

COMMANDING HEIGHTS

The Paradox of Argentina

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Argentina had long been an economic paradox. How did a country that was one of the world's richest in the first decades of the 20th century end up in such economic disorder? A good part of the answer rested with Juan Peron. He is now best remembered, of course, as the husband of Evita, but in the years after World War II he was the embodiment of populism with an almost fascist tinge.

Building on the prewar popularity of fascist ideas, Peron turned Argentina into a corporatist country, with powerful organized interest groups—big business, labor unions, military, farmers—that negotiated with the state and with each other for position and resources. He incited nationalist passions, stoked pretensions of grandeur, and pursued stridently anti-American policies. He nationalized large parts of the economy and put up trade barriers to defend them. He cut Argentina's links to the world economy—which had been one of its great sources of wealth—embedded inflation in the society, and destroyed the foundations of sound economic growth. He was also wildly popular—until Evita's death in 1952. Thereafter, however, the economy became so chaotic that he prudently went into exile.

The years that followed were characterized by a revolving door of elected presidents and military juntas. Peron returned from exile to become president again in 1973. He died shortly thereafter, leaving as president his new wife, Isabel, who was not really prepared for the job, having previously been a nightclub dancer in Panama. The country descended into further chaos. A new military junta took power, and it waged a vicious "dirty war" against the left and others, many thousands of whom were "disappeared" a la Chile—some simply thrown out of airplanes over the Atlantic.

The military showed no competence in running the economy, which was mired in persistent inflation and a deep recession. In 1982, in a desperate gamble to restore its authority and popularity, the military attacked the British-owned Falkland Islands (known to the Argentines as the Malvinas). It was the same war that gave Margaret Thatcher the political clout to

undertake large-scale privatization in Britain. The defeat of the Argentine military dictators under-mined their authority. In the one thing at which they were supposed to be expert—warfare—they had proved quite incompetent. In 1983 they surrendered office to a democratically elected president, Raul Alfonsin.

Alfonsin had campaigned on the slogan DEMOCRACY OR ANTIDEMOCRACY. Argentina had had an abundance of both. Between 1930 and his election in 1983, the country had gone through 24 presidents and 26 successful military coups and several hundred unsuccessful ones.

Alfonsin's great contribution was the restoration of democracy and civic institutions. But with the beginning of the debt crisis, his improvised efforts to stabilize the economy failed. The country remained in a deep economic crisis, and his administration was in disarray. One of his economics ministers, who had ridden on the shoulders of the crowd in the first year of Alfonsin's government, was by the end of his term spit upon by his own neighbors when he dared to venture outside his home.

Alfonsin was succeeded by a flamboyant, almost improbable, white-suited provincial governor, Carlos Menem. Once described as "a psychoanalyst's nightmare," Menem was also pragmatic, quick to adjust to circumstances, and hardly wedded to any set of ideas. Indeed, his policies were initially described as "a mismatch of misunderstood notions, some from Mussolini, some from Maynard Keynes." He ran as a Peronist—he was described as "Peron with sideburns"—with a platform of populism, handouts, and spending. He derided his opponent, who advocated privatization and a freeing up of the economy. Once elected, Menem promptly adopted his opponent's ideas and launched one of the most radical, speedy, and all encompassing market reform programs in Latin America.

There was really no choice. Argentina had run into a wall. Hyperinflation had reached 20,000 percent, the economy was contracting, and food riots were taking place in the streets. The debt burden stood at \$58 billion when Menem took office, and there was no obvious way to pay it off. It was no longer possible to play the old Peronist game of inflationary wage hikes. "We have already seen that movie," Menem once explained. Meanwhile, next door, Chile demonstrated that there was an alternative. Yet even within Argentina an alternative could be found.

In the late 1970s, a candy manufacturer and a building contractor had gotten together and endowed the Instituto de Estudios Economicos sobre la Realidad Argentina y Latinoamericana (IEERAL), an economic research institute in the inland city of Cordoba. Its members were sick of corporatism, with its wheeling and dealing among major interest groups. Smaller entrepreneurial businesses, they believed, were the poor relations, simultaneously ignored and smothered by the system. Researchers at this institute studied market reforms in the rest of the world and then, in their own work, related them to Argentina's experience. By the time Menem came to power, they had articulated and indeed legitimized a host of ideas for reforming the economy. Menem, who had the political momentum, was ready to accept any suggestions if he thought they would help solve Argentina's problems. But he lacked one thing—ideas of his own. He needed someone with ideas. And he found such a person at the institute in Cordoba.

The Broom Maker's Son

The head of the institute, and the one who shaped its agenda, was the economist Domingo Cavallo, who would prove to be one of the most influential figures in recasting the relationship of state and marketplace in Latin America. He was born in 1946, the same year that Juan Peron took power. If he had one nemesis in his career, it was Peron, for many of his intellectual and political efforts were aimed at refuting and rejecting Peronism. Cavallo grew up in the interior province of Cordoba, which he would later say had inured him to Peronism. "It is in the provinces, away from Buenos Aires, where one most easily noticed the pernicious effects of an overexpanded and arbitrary economic system." His own origins were very modest; his father owned a small broom-making shop that was connected to the family house.

Cavallo did his undergraduate studies in Cordoba and then worked in the state government, where he found himself increasingly dissatisfied with what he had learned in university. "At the time, there was a lot of emphasis on market failure and the role of planning," he recalled. He began to educate himself. He was much influenced by *The Principles of Economics* by Raymond Barre, a French economics professor and later prime minister of France. Barre focused explicitly on "the rules of the game"—how an economy is organized, who the players are, how they behave. The rules of the game would turn into a lasting preoccupation—and an oft-repeated phrase—for Cavallo. He also plunged into nineteenth century Argentinean thought on the constitutional basis for a market economy. "I could not relate those ideas to

what I was taught in university," said Cavallo. "I decided to go to the United States to understand the market economy better."

Cavallo [pursued] his Ph.D. at Harvard in the 1970s. He focused on Argentina's persistent inflation and monetarism, out of which came the ideas that would shape his subsequent policies. Argentina's inflation had been created by the fiscal irresponsibility of political leaders, who would spend and intervene no matter what the cost—motivated in part by grandiose illusions. Cavallo believed that the way to check inflation was to rein in the politicians, not the money supply. He was contemptuous of the dependencia theorists. Argentina's long decline, he argued, was the result not of external forces—the terms of trade—but of the internal political culture. Instead of complaining about international trade, Argentina ought to have been expanding and diversifying it.

Returning to Cordoba, Cavallo organized IEERAL; the presidency of this new research institute gave him the platform from which to propound his ideas and develop a cohort of like-minded researchers. His objective was to understand why the Argentinean economy had gone so badly wrong. "Argentina had been the most successful emerging economy in the world in the trade system that Britain created in the second half of the nineteenth century," he said. "What happened?" The attempt to identify the rules of the game became the perennial starting point for any research project at IEERAL.

In the mid-1980s, Cavallo published a book entitled *Economy in Crisis*. He wrote it in four weeks, although it was based on a decade of thought and analysis. The book was a best-seller and made him a national figure in Argentina. His diagnosis of Argentina's ailment became famous; the nation's essential problem, he announced, was the coexistence of "a socialism without plans and a capitalism without markets." He got himself elected to Congress. Despite their differences, he and Carlos Menem became good friends. Menem recognized that Cavallo could be very useful to him.

Cavallo was the logical choice for finance minister when Menem won, but his appointment was strenuously opposed by powerful business interests that wanted to preserve their position and feared competition and deregulation. And so instead, Menem made Cavallo foreign minister. After all, he did speak English very well. Meanwhile, the economy continued to sink further

into crisis. Having gone through three economics ministers in his first 19 months in office, Menem finally turned to the obvious choice, Domingo Cavallo, and handed the economy over to him.

Cavallo was often blunt, abrasive, argumentative, and tactless. Sometimes he could not resist calling in to radio talk shows to set the speakers and listeners straight. But he also demonstrated a remarkable skill at the required politics—identifying goals, communicating, folding groups in, creating and shaping a broad consensus in favor of reform, and building up relationships with the international institutions and financial community whose confidence would be essential. Of course, he was aided by a sense of desperation. No one could doubt that the country was in a severe crisis. The cost of failure was evident—hyperinflation.

Determined to implement shock therapy, Cavallo moved quickly on several broad fronts. First, he rapidly reduced trade barriers and introduced reforms to encourage competition and a new export orientation. Second, he pegged the peso, the Argentinean currency, to the dollar and restricted the money supply to the level of hard-currency reserves in the country. According to the Convertibility Law, the central bank was obliged to convert the austral into dollars at a fixed rate. This step decisively removed a classic form of sovereignty; no longer could politicians and the central bank feed inflation by manipulating the exchange rate and wantonly expanding domestic credit. The mandatory convertibility was of overwhelming importance in bringing down inflation. As Cavallo explained, "We needed to change the minds of Argentineans. That became very important in contributing to discipline. Before that, politicians and participants in the economy did not have any idea of a budget constraint."