest United States investors in Argentina. Mr. Haener, I should say that one of your home State Senators, Senator Stabinow, has looked forward to coming to the Committee today to hear your testimony. Unfortunately, she is the Presiding Officer of the Senate as we speak. There is very little you can do to get out of being Presiding Officer, but she did want me to give you her best regards. She looks forward to reading your testimony and she apologizes for not being able to be in attendance. You can turn on C-Span and see that she is not making this up. She is in the Chair presiding.

Mr. HAENER. I do appreciate that, and there certainly are higher priorities.

Senator BAYH. Well, I would not say higher priorities, but it was unavoidable. When you get called, you have to sit.

Mr. HAENER. I understand.

Senator BAYH. Mr. Mussa, we will begin with you. Thank you for being here today.

**STATEMENT OF MICHAEL MUSSA
SENIOR FELLOW
INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. MUSSA. Thank you, Mr. Chairman.

It is a pleasure to be able to testify on the economic tragedy now gripping Argentina, on how it got into this mess, and on how, with the help of the international community, it might get out of it.

The economic performance of Argentina during the past decade has encompassed a remarkable transition from hyperinflation and deep recession at the end of the 1980's through a spectacularly successful period of stabilization and economic growth from 1991 through 1998. Then into a deepening recession and deflation. And finally, late last year, into a catastrophic collapse economically and financially.

What was responsible for the tragic collapse of Argentina's initially successful efforts of stabilization and reform? Well, a variety of factors could be mentioned and weighed, but I think it is most important to emphasize that the tragedy was due primarily to Argentina's economic policies, either directly or in their failure to respond adequately to other adverse developments.

Argentina's key policy failure was the inability and unwillingness of the government at all levels to run a sustainable fiscal policy. Even when the Argentine economy was turning in by far its best performance in many decades, as it was between 1991 and 1998, the ratio of total public debt to GDP was rising.

You may recall in the United States when we had good growth the debt came down and the deficit came down and went away and

turned into a surplus. That did not happen in Argentina in even better circumstances.

Senator BAYH. We remember those days with great fondness.

Mr. MUSSA. In fact, after the Brady bond deal that helped cut the debt ratio in 1993 to 29 percent of GDP, total public debt rose to 41 percent of GDP by 1998. And then when the economy slowed down and deflation began, the debt moved up to 50 percent of GDP. Moreover, not only was the Argentine government running up large debts, it was also enjoying very large privatization revenues, all of which were being spent during this period.

When financial markets became persuaded that this game was not going to have a good end in the middle of last year, then sovereign default became inevitable.

Argentina's Convertibility Plan, which rigidly linked the peso to the dollar and tightly constrained monetary policy, also played a critical role in the transformation from success to tragedy. Early in the last decade, the Convertibility Plan helped enormously to bring financial stability and economic recovery after decades of chaos. It was a rigid framework that made it more difficult for the Argentine economy to adjust successfully to adverse shocks of the late 1990's; and this did not make the problems for fiscal policy any easier. However, in the end I would say that fiscal imprudence killed the Convertibility Plan, rather than the other way around; and then both together killed the Argentine economy.

What was the role of the International Monetary Fund in all of this? The Fund was deeply involved with Argentina throughout the past decade, as Argentina operated under the close scrutiny of a series of IMF-supported programs. The Fund generally praised most of Argentina's policies and pointed to them as a model for other emerging market economies. Thus, the Fund must take some responsibility for Argentina's tragedy. To be fair, it is important to emphasize that the policies that led to Argentina's tragedy were well and truly owned by the Argentine authorities; Argentina was not pushed into bad policies by the Fund. Rather, the failures of the Fund were sins of omission.

I would emphasize two such failures. First, when the Argentine economy was performing well, the Fund did not press the Argentine authorities as hard as it could have and should have to run a more responsible fiscal policy. This was a serious failure of the Fund to do the job that it is expected to do for a program country like Argentina that had a long history of fiscal imprudence. Second, I believe that the Fund was right to organize a large international support package in December 2000 to help give Argentina one last chance to avoid disaster. However, by the middle of last year, it was clear that the Argentine authorities could not implement the policies required to take advantage of this one last chance. At that time, the Fund made another serious error in significantly augmenting its financial support for Argentina. Money that might be far more useful in aiding Argentina now was wasted in a futile effort to sustain the unsustainable. And the Argentine authorities were not given a forceful message of the need to change fundamentally their policies at a time when the inevitable turmoil arising from such a fundamental change might have been better controlled than it has subsequently proved to be.

Looking at the future, no one should underestimate the immense difficulties faced by the Argentine authorities. The Duhalde administration has taken several important steps, painful but necessary steps, in the right direction. However, my understanding is that they are still somewhat short of the consistent, credible, and comprehensive set of implementable policies that the Fund and others rightly insist are needed to provide assurance of a successful stabilization effort.

In the extremely difficult economic and political environment of today's Argentina, I think that one must recognize that the Duhalde administration may not be able to put together and implement a credible program. The effort may fail, and stabilization and recovery may only come after Argentina has gone through a more prolonged period of economic and financial chaos and political and social upheaval.

However, I believe it would be unwise to surrender to this prospect because the policy program that might avoid it is somewhat less than fully credible. At some point—perhaps sooner rather than later—it makes sense to take some risk by extending international support to the best policy program the Argentine authorities are capable of proposing, even if it has some significant weaknesses. For the Fund and the international community, the risk inherent in supporting such a program can be contained within reasonable limits: By insisting on a reasonable, if not perfect, set of policies that have some chance of successful implementation; by keeping the amount of net new financial support within reasonable limits; and by tranching the disbursement of this support in relatively small monthly packages so that if the program goes seriously off track, remedies may be expeditiously sought.

Senator BAYH. Thank you very much, Mr. Mussa.

Mr. Hakim.

**STATEMENT OF PETER HAKIM
PRESIDENT, INTER-AMERICAN DIALOGUE**

Mr. HAKIM. Thank you, Senators Bayh and Miller. I am glad you are holding this hearing. I have actually found not a whole lot of interest in what is going on in Argentina in Congress so far.

You may remember we did try to organize a small group, the Inter-American Dialogue, to take a few Congressmen and Senators to Buenos Aires. We came close, but we could not quite get people. They had other things on their schedule, as you well know.

Let me say that in your letter to me you asked me to address a large number of questions in a very short time, and I decided in fact to focus on one question that I think has been given too little attention even in this hearing today. That is: What is it that the United States should and can be doing?

As you will see, I think the United States should and can be doing a lot more than it is now doing.

Before getting to that, I do want to say that I fully agree that Argentina is in a mess. It is a terrible tragedy. I agree that most of the blame, if not all of the blame, falls on the Argentine policy-makers and politicians and officials; that it is not a problem of the international organizations. The Argentines were the ones that were making decisions about their own country. I also agree that

they need a real, sustainable, coherent program for their economy to recover. That is absolutely essential.

What I do not agree with, I certainly do not share John Taylor's optimism. I probably share more of Michael's pessimism here. I think it is a disaster. I think it is going to get worse in Argentina, and I think it is going to last for a long time.

What I think is clear, and Michael Mussa made mention of it, is that Argentina does need some external support to resolve the crisis. I do not think there is any question of that.

I think at the same time the U.S. Treasury and the IMF have made clear that there will be no aid without a sustainable program of the kind that I already said was absolutely necessary.

President Duhalde has made some progress toward coming up with a program, but he still has a long way to go to really produce the kind of sustainable program that might be convincing to the U.S. Treasury or to the Fund. And indeed, I think the consensus is increasing that he probably will not be able to come up with such a program, at least any time soon. That he—Senator Miller, you asked this question directly—does not have the political capital to pull it off.

Either the United States and the international community steps in much more vigorously than they have to date, or Argentina will fall into a deeper and more dangerous crisis.

Michael Mussa has already mentioned the possibility of a devastating hyperinflation. Let me add that nobody knows where the country's politics may wind up. But certainly the country, 25 years a democracy, is I think in some substantial danger.

This is a disaster not only for Argentina, but it could be a very serious blow for a number of other Latin American countries, and a lot of them are facing their own very difficult problems at this point. I think it will, if things continue to deteriorate, play havoc with U.S. objectives in this hemisphere. We can talk about each of those more.

So far the economic contagion has been contained. Only small neighboring—Uruguay has really been affected—but there are indications that there may be a decline in investment capital to Latin America, which could seriously undercut the region's prospects.

And like I said, the danger to United States relations with the region, which are already, Argentina is already seen as an example of a United States that is somewhat indifferent to the region. I think this is compounded by the obvious distraction that occurred after September 11.

Again, this is something I would be delighted to talk about. What can the United States do, and what should the United States do?

Certainly more involved than Mr. Taylor suggested than a shareholder in the IMF. Let me be very clear. I do not think the IMF is going to take any action or a decision without the United States taking the leadership on this. The United States is the one that is really going to be calling the shots. I think the Administration in tandem with the IMF should provide the Argentine government with a clear and precise statement of the essential elements of a program that the United States could support.

What does the U.S. Treasury want?

And then make plain what level of resources the United States would help to try and mobilize. I do not say "provided." I say "try to help mobilize" to support the program.

If the Argentine government is prepared to accept these principles, these basic elements as a basis for moving forward, the United States should join with the IMF and begin intensively working with the Argentine government to develop a full-fledged policy blueprint. And then work to get the necessary international contributions from the financial institutions, the IMF, private investors in the G-7 countries.

This is a high level of intervention. I rarely recommend this. But I do not think the Argentines are going to be able to put this together without it. And when you have a house burning down in a neighborhood, you try to help put it out. You do not wait for it to continue burning.

Let me say, with appropriate prior consultations. I think the set of initiatives I have outlined would gain strong political backing from most Latin American countries. Most of them have already been urging the United States to provide this assistance.

I think—and this is just a supposition—there is a good chance that an intensely engaged United States with broad regional support could end some of the political impasse in Argentina, could give the Argentine government the political capital it needed to begin to effectively resolve the crisis.

Let me say, all this may not work. But without the leadership and intense engagement of the United States, the Argentine government will likely remain immobilized. The country's economy and politics will continue to deteriorate. The end will be a terrible and lasting damage to Argentina, possibly spreading harm to other Latin American countries and potentially undercutting our policy objectives in the Hemisphere.

Thank you.

Senator BAYH. Thank you very much, Mr. Hakim.

Mr. Haener.

**STATEMENT OF WILLIAM J. HAENER
PRESIDENT AND CHIEF EXECUTIVE OFFICER
CMS GAS TRANSMISSION COMPANY**

Mr. HAENER. Thank you very much, Mr. Chairman.

First, I have already submitted some formal testimony. I would ask that that be adopted into the record.

Senator BAYH. Yes.

Mr. HAENER. Thank you.

I will try and keep my remarks brief, but frankly this is very important to United States business and to the citizens of Argentina. I am going to talk about it from an energy perspective. The Argentine government's new economic regime is far more than a simple devaluation. It is really much worse than that.

The government has abrogated the contracts of existing investors, and is issuing arbitrary decrees to limit the revenues of energy projects, actions that have no relationship to market forces, and that are without regard to the external debt obligations of those projects. As a result, the government is forcing the energy sector into a crisis. Since 1993, the Argentine economy was fueled

by free market principles and privatization policies really that I think benefited the government and the people.

United States and other foreign investors invested over \$6 billion in the energy industry alone, and brought that equivalent credit. The investments were based on specific commitments and guarantees from the government. For example, dollar-denominated, or peso equivalent, not necessary linked, but peso equivalent rates were allowed to be charged.

Now the impact of this international investment in energy, what is it? Let me tell you what it is. Energy prices have fallen, and reliability and availability have increased. Low energy prices, lots of it, are good for the economy. I think we all know how GNP growth is linked to energy.

Despite the current government rhetoric and somewhat finger-pointing at United States and foreign investors were the cause of the current economic and social turbulence, it has really been the sovereign debt incurred by the central government and provinces due to their inability to limit spending. Period.

We have not taken huge projects out of the country, or profits off the backs of the Argentine citizens. Just the opposite. Let me give you an example. We are a major owner in the TGN Pipeline System. When that System was privatized, the owners—and there are five of us—spent \$392 million to buy that from the government. Since that time, we have reinvested \$1 billion to upgrade that System so it met international safety reliability standards and have expanded deliveries to other parts of Argentina that did not have natural gas service before. I think that is a benefit to the economy.

Now the government has arbitrarily changed policies and laws in results that are punitive and discriminatory to the United States and foreign investors.

Let me be clear. It is not the peso devaluation we are concerned about, but the abrogation of our contracts and the illegal delinking of the peso to the dollar. As an example, under the TGN privatization rules—again, that is their pipeline—the government rules provided that our tariff rates be calculated in dollars or the equivalent in pesos. As a result, companies like TGN received loans and entered into services and supply contracts in dollars. Since revenues would match up in dollars or the peso equivalent, everything was in balance.

Now as a result of a recent change in law, it is now illegal to make that link. You can go to jail for trying to do that.

Obviously, what has happened now with the peso devaluation and delinking the ability to collect what the fair tariff is, our foreign debts effectively doubled compared to our revenues. And if the projections are right that the peso devaluation will be even further, that debt situation is going to go further. So, we won't be able to even think about a profit. You won't be able to pay your debts. We have a problem.

I think in the real world of energy companies, our projects could be expropriated. We will not be able to purchase spare parts, keep up the maintenance. Service will be disrupted. Power outages. Natural gas deliveries will be stopped. All of which I think will disrupt the economic recovery.

There will be a substantial effect on the U.S. economy as well. Shareholders will lose their equity. Banks will lose money on the debt that comprises \$6 billion in energy investments. Insurers that back those banks and investors will lose money. U.S. exporters will lose money. The contracts for the provision of spare parts of the execution of maintenance services agreements are unfilled.

U.S. taxpayers will lose money as OPEC and Ex-Im loans go into default, and as their guarantees are called in. A form of investment or a contagion will begin to spread as prospective investors and other emerging economies shy away, having seen this model program fall and fail.

The United States and international financial institutions have a vital role to play in ensuring that this situation gets reversed and that there is protection against further economic and social turmoil. The international community must work with Argentina to provide a credible yet sustainable plan that enables the Energy Project to return to solvency and to restore the terms and basic economic equation of their contracts.

In order to hold the Argentine government accountable, there must be strict, enforceable conditions and performance requirements to this effect in whatever lending and support the IMF, the World Bank, the Inter-American Development, and other institutions provide. Without these, any financial support would be meaningless, since the recovery will be only sustainable to the extent it attracts private investment.

I think I can summarize this very clearly. I think energy is one of the keys to any economic recovery. The current government's policies are detrimental to the United States and foreign investors, and over the long haul will be harmful to Argentine people.

We do not need a simple bailout. Prior to international aid, we do need strict conditions and performance requirements and international loans to ensure investors that they will be treated fairly. These conditions must support long-term, sustainable economic growth, and you must ensure the reinstatement of prior contracts and rules that allowed us the ability to collect our revenues in dollar equivalence.

We are not the bad guy. I think we are just the opposite.

Thank you.

Senator BAYH. Thank you very much, Mr. Haener.

I have some questions, and I will continue because the clock says 6 minutes, Zell, and then I will turn it over to you. Then if I have a couple more, I will go back for a second round.

Mr. Mussa, starting with you. Over the last 2 or 3 years the International Monetary Fund has advanced \$22 billion to Argentina. Do we have any idea where that went? What it was used for? How about the proceeds from the privatization sales? Mr. Haener mentioned one, what was it, three hundred and—

Mr. HAENER. Three hundred forty-two million.

Senator BAYH. —Three hundred forty-two million. What happened to this money? What did they spend it on? First the IMF, and then the proceeds from the privatization. If we are being asked to advance further sums, there should be some accountability for past expenditures.

Mr. MUSSA. Well, they certainly spent it. I mean since money is fungible, it is impossible to know whether the privatization money was spent to make in the end transfers to the provinces, or was spent on Federal Government level wages and so forth. But it was spent. That is clear.

The IMF money is a somewhat different issue. For one thing, most of the IMF money came just in the last couple of years. For a long time, aside from the Tequila crisis where they had a foreign exchange crisis and so forth and we supported their reserves with IMF lending, the program was largely precautionary until 1999–2000, and then the big disbursements came recently.

Much of the money that was disbursed recently was effectively used to pay off the debt that was maturing over that period of time, or to pay the interest on it. Because Argentina lost access to international capital markets after the first few days of January of this year. They had in 2001 about \$22 billion of interest and principal payments on the debt that they needed to make.

Senator BAYH. Interest and principal payments owed by the Federal Government, the States, or both?

Mr. MUSSA. This was at the Federal level. I think it is a somewhat larger amount if you add in the States.

Senator BAYH. And this is owed to multinational organizations, multilateral organizations, and private lenders as well?

Mr. MUSSA. No, I think this is primarily the private sector debt of the Argentine Sovereign: \$21–\$22 billion. Now part of that was refinanced domestically by selling it to the domestic pension funds, domestic banks, and so forth. But they needed \$10 or \$12 billion of financing externally, which was not available privately. And the international money helped to fill in that gap.

The Argentine government also ran—and this is at all levels—a very substantial budget deficit, and some of the Fund money that was advanced by the Fund, by the World Bank, and so forth, no doubt since money is fungible, wound up financing that.

Senator BAYH. Money you do not use to repay interest and principal is thereby freed up to spend on other things, money being fungible as you were saying.

Mr. MUSSA. Yes. That principal is probably more important going forward than it has been—than it was last year, because last year the interest and principal was being paid. But now they are in actual default on at least the external component of their Sovereign debt. So no interest or principal payments are being made.

Now that helps the budget in the sense that they are not needing to make provision for that, and I think that is one of the reasons why any international support that is provided at this stage should be provided in much more modest amounts than one was thinking about earlier, because they are in fact getting extraordinary financing by simply not paying their debts, and I think that it is not a realistic prospect either this year or next year that there is going to be any significant amount of either interest or principal payments to the external creditors of the Argentine government. But I do not think the Fund should be stepping in at this stage to provide money to make those interest and principal payments.

Senator BAYH. Let me ask you about the tax system. Mr. Hakim, you might have an observation on this as well. I commented that

the statistics that have been shown to me indicate that about 50 percent of the taxes that are owed in Argentina are actually paid. To be a devil's advocate here for a moment, why should foreign lending substitute for domestic tax collection?

In other words, should not one of the emphases of the Argentine government be on not raising taxes but actually collecting what they are already owed domestically? Would that not go a fair part of the way toward solving their problem?

Mr. MUSSA. This has been a continuing issue of discussion with the Argentine authorities, because the tax rates are not low in Argentina. Tax revenue is relatively low. But that is because of this problem that there are a lot of people that do not pay their taxes. And on top of that, the Argentine government has a number of tax rebate schemes and so forth which lose a significant amount of revenue. There are also large-scale transfers of revenue from the central government to the provinces. Well over half of the budget of the provinces is financed by revenue that is transferred from the central level.

Now that is not entirely inappropriate, but I would say—

Senator BAYH. It has been a fixed amount, and apparently the agreement that was announced yesterday is going to make it a percentage?

Mr. MUSSA. There was a fixed amount, a minimum amount, and then there were additional amounts on top of that in most years. And now they are going to get a percentage of the revenue.

What is not clear to me from the press reports was whether the deal said that that is going to be for this year, or that is going to be for all time looking forward. Because what the Federal Government agreed to do, on the other hand, was to take over the debts of the provinces.

That is something that has happened several times in the past 50 years in Argentina. The provinces have never paid their debts. When they get to be too big, they pass them off onto the central government. And when that happens again and again and again, it subsidizes imprudent fiscal policy at the provincial level.

Unlike the United States, I mean Orange County has a problem and they default on their debt, that is Orange County's problem. The Federal Government does not necessarily step in to bail them or the creditors out. But in Argentina, there has been this long history of a central government stepping in. And Argentina is by no means the only country. In Brazil, and many developing countries if not most of them, this has been a problem.

Senator BAYH. My time has expired, so I am going to turn it over to Senator Miller.

I would just say your comment reminds me of something they say in the private sector, Mr. Mussa, that if someone owes you a modest amount of money they are a debtor. If they owe you a large amount of money, they are your partner.

[Laughter.]

It sounds as if that is the arrangement between the provinces and the central government in the past from time to time when the debts have gotten to be so large.

Senator Miller.

Senator MILLER. First of all, I want to thank all three of you for bringing some reality to this hearing. I had begun to wonder if we were going to really get down to the dire situation that we face right now.

I particularly appreciate what you had to say, Mr. Hakim. I wish I had heard you earlier. I might have gone on that trip with you.

Mr. HAKIM. It is still open.

[Laughter.]

Senator MILLER. I want to ask you this first. You talked about the economic and political contagion. You know, of course, that Colombia and Brazil are going to be holding presidential elections later this year. Do you see the potential for more radical anticapitalist parties to increase in power as a result of what has happened in Argentina?

Mr. HAKIM. No, this is really one of the most encouraging developments in Latin America. I mean I have been hearing this for the past 15 years every time there was a downturn. There have been a lot of downturns and crises, that this was going to be the forerunner of a new populist regime in Latin America, and that just has not happened.

There is no indication at all that there is a turn away from free markets, really. What I think the problem is is less a problem of kind of an ideological change than a broad demoralization that is occurring in Latin America.

There is a lost confidence in institutions and leaders generally. That is particularly clear in the case of Argentina where there is no institution that any ordinary citizen—this gentleman, I forget your name—suggests they abrogated contracts with the energy companies. They abrogated contracts with depositors, pensioners, they guaranteed there would be one dollar for one peso. That in itself is terribly demoralizing to Argentina. And then other countries look at Argentina and say this was a middle-class, wealthy country. This is a problem for U.S. policy. It makes U.S. policy harder.

Senator MILLER. Let me follow up with this. You probably saw that editorial some time ago in *The New York Times* that was written by Paul Krugman called “Crying With Argentina.”

Mr. HAKIM. Right. I did.

Senator MILLER. He made the statement that Argentina, more than any other developing country, bought into the promises of U.S.-promoted neoliberalism were slashed.

Mr. HAKIM. I think that is a bit exaggerated.

Senator MILLER. You know what I am talking about?

Mr. HAKIM. Yes, I know precisely. I read that article.

Senator MILLER. You do not think there is a backlash against market-oriented reforms?

Mr. HAKIM. It is hard to find any evidence of it. In other words, if you look at recent elections in Latin America, there have been two elections in Central America, for example, this year. In both elections, the more conservative—both of them were businessmen—won the election.

A classic populist Daniel Ortéga, you may remember, lost the election quite handily. In Brazil, there is a populist candidate who is running for his fourth try at the presidency. He is declining in

the polls over the past couple of months since the Argentine—there is just no concrete evidence of that.

The problem I think, like I said, is a broad demoralization and discouragement. The results in Latin America of free markets, of even democratic change, have not lived up to expectations. There is not any good ideas of how you begin to make them work better.

Senator MILLER. Mr. Haener, do you have investments or business in Chile?

Mr. HAENER. Yes, I do.

Senator MILLER. Would you mind talking to us a little bit about the difference of doing business in Chile and in Argentina?

Mr. HAENER. It is significant right now. Certainly Chile has had a history of living up to their commitments. They have solid economic policy. And I will say that they have always stood up to the agreements and, frankly, I would continue to invest in there.

Senator MILLER. You would.

Mr. HAENER. If you asked me if I would invest in Argentina, I would tell you that if I went to our chairman of the board, it would take them only one nanosecond to tell me to seek employment elsewhere.

[Laughter.]

Senator MILLER. I should have asked you the question that I asked Secretary Taylor awhile ago about what do I tell my Georgia computer and electronics companies back in Georgia.

Thank you.

I have another question, but you go ahead, Mr. Chairman.

Senator BAYH. No, go ahead.

Senator MILLER. This is a question that I asked Secretary Taylor awhile ago, and you have talked about it a little more. What is the relationship that the national government has with those provinces? It is almost as if they have an incentive—you more or less confirmed that—to go ahead and just spend all you want and go into debt, because sooner or later mama's gonna come along and pay for you. Do these Duhalde reforms, in your opinion, really address that?

Mr. MUSSA. I think that is far from clear. Indeed, the fact that they are going to go in and take over the debts one more time as part of the present deal is yet another instance of that system working.

So it is cross my heart and hope to die I won't do it again. Well, Argentina has a long history of it. Indeed, when Duhalde was the Governor of Buenos Aires Province, the largest province, and one of the most fiscally profligate provinces in the country, there was another mechanism of this kind. Sometimes they would borrow from their local/state provincial bank, and then either the government or the central bank had to step in and bail the bank out.

This is yet another instance of what we have seen. The details are not the same each time around, but it is more or less the same business. Well, I think that is a source of concern.

I would say if they are going to do a deal like that, then there should be some type of agreement on a constitutional change which is going to limit in some way the liability. Of course, you can always change the constitution. So that is not an absolute guarantee.

Senator BAYH. Or the supreme court.

Mr. MUSSA. Yes, the supreme court in Argentina is not the Supreme Court of the United States, and they have also been part of the problem as well. In past occasions when the central government has tried to impose some discipline on either state spending and borrowing, or excessive pension payments, or whatever it is, the supreme court has often overruled those decisions. And indeed, a not negligible amount of the borrowing has been the borrowing to finance the fiscal consequences of those adverse decisions.

Senator MILLER. Did you want to add to that, Mr. Hakim?

Mr. HAKIM. International markets also play a role in this. If a country has a province that is not paying its debts internationally at least, or to international companies located in the province, that country will often find its credit ratings deteriorating. We have seen this in Brazil where one governor—

Mr. MUSSA. Governor Franco, yes.

Mr. HAKIM. In other words, it is not simply a constitutional measure. These countries have to perform very, very well fiscally and they have to take control over the provincial finances basically when they break down. In other words, it is not a question you can build into law. You have to have some capacity of the central government to really almost intervene.

Mr. MUSSA. And it is a political problem, as well. Can the central government really face down the provinces and say, this time you are going to take the consequences of your fiscal excesses. And that has proved to be very difficult to do in Argentina, and Brazil, and a number of other countries.

Senator MILLER. I have found it such with my children.

[Laughter.]

Thank you, Mr. Chairman.

Senator BAYH. Mr. Hakim, I have a question for you following up on Senator Miller's last question. You recommended in your testimony outlining specific steps that need to be taken to, in the International Monetary Fund's opinion and the opinion of the U.S. Treasury, constitutes sustainable economic and financial policies.

My question to you would be: If we were to do that, would that not appear that the difficult consequences of those steps were being imposed from abroad, thereby generating a political backlash within Argentina which would make these steps that we were proposing politically unsustainable? In other words, it is a Catch 22. Is there really any substitute for a domestic political consensus about what to do, not appearing to be imposed from without?

Mr. HAKIM. There is no good path here. In other words—

Senator BAYH. You can understand—

Mr. HAKIM. I know exactly where you are—

Senator BAYH. Can I just say one final thing? You can understand how the politician or some political figures in Argentina might play it as it is the bad old United States coming in and telling us what we have—all these adverse consequences you do not like, that is being imposed on us from without.

Mr. HAKIM. But at the same time, the fact is the Argentine political politicians cannot come together on a plan. There is simply not enough political capital in the system. The Duhalde government does not have the authority or the capacity or the will, whatever, to make this work.

He needs external support. I think the United States is the only country that has the leadership, the international authority that can put its weight behind it. Because if the United States does put its weight behind it, the Europeans are likely to be able to be willing to support this.

It is also important the fact—and this is what I think very strongly—that the other Latin American countries, Argentina's neighbors, Brazil, and Chile, would support this kind of initiative from the United States.

Senator BAYH. I am sure——

Mr. HAKIM. I have talked to many representatives of these countries precisely about this idea. They cannot say publicly they want the United States to essentially give Argentina a plan, but I think if this were put together right and presented to them right, we could get public international backing support for this from Brazil, from Mexico, from Chile, and the other countries in Latin America who realize how dangerous——

Senator BAYH. I am sure they would support it, but they do not bear any of the adverse domestic consequences.

I hear what you say. Just from my own perspective, I am very skeptical that all the good advice from abroad can do much good if there is not that domestic political——

Mr. HAKIM. Well, in the end——

Senator BAYH. —and I can see this being demagogued to death by some political figures.

Mr. HAKIM. What I am saying is how you create the domestic support for something like this. In other words, I think at times it takes somebody from outside to say this is the right way to proceed. If you proceed this way, there will be resources available, and the other friends in the region are saying this is the right way to proceed, you might get a good result. The risk is there. You send the firemen into a burning building. There is a risk. There is no question.

Senator BAYH. So, Mr. Mussa, this gets back to my point I think previously, which was in some ways this seems to be as much of a political challenge as an economic or financial one. Clearly, some formal guidance needs to be offered, but overt public, basically laying down of conditions, it seems to me, would run the risk of political demagoguery domestically——

Mr. HAKIM. I have been as much opposed to that intervention. I think this is a particular case that these problems all have to be solved. As we have seen in the 1980's and 1990's, on a case by case basis, and in this case it is the first case I have ever done this, advocated a very heavy-handed intervention.

Senator BAYH. Mr. Mussa, you wanted to comment?

Mr. MUSSA. I think one needs to recognize, first, how clearly terrible this situation is. Probably over the past 3 months, real GDP in Argentina has fallen something like 25 percent. That is what happened in the United States between 1929 and 1933. I mean, this is really an economic collapse that is virtually unprecedented, far worse than we have seen in the other emerging market crises of the 1990's. And it is still going on. One of the things that means is that if you can step in and bring some sense of stabilization,

even if the program is not perfect, that there is a long way to go back up.

So the risks that one takes when the economy is really enormously depressed in going in and trying to assist with a stabilization, the risk that it will be a failure, is reduced because you have already had the big failure.

Everybody recognizes in Argentina that it is the big failure, and the chance is to turn things around.

You do not want to step in at the top. If we had stepped in in December with this type of program, then the international community, the United States and the Fund, would have been blamed.

Senator BAYH. Would you agree with my observation—I think you spoke to it a little bit when you said the funds could be released in the tranches over a period of time—that the assistance provided should be for demonstrated performance as opposed to just pronouncements?

Mr. MUSSA. That is the idea, that they are committed to perform. And if they do not live up to that performance, and there is not a good reason why they fail—I mean sometimes things, you know, the economy continues to sink and the tax revenues sink along with it—but if it is failing because they are failing to deliver on their policy promises, then you have to pull their chain.

That is the way in which the system works. As I say, because they are not paying any debt service at present, I do not think that the amount of money that is needed, aside from postponing the payback of the money to the Fund and others that is due this year and next year, the net new amount of money that would be needed to support them is not in my judgment that large. It is not \$22, \$23 billion of net new money. That is relevant in this circumstance.

It is primarily a political problem, not I think an economic problem. What needs to be done is I think reasonably clear. It is getting it done that is the problem.

Mr. HAKIM. Could I just add one thing? When the United States went to Mexico and helped with their economic crisis in 1995, I understand we placed in the treasury—and Michael can talk to this perhaps better than I can—something like 17 or 18 staff people working with the Mexicans to help them oversee. A plan was already in place, to oversee the implementation of their economic program. In other words, that was also a very heavy engagement.

I think we have to be more involved, and what Taylor suggested then as merely a shareholder of the IMF, I mean that is just totally inadequate for a country like the United States.

Senator BAYH. It should be at the invitation of the Argentines, shouldn't it?

Mr. HAKIM. That would be helpful.

Senator BAYH. As opposed to being imposed from without. I am just worried about the political ramifications. In order for this to work, you have to have—there is no substitute for the Argentines running their own country. So, you have to have a political consensus develop there eventually.

Mr. HAKIM. And believe me, I have actually talked to a lot of the Argentines that are asking for somebody from outside that can impose—impose is a strong word—but at least present a rational way

to proceed, and to strengthen those people that want to proceed in Argentina in a rational, intelligent, technically sound way.

Senator BAYH. I have one more brief comment.

Zell, do you have anything else? I have two questions for Mr. Haener. I have not forgotten you. As a matter of fact, I have great empathy for the situation you are in here today. You are on the front line of all this.

Senator MILLER. No, go ahead with Mr. Haener.

Senator BAYH. My one observation, Mr. Hakim, for you, and then two questions for Mr. Haener. I have heard this from other individuals, too, about the perception in some quarters in South America about American indifference to the plight of the Continent, and so forth and so on.

I can understand that in part, but I just recount the statistics. Our banks are on the line here for \$23 billion. We have direct foreign investment of \$14.5 billion. A great chunk of that is worthless now. The IMF, which you know we fund in great part, has \$22 billion on the line here. There is a good question about whether that will ever be repaid.

This does not sound like indifference to me. We have been major contributors to the country, to our great loss at this point.

Mr. HAKIM. Let me say that all of those companies went to Argentina. They may be doing great for the Argentine economy, and I support them very, very much. They also went there for a profit. They went there because Argentina represented a place where they could earn money. In other words, this was not benevolent—

Senator BAYH. Regardless of their intentions, however, they have suffered great losses, and that does not strike me as indifference.

Mr. HAKIM. I mean the Argentine people have suffered losses, as well. All that I am saying is that there is a crisis now in a country that we considered a close ally, a country that we want to make a partner in free trade, that we want to be part of a hemispheric free trade area, that we meet regularly in summit meetings. The question is how the United States should respond now to that.

Senator BAYH. I do not disagree with any of that. All I am saying is it seems as if there ought to be some recognition in some quarters of the constructive role that both—

Mr. HAKIM. Oh, I think the fact that so many people are asking for the United States to become more involved suggests they know that the U.S. involvement is a good thing. The President of Brazil is not asking for the United States to become more involved in Argentina because he thinks U.S. involvement is bad. On the contrary, they believe the U.S. involvement is good and want more of it now.

Senator BAYH. I am saying that the perception of indifference is not only inaccurate but also unfair.

Mr. HAKIM. That is a conversation we could have. I think that promises have been made and have not been fully kept.

Senator BAYH. By whom?

Mr. HAKIM. By the U.S. Government.

Senator BAYH. Well, what about the promises of the Argentine government?

Mr. HAKIM. That, too. They have not been kept. I agree with that. That is the first thing I said today.

Senator BAYH. Perhaps we will have that conversation later.

Mr. HAKIM. Okay.

Senator BAYH. I would look forward to it.

Mr. Haener, I think that you answered this in response to Senator Miller's question. It sounds to me as if your opinion is that the confiscatory policies that have recently been implemented by the Argentine government, in your opinion would essentially mean no further direct foreign investment certainly from where you sit?

Mr. HAENER. Certainly from the private sector I think it would be very difficult for anyone to justify putting money in there now.

Senator BAYH. I had a major banker tell me that yesterday. Their company has been in Argentina for 60, 70 years and they are considering pulling out entirely because of the complete lack of credibility they now feel exists with regard to the rule of law, sanctity of contracts, bankruptcy procedures, the list goes on and on.

Mr. HAENER. It is incredible, to my way of thinking. Frankly, I am surprised that the people have put up with it.

I think that there is a recognition in Argentina within the populace of the benefits of stable economic policy. I will give you an example. The first time I went to Argentina was after the market reforms and after the days of the hyperinflation. I was riding in a cab, talking to the cab driver, and I said: Well, what do you think about the new economic policies of the free market? He said, I am from the days of hyperinflation. I am working harder now than I ever have before. But I never want to go back. I said, why is that? He said, now I own my own cab. I never could before.

So something was working. And I think there is a will within the country, if we give them some leadership.

Senator BAYH. My last question is for you, Mr. Haener. It seems that some of the policies have disproportionately singled out the energy industry that you represent and some of the financial institutions to help address the crisis. Is that your perception, or no?

Mr. HAENER. Absolutely.

Senator BAYH. Well, why do you think that is? Do you have an opinion?

Mr. HAENER. I think it is politically easy to point the finger outside the country. I think it is that simple.

Senator BAYH. Um-hmm.

Mr. HAENER. Let somebody else shoulder the burden.

Senator BAYH. Very good. Well, thank you, Mr. Haener. Again, I have empathy for your situation.

Mr. Hakim, I appreciate your input today. Mr. Mussa, thank you. It has been very enlightening. Again, just to make my own viewpoint clear, I hope we can play a constructive role here. It is in the best interests of everyone that we try and resolve this in a positive way. It does require a certain suspension of disbelief, I guess, or a greater degree of optimism, but that is also a strain in the American character that has stood us in good stead, and I do hope it turns out well.

The last thing I would say, Mr. Mussa and Mr. Hakim, to both of you, if we can get policies that seem to make sense and get some demonstrable performance on those policies, then by all means I think we should try and lend a hand here.

Thank you all, very much.

Mr. MUSSA. Thank you.

Mr. HAKIM. Thank you.

Mr. HAENER. Thank you.

[Whereupon, at 4:10 p.m., the hearing was adjourned.]

[Prepared statements, response to written question, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

Thank you, Chairman Bayh, for holding this hearing.

I also want to thank our witnesses for talking to us about our concerns regarding Argentina. It is a very important economic partner.

One concern is that, during this insecure financial time, Argentina may take some actions that will not help in the long run and will, at the same time, cause harm to United States businesses.

I am sure that the appropriate United States agencies are working with their counterparts in Argentina and providing all the advice necessary. I hope that some of the issues covered include urging Argentina to preserve its freely convertible currency and avoiding the expropriation or confiscation of private sector assets. I am also interested in hearing the panel's views on President Duhalde's current theory that he can bring Argentina out of this crisis by blocking imports.

The implications on trade, the IMF, the U.S. business and regional contagion are significant. This timely and important hearing will help guide us in policymaking decisions that will hopefully aid our friend and ally, Argentina.

PREPARED STATEMENT OF JOHN B. TAYLOR¹

UNDER SECRETARY FOR INTERNATIONAL AFFAIRS

U.S. DEPARTMENT OF THE TREASURY

FEBRUARY 28, 2002

Thank you very much, Chairman Bayh, Ranking Member Hagel, and Members of the Subcommittee for inviting me to participate in this hearing on the current economic situation in Argentina.

The people of Argentina are facing extremely trying times. Throughout this difficult period, President Bush has made it clear that Argentina is an important friend and ally of the United States of America. We want our allies to be strong leaders of free democracies and free markets. Argentina should be an engine of economic growth in our hemisphere. It is important that Argentina succeeds.

In order to understand the current situation in Argentina, I think it is helpful to begin by reviewing some of the key economic developments in Argentina during the last decade.

The Economy of Argentina in the 1990's

In the early 1990's, the government of Argentina undertook a series of important reforms in economic policy, including monetary policy, fiscal policy, structural policy, and international trade policy. Perhaps most dramatic and immediately noticeable was the change in monetary policy. A highly inflationary monetary policy was replaced by a new "convertibility law," which pegged the peso one-to-one with the dollar and largely prevented the central bank from financing the government's budget deficit by printing money. Fiscal policy was also brought into better control and there was a decline in deficits. On the structural side, a comprehensive privatization program was implemented through which a number of inefficient state-owned enterprises were privatized. Moreover, barriers to international trade and investment were reduced and Argentina's financial sector was opened to foreign investors.

These market-oriented reforms produced very impressive results. Hyperinflation—which had risen to over 3,000 percent—was brought to a quick end by the convertibility law. Economic growth turned around sharply: After falling during the 1980's, real GDP began growing at over 4 percent per year. Investment and exports grew particularly rapidly. The sharp increase in economic growth was even more remarkable given the very rapid disinflation that was occurring at the same time.

However, starting in the late 1990's there were a number of policy setbacks and external shocks which sharply reduced economic growth in Argentina and ultimately led to the financial crises in 2000–2001 and the current halt to economic activity.

First, government budget deficits began to increase and fiscal discipline began to wane. Government spending at the Federal and provincial level increased faster than tax revenues. These deficits could not be financed by money creation because of the convertibility law. Instead, they were financed by borrowing in both the domestic and the international capital markets; however, as the government's debt began to rise and raise questions about sustainability of the debt, risk premia rose

¹This is an update to the testimony submitted on February 6, 2002, before the Subcommittee on International Monetary Policy and Trade of the House Financial Services Committee.

and increased interest rates. Eventually the higher interest rates put additional pressure on the budget deficit and held back economic growth.

Second, the low inflation of the early-to-mid 1990's turned into persistent deflation, which also had negative effects on economic growth. In addition, the currencies of Argentina's major trading partners in Europe and Brazil depreciated relative to the dollar, and therefore relative to the Argentine peso. This effective appreciation of the peso led to deterioration in Argentina's competitiveness, which, along with the higher interest rates, further held back economic growth.

Third, persistent expectations of depreciation of the peso caused interest rates on peso loans to be higher than dollar interest rates. Whenever policy actions were taken that raised questions about central bank independence or about the convertibility law, market expectations of depreciation increased causing domestic interest rates to rise further.

As low economic growth persisted into 2000, concerns began to grow that a vicious cycle of low tax revenues and continued government spending increases would lead to rising interest rates, which would further slow the economy. Following the political turmoil in October 2000 when Vice President Alvarez resigned, Argentina's borrowing costs soared and rolling over government debt became more and more difficult. Renewed plans to reduce the budget deficit brought interest rates down temporarily, but by February 2001 it was clear that further actions needed to take place. The Argentine government introduced a number of policy changes and finally decided to create a rule—the zero deficit law—in the summer of 2001 to try to provide confidence about the government's seriousness in getting its fiscal house in order.

Eventually, however, it became clear that these changes to the budget were not working. Many market participants considered the government's economic plan to be unsustainable, and interest rates on government debt began to increase sharply. By November, it was apparent that the government's debt would have to be restructured and, indeed, President de la Rúa took the step of announcing that such a restructuring would take place.

As the restructuring effort was underway, the uncertainty about its impact on the banking system led to increasingly large deposit withdrawals from banks and international reserves began to fall. In order to stop the withdrawals and the decline in reserves, the government imposed severe restrictions on such withdrawals in December. Soon after the restrictions were imposed, social and political protests turned violent, leading to the resignation of President de la Rúa and his Ministers.

Economic circumstances in Argentina deteriorated after the imposition of the restrictions on deposit withdrawals. The lack of a functioning payments system led to a virtual halt of much economic activity. The shortage of liquidity is hindering economic growth and underlies much of the social frustration. The Duhalde government, which took over in January, is in the process of gradually removing these restrictions and at the same time moving to a flexible exchange rate system.

It is of course up to the government of Argentina to work out the details of a set of economic policies that will increase economic growth in a sustainable way. Secretary O'Neill met with Argentina's Minister of Economy on February 12. I met with the Minister the following day. Argentine officials understand that the decisions they must make will be difficult, but I was impressed with the Minister's sincerity and commitment. We have maintained our dialogue and will seek to build upon the initial progress we have made.

In addition to meeting with Argentine officials, we have also held meetings in recent weeks with U.S. corporate officials operating in Argentina. We apprised these officials of developments taking place on our end, and have listened to their concerns about difficulties that they are facing. In conversations other U.S. Government officials and I have had with Argentine officials, we have repeatedly emphasized the importance of all investors being treated fairly. Foreign investors can play a critical role in Argentina's future.

Summary of IMF Programs

During the period of time discussed above, the government of Argentina had several programs with the International Monetary Fund (IMF). In March 2000, Argentina obtained a \$7.4 billion IMF program. The Argentine government treated the program as "precautionary," meaning that the government did not intend to draw upon it. However, starting in the summer of 2000, the growing concern in financial markets was that the persistent Argentine recession was setting up the potential for a financial crisis.

In December 2000, Argentina drew on \$2 billion from its IMF program, and the next month the IMF approved an additional \$6.3 billion for Argentina's program, bringing the total program size to \$13.7 billion. As a condition for the January pack-

age, the Argentine government agreed to a series of structural measures in the area of fiscal, pension, and health care reforms to help develop a sustainable fiscal position in the medium term and to build investor confidence.

In August 2001, the IMF provided Argentina with a further augmentation of \$8 billion. Of this amount, \$5 billion was to bolster reserves in the central bank to counter a substantial fall in deposits during the summer. The remaining \$3 billion could be used to support a voluntary, market-based debt operation and thereby begin to address Argentina's debt sustainability problem. However, when tax revenues continued to fall short and the government failed to reach an agreement on transfers to the provinces, it became increasingly clear that the government was not going to be able to meet its fiscal targets and had no other sources of financing. This fueled concerns about the government's ability to service its debt, particularly to domestic banks, and eventually prompted an accelerated run on the banking system.

In December, the IMF's staff determined that Argentina was not going to make its fiscal targets for the fourth quarter that were agreed upon in August and that its program was no longer sustainable. Thus, the IMF could not complete its review and consequently did not disburse a loan tranche in December 2001.

Earlier this month, a team from the finance ministry of Argentina visited the IMF. I understand the meetings with the IMF were productive. As President Bush has said, once Argentina has designed a sustainable economic program, the United States is prepared to support it through the international financial institutions.

U.S. Policy

Our engagement with the International Monetary Fund and the government of Argentina during the last year should be viewed in the context of our overall approach to emerging markets. During the last 4 years the flows of capital to the emerging markets have declined sharply, and it has been the intent of the Bush Administration to reverse this trend by reducing the frequency of financial crises of the kind that we have seen in Argentina.

Of course, the ideal would be to prevent crises such as the one in Argentina from occurring. This requires not only early detection of policies or of external shocks that could cause crises, but also the resolve to take actions to reverse such policies or to counter such shocks. The Bush Administration has encouraged the IMF to strengthen its capacity to detect potential troubles on the horizon, and to be willing to warn countries that are heading down a dangerous path to take appropriate action. Effective communication with markets is also key. And the IMF can be more effective and credible in undertaking these tasks if it focuses on issues that are central to its expertise—notably strengthening monetary, fiscal, exchange rate, financial sector, and debt management policies. In the last decade, the IMF became too involved in matters outside of these core areas.

I hope the emerging market asset class grows much more in the future as the rates of economic growth in developing and emerging market countries rise. But we have to recognize that official sector resources cannot possibly grow at such a high rate that we can continue with very large official finance packages to deal with emerging market debt crises as in recent years. There will inevitably be limitations on the use of official sector resources. Moreover, in order to reduce bailouts of private investors it is necessary to limit the use of official resources, especially in cases where debt sustainability is in question. We must, therefore, gradually move in the direction of less reliance on large official finance packages.

An important change has been occurring in emerging markets and we have encouraged this change as part of our approach to emerging markets. Investors are increasingly differentiating between countries and markets based on fundamental economic assessments—judgments that are facilitated by better information. This differentiation is reducing contagion from one country to another, as exemplified most recently by the relative stability in other emerging markets over the past few months despite the crisis in Argentina. Emphasis on the risk of contagion by the official sector in the past led to the expectation on the part of investors and emerging market governments that the official sector would bail them out. That encouraged excessive risk-taking and gave rise to the very conditions that made financial crises more likely. Changing this mindset has been an important priority, and, I think, an area where we have made some progress.

One important challenge that remains is to explore options to promote more orderly sovereign debt restructurings. The official sector should not encourage countries to default on their debts, but we recognize that restructuring can and will happen in certain cases. At the moment, there is a great deal of uncertainty about the process involved in such restructurings. It is important to find a way such that when a sovereign debt restructuring occurs, it does so in a more orderly manner

that treats debtors and creditors fairly and reduces the scope for arbitrary, unpredictable official action.

Thank you again for this opportunity to speak with you. I look forward to hearing your views and answering your questions.

PREPARED STATEMENT OF MICHAEL MUSSA
SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS

FEBRUARY 28, 2002

Thank you, Mr. Chairman. I am a Senior Fellow at the Institute for International Economics here in Washington, DC. As you may know, for 10 years before I joined the Institute last October, I worked on the staff of the International Monetary Fund, serving from September 1991 through June 2001 as its Economic Counsellor and Director of its Research Department.

It is a pleasure to be able to testify today on the important and timely subject of the economic tragedy now gripping Argentina—on how it got into this mess, and on how, with the assistance of the international community, it might get out of it.

The economic performance of Argentina during the past decade has encompassed a remarkable transition: From hyperinflation, financial chaos, and deep recession at the end of the 1980's, through a spectacularly successful period of stabilization, reform, and economic growth extending generally from 1991 through 1998, then into a deepening recession and deflation from 1999 through most of last year, and finally into a catastrophic financial and economic collapse that began with the effective closure of the Argentine banking last December and the subsequent sovereign default and termination of Argentina's Convertibility Plan linking the peso rigidly to the United States dollar.

What was responsible for the tragic collapse of Argentina's initially successful efforts at economic stabilization and reform. Clearly, a variety of important factors played significant roles; and I will not attempt to detail all of them and weigh their relative significance in these brief remarks. However, it is important to emphasize that the tragedy was due primarily to Argentina's economic policies, either directly or in their failure to respond adequately to other adverse developments.

Argentina's key policy failure was the inability and unwillingness of government at all levels to run a sustainable fiscal policy. Even when the Argentine economy was turning in by far its best performance in many decades, as it was from 1991 to 1998, the ratio of total public debt to GDP was rising. In fact, after the Brady bond deal that help cut the debt ratio in early 1993 to 29 percent of GDP, total public debt rose to 41 percent of GDP by 1998. And, this was in a period when the Argentine government was receiving substantial nonrecurring revenues from privatization. With the onset of recession and deflation in Argentina after the collapse of Brazil's exchange rate peg in early 1999, Argentina's fiscal difficulties became more pressing, and public debt rose to 50 percent of GDP by late 2000. When efforts to reign in the fiscal deficit during 2001 repeatedly proved inadequate, financial markets completely lost confidence and sovereign default became inevitable.

Argentina's Convertibility Plan, which rigidly linked the peso to the dollar and tightly constrained monetary policy, also played a critical role in the transformation from success to tragedy. Early in the 1990's, the Convertibility Plan helped enormously to bring financial stability and economic recovery after decades of financial chaos. However, it was a rigid framework that made it more difficult for the Argentine economy to adjust successfully to adverse shocks in the late 1990's; and this did not make the problems for fiscal policy any easier. However, in the end, I would say that fiscal imprudence killed the Convertibility Plan, rather than the other way around; and both together killed the Argentine economy.

What was the role of the International Monetary Fund in all of this? The Fund was deeply involved with Argentina throughout the past decade, as Argentina operated under the close scrutiny of a series of Fund-supported programs. And the Fund generally praised most of Argentina's policies and pointed to them as a model for other emerging market economies. Thus, the Fund must take some responsibility for Argentina's tragedy. To be fair, however, it is important to emphasize that the policies that led to the tragedy were well and truly owned by the Argentine authorities; Argentina was not pushed into bad or inadequate policies by the Fund. Rather, the failures of the Fund were sins of omission, not sins of commission.

I would emphasize two such failures. First, when the Argentine economy was generally performing very well, the Fund did not press the Argentine authorities as hard as it could have or should have to run a more responsible fiscal policy. This

was a serious failure of the Fund to do the job that it is expected to do for a program country like Argentina that had a long history of fiscal imprudence. Second, I believe that the Fund was right to organize a large international support package in December 2000 to help give Argentina one last chance to avoid disaster. However, by the middle of last year, it was clear that the Argentine authorities could not implement the policies required to take advantage of this one last chance. At that time, the Fund made another serious error in significantly augmenting its financial support for Argentina. Money that might be far more useful in aiding Argentina now was wasted in a futile effort to sustain the unsustainable. And the Argentine authorities were not given a forceful message of the need to change fundamentally their policies at a time when the inevitable turmoil from such a change might have been better controlled than it has actually proved to be.

Looking to the future, no one should underestimate the immense difficulties faced by the present Argentine authorities in their efforts to stabilize a rapidly deteriorating situation and then to initiate a sustainable recovery. The Duhalde administration has taken several important steps—painful but necessary steps—in the right direction. However, my understanding is that they are still somewhat short of the consistent and comprehensive set of implementable policies that the Fund (and others) rightly insist are needed to provide assurance of a successful stabilization effort.

In the extremely difficult economic and political environment of today's Argentina, I think that one must recognize that the Duhalde administration may not be put together and implement as credible a program as we would all like to see. The effort may fail, and stabilization and recovery may only come after Argentina has gone through a more prolonged period of economic and financial chaos and political and social upheaval.

However, I believe that it would be unwise to surrender to this prospect because the policy program that might avoid it is somewhat less than fully credible. At some point, perhaps sooner rather than later, it makes sense to take some risk by extending international support to the best policy program the Argentine authorities are capable of proposing, even if this program has some significant weaknesses. For the Fund and the international community, the risk inherent in supporting such a program can be contained within reasonable limits: By insisting on a reasonable (but not perfect) set of policies that have some chance of successful implementation; by keeping the amount of net new financial support within reasonable limits (such as 100 percent of quota for additional annual support from the Fund); and by tranching the disbursement of this support in relatively small (monthly) packages so that if the program goes seriously off track remedies may be expeditiously sought.

The international community cannot simply abandon Argentina in its present desperate circumstances. While recognizing that success is not assured, it must seek a reasonable and a realistic basis for aiding Argentina's efforts to end the present tragedy.

PREPARED STATEMENT OF PETER HAKIM

PRESIDENT, INTER-AMERICAN DIALOGUE

FEBRUARY 28, 2002

There is a broad consensus that any solution to the Argentina's financial crisis will require substantial external economic support from the IMF and other sources. This is the view of Argentine and United States Government officials, staff and officials of the IMF and other international financial institutions, most corporate and financial leaders, and economic analysts of every political stripe.

The United States Government and the IMF have made clear that no external resources will be made available to Argentina, unless the Argentine government comes up with a realistic and coherent program for sustainable economic recovery.

After nearly 2 months in office, the government of President Duhalde is still struggling to develop a program that is convincing to the U.S. Treasury and the IMF. Now, a new consensus is forming—that the Duhalde government, operating under severe political constraints, will not, on its own, ever be able to put together and execute such a program. The government does not now have, and seems incapable of galvanizing, sufficient political support to take the extraordinarily difficult measures that will be required to restore order to the Argentine economy. Those measures will impose enormous economic losses on most Argentines.

If this second consensus is correct, then either: (a) the U.S. government and the IMF have to reconsider their stated position (for example, that they cannot come to Argentina's aid unless the Argentine government first produces a suitable pro-

gram; or (b) Argentina will face a far deeper, more prolonged, and more dangerous crisis. Under these circumstances, hyperinflation, which will leave the economy in total shambles, appears the most likely way that the necessary economic sacrifices will be forced on the Argentine population. And nobody quite knows where the country's politics will end up, but the country's democratic institutions will be at risk.

A deepening crisis would not only be disastrous for Argentina, but also it could well produce serious reversals in many other Latin American countries and play havoc with United States objectives in the hemisphere. So far the consequences of the Argentine collapse seem to be largely contained, affecting in a serious way only its small neighbor, Uruguay. Yet there are already disturbing signs of a decline in investment flows to Latin America. Such a decline, if it occurs, would undercut the region's prospects for economic stability and growth.

The more prolonged and deeper the Argentine crisis, the more impact it will have on United States relations with other Latin American countries. Already, the United States is seen by many Latin Americans as having turned its back on the country that was its strongest ally and supporter in the region (at the same time considerable aid was provided to Turkey, a country facing similar problems, but strategically more important). The United States response to Argentina is also widely seen as further evidence of the low priority that Washington has assigned to Latin America, particularly since September 11. These are attitudes that will make the negotiation of hemispheric free trade more difficult and could result in less cooperation on other key fronts.

There is no getting around it. In order for Argentina to recover its economic health, a technically sound economic program is essential. Nothing can be done without that. But that program can only succeed if two other conditions are met: The Argentine government must have the political capacity and will to implement it and external support must be available. The United States can and should help on all three counts.

The United States, in tandem with the IMF, should now: (a) provide the Argentine government with a clear and precise statement of the crucial elements that must be included in a program for the Argentine economy that the United States could support; and (b) make plain what level of resources the United States is willing to help assemble in order to make the program work. If the Argentine government accepts this as the right basis to move forward, the United States, again together with the IMF, should quickly start to cooperate with the Argentine economic team to develop a full-fledged policy blueprint—and undertake efforts to secure necessary contributions from the international financial institutions, the G-7 countries, and private investors. This set of initiatives would, I believe, gain the political backing of Argentina's neighbors and most other Latin American countries. They, of course, should be consulted from the outset.

Only the United States can provide the kind of leadership that is necessary to make this effort succeed. Without the full weight of the United States behind it, the IMF cannot and will not take the forceful actions needed. And there is a good chance that an intensely engaged United States could end the political impasse in Argentina, and give the government the support and resolve it needs to take the economic and political decisions that are essential to address the crisis.

All this still may not work, but without the intense involvement of the United States, the Argentine government will likely remain immobilized. The country's economy and politics will continue to deteriorate, doing terrible and lasting damage to Argentina and its people, possibly spreading the harm to many other countries of Latin America, and potentially undermining the United States policy objectives across the hemisphere.

PREPARED STATEMENT OF WILLIAM J. HAENER

PRESIDENT AND CHIEF EXECUTIVE OFFICER
CMS GAS TRANSMISSION COMPANY

FEBRUARY 28, 2002

Mr. Chairman, Members of the Subcommittee, I am William Haener, President and CEO of the CMS Gas Transmission Company, a subsidiary of the CMS Energy Corporation. I want to thank you for the opportunity to present my company's perspective on the current crisis and to emphasize the great concerns that we and other investors share.

Argentina had previously—and justifiably—been held up as a model for an IMF-supported economic recovery based on sensible, transparent economic policies and

free market principles that fostered sound investments. In recent weeks, however, both policy and principle have been reversed. The government's new economic regime represents a summary abrogation of Argentina's legal obligations and treaty commitments and contravenes the framework of that country's constitution. It signals an abandonment of Argentina's free market orientation and successful privatization program—which brought billions of dollars of foreign investments into the Argentine economy.

Argentina did not come to its present economic condition because of foreign investors. In truth, neither investment nor credit could keep pace with the speed at which Argentina was incurring sovereign debt. It is Argentina's sovereign debt, which it accumulated by ignoring a giant fiscal imbalance for too long, that is the cause of Argentina's economic troubles. That is something that cannot be cured by forcing the adoption of an increasingly devalued currency or by mounting politically charged attacks on investors. Attacking sources of investment, whether they are domestic or international, will only worsen the plight of the Argentine people and will do nothing to foster a recovery.

Our main concern with the new policy regime is not the devaluation of the peso. Rather, we are far more troubled by the government's cancellation of public and private contracts, its imposition of restrictions on the free transfer of funds and its elimination of adjustments for inflation and currency fluctuations. While in some respects it could be understandable that the government needed to adjust the value of and float its currency, these other measures are throttling the revenue stream of energy projects. Since there is no corresponding relief on the external debts and other obligations of these energy projects, the Argentine government is forcing many of them into a position of insolvency.

Since the energy sector is fully privatized, from gas production through gas transportation, power generation, and electricity distribution, there is a cascading effect throughout the sector. In this type of policy environment, insolvent projects could go into bankruptcy, bankrupt projects could be renationalized, and service to the Argentine citizens definitely will be less efficient, more expensive and subject to disruptions. Over the long term, a sustainable economy can be achieved only if there is access to reliable and affordable sources of energy to fuel the growth of the Gross National Product. But in the short term, Argentina could be exposed to power outages at any time. The energy sector is heading into a crisis that could have grave economic, social, and political implications.

As recently as this week, President Duhalde announced that his government was contemplating a new "emergency tax" on utilities in response to what he termed "the extraordinary" profits that foreign investors have reaped in recent years. I want to be very clear about this issue. American and international investment in Argentina's electricity sector has been of extraordinary benefit to the Argentine government and people in terms of lower prices and increased reliability of service. According to the independent and highly regarded Cambridge Energy Research Associates, spot energy prices in 2001 were the lowest on average in Argentina since 1995. Monthly average prices did not rise above \$14 per megawatt hour during the second half of the year. Only in the winter months of May and June did average prices rise above \$16.50 per megawatt hour. These compare to average prices in neighboring Chile of about \$30, in Peru of about \$30, and in the United States between \$25 and \$35 per megawatt hour. I should emphasize that the prices in Argentina were no accident—they were the outcome of a well designed and transparent privatization process.

Similarly in the natural gas sector, prices to the typical residential customer in Buenos Aires rose only 20 percent between December 1992 and January 2001 while reliability of service rose significantly. The vast majority of the price increase was due to government taxes, which rose nearly 69 percent on gas in that period. Gas transmission and distribution costs were essentially flat, rising only 1.9 percent.

At the same time, due to the robust level of competition in the Argentine marketplace, the returns to foreign investors who produced those low prices were thin—in many cases less than what could be made in the United States. On top of that, CMS Energy and other companies reinvested a large percentage of whatever returns were made in order to strengthen our operations, increase their efficiency, and make them more competitive in the tight market. For instance, CMS Energy and the other shareholders in one of our investments, the TGN Pipeline, have invested more than more than \$1 billion since 1992—above and beyond the \$392 million initially paid for the asset—to upgrade and improve that system. President Duhalde's comments notwithstanding, we have not repatriated huge dividends and profits but rather reinvested them to benefit the Argentine people.

Let me be equally clear about something else. We are not complaining about the fact that we faced low prices or had low returns. We as investors are fully prepared

to live with unexpectedly thin margins as long as our contracts are being honored and implemented. When our contracts are summarily abrogated, however, and when a government changes the rules and reregulates revenues in such a fashion as to place sound investments into a position of insolvency, it is fundamentally unfair, will result in further economic turmoil, and could lead to massive expropriations. Cheap and reliable energy supplies are critical to economic stability and growth but cannot be obtained under current circumstances in Argentina. There will be no recovery, no matter how much financial support is poured into that economy.

Through its interference with public and private contracts, the Argentine government has moved well beyond a simple devaluation and is ensuring that the crisis will be far worse and longer lasting than in other recent cases such as Mexico and Brazil. Unless Argentina honors its contractual and treaty commitments, its actions will continue to undermine its competitiveness, threaten the viability of its energy infrastructure and virtually guarantee that there will be no additional foreign investment in the sector.

I would also urge the Subcommittee to consider that events in Argentina will have an impact on the United States and other economies. American energy companies brought approximately \$6 billion in equity and commercial and other loans into Argentina during the privatization process. Argentina as a whole brought in about \$80 billion in capital and another \$80 billion in credit, mostly in the form of debt. Unless the situation is corrected, there will be losses to those shareholders whose equity was invested. There will be losses to U.S. suppliers and service companies who provide spare parts or hold operations, maintenance, and service contracts. There will be losses to the U.S. banks that hold the debt, and to U.S. insurance companies that backstop the banks and the energy investments. There will be losses to the U.S. taxpayer, as the American government invested in and insured some of these projects through the Overseas Private Investment Corporation and the Export-Import Bank of the United States. And there will be a contagion effect on other emerging economies, as prospective investors and corporate boards look far more skeptically at future investments elsewhere. It is difficult to see how private investors will find their way to other markets in the region, much less to places like Afghanistan or Pakistan, if Argentina is allowed to fail.

As a matter of utmost priority, a bailout is not the answer. CMS Energy urges the Congress, the United States Administration, and the international financial institutions to work with Argentina to produce a credible, sustainable economic plan. That plan must enable existing investors to succeed on the terms that were espoused in their contracts, and in order to achieve this outcome there must be an element of accountability introduced in the process. We would encourage the adoption of strict and enforceable conditions on any future lending to Argentina to ensure compliance with the original terms that were the basis for the initial investments. This means enabling payments to energy companies in dollars or in pesos indexed to the dollar so that prices will cover all costs, including depreciation and financial costs, in accordance with the original economic equation of our contracts. We must also have the ability to transfer funds freely as stipulated in the bilateral investment treaty. Only under these circumstances will energy projects remain solvent, will energy prices remain low and service reliable, and will Argentina's ability to recover stand a better chance.

If you will permit me, Mr. Chairman, I will conclude on a more personal note. CMS Energy was one of the earliest United States participants in the privatization process and is now one of the largest United States investors in Argentina. We have developed deep and lasting ties to the country, have employed and trained hundreds of Argentine citizens, and have been pleased to help develop the country's infrastructure. It disappoints us greatly to see Argentina reverse course and head down the path to economic chaos. It worries us to see the instabilities emerging in Argentina's political system. It alarms us to see the periodic eruptions of social unrest, with perhaps greater turmoil in store. And it especially troubles us to see our Argentine employees and friends have their savings and hard-earned money denied to them and their futures thrown into doubt. As a friend to the Argentine people, we hope very much to be able to work constructively with the authorities there to turn the situation around.

Thank you very much. I will be happy to respond to whatever questions you and the Subcommittee Members may have.

**RESPONSE TO WRITTEN QUESTION OF SENATOR JOHNSON
FROM MICHAEL MUSSA**

Q.1. Argentina is a significant producer and exporter of beef cattle. In light of this fact and the current devaluation of the peso, could there be an adverse impact on international and U.S. domestic beef commodity prices. If there is an effect, how significant could this be?

A.1. This is not really my field of expertise. Nevertheless, I believe that the correct answer is probably that recent developments in Argentina, including the sharp devaluation of the peso, will have only a very small adverse impact on international beef prices and an even smaller adverse effect on United States domestic beef prices. The reason is the following.

Developments in Argentina will affect international beef prices only to the extent that they affect the volume of beef exported from Argentina. The devaluation of the peso will almost surely cause a substantial rise in the price of beef inside Argentina, measured in pesos, while the international price of beef (measured in dollars) is largely unaffected. Higher prices for beef producers in Argentina would normally be expected to induce an increase in production. However, for the next 2 years or so, beef production is largely determined by the size of the existing herd. Beyond this time frame, larger Argentine beef production seems likely if the peso remains sharply depreciated (after adjusting for inflation inside Argentina). But to reach this higher level of production on a sustainable basis, the size of the herd must be increased. This requires that slaughter rates be reduced for a time, with the effect of temporarily reducing the supply of beef. Thus, it would probably take at least 3 years before production of beef in Argentina would rise significantly and on a sustainable basis in response to a lower value of the peso.

Experience in many financial crises indicates that the foreign exchange value of the Argentine peso, adjusted for inflation in Argentina, will depreciate much more in the short run than in the longer run. For example, after the Mexican devaluation in late 1994, the Mexican peso lost more than a third of its dollar value (adjusted for inflation) by mid-1995. But, 5 years later, the foreign exchange value of the Mexican peso (adjusted for inflation) was back near its predevaluation level. If the foreign exchange value of the Argentine peso follows a similar course, the long run effect on beef production in Argentina is likely to be modest.

With respect to the U.S. domestic beef prices, it is essential to recognize that the market for domestic beef is far from completely integrated with the international market. (This very same principle applies with even greater force to domestic beef prices in more heavily protected markets such as those in Japan and Europe.) Accordingly, any effects of Argentine developments on international beef prices are likely to be more muted for United States domestic beef prices.

January 1, 2002

Crying With Argentina

BY PAUL KRUGMAN

Although images of the riots in Argentina have flickered across our television screens, hardly anyone in the United States cares. It is just another disaster in a small, faraway country of which we know nothing—a country as remote and unlikely to affect our lives as, say, Afghanistan.

I do not make that comparison lightly. Most people here may think that this is just another run-of-the-mill Latin American crisis—hey, those people have them all the time, don't they?—but in the eyes of much of the world, Argentina's economic policies had “made in Washington” stamped all over them. The catastrophic failure of those policies is first and foremost a disaster for Argentines, but it is also a disaster for United States foreign policy.

Here is how the story looks to Latin Americans: Argentina, more than any other developing country, bought into the promises of United States-promoted “neoliberalism” (that is liberal as in free markets, not as in Ted Kennedy). Tariffs were slashed, state enterprises were privatized, multinational corporations were welcomed, and the peso was pegged to the dollar. Wall Street cheered, and money poured in; for a while, free market economics seemed vindicated, and its advocates were not shy about claiming credit.

Then things began to fall apart. It wasn't surprising that the 1997 Asian financial crisis had repercussions in Latin America, and at first Argentina seemed less affected than its neighbors. But while Brazil bounced back, Argentina's recession just went on and on.

I could explain at length the causes of Argentina's slump: It had more to do with monetary policy than with free markets. But Argentines, understandably, cannot be bothered with such fine distinctions—especially because Wall Street and Washington told them that free markets and hard money were inseparable.

Moreover, when the economy went sour, the International Monetary Fund—which much of the world, with considerable justification, views as a branch of the U.S. Treasury Department—was utterly unhelpful. IMF staffers have known for months, perhaps years, that the one-peso-one-dollar policy could not be sustained. And the IMF could have offered Argentina guidance on how to escape from its monetary trap, as well as political cover for Argentina's leaders as they did what had to be done. Instead, however, IMF officials—like the medieval doctors who insisted on bleeding their patients, and repeated the procedure when the bleeding made them sicker—prescribed austerity and still more austerity, right to the end.

Now, Argentina is in utter chaos—some observers are even likening it to the Weimar Republic. And Latin Americans do not regard the United States as an innocent bystander.

I am not sure how many Americans, even among the policy elite, understand this. The people who encouraged Argentina in its disastrous policy course are now busily rewriting history, blaming the victims. Anyway, we are notoriously bad at seeing ourselves as others see us. A recent Pew survey of “opinion leaders” found that 52 percent of the Americans think that our country is liked because it “does a lot of good;” only 21 percent of foreigners, and 12 percent of Latin Americans, agreed.

What happens next? The best hope for an Argentine turnaround was an orderly devaluation, in which the government reduced the dollar value of the peso and at the same time converted many dollar debts into pesos. But that now seems a remote prospect.

Instead, Argentina's new government—once it has one—will probably turn back the clock. It will impose exchange controls and import quotas, turning its back on world markets; do not be surprised if it also returns to old-fashioned anti-American rhetoric.

And let me make a prediction: These retrograde policies will work, in the sense that they will produce a temporary improvement in the economic situation—just as similar policies did back in the 1930's. Turning your back on the world market is bad for long-run growth; Argentina's own history the best proof. But as John Maynard Keynes said, in the long run we are all dead.

Back in April, George W. Bush touted the proposed Free Trade Area of the Americas as a major foreign policy goal, one that would “build an age of prosperity in a hemisphere of liberty.” If that goal really was important, we have just suffered a major setback. Don't cry for Argentina; cry with it.

Chronology of Events

PREPARED BY J.F. HORNBECK
SPECIALIST IN INTERNATIONAL TRADE AND FINANCE
FOREIGN AFFAIRS, DEFENSE AND TRADE DIVISION, CRS

1980's

Argentina suffers through an extended period of economic instability including the Latin American debt crisis and hyperinflation.

1989

Peronist candidate Carlos Menem is elected President of Argentina and appoints Domingo Cavallo as Minister of Economy. Together they enact a major structural adjustment program including tax reform, privatization, trade liberalization, deregulation, and adoption of a currency board.

April 1, 1991

Argentina's Congress enacts the Convertibility Law, which legally adopts the currency board guaranteeing the convertibility of peso currency to dollars at a one-to-one fixed rate and limiting the printing of pesos only to an amount necessary to purchase dollars in the foreign exchange market. Effectively, each peso in circulation is backed by a U.S. dollar and monetary policy is forcibly constrained to uphold that promise.

1991-1994

Argentina enjoys strong economic growth and the currency board is considered highly successful.

1995

Following Mexico's December 1994 peso devaluation, capitol flows out of emerging markets. Argentina's GDP declines by 2.8 percent.

May 1995

President Menem is reelected President after convincing Congress to change electoral laws that prohibit a second term.

1995-1999

The U.S. dollar experiences a prolonged period of real appreciation, resulting in similar appreciation of the Argentine peso relative to its trading partners.

1996-1997

Renewed period of Argentine economic growth (5.5 percent in 1996, 8.1 percent in 1997), but current account deficit and debt measures worsen.

July 1997

East Asian financial crisis begins.

1998

Financial crisis moves to Russia and then Brazil. Argentina enters prolonged recession in third quarter (still in effect) and unemployment begins to rise.

1999

January

Brazil facing its own financial crisis, devalues its currency, hurting Argentine exports, 30 percent of which were traded with Brazil.

September

The Argentine Congress passes the Fiscal Responsibility Law, committing to large reductions in both Federal and provincial government spending.

October 24

Fernando de la Rúa of the Radical Civic Union (UCR), the opposition coalition candidate, running on a platform to end corruption (under Menem) and the recession defeats Peronist candidate Eduardo Duhalde for president.

December 10

De la Rúa is inaugurated President of Argentina and shortly thereafter seeks assistance from the IMF.

2000**March 10**

The IMF agrees to a 3 year \$7.2 billion stand-by arrangement with Argentina conditioned on a strict fiscal adjustment and the assumption of 3.5 percent GDP growth in 2000 (actual growth was 0.8 percent).

May 29

The government announces \$1 billion in budget cuts in hopes that fiscal responsibility will bring renewed confidence to economy.

September 15

The IMF concludes an Article IV Consultation, the required annual comprehensive review of member country economics.

October 6

Vice President Carlos Alvarez resigns over de la Rúa's decision not to replace two cabinet members linked to a recent Senate bribery scandal.

December 18

The de la Rúa government announces a \$40 billion multilateral assistance package organized by IMF (see below).

2001**January 12**

Argentina's continued poor economic performance prompts the IMF to augment the March 10, 2000 agreement by \$7.0 billion as a part of a \$40 billion assistance package involving the Inter-American Development Bank, the World Bank, Spain, and private lenders. The agreement assumes GDP will grow at a rate of 2.5 percent in 2001 (versus actual decline of 3.7 percent).

March 19

Domingo Cavallo, Minister of Economy under Menem and architect of the currency board 10 years earlier, replaces Ricardo Lopez Murphy, who resigns as the Minister of Economy.

June 16–17

The de la Rúa government announces a \$29.5 billion voluntary debt restructuring in which short-term debt is exchanged for new debt with longer maturities and higher interest rates.

June 19

The peso exchange rate adjusted to allow for effective 7 percent devaluation for foreign trade in hopes of improving Argentina's international competitiveness. Many raise concern over the effects on the credibility of the convertibility regime.

July 10

Cavallo announces a plan to balance budget, but the markets react negatively, expressing lack of confidence.

July 19

Unions call a nationwide strike to protest government austerity plan.

July 29

The Argentine Congress passes "Zero Deficit Law," requiring a balanced budget by the fourth quarter of 2001.

September 7

Based on Argentina's commitment to implement the "Zero Deficit Law" immediately, the IMF augments its March 10, 2000 agreement for a second time, increasing lending commitment by another \$7.2 billion.

October

The use of provincial bonds as "scrip" to pay public salaries becomes more widespread as Federal revenue transfers decline.

October 14

The opposition Peronist Party wins control of both Chambers of the Congress in mid-term elections.

November 6

Argentina conducts a second debt swap, exchanging \$60 billion of bonds with an average rate of 11–12 percent for extended maturity notes carrying only 7 percent interest rate. International bond rating agencies consider is an effective default.

November 30

A run on the bank begins, with central bank reserves falling by \$2 billion in 1 day. President de la Rúa imposes \$1,000 per month limitation on personal bank withdrawals.

December 1

Protests begin over bank withdrawal limitations.

December 5

The IMF withholds \$1.24 billion loan installment, citing Argentina's repeated inability to meet fiscal targets.

December 7

Argentina announces it can no longer guarantee payment on foreign debt.

December 13

The government announces that the unemployment rate reaches near record of 18 percent. Unions call nationwide strike.

December 14

Supermarket looting begins.

December 19

Rioting spreads to major cities over deep budget cuts. The government declares a state of siege. Minister of Economy Domingo Cavallo resigns.

December 20

President de la Rúa resigns in the wake of continued rioting, leaving 28 people dead.

December 21

Congress accepts President de la Rúa's resignation. Senate President Ramon Puerta is named Provisional President for 48 hours.

December 23

Congress appoints San Luis Governor Adolfo Rodriguez Saa as Interim President until elections can be held in March 2002.

December 26

The liquidity standards for banks are relaxed. Rodriguez Saa announces a new economic plan based on: (1) suspension of payments on public debt; (2) new jobs creation program; and (3) creation of new currency (the *Argentino*) to begin circulating in January 2002 and not to be convertible to the U.S. dollar.

December 30

President Rodriguez Saa resigns after continued rioting and loss of party support. Senate leader Puerta resigns to avoid second appointment as Interim President. No immediate successor emerges to take over the Presidency.

December 31

The Argentine Congress selects Peronist Senator Eduardo Duhalde to complete December 2003 Presidential term.

January 1

Senator Duhalde sworn in as President. He blames Argentina's economic problems on the free market system and vows to change economic course. Except for the debt moratorium, new economic policies are unclear.

January 6

After the Argentine Congress passes necessary legislation, President Duhalde announces the end of the currency board and a plan to devalue the peso by 29 percent (to 1.4 to the dollar) for major foreign commercial transaction, with a floating rate

for all other transactions. Other elements of economic plan include: Converting all debts up to \$100,000 to pesos (passing on devaluation cost to creditors); capital and bank account controls; a new tax on oil to compensate creditors for the losses that will ensue; renegotiating public debt, and a balanced budget.

January 10

Government announces it will “guarantee” dollar deposits, but to curtail bank runs, the \$1,000 (1,500 peso) limit on monthly withdrawals is maintained and all checking and savings accounts with balances exceeding \$10,000 and \$3,000 respectively, will be converted to certificates of deposit and remain frozen for at least 1 year. Smaller deposits have the option of earlier withdrawal by moving to peso denominated accounts at the 1.4 exchange rate.

January 11

The government extends the bank holiday two extra days, while the foreign currency market opens for first time in 3 weeks. The peso falls immediately to 1.7 per dollar.

January 15

The peso fall as low as 2.05 to the dollar in active trading.

January 16

The IMF approves request for 1 year extension on \$936 million payment due January 17, keeping Argentina from falling into arrears.

January 17

The government announces that dollar denominated loans exceeding \$100,000 will be converted to pesos at 1.4 for fixed rate, deepening the balance sheet mismatch of banks.

January 19–20

Duhalde reverses his decision to guarantee dollar deposits, which will be converted to pesos at some undefined devalued exchange rate.

January 23

The Argentine Senate passes bankruptcy law that would use capital controls to restrict payment of foreign private debt payments through December 2003.

January 28–29

Foreign Minister Carlos Ruckauf visits with Bush Cabinet members to appeal for political and financial support (including IMF assistance) as protests continue in Argentina.

January 30

IMF team meets with Argentine officials, who declare intention to adopt a floating exchange rate in near future. Argentina’s Chamber of Deputies passes controversial bankruptcy law, stripping it of the Senate provision prohibiting foreign debt payments, but other capital controls remain in effect. It retains language allowing conversion of dollar denominated debt below \$100,000 to pesos at 1-to-1 rate (benefiting debtors) and suspending creditor action on loan debt defaults for 180 days.

February 1

Argentina Supreme Court rules that government restrictions on bank deposit withdrawals are unconstitutional.

February 3

By decree, Duhalde eases the restrictions on bank withdrawals, but places a 6 month moratorium on enforcement of Supreme Court order. Congress moves to impeach all nine members of the Supreme Court. Government closes foreign exchange markets, declares an end to dual exchange rate system in favor of floating peso, and requires all deposits to be converted to inflation-indexed peso accounts at the previous official rate of 1.4 to the dollar. The dollar ends as an official circulating currency.

February 6

Government announces new Federal budget with 15 percent cut in expenditures, including agreement with provincial governments to reduce the number of Chamber of Deputies and their staff by 25 percent.

February 11

Foreign exchange market opens for first time with a free floating peso, which depreciates 20 percent to 2.5 to the dollar before rebounding to 1.9 to 2.2 by early afternoon.

February 13

Government announces that 20 percent energy export tax will be used for general government expenditures rather than dedicated to bond repayments in support of banking system, as promised when unveiled 2 days earlier.

February 14

In meeting with IMF officials, Argentine representatives suggest that the country will need \$22-\$23 billion in assistance.

February 18

Petroleum industry workers begin strike to protest energy export tax. Unemployment reaches 22 percent, general protests erupt into violent attacks on banks over continued restrictions on withdrawal.

February 22

Social unrest continues and the peso trades at 2.15 to the dollar, a 54 percent depreciation since a unified floating exchange rate was adopted on February 11.