World Agriculture & Trade

The World Bank

Economic Reforms Remain Critical for Argentina & Brazil

The agricultural sectors of Argentina and Brazil have traditionally suffered from economic instability and a high degree of government intervention in their economies. Both countries enacted major economic reforms in the early 1990s. The initial plan was to eliminate the suffocating hyperinflation of the late 1980s and early 1990s by stabilizing currency values. In Argentina, the *peso* was pegged one-to-one with the U.S. dollar. Brazil's *real* was also closely linked to the U.S. dollar.

These currency linkages held through much of the 1990s. Unfortunately for both Argentina and Brazil, timing of the pegging coincided with a 5-year rally in the U.S. dollar in the late 1990s. As a result, *peso*- and *real*-priced commodities were uncompetitive in international markets. By late 1998, problems had magnified for the *real*, creating fears among international investors of a spillover effect following the Russian financial crisis of August 1998. In January 1999, Brazil's government removed the *real's* link to the U.S. dollar and allowed it to float freely. The *real* depreciated 32 percent in the first month.

Depreciation of the *real* helped the country's export sectors by effectively lowering the price of Brazil's export products in world markets. For Brazil's soybean producers, depreciation raised farm prices and continued to boost soybean plantings. However, depreciation also raised costs of imported agricultural inputs—e.g., fertilizer, herbicides, and machinery. Producers and input suppliers have at least temporarily sidestepped this problem by creating a barter-type market for many agricultural inputs that prices most inputs in terms of bags of soybeans.

Brazil's export sector continues to benefit from the currency depreciation. Since January 1999, the *real* has lost over 50 percent of its value relative to the U.S. dollar. Continual currency depreciation has partially cushioned Brazilian soybean producers from the drop in international commodity prices of the past 4 years. Brazil's export competitiveness during the next decade will depend, in part, on the value of the *real* relative to the currencies of its major trading partners and competitors.

Many burdensome costs and policy distortions are still in effect in Brazil. These include inefficient transportation and marketing systems which raise marketing costs, high interest rates which discourage investment, and state-level taxes on the movement of goods and services. Nevertheless, the Brazilian economy continues to improve, with strong gross domestic product (GDP) growth in 2000 and a slight decline in the current government debt. A recent International Monetary Fund (IMF) report concluded that Brazil is now better placed than in the early 1990s to withstand external economic shocks and that strong money management by the government should help the Brazilian economy to continue growing by encouraging growth in the private sector.

The interdependence of trade between Brazil and Argentina connects the countries' economic fortunes and makes each country vulnerable to the others' economic problems.

Argentina's Post-Reform Economy…Losing Stability?

Argentina's reform programs of the 1990s laid the groundwork for a stable investment climate for agriculture by controlling inflation and establishing confidence in the *peso*. Reduction of export taxes, import tariffs, and quotas allowed farmers to capture a larger share of international market prices, and allowed for more of Argentina's surplus agricultural production to flow into export markets. Argentina's economy performed well throughout much of the 1990s—annual GDP growth averaged 8 percent during 1991-98, and inflation has hovered near zero since 1996. Despite three major international financial crises—the 1995 Mexican *peso* crisis, the 1997 Asian crisis, and the 1999 Brazilian crisis—Argentina has managed to maintain its currency peg to the U.S. dollar.

Despite initial successes, the reforms of the early 1990s left many significant problems untouched, and Argentina is now in the midst of a 3-year recession. The economy is still burdened by excessive regulation and labor market problems. Employers have little flexibility in firing employees, lowering wages, or hiring part-time labor. As a result, high payroll costs make many Argentine goods too expensive to compete in international markets. Although many sectors of the Argentine economy changed from public to private control under the reforms, in many cases it simply resulted in substituting a privately owned monopoly for a government monopoly with little improvement in competition or efficiency.

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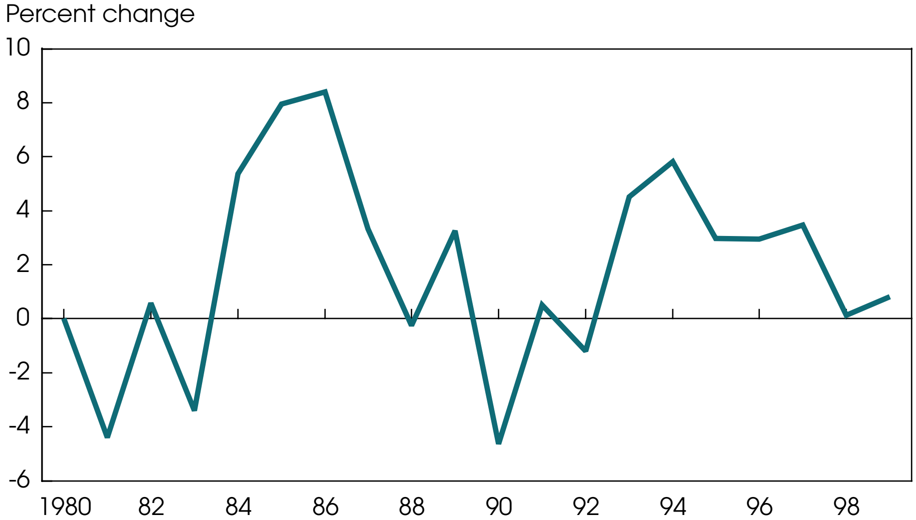
Brazil's GDP Growth Has Varied Widely



1999 estimated.
Source: Oxford Economics, July 2001.

Economic Research Service, USDA

The Government of Argentina (GOA) employs nearly one-third of the Argentine labor force. Despite some initial cuts, government payrolls remain large in 2001, and government expenditures have exceeded revenues since 1995. Rather than cutting expenditures, the GOA has raised taxes in an attempt to close the gap, which has raised business costs. The mounting public debt—$130 billion in June 2001—undermines investor confidence in the country's ability to manage its economy and poses a serious threat to economic stability as much of the debt is financed through short-term credit from international financial markets.

These economic problems are finally catching up with Argentina. The economy has been mired in recession since 1998 with no sign of recovery in the near future, and unemployment has been running at about 15 percent. Significant currency depreciation in Brazil and currency weakness in the European Union (both major trading partners) suggest that the value of the *peso* has become too high. The U.S. dollar's trade-weighted value—weighting the exchange rates of major U.S. trading partners by their share of trade with the U.S.—is at near-record levels.

The current economic outlook in Argentina favors another round of inflation. After negligible inflation during the 1996-2000 period, private forecasters project inflation will rise by 6 to 10 percent during 2002-03. As inflation in Argentina outpaces that in the U.S., the *peso* becomes even more overvalued. The Argentine government has been under pressure both politically and economically to consider changing back to a pegged-float or possibly a free-float exchange rate. Although the likelihood of such an event is difficult to predict, devaluation of the *peso* would clearly improve Argentina's competitiveness in international markets.

Partial Devaluation Of the Peso?

On June 15, 2001, Argentina's economy minister, Domingo Cavallo, announced a package of policy measures referred to as the "convergence factor." This package included a dual exchange-rate system with an indirect devaluation for exporters through implementation of a set of trade-policy tools. Cavallo's plan also includes an austerity program designed to eliminate the government debt. The overall package of measures is intended to boost international competitiveness and revive growth, while avoiding a potentially disastrous default on government debt.

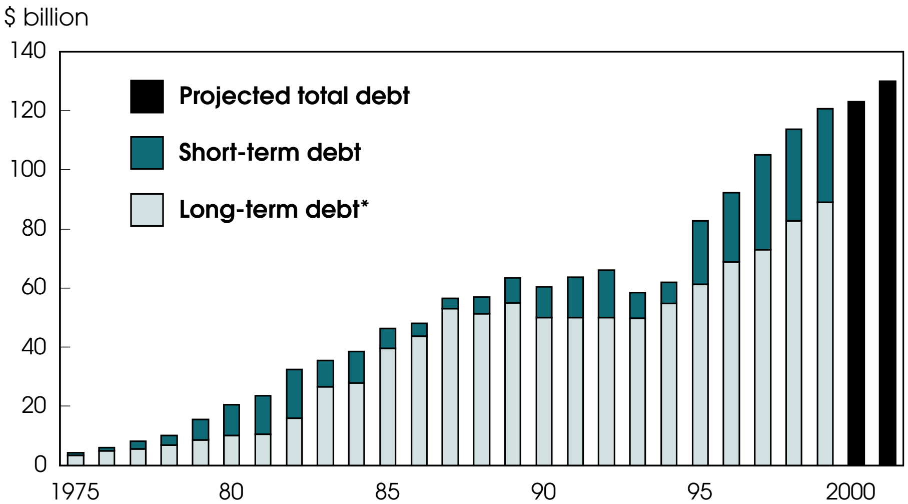
Currency devaluation has always been an obvious remedy for Argentina, but has been avoided due to the enormous government debt. As long as the *peso* is pegged one-to-one with the dollar, the $130-billion debt can be repaid with 130 billion *pesos*. A 10-percent devaluation would raise that price to 143 billion *pesos*. Cavallo's "enhanced convertibility law" tries to have it both ways by cutting the impact of currency overvaluation on exporters while retaining the ability to repay international debt with the overvalued *peso*.

Under the new plan, international finance operates under the usual one-*peso*-to-one-dollar arrangement, but exporters receive an adjustable reimbursement by the GOA in amounts equal to the difference between the current *peso*-dollar peg and a *peso* exchange rate based on a 50-50 mix of the euro and the dollar. For example, during July, the euro traded at about 14 percent below the dollar (1 euro = US$0.86), which is roughly equivalent to a 7-percent devaluation for exporters. On the other hand, importers face what amounts to an implicit tariff of equal magnitude under the new system. The devaluation-induced export gains are to be partially offset by elimination of export tax rebates, while the devaluation-induced higher import costs are to be partially offset by lower tariffs on imports.

If successful, Cavallo's exchange-rate adjustment plan could mean potential gains in Argentina's share of trade in international commodity markets, due to lower priced exports. However, of greater concern is the risk of causing a deeper recession and the possibility of a regional spillover of economic difficulties into Brazil and beyond.

MERCOSUR—a regional customs union between Argentina, Brazil, Paraguay, and Uruguay—has increased economic ties among member countries by establishing essentially duty-free trade within the union. The interdependence of trade among members has made each country vulnerable to each others' economic problems. For example, depreciation of Brazil's currency has made many of Argentina's commodity exports relatively less competitive. In addition, high common external tariffs have sheltered inefficient industries from competition abroad.

Argentina's Debt Has Grown Steadily



Data for 1999-2001 are projections based on information from various sources. Data for 1975-98 are from World Development Indicators 2001 CD-ROM, World Bank.
*Long-term debt includes outstanding International Monetary Fund loans.

Economic Research Service, USDA

Argentina's farmers are less optimistic about the new policies even though there are some positive aspects for agriculture. For example, taxes on interest payments on credit are to be eliminated, payment of a banking transaction tax and fuel transfer tax are to be deductible against farmers' value-added tax liabilities, and the government announced an up-to-60-percent lowering of costly highway road tolls.

However, diesel fuel prices are to be raised by over 15 percent. According to Argentine sources, every centavo (1/100 peso) increase in the price of diesel fuel costs the country's farmers an additional US$45 million. In addition, farmers are dependent on imports of many critical agricultural inputs such as farm chemicals and machinery. Import costs would increase under the dual exchange-rate system. In the end, the proposed exchange rate could simply accelerate the process of squeezing out less efficient or less well-financed operators which has been underway in Argentina for most of the past decade.

The bottom line for international commodity markets is that Argentina's wheat, corn, soybeans, soymeal, and soyoil could potentially cost less relative to competitors under the new exchange-rate mechanism. This could mean potential market share gains for Argentina and greater pressure on international commodity prices in general. If the GOA decided to let the *peso* float freely (as in Brazil), there would likely be a drop of 25 to 30 percent, perhaps temporarily overshooting to as much as 50 percent in the beginning.

What's Ahead for Argentina's Economy?

Some commodity markets are still recovering from the last global crisis—the 1997 Asian crisis. Argentina's continuing ability to finance its debt is an important issue for global financial stability because more than 20 percent of all tradable emerging debt has its origins in Argentina. However, the ties between Argentina and the other emerging countries are not tight, except for Brazil. Although the possibility of impacts in Latin America exists, the overall risk of spillover is relatively low. If there were spillover, Asia appears to be far more vulnerable than Latin America, in large part because most of the Asian countries affected by the 1997 crisis have failed to make necessary economic reforms.

Concerns have been raised in international money markets that Cavallo's announcement merely signals the possibility of even larger currency devaluation and further enlargement of Argentina's debt crisis. Much of Argentina's government debt is short-term credit that will need to be repaid or refinanced soon. Cavallo's policy package is only part of a recent series of measures taken to avoid economic crisis similar to the 1980s, which was due to the inability of the government to repay or refinance its debt. In December 2000, the GOA received a $40-billion rescue package from the IMF and other sources to temporarily hold off its mounting debt crisis. In May 2001, the GOA traded $30 billion in short-term credit for long-term bonds to defer repayment and ease the immediate burden.

Argentina's debt problems will not disappear anytime soon. The country will need to raise about $12 billion in 2002 to repay or refinance more short-term debt coming due. This dilemma is compounded by the likelihood of deepening the current recession. However, if Cavallo's austerity plan with labor market reforms were rigidly followed by the provincial governors, it would go a long way toward restoring investor confidence and building the foundation for future economic growth. AO

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Argentina and Brazil

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