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This Argentine scheme

The new government is courting Brazil and planning to protect local industry. This is bad economics, says **Sebastian Edwards**

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At his first press conference, Jorge Remes Lenicov, Argentina's economy minister, was asked whether, in light of the country's inflationary history, the devaluation of the peso had any chance of success. Without hesitation, the minister referred to a historical precedent. Although he was then very young, he said, he remembered that in 1967 a 40 per cent devaluation had been highly successful; it did not generate inflation and the value of the peso stabilised rapidly.

Politicians can indeed be guided by history, but not if they draw lessons from it selectively. What Mr Remes did not say is that the 1967 exchange rate realignment was complemented by a drastic reduction in Argentine import tariffs, a severe fiscal retrenchment and an extremely austere wage rate policy. The main objective was to restore international competitiveness while achieving fiscal balance and reducing inflation. A dual exchange rate system that had existed since 1964 was eliminated, no attempts were made to impose capital or exchange controls, and wage indexation was prohibited. During 1967 the fiscal deficit was reduced by 50 per cent and the following year it was cut in half again.

In spite of severe external shocks - an outbreak of foot-and-mouth disease and a devaluation of the British pound - the 1967 programme was highly successful. The exchange rate parallel market premium disappeared overnight and by 1968 inflation had retrenched significantly. International reserves were replenished and after one year there was no need to renew a \$125m loan from the International Monetary Fund. More important, in 1968 gross domestic product growth was almost 5 per cent and by 1969 it had climbed to an impressive 8.5 per cent.

Although circumstances today are different, the 1967 episode offers important lessons on how to orchestrate a successful adjustment programme. The most important, perhaps, is that in 1967 Adalbert Krieger Vasena, economy minister, reduced import restrictions in order to increase competitiveness and productivity growth.

Currently, Argentina has one of the most closed economies in the world - exports are less than 9 per cent of gross domestic product - and during the 1990s productivity growth was negative. In Chile, exports exceed 25 per cent of GDP, and productivity improvements have

contributed, year after year, almost 3 percentage points to GDP growth.

During the last decade two factors have contributed to Argentina's poor export performance and productivity growth: an overvalued exchange rate; and membership of Mercosur, the regional trading bloc that includes Chile, Bolivia, Brazil, Paraguay and Uruguay.

Several studies by the World Bank and others, have shown that Mercosur, with its high common external tariff on imports from outside the bloc, is the prototypical case of an inefficient customs union.

Moreover, through Mercosur, Argentina has imported Brazil's rather weak institutions, historical protectionism and macroeconomic instability.

If Argentina became truly integrated with the world economy, exports would rapidly become an engine of growth. Doing this, however, will require reducing tariffs as Krieger Vasena did in 1967, and by redefining Argentina's relationship with Mercosur.

The best move would be to abandon the trading bloc, moving firmly towards unilateral trade liberalisation. This was the path followed by Chile during the 1970s, when it deserted the Andean Pact and embraced an export-oriented strategy.

A second-best alternative would be to transform Mercosur into a free trade area, where each country decides the level of its import tariffs with the rest of the world.

Under this type of arrangement, Argentina could still reduce its overall import tariffs while pursuing some type of diplomatic integration with Brazil and the other Mercosur members.

The news coming from Buenos Aires suggests that Mr Lenicov is intending to do exactly the opposite.

Instead of opening the economy, Brazil and Mercosur have been courted and Jose de Mendiguren, the new minister of production, has said that the government will protect local industry. A policy that requires the public sector to purchase, even at higher prices, locally produced goods, is to be strictly enforced. This is bad economics.

If policies aimed at encouraging productivity improvements and international trade are implemented instead, Argentina could get over its present plight and recover growth rapidly.

But if the populist and protectionist rhetoric takes hold, it will be difficult to disagree with Oscar Wilde's character Sir Robert Chiltern, who in the play *An Ideal Husband* declares, with great conviction: "This Argentine scheme is a commonplace swindle."

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