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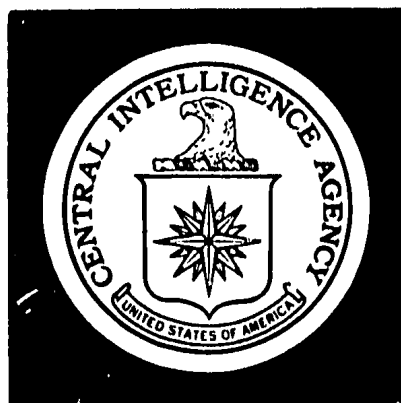
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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*Argentina's Economic Reform Program:
Progress And Vulnerability*

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March 1970

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
March 1970

INTELLIGENCE MEMORANDUM

Argentina's Economic Reform Program: Progress And Vulnerability

Introduction

Widespread labor and student unrest in mid-1969 has brought into question the continued success of the economic reform program that Argentina initiated in early 1967. These disturbances led to wage increases beyond the stabilization program's norms, foreign exchange losses, and the forced resignation of Krieger Vasera, the economics minister and architect of the reforms. Although Krieger's replacement promised to follow his predecessor's policies, some observers have predicted a return to the old pattern of rapid inflation, sluggish economic growth, over-emphasis on industrialization, and repeated currency devaluations. This memorandum considers the accomplishments of the reform program, the threats to it, and the outlook for the next several years.

Background

1. Argentina, once Latin America's most prosperous and economically advanced country by far, has suffered slow and unbalanced economic growth, chronic inflation, and balance-of-payments difficulties in most years since the mid-1930s. These problems were made worse during General Juan Peron's administration (1946-55). Peron shifted political power from the landed aristocracy to the urban masses by undertaking

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a crash program of industrialization at the expense of agriculture. Most succeeding governments failed to improve the situation much. It was, for example, largely because of the economic failures of the Illia government during 1963-66 that a military government headed by General Juan Carlos Ongania assumed power in June 1966. During his first six months, however, Ongania did little to slow inflation or stimulate production.

2. In December 1966, Ongania initiated decisive reform by appointing Adalbert Krieger Vasena, a respected economist, as Minister of Economy and Labor and giving him full discretionary powers. In its first three months, Krieger's new economic team drew up and launched a broad, complex program of financial stabilization and economic development. The program included a substantial currency devaluation, wage and price controls, sharp tariff cuts, a reduced budget deficit, tax incentives for private investment, and increased public investment.*

Reform Program's Successes Under Krieger Vasena

3. Few hoped-for results showed up in 1967. The cost-of-living increase remained above 25%, real output increased little, and export earnings fell somewhat. Even so, the balance of payments gained strength. The capital account improved by \$470 million, and gross foreign reserves nearly tripled, reaching \$767 million. The reforms did stimulate direct investment by foreign businessmen, but the added capital inflow apparently consisted mostly of short-term credits and repatriation of Argentine capital after the peso was devalued and exchange restrictions lifted.

4. Economic progress in 1968, the reform's first full year, was generally impressive. The cost-of-living increase was only 10% because demand and cost pressures eased and the government pressured leading firms to "voluntarily" hold the line on prices. Stable wages and some cuts in

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interest rates helped to hold down production costs. Although better tax enforcement raised government revenues less than expected, the budget deficit was still well below the 1966 level. Substantial increases in manufacturing, mining, and construction outweighed the slight decline in agricultural production that resulted from poor weather and helped to generate a 5% rise in real gross domestic product (GDP), compared with 2% the previous year. A drastic reduction in the time lost through strikes* helped producers respond to increased demand, including inventory buildup. The unemployment rate as of April, which rose from 6% in 1965 to 6½% in 1966-67, declined to 5½% in 1968. Although exports continued their 1967 decline, capital inflow -- while not as great as in 1967 -- remained high. As a result, foreign reserves reached \$810 million -- their highest level since the late 1940s.

5. Economic developments in early 1969 augured well for the continued success of the reform program. Businessmen, who had been very cautious in 1967 and most of 1968, were beginning to increase their investment spending. Moreover, export earnings -- the most disappointing aspect of performance in 1968 -- were beginning to rise. At the end of 1968 the government lifted the wage freeze imposed in May 1967, as promised at that time. Wages (including family allowances and other cash benefits) were allowed to rise by 12%, but this was only a little more than the cost-of-living increase in 1968. Organized labor, while dissatisfied, was too cowed to protest.

Labor Disturbances in Mid-1969

6. The May 1969 disturbances surprised both the government and its opponents. The disturbances, although largely political in origin, soon moved to the economic sphere. Motivated by the heavy-handed reaction of the police to minor student complaints at a provincial university, rioting soon became serious in Rosario and Cordoba, the second and third largest cities. Members of all classes,

* *The loss in Buenos Aires -- the only area for which statistics are available -- dropped to 24,000 man-days, compared with 245,000 in 1967 and 1.9 million in 1966.*

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frustrated by the regime's benign authoritarianism, took to the streets in support of the students. Organized labor was slow to take advantage of the situation because of its divisions and recent defeat in the La Plata oil refinery strike. By the month's end, however, the unions mounted the first effective general strike since Ongania took power.

7. Although rioting never seriously affected the capital and was brought under control with troops after about two weeks, strikes and other labor unrest continued. In June a highly successful 37-hour general strike was held in Cordoba, fire bombing destroyed 14 Buenos Aires supermarkets owned in part by Rockefeller interests, and Augusto Vandor, the nation's most important labor leader, was assassinated by unidentified gunmen. July started with a relatively unsuccessful general strike called by the "rebel" sector of the General Confederation of Labor (CGT). A "Day of Protest" in the form of a strike in Cordoba and demonstrations elsewhere were held on 30 July by all segments of the CGT. Other major strikes followed, culminating in mid-September in a nationwide rail strike and further serious rioting in Rosario.

8. The Ongania government, accustomed to imposed social peace, responded ineptly. Police repression of the original student demonstrations had alienated many Argentines, and the subsequent use of troops further enraged them and threatened to divide the military -- Ongania's power base. The government's explanation of the disorders' origins as a "Castroite conspiracy" was not believed by even its staunchest supporters. Finally, Ongania's ouster of unpopular cabinet members was seen as weakness, while their replacement with men of similar philosophy was considered proof that he had learned nothing from events.

9. Krieger, whose wage policies and general economic orientation had become anathema to labor, was replaced in June by Jose Maria Dagnino Pastore, a 35-year-old, Harvard-trained economist. Dagnino promised to continue Krieger's policies, but his will and ability to do so were openly questioned by Argentine businessmen and international financiers. They doubted, for example, that he would

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receive as much support from Onganía for unpopular economic moves as Krieger had. The new minister's handling of the wage question strengthened these doubts. After his June announcement that wages would be frozen through December and that increases in 1970 would have to reflect improved productivity, he reversed himself in October and allowed a blanket increase for privately employed workers of 3,000 pesos -- about 4% for the average employee. This increase, which became effective in November, was to be followed by a 7% increase in March 1970. In December, government employees received wage increases approximating the two approved for the private sector.

The Economy's Progress in 1969

10. Despite unrest, 1969 was a generally good year. Real GDP increased about 7%, continuing the improvement experienced previously (see Figure 1). Output was spurred by an 18% jump in investment, which rose from 20% to 22% of GNP. The unemployment rate fell to about 4½%, one of the lowest levels ever recorded in Argentina.

11. Real wages, after stagnating in 1966 and falling in 1967 and 1968, turned up in 1969 (see Figure 2). Increased wages and benefits allowed at the beginning of the year approximated 12% for the average worker. The cost of living rose only 6½% as a result of continued "voluntary" price controls, tight credit, and a government deficit that fell from 8% to 6% of expenditures. Wholesale prices, however, rose by 7½%, mainly because of increased export demand for agricultural products. Wholesale prices of agricultural commodities increased by 22% during January-September 1969, compared with 2% a year earlier. Although a further shift in the internal terms of trade in favor of agriculture was desirable, this large price rise put heavy pressure on the cost of living at the end of 1969.

12. Foreign trade boomed in 1969. Exports increased about 18%, to \$1.6 billion -- the highest level in 30 years. The 26% gain in exports of meat and hides far outweighed the disappointing growth of grain exports following a poor wheat crop. Imports grew even more rapidly than exports

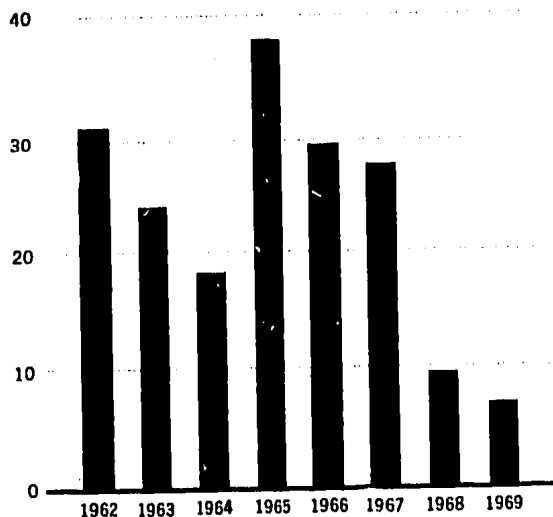
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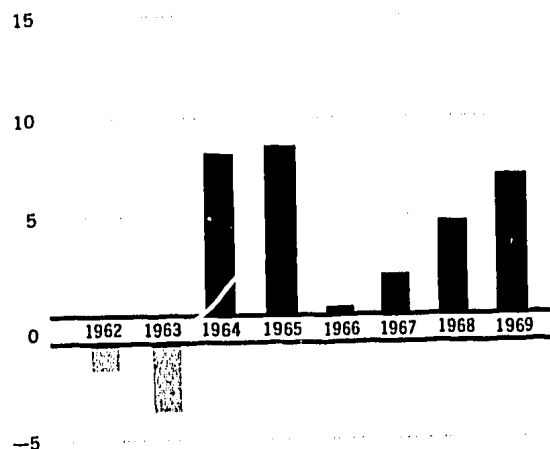
Figure 1

ARGENTINA: Percentage Change in Selected Economic Indicators

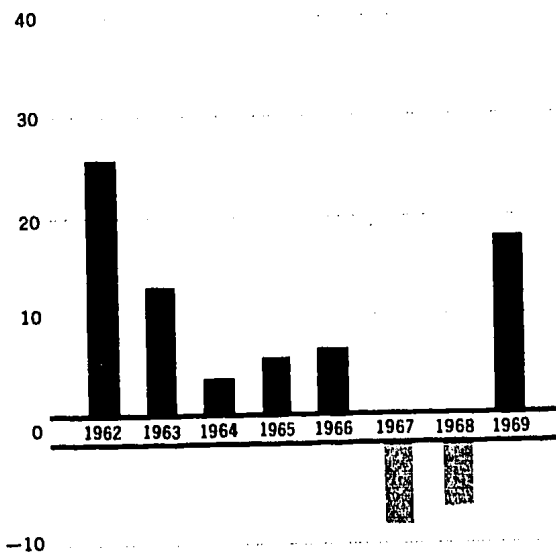
COST OF LIVING



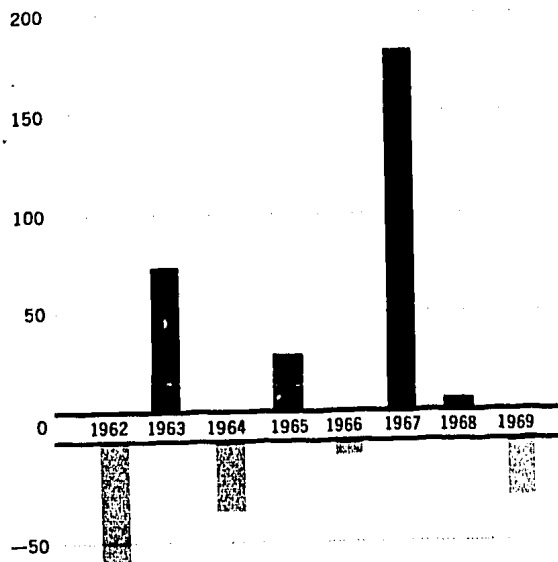
REAL GROSS DOMESTIC PRODUCT



EXPORT EARNINGS



GROSS FOREIGN RESERVES

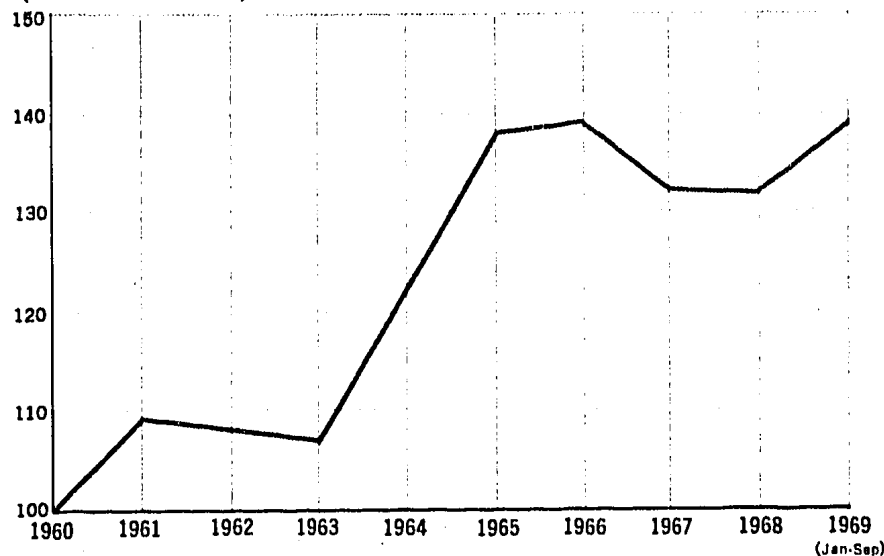


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Figure 2

INDEX OF REAL WAGES
(Including Family Allowances and Other Cash Benefits)
 (INDEX 1960=100)



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because accelerated investment and manufacturing activity required more foreign inputs. As a result, the trade surplus fell from about \$200 million to \$70 million. Although the long-term capital inflow rose, the unrest and speculation about devaluation provoked a \$60 million outflow of short-term capital in 1969, compared with a \$130 million inflow in 1968. Argentina consequently experienced its first balance-of-payments deficit under Onganía and suffered a \$231 million (or 29%) loss in foreign reserves during the year.

Record on Structural Changes

13. During the first three years of the reform, the Onganía administration has had mixed success in changing the economy's structure. Investment increased from 19% of GNP in 1966 to 22% in 1969.*

* Although machinery, equipment, and construction work still are relatively high-priced in Argentina, the disparity with other prices apparently has been reduced since 1966. If relative prices had not changed, the investment rate would have risen more than these figures indicate.

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Virtually all of the growth occurred in the public sector, which accounted for about two-fifths of the total in 1968, compared with one-third in 1966. Much of the rise consisted of badly needed expansion and modernization of infrastructure, especially of the transport and electric power systems. The share of investment devoted to agriculture probably has not risen much yet. The terms of trade for farmers declined slightly from 1966 to 1968 and rose substantially (and perhaps only temporarily) in 1969 because of strong export demand rather than of government policy. Furthermore, the government has made the operations of the railroads and other state enterprises a little more rational. It has corrected labor abuses, reduced employment slightly, discontinued some uneconomic services, and raised rates to more reasonable levels. Treasury transfers to state enterprises for current expenses consequently have dropped by one-third.

14. Other structural reforms have progressed only slowly. The government has provided tax rebates and other incentives to stimulate exports of manufactures, but agricultural commodities still accounted for 94% of exports in 1969, compared with 98% in 1966. Decentralization of industry has been very slow and did not prevent unemployment in the Tucuman area -- depressed because of the long-term decline in the sugar industry -- from rising from 9% in April 1966 to 13% in April 1969. Tax reforms have been far less radical than promised. The one exception -- the controversial land tax that was intended to force underutilized land into more intensive use -- is too recent to have had much effect so far. The government apparently has some goals for redistributing income to the lower classes but has taken no action.

The Reform Program's VulnerabilityPolicy Background

15. The main significance of the 1969 disturbances is not that wage concessions were wrung from the government but rather that doubt was cast

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on its durability, competence, and commitment to reform. Although delay and moderation in relaxing wage control is advantageous to the reform, a softened policy probably can now be accommodated. The danger is that impatience with Ongania's economic program and authoritarian rule will overshadow feasible, gradual improvements in popular welfare. Further unrest and violence could bring policy changes that would hamper further progress or even cause setbacks.

16. Ongania's inept handling of the riots and strikes has brought the government's popularity to a new low. Rumored frictions within the military establishment have made many Argentines wonder if a change in government or economic policy is not likely soon. Some people have interpreted the leadership's vague references to the beginning of the economic reform's "Social Phase" as presaging a return to an easy-going wage policy and large-scale deficit spending. Businessmen again have become extremely cautious in initiating investments, and both friends and enemies of the government speak increasingly of the "failure" of the economic program.

17. Apart from the wage concessions forced on it, the government has not materially changed the goals and methods of the economic reform. Emphasis shifted slightly in 1969, from "stability with growth" to "growth with stability" -- a reasonable and expectable change after two years of austerity. Although officials favorable to free enterprise may have further strengthened their position in the government, they are becoming a little more receptive to "developmentalist" ideas as the reform proceeds. Economics minister Dagnino recently stressed the priority of heavy industry, setting the goals of self-sufficiency in steel by 1974 and rapid development of aluminum, copper, and petrochemical production. On the other hand, he said that these industries will not be overly protected, "hot-house" creations but must be competitive internationally. To spur development, Dagnino hopes to raise the investment rate by one more percentage point (to 23%) in 1970 and to maintain this rate in the future. He apparently believes that a growth rate of 5½% to 6% must be achieved

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even at the cost of continued moderate inflation and budget deficits, but there are no indications that he would allow renewed hyperinflation.

The Inflation Question

18. Although rising prices remain a problem, the battle against inflation has been successful by South American standards. Brazil, Chile, and Uruguay also have attacked rapid inflation, but only Argentina has cut the annual rate below 10%. At the same time, it has gradually restored an adequate economic growth rate. Further progress in reducing price increases is likely to be slow, however.

19. The wage raises of October 1969 and March 1970, which total 11% for the average worker, will put further pressure on prices even though only part of the resulting rise in costs is supposed to be passed on to purchasers, under government guidelines. For a firm with labor costs equal to half of sales revenues, for example, only about three-fifths of the rise can be passed on. The psychological impact of the latest wage increases also is important. Had the government been able to grant them voluntarily, without appearing to give in to labor pressure, Argentines would be less concerned about accelerated inflation.

20. The newly militant labor organizations may not be content with the recent wage increases. As justifications for new demands, union leaders already are pointing to the rise of 10% to 18% since the beginning of the year in the price of beef -- a staple food even for the working class -- and increased prices in January for bread and some transportation and public services. Although additional wage hikes would stoke inflation, strikes or labor disorders could also be detrimental. Extensive work stoppages would not only reduce production and increase costs but also dampen investor confidence and provoke further capital flight. Such disturbances also would discourage purchases of government bonds and thus make non-inflationary financing of the budget deficit more difficult.

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CONFIDENTIALThreat of an Overvalued Currency

21. The 40% rise in prices since the last devaluation in March 1967 and the prospect of continued moderate increases suggest that the peso may have to be devalued again during the next several years. In the 1967 devaluation, which was larger than necessary, the government established export taxes of 16% to 25% on traditional agricultural exports to eliminate windfall gains for producers and to allow leeway for future de facto devaluations by tax reduction. A part of this leeway has now been used up; current export taxes amount to 13% for chilled and frozen beef, 6% for wheat, and 8% for corn and grain sorghum. If world market prices for meat and coarse grains had not increased in recent years, the government probably would have had to eliminate export taxes to keep exports attractive to farmers.

22. The government is probably correct in judging that devaluation will not be necessary in the near future. A weakening of world prices for meat and coarse grains -- which does not seem likely in the short run -- could be offset at least partly by ending export taxes. Argentina's foreign reserves and good credit rating and the likelihood that the government would restrict imports if exports sagged also favor the peso's short-term stability. But in order to maintain financial stability over the longer run, the government will have to choose between (a) further reducing the inflation rate; (b) devaluing at infrequent intervals, at some cost in national prestige, speculative capital flight, and temporarily less competitive exports; or (c) instituting a "creeping peg" exchange rate, which smooths out necessary adjustment but may lessen fiscal responsibility. Although export success depends heavily on factors beyond Argentine control -- notably the weather in Argentina and elsewhere and protectionist barriers in major markets -- proper valuation of the peso will at least allow the country to make the best of circumstances.

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CONFIDENTIALOutlook

23. Because many Argentines obviously dislike the economic medicine they have been taking and detest the officials dispensing it, the economy's prospects during the next several years remain highly uncertain. The fact remains, however, that the reform effort was well conceived and has been carried out effectively, aside from government's vacillation and sacrifice of Krieger during last year's labor agitation. More can be accomplished if it is continued. And if it is not continued, the gains of the past three years can easily be lost.

24. There is more doubt now than two years ago that workers will be satisfied with the small gains that the government can provide without undermining the reform. The urban working class has chafed over policies that depressed their real income for two years and has waited impatiently to share in the widely hailed economic improvement. The initial relaxation of wage control seemingly has only encouraged labor to demand more. Perhaps even more questionable is the idea that the Argentines will willingly accept an authoritarian government as the price of economic modernization and development and, eventually, much higher living standards for everyone. The middle and upper classes, which probably suffered less from reform than the lower classes but are more politically conscious, are distressed that the promised transition to more normal political life has scarcely begun. Just how the military caterpillar will be transformed into a democratic butterfly is unclear, as is the impact on economic policy if such a change occurs. The longer the government can stay in power without radically modifying the reform program and the more its successor is united and responsive to broad business and agricultural interests rather than to nationalistic labor or military factions, the greater is the chance that the reform will have a lasting beneficial effect.

25. The economy probably will make good progress in 1970 even if there is some retreat from reform. Although Dagnino will probably bend wage policy further to avoid serious work stoppages and might accept stepped-up public spending and an increased

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budget deficit if private investment lags, large increases in wages and the deficit seem unlikely. Recent public investments and unused capacity in many private firms should permit continued rapid industrial growth even though capacity may become a bottleneck in others. Export demand is favorable for several leading items (corn, sorghum, and meat), although poor crop conditions and growing protectionism abroad could hurt overall export expansion. Foreign reserves are sufficient to cushion some renewed capital flight or decline in foreign investment, so that highly restrictive measures would not be necessary immediately. All in all, the country has a good chance of realizing the economic minister's expectations of a 5½% to 6% economic growth rate, a price rise no higher than in 1969, and a \$250 million trade surplus, compared with \$70 million last year.

Conclusions

26. In spite of riots, strikes, unscheduled wage increases, capital flight, and a change of economics ministers, Argentina's reform program generally moved ahead in 1969. In most respects, the performance of the economy surpassed that in 1967-68, the program's first two years. Real output increased by about 7%, the cost-of-living rise was held to 6½%, investment rose markedly, and exports reached their highest level in 30 years. Although the government granted moderate wage increases at the beginning of the year after a two-year decline in real wages, labor militancy forced additional raises in October. Foreign reserves dropped by about 30%, partly as an indirect result of the year's unrest.

27. The economic reform has accomplished about as much as could be expected of it in three years. Its continuation during the next several years is by no means assured, however. The disturbances that erupted in 1969 underscored the unpopularity of both the government and the austerity program. This opposition, which may surface repeatedly in the future, could eventually lead to a scuttling

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of economic reform. Although shaken by the unrest, the government has made no major economic policy changes so far. The wage increases forced on it last October will not in themselves undermine the reform and probably would have been forthcoming a few months later anyway.

28. Economic performance in 1970 promises to be favorable, unless widespread labor disturbances occur. Export demand continues strong, foreign reserves remain fairly large, the current harvest apparently is favorable, and completion of some public investment projects should compensate for capacity problems that private industry anticipates. Over the longer term, the economy's progress depends mostly on the course of government policy. If the reforms can be sustained, more can be accomplished; if not, recent advances can be largely lost. The population's gains from reform will not necessarily be decisive in determining how long the Ongania government and its economic policies will survive. Economic improvements, which normally cannot be large over a short period, do not unerringly insure political stability, as the recent Argentine disorders demonstrate. Unrest is likely to continue under the Ongania government. Whether the present government can retain power without seriously weakening the reform program and whether it or its successor will be willing and able to institutionalize the reforms in a lasting form remain open questions.

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