Argentina's Experience: Any Lessons for Turkey?

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The purpose of this note is to present a recap of the Argentine and Turkish experiences with stabilization over the years in order to help shift the focus of comparison between the two countries within domestic circles towards a more academic discussion. This said, a full-fledged comparison of the two countries' experiences and *definite* lessons for Turkey are beyond the scope of this note. Rather, the note has the more humble objective of providing a spark to ignite further and more complete analyses of the issues as they relate to drawing lessons for Turkey from Argentina's long list of stabilization plans. There seem to be significant similarities between Turkey and Argentina regarding the dynamics of inflation and how it has changed over time. There are differences as well, but still Turkey can benefit from Argentina's past experience going forward. A critical lesson to be learned is that once fundamental weaknesses related to the fiscal regime and the banking sector are corrected; the choice of the exchange rate regime is likely to matter *less*. Nevertheless, progress in disinflation is likely to be slow with Turkey's floating exchange rate and inflation targeting framework, unless the government can effectively coordinate wage and price increases in the private sector.

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Introduction:

Argentina and Turkey have been at the center of economic debates, with both countries having been regarded as a potential disturbance to the stability of the international financial system, particularly in a year of worldwide poor economic growth. Both have experienced major crises, and there is a growing perception that while international organizations seemed to have been in a hurry to provide plenty of support to Turkey, Argentina, at least initially, was left to deal with her growing problems alone. Recently, comparing Turkey to Argentina has become something of a fad among Turkish analysts, media, and the public in general. People in Turkey have praised the persisting calm observable in the country, and the resilience of the Turkish public for not succumbing to social unrest given the severity of the economic crisis. More explicitly, in the eyes of many, despite having markedly similar economic problems, Turkey had not replicated Argentina. There was no run on the banking system, no need to freeze bank deposits, no social disturbances such as rioting or looting, and most importantly, Turkey did not default on her debt. In essence, the purpose of this note is to present a recap of the Argentine and Turkish experiences with stabilization over the years in order to help shift the focus of comparison between the two countries towards a more academic discussion. This said, a full-fledged comparison of the two countries' experiences and *definite* lessons for Turkey towards reaching inflation rates compatible with sustainable growth is beyond the scope of this note. Rather, the note has the more humble objective of providing a spark to ignite further and more complete analyses of the issues as they relate to drawing lessons for Turkey from Argentina's long list of stabilization plans.

Argentine and Turkish Stabilization Efforts, Past and Present:

Between the early 1970s and until the introduction of the currency board system in early 1991, inflation in Argentina was extremely unstable. It is argued that the fiscal nature of inflation was very apparent, as changes in Argentina's inflation were closely related to changes in the budget deficit. The 1973-75 and 1983-85 inflation explosions (to 2300% and 600%, respectively) occurred in periods of

extremely high budget deficits, in which seigniorage reached unsustainable levels when it exceeded 7% of GNP (Kiguel and Liviatan, 1992). Although the fiscal view explains a significant part of the behavior of inflation, non-fiscal factors have seemed to have a bearing on the inflation process as well. The long tradition of failed stabilization attempts, for example, implied that each new anti-inflation program had to confront severe credibility problems that added to the downward rigidity of the inflation process (Kiguel, 1989). In practice, this means that stabilization attempts based on pure orthodox programs would have difficulty in achieving rapid reductions in inflation. The slow pace of disinflation in Argentina during the late 1970s is explained by a lack of credibility surrounding the ability of the government to enlarge and sustain the fiscal adjustment. Yet equally important was the lack of credibility in the maintenance of nominal anchors (Dornbusch, 1984). Doubts over whether the government would stick to the pre-announced exchange rate rule (the tablita) when faced with an overvalued currency certainly added to the downward rigidity of inflation, which eventually led to the failure of the attempt, as the adjustment in the exchange rate led to a full-fledged banking crisis as well [1]. The period from 1985 to 1989 saw a number of comprehensive heterodox stabilization plans that relied heavily either on caps or a complete freeze on prices and nominal wages (in the public as well as private sector).[2] The motivation behind the implementation of these plans (five to be exact) was the growing perception that non-fundamental forces (expectations, backward indexation, etc.) were important in explaining the short-run dynamics of inflation. Prominent economists who have written extensively on Argentina have hinted that the first of these plans (the Austral Plan) was superior in design, as it sought the correction of fundamentals (fiscal and monetary discipline) in addition to the implementation of incomes policies.[3] Indeed, following the large fiscal adjustment taken under the Austral plan, subsequent plans either lacked fiscal adjustment completely, or else adjustment was minor and temporary. Additionally, the heterodox elements seemed to have strengthened progressively with each new plan introduced, as the correction of fundamentals was pursued with less vigor.[4] Five plans of temporary price controls during the second half of the1980s led to substantial volatility in

[1] For details see Bruno (1993) chapter 6
[2] For a summary of measures included in each of the five programs see Kiguel and Liviatan (1992) table 6.1
[3] See for example Kiguel and Liviatan (1992), Kiguel (1989), Heyman (1987).
[4] For a complete description of measures and their duration, see table 6.1 in Kiguel and Liviatan (1991).

inflation with several major explosive cycles, which Kiguel and Liviatan (1992) largely attribute to the repeated use of price controls without a supportive correction of fundamentals.

Having gone through several stabilization plans and average GDP growth of below 1.5% during the second half of the 1980s, the Argentine authorities introduced the now-infamous convertibility plan in April 1991, which pegged the currency to the dollar under a currency board law that stipulated 100 percent foreign exchange backing for the currency.[5] The plan was put into effect following a period of several fiscal reforms aimed at improving tax collection, expenditure control, rationalization of public sector enterprises, and better administrative practices in the public sector in general.[6] The interim period between the last of the five heterodox programs and the convertibility plan also entailed the implementation of a floating exchange rate regime that had led to a large depreciation of the peso. While not explicitly underscored by any papers the author has read on Argentina, it seems that three important developments following the introduction of the currency board must have provided considerable support to the new regime at its early stages. These were namely, the abolishment of indexation altogether, retrenchment in the public sector through privatization, and the alignment of wage increases with productivity gains. The program brought immediate gains, as inflation declined sharply from over 600% annually in 1989 to 7.3% in approximately 20 months and, more importantly, low inflation and high growth (average of 5%) were sustained for more than seven years. Economic performance deteriorated substantially during years of significant external shocks such as the 1995 tequila, 1998 Russia, and 1999 Brazilian crises, the latter having the strongest effect that heavily contributed to the 5.2% contraction in the Argentine economy. Rightly or wrongly (see below), the currency board was kept intact throughout difficult times. Yet, some ten years after its inception, what had been viewed for the longest time by many pundits as the plan to have successfully moved Argentina onto a more sustainable stabilization path, collapsed.

[5] However, Hanke and Schuler (2002), known as strong advocates of currency board regimes, argues that the convertability plan was a *currency board-like* system, as up to 33% of the monetary base was allowed to be backed by dollar securities, which made it less credible than a system of 100% backing.
[6] For details see Bruno (1993) chapter 6.

Economists seem to have been broadly divided into two camps regarding the causes of the Argentine crisis and the lessons to be drawn for other countries. An overvalued fixed exchange rate, excessive amount of foreign debt, and low productivity growth appear to be the three widely mentioned causes of the crisis according to a large group of researchers (for example Feldstein, 2002, Eichengreen, 2001). Argentina's growing trade imbalance made it more and more difficult for her to meet foreign debt obligations, which mainly belonged to the public sector. The fixed exchange rate could only succeed if the peso could become sufficiently competitive to generate more exports than imports such that the net foreign exchange earnings could be used to pay interest on the outstanding international debt. Although the one-to-one exchange rate made Argentine products uncompetetively expensive, this could have been remedied if productivity were able to rise faster than wages, permitting Argentine prices to decline relative to those abroad (Feldstein, 2002). Essentially, wages and prices must adjust to return the economy to equilibrium where the exchange rate cannot as it is fixed, which makes flexibility in labor markets a particularly desirable feature under fixed exchange rate regimes. During the early years of the currency board, low inflation and liberalization, in general, led to a rapid rise in productivity, which permitted a rise in real wages without the loss of competitiveness. Yet, strong union pressures prevented the further reduction of production costs that Argentine exporters needed to be internationally competitive.[7] Brazil's devaluation at the end of 1998 was a further blow to Argentine competitiveness (Eichengreen, 2001). The inevitable result was increasing current account deficits and mounting foreign debt. And the counterparts to current account deficits were rising budget deficits (largely of the provinces) that were being financed by capital inflows. Finally, the collapse came in December of 2001 when Argentina defaulted.

Led mainly by staunch proponents of currency board regimes, other economists mainly state two reasons for Argentina's failure with the convertibility plan, downplaying the overvalued currency and a growing competitiveness problem. Hanke and Schuler (2002) argue that the convertibility plan was not an orthodox currency board. Rather, it was a regime comprising a mixture of currency board and

central banking features. The Argentine regime differed from an orthodox currency board as it allowed the backing of the board's monetary liabilities by less than the 100% requirement of the latter. The authors state that the central bank was allowed to hold true foreign reserves corresponding to as little as 66.6% of its monetary liabilities. The implication of this less than 100% backing was that the central bank essentially engaged in sterilized intervention, which meant targeting two incompatible variables simultaneously, namely the exchange rate and money supply. This undermined the credibility of the regime, since it meant that the exchange rate target could be abandoned if deemed appropriate by the central bank. Indeed, the authorities tampered with the system roughly six months prior to its collapse by introducing a dual exchange rate system by changing the exchange rate link from the dollar to a basket of the dollar and the euro. Hanke and Schuler (2002) argue that the overvaluation in the peso was vastly overstated. Argentina's exports increased every year, including 2001, with the exception of 1999 when the Brazilian crisis erupted. The authors argue that the export performance, particularly given the low growth of world trade volume in 2001, was a strong sign that competitiveness was not a major problem for Argentina.[8] Finally, this camp emphasizes that the Argentine economy had plunged into a recession following the Russian crisis of 1998, which was largely due to the significant reduction of capital flows to emerging markets in general. Yet, the economy had shown signs of recovery in 1999 and early 2000 before the authorities introduced a series of tax increases that interrupted the recovery and aggravated the recession. This raised fears of debt default and devaluation, which became a reality in December 2001.

From a historical perspective, it seems as though Argentina tried every remedy in the book to reduce inflation and achieve sustainable growth. There are similarities between Turkey and Argentina in terms of the dynamics of inflation and how it has changed over time, yet the number of genuine stabilization attempts are far too few in the Turkish case over a period of high inflation that extends

[7] Indeed, in his return as the Economy Minister in 2001, Domingo Cavallo introduced several measures to enhance labor market flexibility in Argentina.
[8] Hanke and Schuler (2002) also argue that a comprehensive survey of prices in the world's largest cities and the Bic Mac index indicate that the peso was not too far off its equilibrium value in real terms.

roughly as long as Argentina's. Additionally, it took Argentina's peg several years to collapse, while it would be an understatement to say that Turkey was in a hurry to collapse, as the 2000 exchange rate-based program collapsed just 13 months after its inception.

Turkey has gone through roughly six phases of inflation control during the past twenty years. First, inflation declined from over 100 percent per year in 1980 to the 25-30 percent range in 1981-83. Next, inflation increased to the 35-45 percent range during 1984-86. The third phase began with a sharp acceleration in inflation in 1987 and extends through 1993, during which annual inflation was in the 60-85 percent range. The fourth stage was a peak in annual inflation when it exceeded 125 percent in 1994, as the economy experienced a balance of payments crisis. The introduction of a stabilization package brought inflation down to around 70 percent in 1995, and this plateau more or less extended through 1999. The sixth stage began with an exchange rate stabilization plan that brought inflation down to the 30% range. Inflation reached nearly three digits at the end of 2001 following the collapse of the 2000 program, and it is likely to decline substantially to a range close to the government's year-end 2002 target of 35%.

As in Argentina, Turkish inflation also has a strong fiscal component. [9] Yet, several studies of inflation dynamics in Turkey have indicated that there exists a strong inertial component, as well.[10] Again, like the Argentine case, it can be said that inertial forces have progressively strengthened over the years as evidenced by the lethargic downward response of inflation to sharp contractions in economic activity in recent years. The now-deceased 2000 economic program, in my opinion, had the right features to achieve low-cost disinflation, given the short-term dynamics of inflation and its root cause.[11] While the program suffered from imbalances observed in most exchange rate based programs, it appears that the extent of the problems was somewhat milder than those observed in most similar programs that have collapsed over the past two decades. For example Goldfajn and Valdes (1996) study several cases of real

[9] See for example Akçay et al (1997), Metin (1998), and Lim and Papi (1997).
[10] See for example Akyürek (1999) and Alper and Üçer (1998).

exchange rate overvaluation and empirically discover that the probability of a collapse in the exchange rate grows to 60%, as the cumulative overvaluation rises to over 30% over a period of two years.[12] Estimations of real exchange rate changes are rather controversial. The author believes it is safe to say that the overvaluation in the Turkish Lira that occurred during 2000 was nowhere close to what would be regarded as a dangerous threshold, no matter what measure one uses, particularly when one considers that a smooth exit from the crawling peg was just four months away when the exchange rate collapsed. Then why did Turkey's program collapse, and why did it collapse so soon?

The level of the real exchange rate did not warrant a restorative depreciation, and the current account deficit was bound to decline given the projected level of future economic activity. In my opinion, the growing perception of fiscal unsustainability played the major role in the collapse of the currency. It was adverse developments in fiscal reform that increased doubts over the sustainability of the program, and it was the altercation between the prime minister and the president that determined the timing of the collapse. The main problem with fiscal discipline in Turkey was its 'quality' rather than its 'quantity'. Several fiscal developments resulted in a dramatic shift in sentiment towards the program. A front-loaded increase in the primary surplus was achieved through one-off taxation, which helped to improve debt dynamics together with the decline in interest rates in the initial year of the program. However, the credibility of fiscal policy began to deteriorate in the second half of the year. Firstly, the government put no effort into 'durable' fiscal measures. Instead, it seemed to be content with the savings on interest expense, and the success achieved in the collection of one-off tax revenues. There was virtually no progress on measures included in the IMF plan that was supposed to help increase the tax base/collection and reduce expenditures. The closure of extra-budgetary funds, which was seen as a major step towards retrenching the public sector, increasing transparency, and de-linking politics from economic policy in general, was completed on the eve of the February 21 collapse, which proved to be too little too late. Secondly, the structural measures that were completed,

[11] The program was essentially a multiple-anchor approach such that wages and prices in the public sector were indexed to targeted inflation as well. Yet, no measures were taken to coordinate wages in the private sector, which appeared to be a weakness of the program.

or on which there seemed to be major progress, seemed to bear little fruit (for example social security and agricultural reform). Thirdly, the fiscal performance criteria of the IMF plan had been set on the consolidated public sector (as opposed to the narrower concept of central government), which was viewed as an important step towards improvement in transparency, as well as towards the measurement of the true stance of fiscal policy. Yet, the government failed to release data on this measure on a timely basis, and eventually stopped reporting it after the first quarter. Fourthly, a lack of transparency increased concerns over the size of quasi-fiscal activities. Fifthly, the fiscal picture looked increasingly bleak in the face of bank failures (pre-crisis) and the accumulation of contingent liabilities (for example a blanket guarantee was offered to all creditors). While all of the above eroded the confidence in the fiscal outlook going forward, developments in privatization shattered the prospects for fiscal improvement in the following year (2001). At that juncture, strong fiscal-signaling on the part of the government could have gone a long way before another crisis erupted.[13] Instead, with a combination of rising interest rates and the worst possible signaling from the government (looking for ways to improve growth by increasing transfers to the private sector from the budget), fiscal worries reached a climax. The weakness of the banking system certainly played a major role in the crisis *once* confidence was shaken, but it was not the underlying cause of deteriorating confidence in the program. It is unlikely that a stronger banking system could have helped to avert the crisis once things had gotten out of hand the way they had in the weeks preceding the February 22 collapse. Yet, the authorities and the IMF are jointly at fault for assuming that the banking system would never be subjected to such a stress-test throughout the implementation of this stabilization plan, which had seemed a very tight one with very little room for error.

Concluding Remarks:

What lies ahead for Turkey in terms of disinflation? Should Turkey stick to the floating exchange rate regime? Are there any lessons to be drawn from Argentina's experience? A model using past inflation, output gap as a proxy for slack in the economy, and real exchange rate appreciation does a fairly good

[12] A case is defined as a 'collapse' when at least 95% of the correction in the real exchange rate is caused by nominal depreciation.

job of describing the path of inflation in Turkey over the past several years.[14] Currently and for the good part of next year, the economic plan lacks a clearly defined *aggressive* plan of action against inflation. Slack in the economy and real appreciation appear to be the mechanisms through which inflation can decline. Basically the policymakers must hope that the economy responds more to slack and shows less inertia going forward, and there is early indication that this is happening. And yet the favorable slack-effect on inflation cannot persist for too long, and neither could the real exchange appreciate continuously going forward. Thus, the bottom line with regards to disinflation is that at some point, a much more comprehensive strategy, addressing all apparent aspects of inflation dynamics, must be introduced to bring inflation to levels that would help initiate sustainable growth rates over the next two years.

It seems that with recurring problems associated with soft pegs and the polar view (dollarization/currency board or free floating and inflation targeting) receiving so much publicity in recent years, it would be difficult for Turkey to adopt any intermediate regime going forward. Inflation targeting in Turkey is likely to face several disadvantages. To name a few, the CB has no track record of discretionary/ disinflationary monetary policy, as its role in the past has been limited, due to fiscal dominance, for several years. Put differently, the CB has never been given a clear mandate to fight inflation, and it will take some time and bull's-eye results before targets set by the program will achieve credibility. Most successful inflation targeters have commenced inflation targeting at much lower levels of inflation than Turkey and, more importantly, the economy in these countries had been to a large extent de-indexed prior to the commencing of inflation targeting. Unless there is some speedy improvement in some of these problem areas, the mere announcement of lower inflation as a target will carry little benefit in reducing inflation *further* once the economy starts moving out of the recession.

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[13] For example, the introduction of a 'fiscal' rule. For more on this please see Akyürek and Yenigun (2001a,b).
[14] For details please see Akyürek and Yenigun (2001a,b).

An alternative strategy would of course be the other extreme, that is, a currency board, which has been receiving plenty of bad publicity thanks to the Argentine situation. Nevertheless, as summarized above, several economists have argued that the currency board in Argentina ran into trouble largely due to Argentine-specific issues (less than 100% backing of base money, inflexible labor market, the sharp devaluation of the Brazilian Real, etc), rather than the perils of the currency board itself. A currency board could be a viable choice for Turkey. In fact, given that the EU zone is the destination of almost 60% of Turkish exports, the business cycles in Turkey are likely to be more correlated with those in Europe in the future. This could provide an opportunity to peg the Turkish Lira to the Euro under a currency board arrangement. Yet, the most important lesson to be drawn seems to be the fact that once the important fundamental weakness of the economy related to the fiscal regime and the banking sector is corrected, the choice of the exchange rate regime is likely to matter *less*. Nevertheless, with Turkey's floating exchange rate and inflation targeting framework, progress in disinflation is likely to be very slow unless the government can effectively coordinate moderate wage and price increases in the private sector. Recent Letters of Intent submitted to the IMF have included a weak statement regarding a greater effort by the government in the settlement of private sector wage contracts in line with targeted inflation, yet no progress has been achieved to date.

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