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CIA/OER/IM 71-109

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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

Argentina: Fading Hope For Basic Economic Reform

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ER IM 71-109
June 1971

Copy No. 51

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
June 1971

INTELLIGENCE MEMORANDUM

ARGENTINA: FADING HOPE FOR BASIC ECONOMIC REFORM

Introduction

1. Recent events have further dimmed the hopes raised by Argentina's good economic performance during the first four years of military rule. Increased political instability, dating from serious student and labor disorders in mid-1969, has been reflected in the ouster of two presidents and four economics ministers. Nationalistic programs and political expedients are replacing the original, largely successful policies emphasizing free enterprise and financial stability. An unresolved crisis in the beef industry is affecting the entire economy, and rapid inflation is once more the order of the day. Nevertheless, the nation is still in a far better economic position than when the military took over in 1966. This memorandum examines the present economic situation and assesses the outlook for the next few years.

Discussion

Background

2. Once the showcase of Latin American development, Argentina has suffered from erratic economic performance, chronic inflation, and periodic balance-of-payments crises since the 1930s. Its stop-go cycles have been especially pronounced since the 1950s, when basic structural distortions were significantly magnified by Peron's dramatic and probably irreversible shift of economic and political power from the pampas to industry and the urban masses. Because Argentina's large, inefficient manufacturing sector contributes little to export earnings and is heavily dependent on imports, industrial growth – if not accompanied by increased agricultural exports – leads rapidly to balance-of-payments crises. When such crises occur, the government usually responds with a growth-killing mixture of devaluation, export taxes, import restrictions, and credit

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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limitation. The ensuing recession, typically accompanied by inflation and capital flight, continues until the government is forced to spur production with increased imports, and the cycle begins again. Attempts to break this cycle before 1966 – most importantly during the Frondizi administration (1958-62) – failed largely because governments lacked the power to take remedial actions opposed by powerful segments of the Argentine populace.

3. When General Ongania seized power in June 1966 after three years of ineffectual rule by President Illia, the military was given a tacit mandate to make basic changes in the political and economic system. The relative quiet that prevailed in the country until the May 1969 riots in Cordoba was the result not so much of military force as of apathy mixed with hopeful waiting on the part of the populace. From the economic point of view, this time was well used. By early 1967, Adalberto Krieger Vasena, then Minister of Economy and Labor, had launched a well-conceived and complex program designed to achieve both financial stability and enduring economic growth. Its measures included wage and price controls, conservative fiscal and monetary policies, reduced tariffs and exchange controls, and policies favoring foreign as well as domestic private investment. 1/ Although many of these measures were similar to those earlier attempted by Frondizi, the program differed in one essential respect: it had the unified support of a military government that promised continuity in policy for as long as needed to achieve its goals. Results were gratifying with regard not only to price stability, investment, production, and foreign reserves but also to employment and real wages (see the table).

4. Contrary to the slogans voiced by students and workers at the time, the disorders of mid-1969 were political rather than economic in origin. In the face of high employment, a sharply reduced inflation rate, and the highest real wages in more than a decade – the result of substantial pay hikes at the beginning of the year – there was little economic justification for heightened public discontent at that time. In an ill-considered reaction to the disorders, Krieger was dismissed and replaced by Dagnino Pastore who espoused essentially the same liberal economic line. The economy quickly recovered from the shock of the riots, but political instability was clearly on the rise and organized labor was beginning to regain much of its earlier muscle. Perhaps most important, the government's [redacted] sacrifice 25X6
of the key architect of the economic program gave rise to a credibility gap that widened considerably in the months that followed. 2/ In June

[redacted] 25X1

Argentina: Selected Economic Indicators

Percentage change in GDP		Percentage change in cost of living (December - December)	
1965	9.4	1965	38.2
1966	0.1	1966	29.9
1967	2.3	1967	27.4
1968	4.7	1968	9.6
1969	6.9	1969	6.7
1970	4.9	1970	21.7

Investment as a Percent of GDP		Index of real wages (1960 = 100)	
1965	19.0	1965	138.3
1966	18.0	1966	139.4
1967	18.6	1967	132.8
1968	20.2	1968	131.8
1969	22.2	1969	143.2
1970	22.5	1970	135.0 (est.)

Unemployment rate (April)		End of year gross foreign reserves (Million US $)	
1965	6.0	1965	285
1966	6.5	1966	266
1967	6.4	1967	767
1968	5.5	1968	810
1969	4.5	1969	579
1970	5.5 (est.)	1970	740

1970 the junta of commanders-in-chief removed Ongania because it feared he intended to form a corporate state and perpetuate himself in power.

Economic Policy Under Levingston and Lanusse

5. The new president, General Roberto Marcelo Levingston, and the junta that selected him apparently had no well-developed economic views. Nationalists and free-trade liberals vied for influence in the government with the result that the new economics minister, Carlos Moyano Llerena, received no firm backing for his policies. More important, Moyano – although a highly regarded liberal economist and former advisor to Kreiger and Dagnino – seemed overwhelmed by the responsibility for dealing with the nation's problems. After carrying out an early, unexpected devaluation (which was severely criticized as unnecessary and inflationary by Argentine economists and businessmen alike), Moyano avoided major decisions, and economic policy drifted. His resignation was willingly accepted in October 1970.

6. During the summer of 1970, President Levingston had steadily moved toward a more nationalistic stance in an effort to create a power base independent of the junta that had selected him. His appointment of Aldo Ferrer as Moyano's replacement was an important step in this direction. Ferrer, an internationally known economist and economic historian who previously had been Levingston's Minister of Public Works and Services, immediately set about reversing the policies of the preceding four years. No longer was financial stability considered the precondition for economic growth, but rather growth was the precondition for stability. To achieve his announced goal for an 8% annual growth, Ferrer stressed "Argentinization" of the economy – essentially a return to discrimination against foreign goods and industry – and income redistribution. Given the existing political and economic uncertainty, a crisis in the meat industry, and the resurgence of rapid inflation, conditions for implementing Ferrer's plan were far from ideal. Nevertheless, when Levingston was ousted in March 1971 by General Alejandro Lanusse, earlier reputed to be an economic liberal, the new president retained both Ferrer and his policies. Although Ferrer has lost power in the still incomplete reorganization of the economics ministry, it is doubtful that this signifies a major shift in direction.

The Economy's Performance in 1970

7. Despite a marked deterioration on all fronts at the end of the year, overall economic performance in 1970 was good. Investment increased by more than 6% from 1969's high level and output rose by about 5%, less than in 1969 but well above the average of pre-coup years. Construction, petroleum production, farming, and manufacturing led the way with increases of 14%, 9%, 6-1/2%, and 6%, respectively. By contrast, livestock

production declined by almost 4%. Aided by a 10% gain in export earnings and a reversal of the capital flight that followed the mid-1969 riots, foreign exchange reserves increased by some 28% to $740 million. Performance on the price front deteriorated sharply, however, pushing the inflation rate to 22%, compared with an 8% average in 1968-69.

Emerging Economic Problems

The Beef Crisis

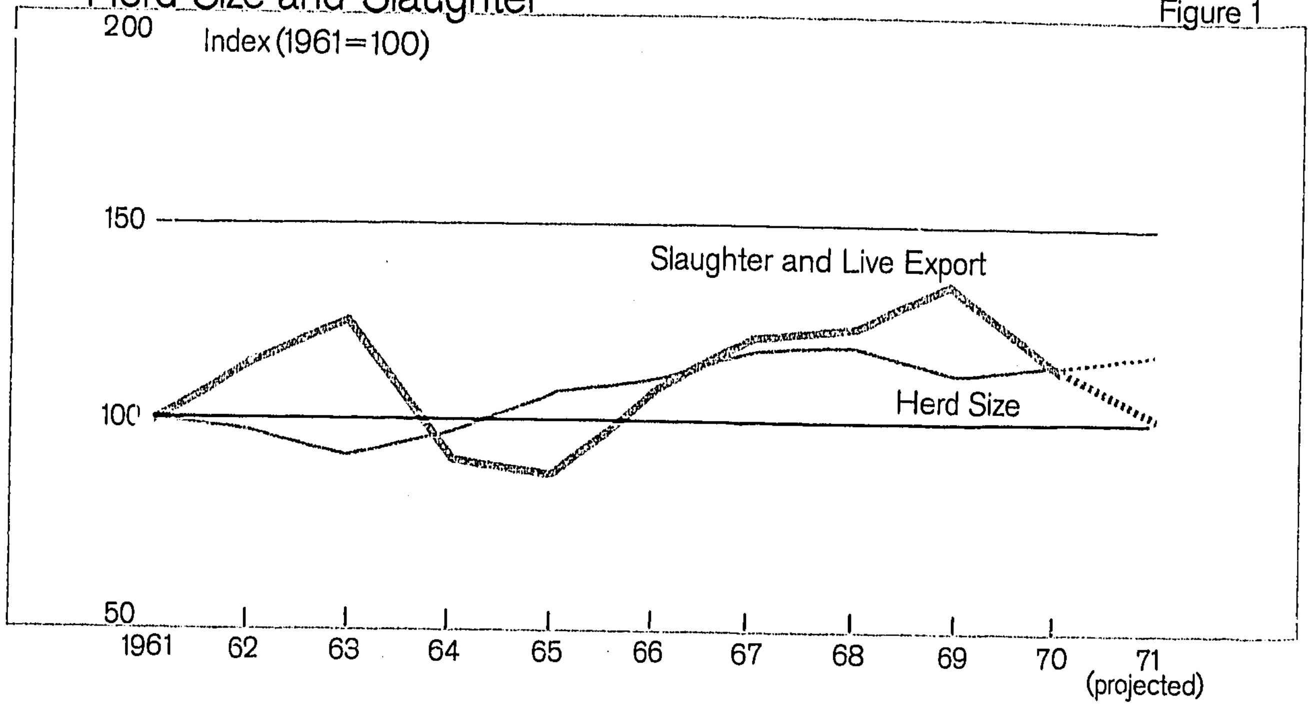
8. Beef -- Argentina's most important export, principal staple in the domestic diet, and main symbol of national well-being -- is in short supply, and the ramifications are shaking the entire economy. Both exports and domestic consumption were able to increase from their 1965 lows without greatly affecting herd size until 1969, when a sudden upsurge in demand cut the herd from 51.5 million head to 48.3 million (see Figure 1). Despite continuing high international prices and rapidly increasing domestic prices, cattlemen sharply reduced slaughter in 1970 in order to build up their herds -- thus driving prices still higher.

9. About three-fourths of total slaughter is consumed domestically. Largely because of the government's more liberal incomes policy, retail beef prices, which weigh heavily in the cost of living index, jumped 37% in 1970 and are still rising rapidly -- a fact that is not lost on labor leaders who are demanding still higher wages. Suffering from credit limitations, large debts, and rising wage bills and unable to buy cattle cheaply enough to make a profit after producer prices rose by 50%, three major export houses have shut down. Beef exports in December 1970 were less than half the volume of the previous year and have continued low during the first quarter of 1971, leading to predictions of a 20% drop in beef earnings for the year. Although domestic per capita beef consumption is still the world's highest -- 180 pounds yearly compared with about 90 pounds in the United States and less than 50 pounds in West Germany -- it has declined by more than 10% from its 1969 record level, leaving the typical Argentine with a feeling of deprivation and maltreatment. "Meatless days" -- the imposition of which has shaken previous governments -- have been extended into "meatless weeks."

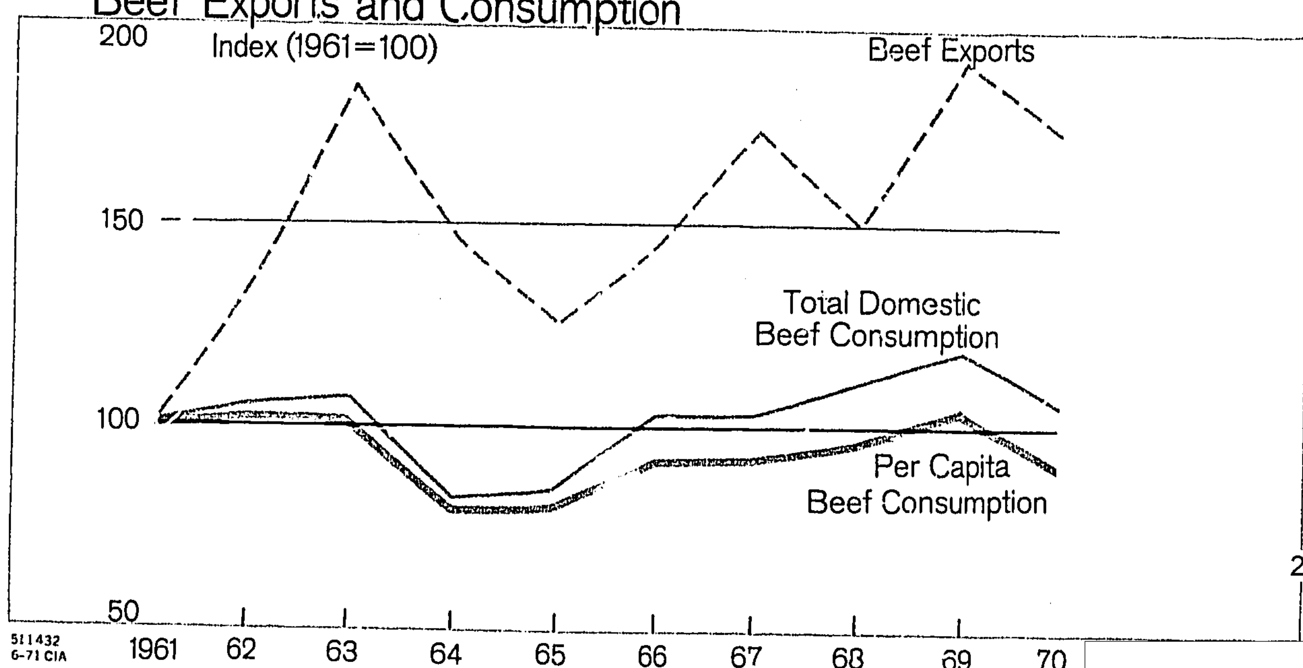
10. There is no easy solution to the beef crisis. High beef export earnings are economically essential but can be sustained only if politically unpopular restrictions on domestic consumption are effectively maintained. Both internal and external demand cannot be fully met without depleting the herds upon which a long-term solution depends. Past attempts to limit domestic demand and rising prices have been largely unsuccessful. Early in 1970, when beef prices began their rapid rise, the Ongania administration responded by establishing two meatless days a week and putting price

Figure 1

Herd Size and Slaughter



Beef Exports and Consumption



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ceilings into effect. These regulations were never fully observed, and the government fell shortly thereafter. Levingston's first economics minister established a compulsory 15% reduction in slaughter for the domestic market – a move that was largely meaningless because it only approximated the expected seasonal decline. After a series of unsuccessful half-measures, economics minister Ferrer in March 1971 restricted domestic beef consumption to 15 days per month and established a graduated tax on beef exports sold at above a given parity price. The intent of these measures was to maintain export levels but not allow an export boom that would further increase pressure on domestic prices or deplete the herds. After Lanusse took power, Ferrer lifted the tax but left in effect domestic consumption and price controls – measures that are difficult to implement and thus have not been markedly successful in the past.

Quickening Inflation

11. Last year's 22% inflation rate and the accelerated price rise in 1971 (currently running at a 30% annual rate) signify a return to the wage-price spiral of the pre-Ongania period. The economy was able to absorb relatively large wage hikes in 1969 mainly because businessmen and consumers believed that the overall economic program remained intact. This faith received a sharp setback when Ongania was removed from power in June 1970. In the same month the new economics minister devalued the peso without taking adequate compensatory measures. As a result, the inflationary mentality – never completely broken – was renewed with vigor. The cost-of-living index, which was the same at the end of June as at the end of December 1969, rose by some 22% during the next six months. Ferrer's official downgrading of the goal of price stability in October – as well as his relaxing controls on wages, rents, and public utility and transportation rates in early 1971 – contributed significantly to accelerating inflation.

12. Wage hikes and budget deficits are more important factors in 1971's inflation than they were last year. Average money wages increased only about 15% in 1970 – considerably less than the rise in the cost-of-living index – whereas the gains allowed in recent collective bargaining agreements average about 24% in addition to a 6% across-the-board raise given at the beginning of the year. With the pace of inflation quickening, union leaders already are beginning to question the adequacy of these wage hikes. Under prevailing rules of the game, organized labor is unlikely to stand still for a deterioration in real wages – as occurred in late 1970 when the accelerated price rise outstripped earlier wage gains.

13. The government also has adopted more expansionary fiscal policies than it followed last year, when the budget deficit was held to about 12% of expenditures – about the same level as in 1969 and far below

the 36% average of the pre-Ongania period. Although the government has been able to keep the budget deficit within bounds during the early months of 1971, wage increases for government workers are expected to average more than double the 14% anticipated at the time the budget was formulated. The rapidly rising wage bill and increases in other current expenditures will almost certainly cause serious overruns if funds are not diverted from the capital account – a problematic option in the face of flagging private investment. Waning investor confidence also has made the floating of domestic and foreign bond issues far more difficult, and thus inflationary borrowing from the central bank – already up in 1970 – is once again becoming the primary means of financing the government deficit.

Waning Investor Confidence

14. The return to rapid inflation, political instability, and vocal nationalism is responsible for a marked deterioration in the business climate. Estimates of deferred or canceled foreign investment range as high as $200 million, and domestic private investment – supposedly favored by the government's nationalistic policies – shows few signs of taking up the slack. Moreover, inflation and the high cost of credit already are causing increasing resource misallocation by diverting funds to short-term, high-yield investments. Although government capital expenditures helped buoy up overall investment levels in the first quarter of 1971, output increased only a little more than 2% compared with almost 6% during the same period last year.

15. Political uncertainty and dimming prospects for economic growth are the main determinants of reduced foreign investment, but the government's nationalist stance is also a factor. Diatribes against "foreign monopolies" – particularly frequent during the last months of the Levingston administration – and vague threats of further discriminatory actions were probably more important than actual measures proposed or taken in creating this negative atmosphere. Nevertheless, anti-foreign discrimination is inherent in three recent government actions: the "buy Argentine" law, the new petroleum policy, and the draft automobile law.

16. The "buy Argentine" law, signed in December 1970, is intended to force state entities to buy from domestic sources whenever possible. The law discriminates both against imported goods and services and output by local companies with a substantial amount of foreign capital. Recognizing that the state accounts for about one-third of capital goods purchases and some 40% of construction contracts, Ferrer reasoned that channeling this demand exclusively to local firms would greatly stimulate their production and eventually lead to economies of scale and increased efficiency. It is doubtful that the law will be rigidly enforced; an almost identical law in 1963 became a dead letter as soon as it was written because of resistance

from the state enterprise managers. These managers markedly prefer imported goods for reasons of both cost and quality and so far have had little difficulty in avoiding the new law's restrictions.

17. The new petroleum policy, while moderate compared with petroleum laws in other Latin American countries, has further dampened the investment climate. The new policy does not affect exploration, drilling, and production contracts but limits crude oil supplies to foreign-owned facilities in an effort to keep refineries of the state oil company (YPF) working at capacity. Because YPF produces most Argentine crude, this policy should be fairly simple to implement. Of the three foreign companies affected – Esso, Shell, and Cities Service – only Cities Service is a substantial producer of crude oil, accounting for about 10% of Argentine output. Whereas these companies formerly were allocated crude oil based on their share of the retail market, they now will receive only the surplus that YPF cannot process. Under this system, private refineries will be forced to reduce operations from 91% of capacity to about 70% and will suffer substantial financial losses until Argentine crude oil output expands sufficiently to take up the slack. Esso, for one, claims to be reconsidering its Argentine investment plans because of this factor.

18. The proposed automotive industry law, which is unlikely to be signed without some modifications, would effectively oust foreign manufacturers from the parts industry and would restructure the automobile manufacturing sector. The clauses dealing with automobile manufacture seek mainly to eliminate production of "non-rational" models. The law as written, however, requires Argentine ownership and control of the parts industry by 1 January 1972, prohibits foreign licensing arrangements, and restricts profit remittances. Given the state of Argentine technology in this field, it is unlikely that the law could be enforced in the time allowed without shutting down the parts industry.

Overvaluation of the Peso

19. Because of the rapid deterioration in domestic price stability since the 12-1/2% devaluation in mid-1970, the peso at present is overvalued. For the first time in more than four years, an active and extensive parallel market for the peso has developed. This market, which began to establish itself in October 1970, has continued even after the adoption of the crawling peg 3/ and small devaluations in April, May, and June of 1971. The

3. Under the crawling peg system, large devaluations are avoided and frequent small devaluations are used to equalize the internal and external purchasing power of the currency.

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unofficial rate now hovers at about 5.00 pesos to the dollar – some 20% above the official rate of 4.20.

20. Foreign exchange reserves have declined steadily since October of last year, largely reflecting capital flight to safer and more profitable investments abroad (see Figure 2). Currency overvaluation has negatively affected the trade balance as well, although the beef crisis and hedging against expected import tightening are more important factors. Continuing a trend apparent since late 1970, exports declined 14% while imports rose some 16% during the first quarter of this year. A subsequent slight improvement in trade performance has not been sufficient to offset the continuing deterioration in capital transactions.

Outlook for 1971 and Beyond

21. Inflation – expected to average at least 30% for 1971 – should sustain output during the next few months, but thereafter economic growth is expected to fall off sharply as cut-backs in investment make themselves felt. The growth rate of gross domestic product may fall below 3% for the year, compared with 5% for 1970. Despite massive wage increases, the rapid pace of inflation threatens a further reduction in real wages – thereby nullifying the effect of Lanusse's popularity-seeking measures. Even if organized labor succeeds in its efforts to outpace the price spiral, unemployment will continue its rise from 1969's historical low as economic growth slows. Exports will probably fall to about $1,600 million from 1970's record $1,770 million, while imports may rise above last year's $1,680 million level, thus bringing about the nation's first trade deficit since 1962. Even if the trade account fares better than now indicated, the worsening business climate and currency speculation make an overall balance-of-payments deficit almost inevitable.

22. During the next three years, we expect a steady but not dramatic deterioration in all aspects of the Argentine economy. This decline will be more a function of the "lame duck" nature of the Lanusse administration than of the particular policies or attitudes of that government. Even if it were politically possible to do so, a return to sound economic policies would have only a marginal effect as long as the government's tenure is limited and its successor uncertain. Given Argentina's resources and stage of development, it probably could follow the Mexican example of pursuing nationalistic policies without discouraging growth and investment, provided that political stability and continuity in economic policies were assured. Because investors can be expected to resume a "wait and see" attitude at least until the guidelines for the return to democratic rule are clarified, Argentina's greatest economic problem once again is its political problem.

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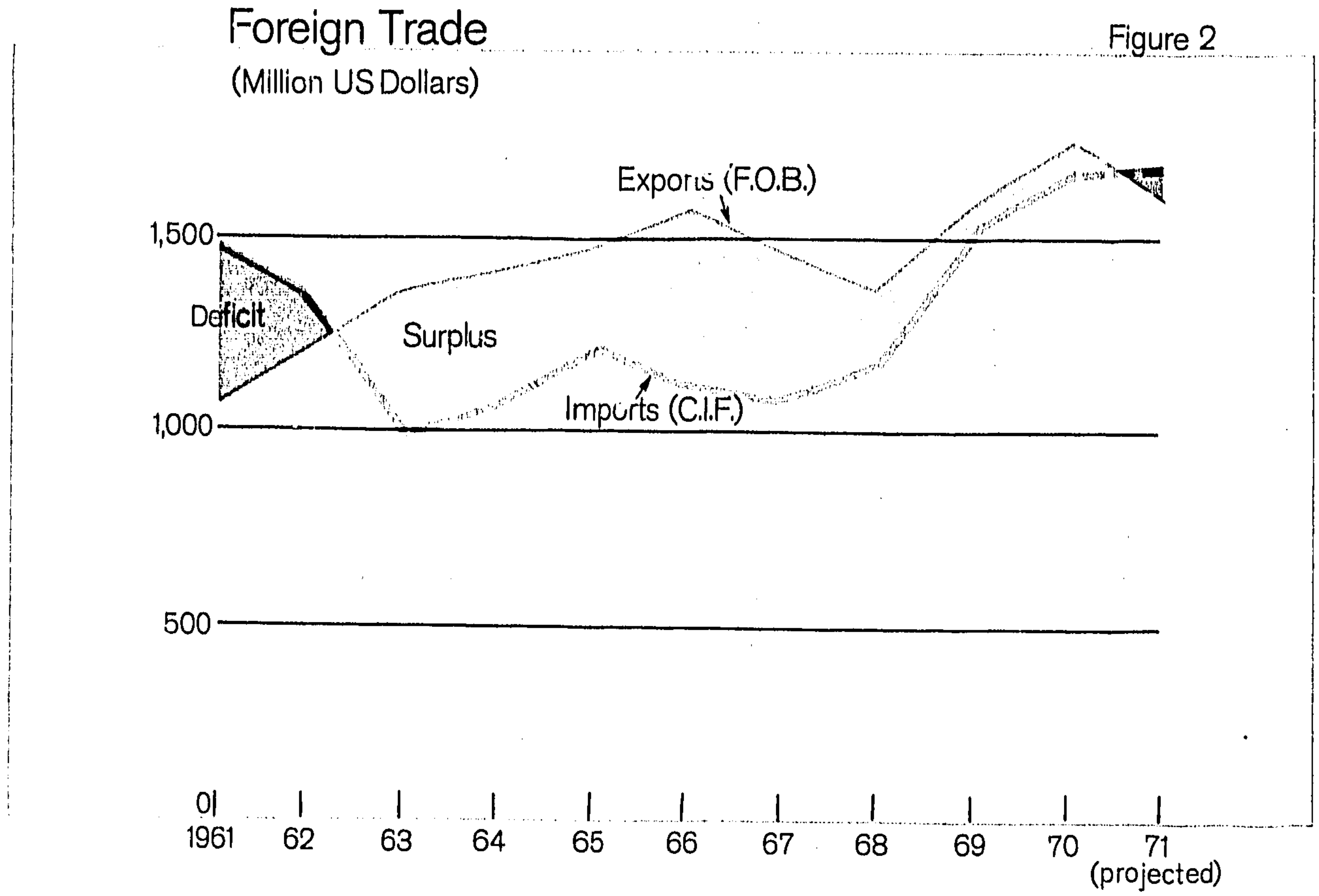

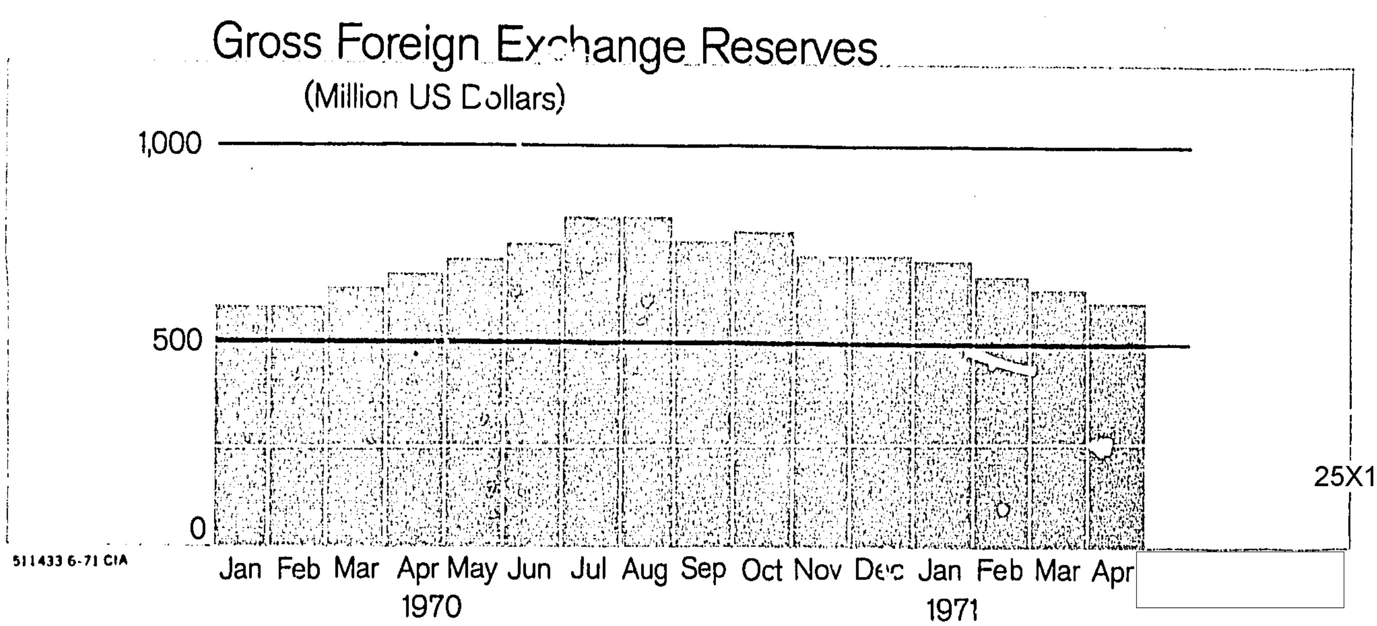

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23. Several favorable factors will limit the speed and extent of the decline. The trend toward higher world prices for meat and coarse grains will buoy Argentine exports, while imports will probably be restricted by increasingly protectionist policies. The increasing size of the Argentine herd should release greater supplies of meat for export by 1972, provided that domestic demand is curbed. Farmers will undoubtedly continue to shift resources out of low-value wheat production into beef, corn, and grain sorghum that are in greater demand on the international market. Most important, the country's large foreign reserves provide a cushion that the economy did not have in previous periods of crisis. Moreover, the crawling peg exchange rate system, although inadequately used at present, provides a relatively easy means of limiting peso overvaluation.

24. There appears to be little or no possibility of a substantial cut in the inflation rate in the intermediate future. The government -- intent upon gaining popular support -- seems disinclined to oppose inflationary wage hikes. "Voluntary" price controls, so essential to Krieger's successful stabilization program, have been allowed to lapse except for a few popular consumption commodities. Inflationary budget deficits will increase not only because of wage raises in the public sector and the government's ambitious investment program but also because a probable decline in economic activity will reduce tax returns. Moreover, the crawling peg system will tend to eliminate external constraints on fiscal and monetary policy.

25. On balance, the outlook for investment and output is poor. Inflation, nationalism, and political instability already have altered domestic and foreign private investment plans. In the future the trend toward less investment will probably accelerate, despite increased government spending and the availability of some international loans. Because investor confidence has been shaken, relatively minor crises can trigger large capital outflows. Declining investment and import constraints in turn will slow growth of the gross domestic product. The stage is set for a return to the stop-go cycle of the pre-Ongania period.