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Argentina: Prospects for Economic Stabilization

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An Intelligence Assessment

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ALA 85-10112
November 1985

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Argentina: Prospects for Economic Stabilization [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted] 25X1
Office of African and Latin American Analysis, with
a contribution from [redacted] OCR. It was 25X1
coordinated with the Directorate of Operations.
Comments and queries are welcome and may be
directed to the Chief, Research Branch, South
America Division, ALA, [redacted] 25X1

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Argentina: Prospects for Economic Stabilization

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Key Judgments

Information available as of 1 October 1985 was used in this report.

President Raul Alfonsin in June 1985 launched a forceful new economic program to break the cycle of inflation and economic stagnation that has gripped Argentina throughout the postwar era. He ended his government's yearlong tactic of avoiding economic austerity and announced a shock treatment known as the Plan Austral that includes a freeze on wages and prices, a currency reform, and budget cuts to halt an inflation rate that had soared beyond a 1,000-percent annual rate. These moves followed an agreement with the IMF that aims to provide Argentina up to $6 billion in IMF and foreign bank loans. To the surprise of many, the Argentine public—not known for its willingness to bear sacrifice—rallied to support the harsh measures.

We believe that Alfonsin will be able to hold to his economic stabilization program through early 1986. His success to date in drastically reducing inflation to a 55-percent annual rate during July-September, Argentina's receipt of $2.7 billion of the loan package, and the absence of any unified political opposition will probably allow Alfonsin's Radical Civic Union (UCR) at least to retain its congressional majority in elections this November. Nonetheless, we and most other outside economic observers foresee a deepening recession over the next several months, one that almost certainly will intensify pressure from labor, business, the political opposition—and even the more populist members of the ruling party—for government intervention to revive the sagging economy. The military, which is clearly displeased with the administration, probably will also look for opportunities provided by any increases in public disorder to intimidate Alfonsin and counter proposed military budget cuts.

We believe it is likely—perhaps two chances in three—that the President by mid-1986 will slip back into the pattern of stop-go economic policies that historically has prevented the economy from realizing its potential. We envision Alfonsin boosting government investment to spur a recovery at the cost of compliance with IMF performance targets. Even if Buenos Aires obtained waivers from the Fund, we expect that loan disbursements would be halted temporarily, cash problems would resume, and inflation would be rekindled.

In the worst case, Alfonsin could fully reverse the Plan Austral and opt for a major exercise in pump priming—a 1-in-10 possibility, in our view. Such an approach would generate rapid short-term growth, but at the cost of

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price and financial instability, and, eventually, Alfonsin's credibility. We believe that political disorder would spread and the military would be tempted to intervene. Whether Alfonsin held on to power or not, Argentina would be likely to turn inward. In a nationalistic tussle with creditors and investors, Buenos Aires would be likely to lose access to foreign credit and respond by declaring an indefinite moratorium on debt payments and by seeking the support of the 11-member Cartagena Group of Latin debtors. Alfonsin also would be more likely to expand economic relations with the Soviets, in our view, albeit cautiously.

If Alfonsin can continue to walk the fine line between maintaining the tough stabilization measures and meeting public expectations for economic growth—a 1-in-5 chance, in our judgment—Argentina could break away from 50 years of economic lethargy. With steady economic policies and thoroughgoing reforms, he could launch Argentina on the path toward realizing its great economic potential. His ability to do this will hinge to a large extent on the willingness of the Argentine people to endure prolonged austerity. Popular tolerance for austerity to date has rested heavily on the President's personal popularity and his success in consolidating democratic rule—his administration's stated primary goal.

Under the most likely scenario for 1986—a resumption of stop-go economic policies—we believe US relations with Argentina would be likely to experience new strains as Alfonsin responded defensively to domestic and foreign criticism of his policies. US banks probably would face a slowing of debt service payments, and any hopes for increased US exports and investment in Argentina would fade. In the extreme case that Alfonsin's program failed and he abandoned stabilization completely, democracy in Argentina and perhaps the region would be jeopardized, nationalistic economic policies would threaten the interests of US lenders and investors, and US debt policy toward Latin America would be at risk.

If, on the other hand, Alfonsin can stay largely on track with the economic stabilization program, he could foster regional economic moderation to counter radical debt proposals from Cuba's Castro and Peru's Garcia, and he could burnish democracy's image in the hemisphere. A revitalized Argentina would provide tough competition for US farm product exporters, but also would create an expanding market for US manufactures and technology, attracting new direct investment while providing a steady stream of payments to US banks.

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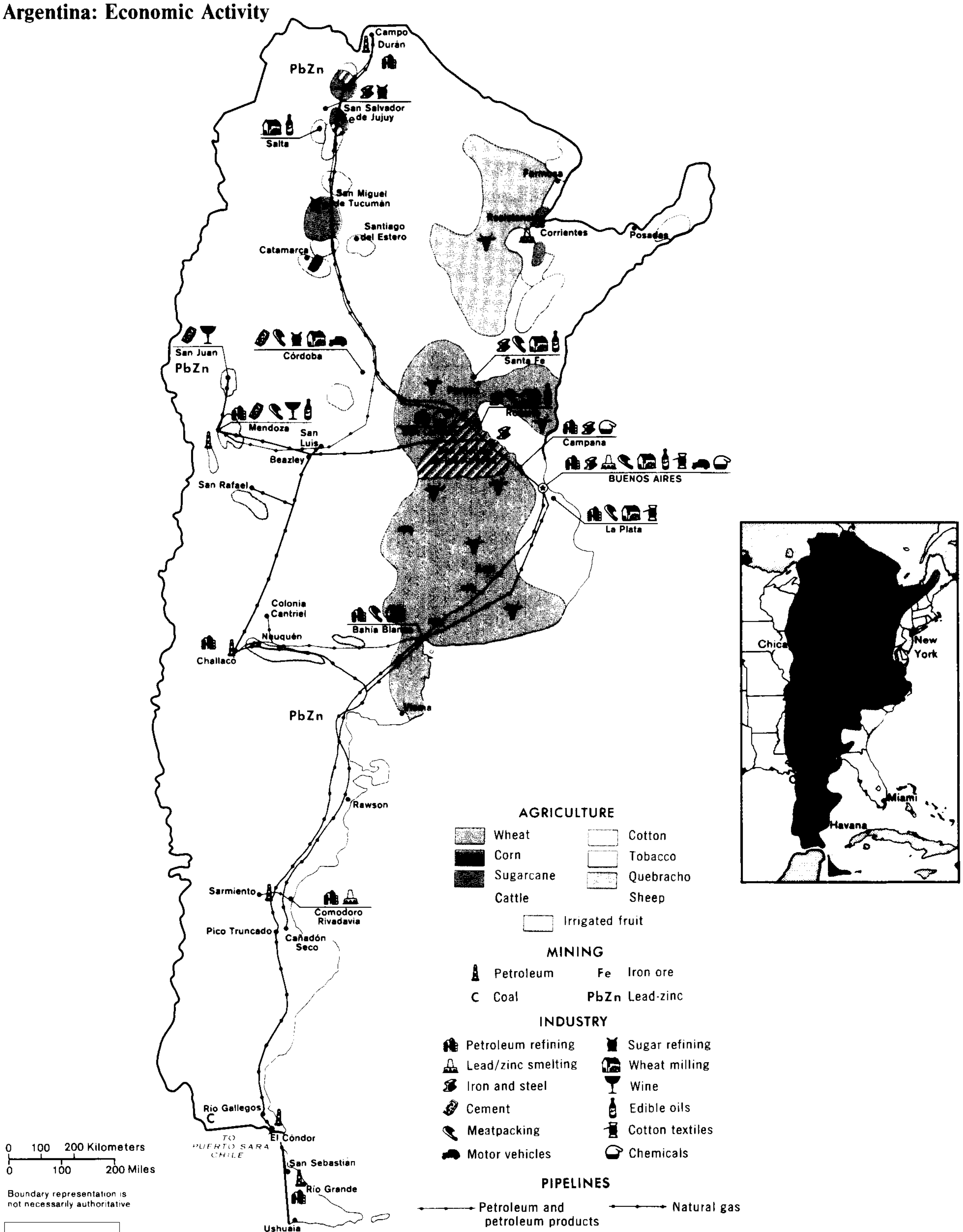
Figure 1
Argentina: Economic Activity



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Argentina: Prospects for Economic Stabilization

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Introduction

The government of President Raul Alfonsin took power in December 1983 without a coherent economic stabilization plan and with a philosophical aversion to tough austerity measures. Alfonsin felt, according to Embassy reports, that the best way to implant democracy deeply in Argentina was to adopt a populist governing style that would sustain his personal popularity, thereby keeping his political and military opponents at bay. Throughout his first months in office, all other considerations seemed to him secondary, and in our view he squandered the opportunity to use the political honeymoon following his inauguration to coax the Argentine people into accepting unpalatable economic realities.

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By mid-1984, however, the government began to show public signs of recognizing that major economic adjustments were needed, lest mounting inflation fan public discontent to the point that it could threaten the new democratic administration. Buenos Aires also had reached the stage where it critically needed foreign loans to service its $48 billion foreign debt. Although the resulting policies proceeded in fits and starts, the government finally launched a coherent stabilization program—the Plan Austral—in June 1985, and since then the attack on inflation has been pressed with surprising vigor. This paper assesses Alfonsin's chances of staying this course, the potential for and consequences of alternate policy directions for Argentine and regional democracy, as well as their impact on US-Argentine relations.

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Table 1
Argentina: Key Economic Indicators

	1984	1985 [a]
GDP *(billion US $)*	71	68
GDP *(percent change)*	2	−5
Consumer prices *(percent change)*	627	800
Exports (f.o.b.) *(billion US $)*	8.1	7.7
Imports (f.o.b.) *(billion US $)*	4.1	4.2
Current account balance *(billion US $)*	−2.5	−2.0
Budget deficit [b] *(percent of GDP)*	15.5	8.5
Unemployment rate *(percent of labor force)*	3.8	6.5

[a] Projected.
[b] Combined deficit of the public sector and Central Bank, plus estimated deficit of public corporations.

Note: The population of Argentina will reach 30.5 million this year, yielding a projected per capita GDP of about $2,200.

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Alfonsin's Gradual Turn to Stabilization

Two of Alfonsin's economic goals upon taking office—boosting the purchasing power of workers and expanding social services—clashed immediately with his early, modest efforts at austerity. Through mid-1984, according to the US Embassy, the only concrete efforts to rein in the large budget deficit Alfonsin had inherited involved cutting military and nuclear programs and delaying the payment of government bills. These moves helped drop the deficit to under 13 percent of GDP, from 17.5 percent in the last quarter of 1983, but failed to produce lasting budget gains. Inflation rose steadily from 434 percent in December 1983 to 580 percent in June 1984, and contentious debt negotiations with the IMF and commercial banks reached an impasse.[1] In a last major show of

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[1] Unless otherwise cited, economic performance data are from official Argentine sources.

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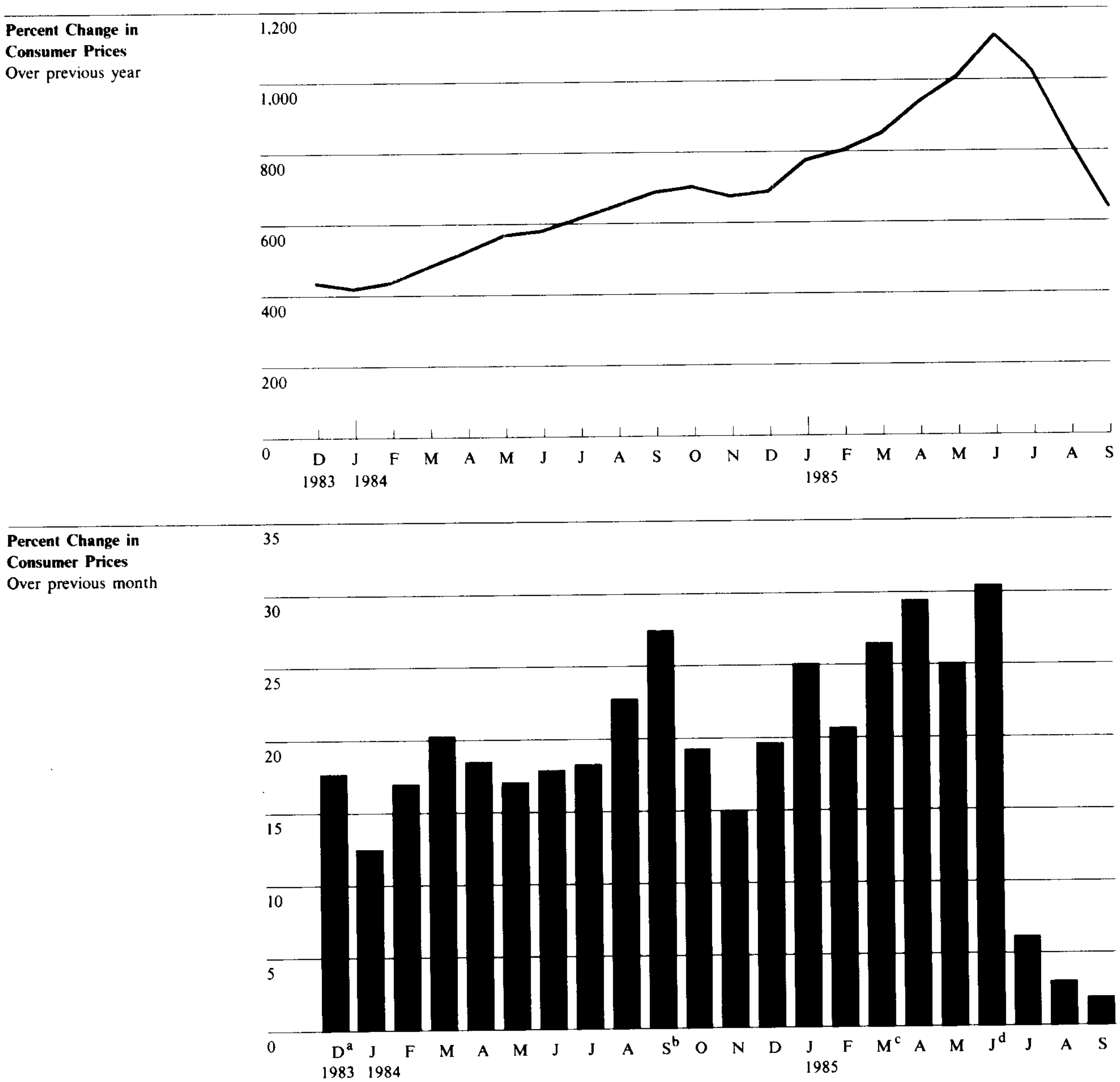
Figure 2
Argentina: Inflation Trends



[a] Alfonsin takes power.
[b] First IMF program signed.
[c] Argentina found out of compliance with program.
[d] New IMF targets reached and price freeze imposed.

[redacted]

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defiance, Alfonsin bypassed the IMF negotiating team and publicly announced he was sending a draft economic program directly to the Fund's managing director. The IMF ruled the Argentine proposal inadequate and refused to accept it.

Economic Policy Realignment in 1984
Faced with these setbacks, Alfonsin altered his public stance at midyear and acknowledged the need for belt-tightening. in particular, spiraling inflation and the continued contraction of private investment helped convince him that a major shift in economic policy was needed. In a nationwide speech, he told the Argentines that those in the higher income brackets would have to suffer some reduction in their standard of living.

Shortly thereafter, Argentina signed a memorandum of understanding with the IMF, the first concrete step toward a stabilization program. In return for $4.2 billion in fresh bank loans and $1.7 billion in IMF credit, Buenos Aires agreed to reduce the budget deficit to slow inflation, devalue the peso faster to improve international competitiveness, and set interest rates above the level of inflation to increase savings. In addition, Alfonsin reversed his pledge to boost real wages by introducing a wage formula that produced real salary cuts during the last quarter.

The government lacked a clear commitment to the program, however. Only the wage and devaluation policies were strictly implemented, while the budget deficit and the money supply expanded rapidly. The local press reported that the resulting climb in inflation—then at 800 percent—fostered a sense of economic drift.

Figure 3
Argentina: Investment Trends (Fixed Domestic Investment as a Share of GDP)

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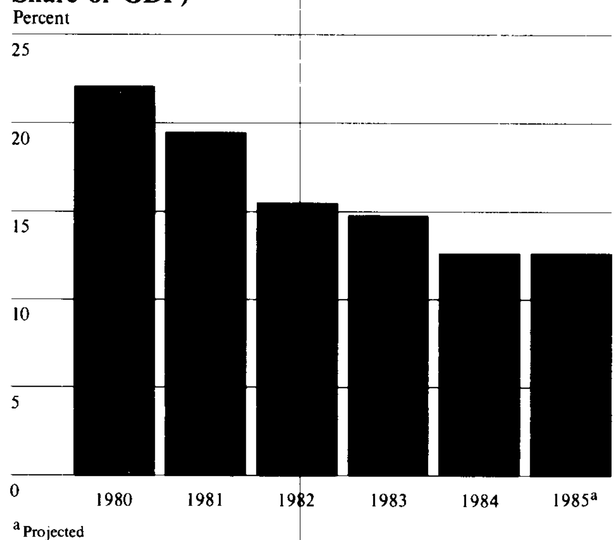

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[a] Projected

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Financial Team Shuffled
These inconsistencies in part reflected the policy differences between the President's principal economic advisers. Economy Minister Grinspun, Alfonsin's longtime friend, favored policies to maintain employment and wages, 225X1
The head of the Central Bank, Enrique Garcia Vazquez, supported greater austerity. Regular press reports on conflicts between the two men further undermined public confidence in economic management, and Alfonsin finally removed both advisers in February.

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Grinspun was replaced by Planning Minister Juan Sourrouille, a technocrat who had gained sudden prominence by proposing a five-year recovery plan that drew Alfonsin's public admiration and national

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Argentina's Economic Challenges

Most economic experts believe Argentina has enormous development potential. It is well endowed with fertile land, is self-sufficient in oil, has a 94-percent literacy rate among a homogeneous population of 30 million, and is still underpopulated. Much of its mineral resources remain untapped—a known copper deposit that would make Argentina self-sufficient lies fallow for want of investment funds—and much of the land surface has yet to be fully explored. Its nuclear energy program is one of the most advanced among the developing countries, and includes the full cycle from uranium mining to fuel reprocessing.

Nonetheless, Argentina remains a country of unfulfilled promise. Riding a wave of development based on agriculture, Argentina reached its economic peak in the 1920s. Although the country has had growth spurts since, and various governments have attempted industrial development, per capita real income has risen only marginally in the last 50 years.

In 1984, nearly three-quarters of Argentina's $8.1 billion in exports were either agricultural products or processed foodstuffs. Buenos Aires has habitually siphoned off such farm-sector earnings to underwrite industrial development and repay foreign creditors. The industrialization drive of 1958-62 was in part undone by two bad harvests, and, while recent bumper harvests have ameliorated Argentina's debt problems, falling grain prices have dimmed the picture. Argentine governments have failed to plow back very much into agriculture itself, leaving even this sector backward. Agricultural experts estimate that Argentina could boost its grain production by 50 percent by the 1990s, largely through increases in yields.

Argentina's pattern of interrupted modernization, which also reflects abrupt policy shifts emanating from alternating military and civilian governments, has left a legacy of deteriorating infrastructure. Although Argentina has the most extensive rail system in South America, the tracks are of three different gauges and badly in need of overhaul. The ports need dredging because of constant silting, and expansion and modernization are needed to relieve port congestion that is especially severe during peak grain shipping seasons. Of 650,000 miles of roads and highways, only 5 percent are paved. There is only one telephone available for every 10 inhabitants and the system is antiquated and unreliable; in Buenos Aires many firms use bootleg systems and bunches of wires can be seen dangling between buildings.

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Inflation has been a serious impediment to economic development, especially over the last decade when it remained in triple digits. Financial speculation—known locally as "riding the bicycle"—is commonplace in Argentina, but it absorbs vast amounts of potentially productive time. In early 1985, the peso *was so shunned as a store of wealth that the money supply was circulating six times faster than in most industrialized countries.*

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Argentina's 350 publicly owned firms are a considerable financial drag on the economy, and inhibit innovation and growth. The railroads lost over $500 million last year, and the national oil company YPF, which lost $38 million in 1984, remains delinquent in transferring the taxes it collects on petroleum products to the federal government. Alfonsin is coming under pressure to shake up the management of the larger state fiefdoms, and he has put the firms on notice that they will have to meet their foreign debt payments out of their earnings instead of relying on the federal government.

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Note: Factual information in this inset has been drawn from US Embassy reporting or open sources.

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attention. The Sourrouille plan marked the administration's first attempt to look beyond short-term fixes for the economy and identify the prerequisites for sustained recovery. It stressed that sharply reduced inflation would stimulate private investment while increased agricultural and oil production would boost export earnings, thus allowing GDP to grow an average of 4 percent during 1986-89, a rate not achieved since the 1970s. Although the plan emphasized goals rather than prescriptions, it helped persuade Alfonsin that fundamental and prolonged adjustments were necessary if Argentina were to achieve its economic potential. [redacted]

Mounting Difficulties in 1985

Sourrouille's immediate task, however, was to head off a looming economic crisis. The first shock came in March 1985, when the IMF—finding Argentina out of compliance with several fourth-quarter 1984 targets—halted loan disbursements. Inflation—driven by rapid monetary expansion—was above target, causing the government to exceed spending and budget deficit limits, according to US Embassy reporting. As a result, exasperated creditors suspended completion of the $4.2 billion bank loan and $14.5 billion debt rescheduling packages that were keys to resolving Argentina's debt problems. [redacted]

Buenos Aires sought to placate the IMF by announcing a hiring freeze for public employees, reducing public investment, asking Congress to trim another 12 percent from the budget, and introducing reforms to improve control over the monetary system. These measures had little immediate impact, while attendant financial reforms nearly precipitated a domestic banking crisis. For example, according to US Embassy reports, new lending regulations precipitated several bank failures, including that of the third-largest private bank. This sparked a run on other banks, led to increased labor protests—in sympathy with bank workers—[redacted]

Discontent Rises

The most serious cause of public discontent in early 1985, however, was inflation's unrelenting rise toward the four-digit level. Monthly consumer and wholesale price increases are reported quickly in the Argentine press, influencing pricing decisions, union wage demands, and individual speculation. Indeed, we believe this price spiral was the major factor compelling the Alfonsin government to focus greater attention on managing the economy. [redacted] 25X1

Labor in particular felt the brunt of inflation; between December 1984 and May 1985, real wages fell 12 percent, according to the estimates of a major Argentine statistical service. To allow workers to let off some steam without disrupting the economy and to demonstrate union ability to mobilize support, the National Labor Confederation (CGT)—Argentina's largest labor organization—staged a general strike in May. The presence of some 150,000 workers and sympathizers outside his offices on the Plaza de Mayo prompted Alfonsin to increase his personal lobbying with union leaders, according to the US Embassy, which helped defuse tensions with labor. [redacted] 25X1 25X1

Discontent also surfaced within the military, where real earnings fell, according to the press, and major budget cuts forced the services to reduce sharply equipment purchases and military exercises. [redacted] 25X1 25X1

[redacted] 25X1

[redacted] the military's lack of public prestige and the existence of interservice rivalry have prevented the high command from pressing the government directly. [redacted] 25X1 25X1

The business community also became increasingly uneasy about the lack of a clear economic policy, according to the press. With price controls clouding the profit picture and the economy already drifting 25X1 25X1

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Chronology of Economic Events

1983	*December*	*President Alfonsin takes office as the first elected head of state since 1976. He promises to raise real wages by 6 to 8 percent by December 1984.*
1984	*March*	*After a near collapse of debt talks with bank creditors, Argentina is rescued by a $300 million bridge loan provided by Mexico, Brazil, Venezuela, and Colombia, and guaranteed by the United States.*
	June	*Argentina fails to generate unified support for joint debtor action. The meeting of 11 Latin debtors in Cartagena, Colombia, is only able to produce a watered-down consensus statement calling for a political dialogue between debtors and creditors.*
		Government issues a unilateral letter of intent to the director of the IMF after failing to reach a compromise with the negotiating team.
		Another foreign debt crisis is averted when Argentina pays $225 million out of its reserves to cover a $450 million interest payment. Foreign banks and four Latin countries provide short-term loans to cover the rest.
	September	*In another last-minute maneuver, Buenos Aires and the IMF agree on a memorandum of understanding that calls for a rapid reduction in inflation. The pact provides the basis for a loan package from banks, governments, and the IMF totaling $6.9 billion.*
		The last of the three quarters of economic expansion under Alfonsin ends. Data shows consumer spending was the leading engine of growth.
	December	*A rapid expansion of the money supply helps doom the IMF program.*
1985	*February*	*Alfonsin shakes up his economic team; Sourrouille is named Economy Minister, Concepcion installed as head of Central Bank.*
	March	*IMF finds Argentina out of compliance with several program targets; disbursements are halted and new negotiations begin.*
	April	*Financial reforms are initiated to improve operations of the banking system and stimulate private savings.*
	May	*A major bank fails. The Central Bank refuses to guarantee the dollar deposits held by the bank, causing a run on other banks. Dollar deposits are frozen for 120 days.*
	June	*A new IMF agreement is reached; within less than a week, Alfonsin announces a wage and price freeze and replaces the peso with the* austral.
	August	*Economy Minister announces inflation fell to 6.2 percent in July from 30.5 percent in June. Polls show program is overwhelmingly popular. The $4.2 billion bank loan package is signed, allowing disbursement of the first $2.2 billion.*

Note: This information is drawn from US Embassy and press sources.

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down, the Embassy reported that Grinspun's replacement by Sourrouille did little to restore business confidence. New financial reforms in April were seen as cosmetic, according to the US Embassy. The press reported that accelerating inflation and the absence of signs that the budget deficit was being brought under control left business resigned to a continued deterioration of the economy. Consequently, the four-year decline in investment continued into 1985.

Alfonsin's Shock Treatment

After 18 months of gradualism and vacillation, Alfonsin's decision in June to implement bold economic measures was sudden and politically risky. We believe the principal objective of this dramatic shift in policy was to brake the slide into hyperinflation, and in our view several factors had a bearing on his decision:

- The administration's concern that the floundering economy might provide military and civilian opposition groups with the pretext for a power-grab.
- The influence of discussions Alfonsin had in the United States during his visit to Washington in March.
- The quick collapse of the 1984 IMF program, precipitated by rising inflation.
- The ascendancy of Sourrouille over the mercurial, populist Grinspun as top economic adviser.

As a first step in the new policy direction, Argentina reached agreement with the IMF on a new set of targets this past June after three months of difficult negotiations. According to the text of the agreement, the refurbished program called for reducing inflation to 8 percent per month by the first quarter of 1986 and cutting the budget deficit as a share of GDP from 13.1 percent in the second quarter of this year to 3 percent in the final quarter.[2]

[2] Despite the agreement, Argentina needed the assistance of the United States in arranging a bridge loan of $480 million because IMF and bank loan disbursements would not begin until August, and Argentine interest payments had fallen more than 180 days in arrears. Argentina added $100 million from its reserves to bring its arrearages to under 120 days, thereby smoothing the way for completion of the bank loan package.

Before the Argentine public had time to react to the new IMF program, Alfonsin augmented it with a wage-price freeze and the introduction of a new currency—the *austral*. After making the *austral* equal to 1,000 of the former *pesos argentinos,* the government froze the official exchange rate at 0.80 *australs* to the dollar to demonstrate its determination to make this a strong currency. Buenos Aires also announced it would no longer print money to cover its budget deficits. 25X1 25X1

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Surprising many observers, public support for the measures quickly solidified. This signified not only the Argentines' recognition of the increasing peril of hyperinflation but also the strength of Alfonsin's personal appeal. When the first opinion polls showed that three-quarters of the public supported the measures, criticism from unions and opposition parties quickly dissipated, according to the US Embassy. the military 25X1 also supported the drastic attack on inflation because it reduced the near-term chances for economic and social chaos. Industry saw the move as a necessary first step toward controlling inflation and permitting rational planning, according to the press. 25X1

Potential Obstacles Ahead 25X1

Despite continuing public support to date—an August poll showed 71 percent in favor of the program—we believe Alfonsin's stabilization measures will face cultural barriers as well as direct challenges in the months ahead. Academic experts agree that Argentines do not suffer belt-tightening well. Many Latin American specialists see in Argentina the clearest manifestation in the hemisphere of the Spanish sociological phenomenon referred to variously as the *Don Yo* or *viva yo* (me first) complex. Moreover, in a 25X1 country where natural resources and fertile land have produced an easy prosperity, it is difficult to sustain popular commitment to an austerity policy that does not promise some near-term payoff. 25X1

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- The state will no longer print money to finance its spending.
- Zero (money) emission.
- You begin to treasure a coin that has value.
- To beat inflation is the beginning of growth.
- Argentines are doing it.

Government public-service advertisement

Clarin ©

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The labor movement, in particular, has grown accustomed since World War II to deferential treatment from civilian governments—notably those under Juan Peron—and to a considerable voice in economic policy making. This freeze in mid-1985 on wages, modest price rises, and increasing layoffs led blue-collar and lower paid public workers to push for a second general strike on 29 August. Although the turnout was lower than in May, pointed references by the unions in the press to the rapid rise in layoffs and the need for a return to growth-oriented policies lead us to believe that labor dissatisfaction will grow.

We also believe industry will attempt subtly to skirt some provisions of the reform program. The US Embassy reports that over the years the business community has developed a short-term mentality conditioned by the numerous and rapid policy reversals of various governments. Business, the Embassy adds, is quick to find loopholes in new laws, many firms and banks simply ignore government decrees, and business lobbyists press for policy modifications.

For its part, the largest opposition party, the Peronist movement, is attempting to make the recessive aspects of the stabilization program a major political issue. The Peronists publicly advocate a five-year debt moratorium and the use of the $4.5-5 billion saved in interest payments to underwrite major investment projects. The CGT labor confederation, which the Peronists dominate, has supported the call for a moratorium. Both groups are ridden with factional disputes, however, and these themes have failed to generate substantial public support. In fact, a recent poll showed the Peronist party trailing their UCR opponents 2 to 1. Nonetheless, we believe a considerable worsening of unemployment, a wave of bankruptcies, a drop in popular support for the administration, and a much poorer government showing in the 3 November congressional elections than Alfonsin expects, could permit the Peronists to exploit the economic issue.

Political infighting in the ruling UCR is another potential, but less likely complication in sustaining the adjustment process. The party has a strong doctrinal aversion to austerity and contains large factions that favor government intervention and stimulation of the economy, according to the US Embassy. Moreover, the Embassy notes that, with the congressional elections approaching, various factions are pushing Alfonsin to grant wage hikes, assume the debts of troubled firms, and implement labor-intensive investment projects in order to attract votes. We believe that, because he still dominates the UCR apparatus, he will not be forced by intraparty pressures alone into yielding significant concessions. 25X1

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Mixed Economic Prospects

Until widespread public opposition or effective political challenges arise, Alfonsin is likely to remain committed to the economic stabilization course. We believe his principal incentive is the fact that Argentina will gain the external financing needed this year to help pay off interest arrearages, finance a projected $2 billion current account deficit, and rebuild a cushion of foreign reserves. By submitting to a new set of IMF targets, Argentina already has received access to $2.7 billion during August-September from the IMF and creditor banks. If the Fund finds Argentina in compliance during all of its coming performance reviews (we believe the country will pass its October review), then another $2.7 billion will be doled out later this year and early next year. 25X1

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We believe Alfonsin's desire to adhere to the stabilization program also is motivated by his hope of attracting foreign investment. He has publicly stated that he wants Argentina to expand its export potential, restructure its industries, and better develop its natural resources. 25X1

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The major domestic payoff for Alfonsin's policies revolves around the control of inflation. It is particularly difficult to project inflation at this time given the imposition of price controls and the lack of information on how monetary and budget performance have 25X1

Table 2
Argentina:
Balance of Payments

Billion US $

	1983	1984	1985 [a]	1986 [b]
Trade balance	3.7	4.0	3.5	3.5
Exports, f.o.b.	7.8	8.1	7.7	8.0
Imports, f.o.b.	−4.1	−4.1	−4.2	−4.5
Service balance	−6.1	−6.5	−5.4	−5.3
Interest	−5.4	−5.5	−4.3	−4.2
Other	−0.7	−1.0	−1.1	−1.1
Current account balance	−2.4	−2.5	−1.9	−1.8
Capital account balance	−0.1	1.8	1.6	1.0
New borrowing (medium and long term)	1.9	0.6	4.0	2.0
Repayments (medium and long term)	−1.5	−0.7	0	0
Other, net	−0.5	1.9	−2.4	−1.0
Change in reserves	−2.5	−0.7	−0.3	−0.8

[a] Estimated.
[b] Projected.

been affected by the economic shock program. If the government can keep inflation below 8 percent per month [3] once price controls are removed—or at least greatly relaxed—we believe most Argentines would view this as a success compared with the 25 to 30 percent monthly price rises posted earlier this year. In fact, we suspect the government will adopt a long transition period before abandoning the freeze.

In an economy where moonlighting is the norm, any euphoria on price stabilization will wane quickly if unemployment mounts to the 10-percent range. The 6.2-percent rate recorded in April was already a 10-year high. US Embassy reporting and the Argentine press indicate, however, that higher taxes, increased fees for transportation and energy, and cuts in public investment are already deepening the recession. Moreover, we and the US Embassy predict that bankruptcies—and the accompanying loss of jobs—will increase if money remains tight, because the high cost of borrowing will make domestic debt service unmanageable for many heavily leveraged Argentine firms. 25X1

Unfortunately for Alfonsin, we see little chance for any near-term economic recovery. Our assessment is that real growth will decline in 1985 because:

- Real wages are falling in the face of salary restraints.
- Private investment is still declining, according to the press, because of slumping demand.
- Prices for grain exports are weak, which has caused some reduction in planting, according to US Embassy reporting.
- Foreign investors are adopting a wait-and-see attitude toward the government's commitment to stabilization before undertaking major new investments.

As a result, Alfonsin will face an economic decline for the next several months and will need to maneuver skillfully to maintain broad popular support for the program. 25X1

According to the US Embassy, the government, in an effort to aid ailing public-sector firms and commercial banks, already is watering down financial-sector reforms. Government-owned firms are being assured access to low-cost bank loans, and, to bolster the profits of commercial banks, the Central Bank is selling them bonds carrying high interest rates. 25X1

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Alternative Tracks and Alfonsin's Choices

To foster longer term economic growth, we—and the US Embassy—believe that the government will have to eliminate the distortions that have arisen from years of government intervention and inconsistent policies. For example, industry reports indicate that

[3] The IMF-supported agreement calls for inflation to fall to this rate by the first quarter of 1986. We believe achieving this target inflation—an annual rate of 150 percent—is possible, but only if the government comes close to its budget targets.

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Argentina's agricultural production is being held far below potential by a welter of heavy taxes and controls. Government plans to boost grain production by 50 percent by the early 1990s will require a reduction in levies on farm exports to bolster producer incentives, as well as reduced controls on fertilizer imports, [redacted] 25X1

Without a gradual dismantling of import controls—some 5,900 products are covered, according to US Embassy reporting—Argentina's long-sheltered industries will not become competitive internationally and domestic prices will remain higher than they should be. In addition, once wage and price controls are removed, the *austral* must be devalued in line with inflation to prevent imports from swamping the Argentine market and undermining the financially fragile industrial sector. We and other observers also believe that steadier economic policies would encourage economic diversification and help Argentina to stimulate its manufacturing sector, which accounted for only 22 percent of exports in 1984. [redacted] 25X1

The Sourrouille plan encompasses many of these policy imperatives, and President Alfonsin apparently continues to favor major reform. Nevertheless, we believe there is a 70-percent chance that by early next year Alfonsin will begin to compromise on his program. As noted, history and Argentine culture suggest that the domestic consensus in favor of austerity is unlikely to last. We believe the President continues to regard the consolidation of democracy as his prime goal and continues to view his high personal popularity as the key to that objective. Thus, we expect he will respond to shifting public opinion by gradually introducing labor-intensive public works projects. He has already said publicly that he will boost government investment once current expenditures have been cut. We doubt, however, that he will be able to find enough savings elsewhere in the budget to offset a surge in public investment; the result will jeopardize compliance with the IMF program. Moves to boost employment also will probably cause inflation to increase, in part through the larger deficit, but also by reigniting inflationary expectations. [redacted] 25X1

Table 3
Projected Changes in GDP

Percent change over previous year

	1985	1986	1987
DRI	−2.7	2.5	4.4
WEFA	−5.6	1.0	3.1
Chase	−1.1	−0.2	2.7
W. Cline	−4.5	2.0	3.0
CIA	−5.0	1.0	2.0

Note: Most recent available projections by Data Resources Incorporated, Wharton Economic Forecasting Associates, Chase Econometrics, and William Cline.

[redacted] 25X1

Alfonsin, in our view, would be able to get a waiver from the IMF for exceeding budget deficit targets, but probably only if he agreed to clamp down again on spending. Delays in final loan disbursements would be likely, fueling anti-IMF sentiment, calls for a debt moratorium, and demands for economic stimulation policies. We see great danger that, once Alfonsin waters down the program, remaining public support will vanish, bringing the government back to the position it faced in early 1985—being attacked from all sides because of a stop-go economic policy. [redacted] 25X1

If Alfonsin abandons his program altogether and turns to growth-oriented policies aimed at vigorous job creation—a 1-in-10 chance, in our view—control of inflation will be lost, foreign sources of finance will dry up, and private investment will plummet further. Alfonsin probably could generate strong, temporary economic growth by boosting wages, but we believe that, as in 1984, such a consumption-led boom would quickly lose momentum, and, as 1986 progressed, the economy would begin slipping again. More important, Alfonsin would lose the confidence of the business community, dooming Sourrouille's objective of generating growth through private investment. [redacted] 25X1

[redacted] 25X1 25X1

[redacted] Argentina will be able to increase its grain output only 25 to 30 percent during the next seven to 10 years. Nonetheless, Argentina could displace the United States in traditional Latin American markets during this period. [redacted] 25X1

We do not rule out the possibility that the Argentines will be genuinely sobered by their economic difficulties and accept prolonged austerity, but we regard it as only a 20-percent likelihood. We concur with a recent US Embassy assessment that Alfonsin's ability to persist with his economic program would enable him to go down in Argentine history as the leader who helped launch the country on the path toward realizing its vast economic potential. Should Alfonsin be able to walk the fine line between meeting financial imperatives and maintaining popular support, he also could become a force for moderation on regional economic questions and a counterweight to Peru's Alan Garcia. Success would additionally help burnish democracy's image in the region.

Implications for the United States

Under the scenario we regard as most likely—compromises on austerity in favor of growth and job creation—we believe US interests would suffer. Missed IMF targets and delays in loan disbursements would probably lead to increasing lags in interest payments to banks, and dampen any budding hopes among US exporters and investors for the emergence of a healthy Argentine economy. The failure of the economic program and policy flip-flops would embolden Alfonsin's political opponents, creating uncertainty about the survival of the government. Under criticism at home and from financial institutions abroad, Alfonsin could become defensive and turn away from his new set of technocratic economic advisers and seek solutions in greater government intervention. Under these circumstances, relations with the United States would almost certainly face new strains.

A renewed Argentine economic slide resulting from outright abandonment of the stabilization plan—perhaps a 10-percent likelihood—almost certainly would mean higher inflation, another financial squeeze, increased military discontent because of budget cuts, labor militancy, and violent acts by extremists on the left and right. These are all conditions that led to the military takeover of the last UCR government in 1966, and in this case the Argentine public might accede to military intervention to halt spreading economic and social chaos. Renewed rule by generals, either alone or in coalition with Peronists or various right-of-center politicians, would not only uproot the new democracy, but also would probably be highly nationalistic. A debt moratorium, stricter controls on imports, and heavy government intervention in the industrial and agricultural sectors would harm US lenders, investors, and exporters, and it could trigger radical debt actions by other countries in the region. 25X1

If Alfonsin were able to hold on to power, he probably would solicit support for joint action against creditors by the 11 member countries of the Cartagena Group of Latin American debtors. Alfonsin might also resort to economic autarky: blaming Argentina's problems on foreign creditors, declaring an indefinite debt moratorium, and curtailing imports. We also believe Alfonsin would be more likely to intensify economic ties to the Soviets—the largest purchaser of Argentine grain—although in our view he would seek to avoid political and economic complications from such a shift. He would also probably put greater stress on intraregional economic cooperation and the use of barter, which would reduce US sales in Argentina and other Latin American markets. 25X1 25X1

US interests would best be served by Buenos Aires's closely pursuing its IMF program once the wage, price, and exchange rate freezes of the Plan Austral are dismantled. If, as Alfonsin hopes, bringing order to public finances helps provide the basis for long-term economic growth at greatly reduced inflation rates, this will boost Argentina's political stability and help consolidate democracy. Nonetheless, Alfonsin is looking for concrete signs that the major creditor countries understand the domestic political consequences of Argentina's austerity measures. He also wants assurances that commercial banks and multilateral credit institutions will provide credits to underwrite Argentine economic growth. Alfonsin's success would be an effective counter to the radical debt proposals of Cuba's Castro and Peru's Garcia. 25X1

25X1

The revitalization of the Argentine economy would be a positive development for US commercial interests. A more efficient agricultural sector would provide greater competition for US farmers on world markets, but US manufacturers would benefit even more through greater sales to Argentina. The United States is already Argentina's major supplier of capital goods and industrial inputs, according to the US Department of Commerce, and modernization efforts would boost sales of industrial machinery, computers, and telecommunications equipment. 25X1

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