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South America: Mixed Outlook for the Southern Cone Economies [redacted]

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Summary

Publicity about the successes of Argentina's Austral Plan and Brazil's Cruzado Program is obscuring emerging economic problems in each country. Both Buenos Aires and Brasilia are promising to make adjustments to keep their economic programs on track, but we are skeptical about the ultimate success of current policy initiatives. In contrast, Chile's quiet commitment to free-market policies has enabled the country to grow although its dicey political situation could cause economic setbacks in the future. [redacted]

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Argentina's Economic Regrouping

The bloom has faded from President Alfonsin's Austral Plan, which initially brought such success in arresting Argentina's hyperinflationary spiral. Basking in the Plan's initial success, Alfonsin failed to implement structural reforms--eliminate the deficit, spur private investment, reform capital markets--necessary to lay the foundation for long-term, non-inflationary growth [redacted]. As a result, the official inflation index rose at an annualized rate of about 70 percent during the first half of 1986, heightening inflationary expectations. Instead of spurring new capital formation, consumer spending increased, triggering a short-term boom, especially for durables. The economy grew by 3 percent during the first half of 1986 compared to an equal drop during the same period in 1985, but new investment remained stagnant. After recording a double-digit jump in inflation last August, Alfonsin was jolted from complacency. [redacted] 25X1

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This memorandum was requested by Dr. Michael L. Mussa, Member of the Council of Economic Advisors. It was prepared by [redacted] the South America Division, Office of African and Latin American Analysis. Comments and queries regarding this memorandum my be directed to Chief, South America Division, [redacted]

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Buenos Aires is now beginning a fresh attack on deeply embedded economic problems. Last week Alfonsin announced plans to insulate state-owned enterprises from political pressures that create operating inefficiencies, placing the firms within a semi-autonomous holding company, headed by a senior executive from the private sector. He also pledged to reorganize public-sector wage schedules and cut government employment through a voluntary retirement program. Moreover, he recently replaced his populist Central Bank head, who had resisted efforts to impose monetary discipline, with a technocrat committed to tight money policies. [redacted] 25X1

These moves will facilitate Argentina's efforts to shore up its current account position, which remains in chronic deficit [redacted]. Negotiations currently are under way with the IMF for a $1.2 billion standby agreement and a $350 million compensatory financing facility to help cover a current account deficit caused by agricultural export losses. Successful IMF negotiations will facilitate upcoming discussions with commercial bankers for debt rescheduling and around $1.5 billion in new lending. Argentina will need the new money to cover a projected current account deficit of $3.2 billion in 1987, up from about $2.8 billion this year, caused in part by continued weakness in the international grain market--highlighting its inability to diversify exports--and increased demand for imports. [redacted] 25X1 25X1

Notwithstanding Alfonsin's new-found commitment to revitalize the economy, in our judgment the opposition of major interest groups will work against implementation of the sweeping, market-oriented reforms needed for long-term growth in Argentina. [redacted] 25X1 25X1 [redacted] organized labor, the Peronist opposition and even factions of Alfonsin's Radical Civic Union party will continue to oppose any large-scale, public-sector worker lay-offs, as well as efforts to reduce state control and regulation of the economy. 25X1 Such sentiment, in our opinion, will hinder moves to either reform the largest money-losing state enterprises or sell them to the private sector. Additionally, nationalist fervor will hamper the opening of the economy to foreign competition and increased participation of overseas capital. [redacted] 25X1

In the Argentine political context, we expect Alfonsin to more readily accommodate these interest groups as the November 1987 gubernatorial and congressional elections near. Based on recent experience, anti-inflationary, tight money policies will probably give way, starting next spring, in an effort to lower real interest rates and increase public spending to improve Radical party electoral prospects. Such policy backsliding would also cut against efforts to reform the economy because it would refuel budget deficits and discourage private-sector investment. Over the longer term, public support for Alfonsin's policies would shrink making difficult the tasks of effectively managing the move of the capital from Buenos Aires, overseeing trade integration with Brazil, and facilitating the diversification of the Argentine agricultural economy to expand its industrial export base. [redacted] 25X1

Brazil's Economic Outlook Turns Sour

Brasilia's nine-month old Cruzado Plan is unraveling in the face of highly expansionary economic policies that have fueled a runaway economic boom and inflationary expectations. Burgeoning consumer demand sparked by real wage hikes, reduced unemployment, and the

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rush to buy before the price freeze is lifted will result in the second consecutive year of Brazilian economic growth in excess of 8 percent [redacted]. Inflation--as measured by the official price index--is down sharply to a monthly level of about 1.5 percent since the anti-inflation program was implemented, but disguised inflation, manifest by shortages of consumer and producer goods alike, is on the rise. Although several critical industrial sectors are operating at full capacity, the US Embassy reports that businessmen are increasingly reluctant to invest in sorely-needed plant expansion. [redacted] 25X1

As Brasilia attempts to reduce shortages by increasing imports and diverting exports to the internal market, its strong external payments position is eroding. We estimate that the trade surplus probably will drop to about $10.5 billion in 1986--only $1.5 billion more than interest payments--from $12.4 billion last year. With foreign investment at a 15-year low and new borrowing at a near standstill, Brasilia is drawing down reserves rapidly to meet its debt servicing obligations. Cash reserves probably will drop 50 percent this year to under $4 billion by yearend, according to our calculations. [redacted] 25X1

The immense popularity of the price freeze is likely to continue to limit the Sarney administration's ability to respond to growing economic distortions. For example, the recently announced selective price hikes meant to reduce demand sparked violent demonstrations and cost Sarney considerable public and political support. The extent of the disapproval probably will thwart him from implementing further adjustments needed to dampen demand and spur new investment necessary to alleviate supply bottlenecks. Consequently, we believe growth almost certainly will slow next year, while inflationary pressures build and the payments accounts continue to deteriorate. Because of the Brazilian public's hostility toward the IMF, Sarney is unlikely to enter any agreement that involves a conventional Fund program. We believe that Brasilia is still reluctant to implement the free market reforms--reducing budget deficits, paring back state enterprises, opening the market to foreign competition--necessary to lay the foundation for noninflationary, long-term growth. Instead, Brazil probably would try to secure a new debt agreement that significantly reduces its payments, threatening a partial interest moratorium in an effort to bully its creditors. [redacted] 25X1

Chile's Free Market Approach

Despite Chile's publicized political problems, its commitment to free market economic solutions is paying handsome dividends. According to Finance Minister Buchi, [redacted] 25X1 public investments in infrastructure--devasted by earthquake in 1985--and in export promotion will likely spur Chile's economic growth by over 4 percent this year. Growth may nudge real wages up and lead to a nearly 2 percent drop in unemployment with rural areas as the chief beneficiaries. Meanwhile, careful budgeting by Chile's economic team could shear almost 1 percentage point--to 1.7 percent of GDP in 1986--off the non-financial budget deficit, thereby lessening inflationary pressures. Moreover, the economic team will also slow inflation from last year's 26 percent by implementing a moderate money expansion policy and by slowing the peso devaluation rate, according to Embassy reporting. [redacted] 25X1

Despite stagnating world commodity prices, Chile's current account deficit will likely decline this year. Chile's trade surplus could jump by a fourth to $1 billion with a 10 percent rise in exports leading the gain, reflecting the success of its promotion policy [redacted] 25X1

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[redacted]. Additionally, tougher import barriers, such as a price floor on wheat and other agricultural imports, will consolidate the gains in the trade account. Meanwhile, falling world interest rates and strong incentives to convert debt-to-equity--more than $700 million in debt will be converted to equity this year--will probably save Santiago $200 million in foreign exchange. The unanticipated boon in its external accounts has helped Santiago add over $100 million to its gross reserves, pay off its Bank of International Settlement loan, and reduce short-term dollar loan holdings of the Central Bank. [redacted] 25X1

Chile's economic team believes it can achieve similar results in 1987 and 1988 by maintaining its present monetary and fiscal policies and continuing efforts to obtain foreign investment for its chief export industries--mining, forestry, fish, and fruit products. Nevertheless, these hopes hinge on Chile's receiving development bank lending and commercial bank funds needed to cover its chronic financing gap [redacted]. Chile's creditor nations could again try to apply pressure for a political transition by threatening to stall multilateral project loans necessary to support the country's structural adjustment. The other major risk in the outlook involves President Pinochet's pressing his economic team for more populist economic policies in hopes of assuaging political discontent and improving his popularity. In this scenario, negotiations with commercial bankers for $650 ~~million~~ in new loans or debt service concessions for 1987-1988 could be brought to a standstill. In either case, economic growth and Chile's commitment to free market principles would suffer. [redacted] 25X1

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