Sustaining Reform in Argentina

A recent OED study reviews the World Bank’s evolving relationship with Argentina over the 1985-95 period. The first half of this period was marked by hesitant and eventually unsuccessful government attempts at reform followed in the second half of the decade by a highly successful program of structural reform. The Bank’s performance evolved through a similar pattern. High levels of Bank lending in extremely poor economic conditions had led to poor outcomes in 1985-89. As macroeconomic stability returned with new reforms, Bank lending performance improved as well, aided also by better project preparation and improved portfolio management.

Bank support during 1990-95 was very fruitful. It helped Argentina implement a comprehensive privatization program, restructure its external debt, and restore access to private capital markets. The reforms, initiated in 1989 and culminating in the Convertibility Plan of 1991, brought Argentina its first period of price stability and growth in decades. Given the success of the reforms, Argentina is more likely to achieve sustained economic growth and poverty reduction now than it did in 1991. Yet, the recovery is still vulnerable to reversals. And delayed action on several fronts—namely, in reining in the fiscal deficits of provincial governments and the social security system; reforming the strained financial system; and correcting the neglect of social services—can undermine the sustainability of reforms. The OED study concludes that for the recovery to continue, Argentina needs to focus on completing the reform agenda. For the Bank, that means concentrating assistance on improving provincial finances, controlling the cost of social security, and strengthening the banking system. In turn, these objectives are intertwined with the continuing need to address health and education services and the welfare needs of the poorest.

By the early 1980s, Argentina faced serious macroeconomic instability, with a huge fiscal deficit and a seemingly unsustainable debt problem. In those years, Bank assistance to Argentina averaged about $160 million a year, a comparatively modest amount given the country’s size and importance. But when a new democratically elected government came to power in June 1983, pledging economic reform, international financial institutions stepped up their support. The International Monetary Fund (IMF) responded immediately; increased Bank lending followed. Total Bank lending exceeded $7 billion over the 1985-95 period.

**World Bank strategy**

1985-89: relevant strategy, inadequate treatment

Over 1985-89, the Bank’s assistance strategy was relevant, but the effectiveness and efficiency of its support was poor. In 1985, Bank strategy gave priority to supporting government efforts to stabilize and reactivate the economy by promoting export-led growth and increasing the availability of foreign exchange. Bank assistance sought to strengthen the export capacity of agriculture and industry, rationalize the energy sector, liberalize trade, strengthen public sector management, reform the banking sector, and make some improvements in infrastructure and human resource development. The Bank correctly judged that Argentina’s future growth and development depended on the government’s ability to achieve stabilization. Thus it linked lending disbursements to progress on stabilization.

Between 1985 and 1989 the Bank approved $3.2 billion to Argentina, about half for structural adjustment. But none of the three economic reform programs the Alfonsin government attempted during those years achieved stabilization. The programs shared a major flaw: they failed to address the fundamental causes of the fiscal deficit. Although Bank studies correctly identified the main sources of the deficit—public enterprises, provincial governments, and the social security system—Bank recommendations fell short of proposing fundamental changes to the structures governing them.

The Trade Policy Loan, approved in 1988, sought to promote and liberalize exports. During 1987, the government met its sectoral policy conditions: it expanded and increased the efficiency of a temporary admissions regime for exporters, eliminated export taxes on manufactures, and broadened an indirect tax reimbursement scheme, in effect granting free trade status to industrial exporters. Compliance with loan conditions, together with initial stabilization efforts, led the Bank to approve the release of the second tranche. The loan was fully disbursed by the end of 1987. Yet most fiscal measures at the heart of compliance with the macroeconomic program were merely promised. In the ensuing months, Argentina’s fiscal situation steadily deteriorated. By February 1989, the adjustment program collapsed, due primarily to an untenable fiscal situation. In April 1989, an explicit across-the-board export tax of 25 percent was introduced, and prior approval of advance import declarations as a condition for import financing was reintroduced. Major progress under the loan was thus nullified. (See also, Stabilization and Adjustment in Argentina, Precis No. 69, June 1994.)

The first of the programs—Plan Austral, approved in 1985—sought to improve public finances, primarily with emergency measures to increase fiscal revenue and reduce overall expenditures, and to control inflation, mainly through an unorthodox program of foreign exchange controls and price freezes. But none of the measures targeted the structural deficit—that is, the deficit that remains after transitory factors in fiscal revenue and expenditures are adjusted for. In particular, they failed to change the major culprit of the public sector deficit: the inefficient public enterprises. In the end, Plan Austral was too narrow and poorly implemented to bring about meaningful change. As economic conditions worsened, the climate for successful lending deteriorated. (See Box 1.) Yet instead of reducing lending as the assistance strategy had planned, the Bank increased lending in support of another reform program, Plan Australito in 1987, and again for Plan Primavera in 1988.

Coming on the heels of two failed economic reform programs, Plan Primavera was particularly controversial, both inside the Bank and between the Bank and the IMF. The Fund, which had also financed the two previous attempts, refused to back the new package because of the Plan’s weak financing measures. Although the Plan Primavera focused on rationalizing the public sector, the fiscal package was not strong enough to address short-term internal and external financing problems. The program’s failure led to the worst episode of hyperinflation in Argentina’s history and an early exit for the Alfonsin government, in mid-1989. That failure also led the Bank to adopt a cautious lending strategy in 1990-92—when a new government initiated broader reforms—intensifying instead the economic dialogue and provision of technical assistance. (See also, Stabilization and Adjustment in Argentina, Precis No. 69, June 1994.)

In the face of the government’s history of unfulfilled reforms, the Bank should have been more cautious in continuing lending in 1985-89. At a minimum, it should have required upfront actions as demonstration of government’s capacity to carry out the reform program.

1990-95: good mobilization and policy dialogue, but slow start in lending

Contrary to the Bank’s low expectations following the failure of

During the first two years the Bank actively supported the reforms through intense policy dialogue, economic and sector work, and technical assistance rather than lending. The Bank returned to a large lending program in late 1992, after the government had demonstrated clear ownership of a highly successful reform program.

The Bank recognized that sustained stability and growth required continued attention to fiscal fundamentals. It thus focused its early operations (in 1991) on reorganizing public enterprises, the most pressing of those problems, and as fiscal conditions improved, financial sector reform and later, on improving social services.

The Bank’s public sector management loans helped the government carry out the most far-reaching privatization program ever attempted in any country (see Box 2; also see Privatizing Argentina’s Public Enterprises, Precis No. 100, December 1995). They also helped reorganize the central bank, mobilize revenue, and reduce expenditures, measures that proved instrumental in helping the government implement the Convertibility Plan. A large financial package, introduced in 1993, included a debt reduction component that helped Argentina to reduce its debt and debt service obligations, enabling the country to regain access to pri-
vate capital markets. These operations played an important role in effecting Argentina's economic recovery, but the program also had several weak links.

For example, the Convertibility Plan, which had curbed spiraling inflation, had also made the economy highly vulnerable to movements in capital flows. While the Bank's risk analysis in the 1992 strategy pointed to this possibility, it offered no contingency action plan to protect against it. Despite such weaknesses, by 1993 Argentina's reforms had brought the country growth and price stability for the first time in decades. Success led to overoptimism, however. Even though the economy remained highly vulnerable, the Bank's 1994 strategy paper proposed to phase out adjustment lending and pressured the reduction of Bank assistance. But by late 1994, the Mexico financial crisis had induced a major reassessment. This time, the Bank reacted quickly: within four months a new country assistance strategy and lending program had been formulated aimed at helping Argentina complete its structural adjustment program.

Sustained economic growth and poverty reduction remain uncertain, however. Sustaining them will depend on how quickly the government can make headway on the remaining economic agenda: alleviating poverty; improving the financial performance of the social security system and of the provincial governments; restructuring the banking system, particularly that of the provinces; and improving social sector expenditures.

**Bank instruments**

**Useful nonlending services**

Throughout the ten years, well-targeted economic and sector work helped shape a constructive policy dialogue. The Bank's early economic and sector work provided detailed analysis of Argentina's major economic constraints. But Bank advice during the early years failed to recommend fundamental structural change. Recommendations often validated existing policies or focused on making the institutional frameworks work better. Yet, the early studies, particularly those of trade policy, public expenditure management, and fiscal prospects, helped to lay the foundation for the reforms of the 1990s. And later studies on agriculture, industry, and finance contributed directly to the economic reforms of the Menem administration.

Much of the better economic advice came from studies financed through project preparation and technical assistance, or in informal discussions and policy dialogue. The latter, for example, proved essential to the success of the privatization initiative.

**Quality of lending improves**

Lending volume during 1985-89 was high, at about $3.2 billion, but of poor quality, the result of macroeconomic instability, inadequate attention to the quality of project preparation (quality at entry), and weak portfolio management. Cancellations were high at $0.8 billion or 26 percent of the total amount approved during the period. And the proportion of unsatisfactory outcomes was among the highest in Latin America and Bankwide (7 out of the 12 projects evaluated, representing more than 80 percent of commitments).

During 1990-94, lending remained high at $4.1 billion, and quality at entry improved. More than 70 percent of the portfolio approved during this period was assessed as having good quality at entry compared with less than 45 percent in a prior cohort. The composition of lending proved especially attuned to reform priorities. About 70 percent of lending was for adjustment or technical assistance linked to structural adjustment. Technical assistance loans, among the most problematic in Bank portfolios, proved remarkably successful—another indication that the country policy dialogue was fruitful. But the final outcome of Bank operations for this period is still to be determined since most projects are ongoing.

**Recommendations**

Sustainability of reforms hinges on continuation of the reform agenda.

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**Box 2: Argentina's privatization program**

In 1989, when the Menem government launched its privatization program, public enterprises accounted for about 50 percent of the public sector's total deficit. The privatization program was unique in the world since it covered all major enterprises and it was accomplished in record time. The major shortcoming was an absence of a regulatory framework to govern the monopolistic behavior of the newly formed enterprises. Nevertheless, it was important for the government to go through with privatization, since waiting until the framework was established would have resulted in lost momentum to the detriment of the program.

In just four years, the program privatized banks, the national airline, railways, fuel, natural gas, electricity, telecommunications, ports, water and sewerage services, and manufacturing, including steel, various assembly operations, and defense-related industries. By 1993, the program had produced a significant impact on the economy. It generated more than $8 billion in cash and reduced public external debt by more than $10 billion at face value and over $4 billion in cash equivalents. The program eliminated the bulk of subsidies and resulted in higher tax revenues, greater investment in infrastructure, and improved quality of public services. But the need for establishing the legal framework remains a priority issue requiring both Bank and government attention.
For the Bank, this means continued support for policy reform to help Argentina achieve full access to the institutional financial markets.

The Bank should complement local capabilities and focus the bulk of its assistance strategy on areas in which it has a comparative advantage. Given the high levels of technical capabilities in Argentina, the Bank should concentrate its assistance on the highest priorities for reform: the banking sector, provincial finances, and social security. These, however, are intertwined with the continuing need to address health and education services and the welfare needs of the poorest groups.

The Bank should avoid changing the focus of its lending strategy too often. In particular, the areas of concentration should not oscillate in response to fluctuations in the flow of private capital. The increase in Bank commitments to Argentina in 1995 (a direct consequence of the financial crisis in Mexico) was both appropriate and essential for enabling Argentina to balance accounts and restore confidence in private financial markets. But the remaining development agenda for Argentina in 1995 was not significantly different from that in 1994 or in 1992, while the focus and composition of the Bank’s assistance strategy changed significantly. Flexibility should be allowed in the margin—possibly through lending instruments that make funds readily available in emergencies—but continuity in terms of issues addressed should be at the core of the strategy. If the strategy requires conditional lending, conditionality should be transparent and adhered to.

Portfolio management requires continued improvement. As part of this effort, the Bank should focus on improving quality control of projects at entry and strengthen supervision by using performance indicators, especially to monitor the structural fiscal deficit. Finally, it should pilot new lending instruments better adapted to risk management.

Bank management, in its response to the study, agreed with most of OED’s conclusions and accepted the proposed recommendations regarding the priorities for the Bank’s country assistance strategy, greater focus on the fiscal performance of the provincial governments, the level and efficiency of social sector spending, and the financial sector. And it agreed on the importance of improved quality at entry and better portfolio management. It noted that the Bank is actively supporting efforts to expand the reform agenda into the provinces. And it will continue to implement and expand coverage of the growing portfolio of operations at the province level, seeking to enhance the quality and efficiency of education and health services and supporting poverty reduction. In three areas, however, management disagreed with OED: First, it thought the study overplayed the importance of the Bank’s financial assistance relative to that of policy advice and economic and sector work. Second, while it agreed that the Bank needs contingency plans to deal with risks, it cautioned against ex post judgments that could discourage all risk taking. Finally, it noted that OED’s suggestion that the Bank develop new instruments to assist countries with transfer of resources, particularly in the short term, is more appropriately the Fund’s responsibility.

The Committee on Development Effectiveness, in its comments on the study, found the report’s findings relevant for other countries in transition and for guiding future operations in Argentina. It agreed with OED that the Bank needs to improve its assessment and management of risk and address the issue of overoptimism in Bank rating of projects and in economic projections. Nevertheless, it also noted the importance of judicious risk taking in development programming. The committee expressed concern about the transfer of responsibilities to provinces without adequate assessment of their institutional capacities, noting that with greater focus on provinces, the Bank will need to strengthen its field presence in those areas. It emphasized the need for a regulatory framework to guide privatized firms. And while it acknowledged the clarification offered by Bank management on the timing of Bank assistance to the Menem administration, it also agreed with OED that there was a potential conflict between the objective of resource transfer to achieve macroeconomic purposes and sectoral reform objectives. Finally, the committee suggested that future country assistance reviews assess the roles of bilateral and other multilateral agencies, provide more analysis of ongoing projects, discuss environmental issues, and examine the adequacy of the Bank’s field presence and of the interaction between headquarters and the field.