It's the “Political Economy” Stupid:  
The Crisis of Convertibility in Argentina

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Summary:  
As Argentina’s current economic crisis deepens, a chorus of opinion has identified its origins in  
the dysfunctional nature of Argentine politics. Although there can be no doubt that this perspective  
identifies a very important piece of the analytic puzzle, it presents only a partial truth that can lead to  
inappropriate conclusions about the real lessons to be extracted from the Argentine crisis. Argentina finds  
itsself on the verge of bankruptcy today not merely because of politics, but also because of the interplay  
between economics and politics. The collapse the anti-inflationary political consensus increasingly forced  
politicians to choose between the “responsible” economic management needed to sustain convertibility  
and governability and their own political survival. Under these circumstances, politicians not surprisingly  
risked rolling the economic dice under the pressure of political need. This paper traces the disappearance of  
Argentina’s anti-inflationary coalition since 1995, the impact this had on economic policy, and the  
consequences of this political-economic process for the survival of convertibility in Argentina.
Introduction

As Argentina’s current economic crisis deepens, a chorus of opinion has identified its origins in the dysfunctional nature of Argentine politics. From serious analysts of Argentine politics (Corrales), to past and present government officials trying to divert blame away from themselves (Cavallo; Menem), to economists wedded to the wisdom of convertibility (Rodriguez), the growing consensus seems to be that convertibility would have worked if it were not for that pesky problem of politics. In Mexico, this chorus has echoed with perfect pitch suggesting that unless the Fox administration emerges from its legislative paralysis, it will not be long before this lack of governability has the same impact in Mexico as in Argentina.

Although there can be no doubt that this perspective identifies a very important piece of the analytic puzzle, it presents only a partial truth that can lead to inappropriate conclusions about the real lessons to be extracted from the Argentine crisis. Argentina finds itself on the verge of bankruptcy today not merely because of politics, but also because of economics, and more importantly because the interplay between economics and politics (Oxhorn and Starr). Simply put, the anti-inflationary coalition that ensured the political viability of the economic policies needed to ensure the sustainability of Argentina’s currency board system has evaporated over time. As this occurred, the ability of politicians to both implement the “responsible” policies required for the survival of convertibility and those needed to ensure governability and their own political survival began to clash. Not surprisingly when faced with this dilemma, Argentine politicians leaned increasingly toward survival and governability risking the survival of convertibility in the process (the inevitability of this course of events was is discussed in Starr, 1997). This refined version of the events that produced Argentina’s current political-economic mess suggests also that the lessons for Mexico and the rest of Latin America from the Argentine experience are much more nuanced than the screaming editorialists in Mexico City would like us to believe.

This paper traces the disappearance of Argentina’s anti-inflationary coalition and the unfortunate impact this had on the formation and implementation of economic policy during the second presidency of Carlos Menem (1995-1999) and during the current presidency of Fernando de la Rua. In so doing, it will demonstrate the essential role of “political economy” in this process. The paper was also slated to overview the first seven months of economic policy under the government of Vicente Fox in Mexico to demonstrate the clear political-economic distinctions between the two cases alongside their striking similarities. Time has prohibited the inclusion of this final section.

Of Currency Boards and Coalitions

The ability of the government of Carlos Menem to implement successfully a currency board monetary system in Argentina owed much to fortuitous international economic and domestic political conditions. At the time the program was initiated in April 1991, international capital markets were becoming increasingly willing to lend to those developing countries that had implemented pro-market economic strategies and had thereby proved themselves to be a reasonable credit-risk. This enabled Argentina to augment domestic investment capital with the international variety, and to finance the
expanding current account deficit and limited fiscal deficit that accompanied its new economic strategy. Stabilization was thus accompanied by economic growth until the end of 1994. Economic growth translated into increased tax receipts and the resulting room for a significant increase in government spending. Meanwhile, the shared trauma that hyperinflation had created within Argentine society produced an anti-inflationary coalition that was national in scope and that was willing to support any policy capable of eradicating inflation. The success of the convertibility plan in the battle against inflation thus produced a natural support coalition for the government that implemented it. It was the best of all possible political-economic conjunctures.

Sustaining convertibility over time, however, has proven to be a much more challenging task. Volatility in international capital markets since the mid-1990s has twice forced the Argentine economy into a deep recession (1995-96 & 1998-present). Under a currency board arrangement (CBA), any reduction in international reserves must be matched by a decline in the supply of money circulating in the domestic economy. Argentina’s CBA has also been accompanied by an over-valued exchange rate which has tended to produce a current account deficits. As long as Argentina is able to attract enough international capital to finance this deficit, all will be well with the Argentine economy. But should capital inflows cease to finance this deficit, Argentina must dip into its international reserves to meet its international payments. The resulting drop in the domestic money supply will send the domestic economy into recession. This automatic adjustment mechanism has the happy consequence of preventing the development of inflationary pressures in the Argentine economy and of reducing the current account deficit and hence Argentina’s borrowing needs. But the price of these benefits is rising unemployment and bankruptcies and declining tax revenues. Declining tax revenues without an effective means to finance a budget deficit will force the government to cut its spending as recession advances, just as declining international reserves force a reduction in the domestic money supply. In other words, not only is government devoid of the economic policy tools that could help mitigate the costs of recession in the most effected sectors of society and/or to help stimulate the economy out of recession, it is forced into implementing a pro-cyclical fiscal policy to complement a contracting money supply (on the operation of CBAs, see Williamson).

Periodic recessions produced by shifting conditions in the international economy is an unfortunate but unavoidable cost of any CBA. One of the keys to sustaining a currency board therefore is to have a domestic political environment supportive of the CBA in spite of this cost associated with its operation (Starr, 2001). Although Argentina enjoyed such a domestic political environment in the early years of its CBA, the very success of the currency board at eliminating inflation has since undermined the integrity of Argentina’s anti-inflationary coalition. This is not to say that Argentines do not continue to support the currency board. Poll after poll demonstrates that they do indeed still support strongly the convertibility plan and the price stability it has guaranteed. But Argentines also believe that inflation has ceased to be a problem. They see it is a defeated enemy that is quite unlikely to come back to torture them again. Other forces such as recession, low wages, and unemployment are now seen as the culprits behind low and declining living standards, and Argentines are increasing demanding government action to redress these problems. Without realizing it, Argentines have fallen into a dilemma—although they continue to
support convertibility, they are no longer willing to tolerate the collateral damage inflicted from time to time by the very policies needed to sustain their currency board system.

This collapse of Argentina’s currency board coalition occurred gradually. It was only with the passage of time and the accumulation of experience that Argentines began to weigh differently the benefits and costs of convertibility. As early as 1993-1994, the dominance of anti-inflationary preferences in Argentine society had begun to weaken in the wake of the currency board’s rapid and sustained success against inflation (Starr, 2000). It was in the wake of the “tequila crisis” of 1995, however, when the coalition imploded. The stunning absence of an inflationary response to an international financial crisis of this magnitude (not only did prices not increase significantly as they repeatedly had under similar circumstances in the past, they actually declined further) combined with a very deep recession in the Argentine economy shifted Argentine preferences. Inflation had ceased to be a threat, even a latent one, to Argentine living standards, while low wages, unemployment, and the corruption held responsible for inadequate government responses to societal problems loomed larger than ever. Argentines had ceased to be consumers with a shared interest in a single economic policy objective. They had returned to their stable state as workers, professionals, service providers, and businessmen of all stripes with different needs and interests, and ones that were often in conflict.

For the Menem government this shift in popular attitudes posed an increasingly serious policy challenge from mid-1995 onward. How might the President sustain his capacity to govern and reconstruct a viable electoral coalition out of this increasingly dissatisfied mix of competing interests and actors given the fiscal and monetary constraints imposed by the CBA and by Argentina’s associated dependency on capital imports? It was a challenge Menem would be unable to meet (on the difference between electoral and governing coalitions see Starr, 1993; Gibson, 1997).

Tangible Troubles Emerge in the Menem Coalitions, 1995-1996:
The Second Menem Presidency

Carlos Menem won election to his second term as President of Argentina on 14 May 1995 with 49% of the vote while his party took control of both houses of the legislature. It was expected that such a significant victory would solidify the support of Peronist politicians behind their president and thereby ensure a long legislative honeymoon for Menem. The reality was to be quite different owing to the rapid descent of the Argentine economy.

The explosion of the Mexican crisis onto international financial markets beginning in late 1994 hit the Argentine economy like a steamroller. Surging capital outflows and rocketing interest rates drove the economy into rapidly recession. Beginning in March 1995 firms began to furlough and lay off workers, the bankruptcy rate began to rise, in April wages began to fall (EIU, 4Q95, 18). Although the government denied throughout the election campaign that the economy was moving into recession, in June economy minister Domingo Cavallo let slip the fact that the economy was souring very rapidly. He also admitted that the government’s fiscal situation was deteriorating quickly (the Argentine tax base is dominated by consumption taxes, the very sort which decline sharply
during economic downturns) suggesting that the government would soon be forced to add to the economy’s woes by cutting its spending. The Labor Minister also announced that the soon-to-be released unemployment figures for May were likely to show an increase from the October figure of 12.2% to around 13% or 14% (LAM, Jul 95, 3).

Even these very preliminary signs of trouble with the government’s economic model were enough to produce protests from within the peronist movement. Old line peronists, who had never been comfortable with the new market model of development for the Argentine economy, jumped at this first opportunity to criticize the weaknesses of the model (the leader of the Peronist bloc in the lower house, for example, called for deficit spending to fight unemployment), and to renew their attacks on its intellectual father, Economy Minister Cavallo (LAM, Jul 95, 3).

This incipient rebellion within Peronism deepened significantly in August as a direct consequence of the release of the May 1995 unemployment figures in late July. The 18.6% rate far exceeded all estimates. It was the highest unemployment rate registered in Argentina since WWII, was 6.4 points higher than the October 1994 rate, and was triple the rate of unemployment extant at the time the currency board was initiated. It is hard to overestimate the psychological impact this figure had on Argentines. It not only offered the first statistical picture available to the general public of the depth of the recession now under way, it also raised serious doubts about the capacity of the Menem government to right the situation. Only a few days earlier in his inaugural address Menem had promised to “annihilate” and “pulverise” unemployment. Meanwhile, his labor minister had stupidly admitted that the economic model had destroyed jobs (LAM, Aug 95, 3).

The “obvious” solution to this problem would have been to announce government programs to provide jobs for the unemployed. Unfortunately, the exploding fiscal deficit seemed to prohibit it and Cavallo strongly opposed it. Reenergized by the unemployment figures, old-line peronist politicians initiated a barrage of attacks on Cavallo blaming his economic policies for high unemployment. Clearly these attacks were designed in part to scapegoat Cavallo and thereby minimize the political damage high unemployment would inflict on Menem and the peronist party. But it also seems that this attack had another purpose. They were clearly coordinated, carried out by some of Menem’s closest associates including cabinet coordinator Eduardo Bauza and vice president Carlos Ruckauf (as well as the opportunistic presidential hopeful, Buenos Aries Governor Eduardo Duhalde), and included a headline in a newspaper close to the president (El Expreso) indicating that Cavallo was on his way out (LAM, S95, 3). The origins and circumstances of the attack suggests that is was more than a renewed effort by peronist politicians to weaken their perpetual adversary and to encourage again his removal from the cabinet. The attacks also seem to have been an attempt by the Menem government to see how much heterodoxy the markets were prepared to accept from Argentina. If they had been willing to see Menem as the guarantor of convertibility rather than Cavallo, they might also have be willing to finance a slightly less orthodox fiscal policy as well. Menem’s policy dilemma would thereby have been eliminated. As it turned out, the markets were not willing to dance to Menem’s tune just yet. After six days of attacks and counter attacks during which Cavallo made the striking charge that the government was permeated by mafias responsible for corruption and obstructionism, support within the
business community for Cavallo was almost unanimous. Cavallo stayed and no new jobs programs were announced.

As the Argentine winter turned into spring, popular disaffection with the government and its economic policies became more evident. In July the pro-government union confederation, the CGT, elected a new leadership under pressure from its member unions to protect jobs more actively in the face of rising unemployment. The new CGT leaders thus quickly made clear their demands for an increase in government assistance to those hurt by the recession and the development of programs to combat unemployment (EIU, 3Q95). These demands were backed up by a strike in early September 1995 and the threat of another in March. The first strike call by the CGT against the Menem government since 1991 proved to be quite successful in Buenos Aires and several other important cities. As such it was a very tangible reflection of increasing worker dissatisfaction. But it also demonstrated growing popular opposition to the government’s economic policies. By the time of the strike, only 22% of Argentines continued to support the government’s economic policies (down 11 points from May) (LAM, D95, 4). And the September strike was followed by a November protest against the government’s economic policy organized by anti-government unions and supported by the two main opposition political parties, Frepaso and the Radicals.

Despite these protests and party pressures, Menem made no changes in his economic strategy. With the economy reeling and skepticism in financial markets growing, Menem had very few options. He could not risk undermining further the creditworthiness of the Argentine economy in the eyes of investors by increasing government spending, in spite of the growing public demand for action. He thus bowed to the demands of the IMF (without whose support no international credits would be forthcoming) and allowed Cavallo to design a series of highly orthodox policy measures for legislative approval: a new budget law calling for tax increases and spending cuts, a reform of the state designed to streamline its operation and reduce spending, a request for emergency powers allowing the executive to institute tax increases by decree and to eliminate or merge state agencies, a labor reform, and a revised plan for revenue sharing with the provinces.

The peronist politicians and labor were not pleased. Much as it had done in the past, however, the peronist-dominated legislature ultimately approved the emergency powers request, the reform of the state, and the budget legislation knowing that this was necessary to reduce a ballooning fiscal deficit and thereby to secure approval for an IMF loan. Unlike in the past, however, it did so only after long delays and many changes. The emergency powers legislation produced such serious divisions in the peronist party, and consequent defections, that its approval required the support of conservative provincial parties. Further, opposition from peronist legislators and labor not only blocked any serious labor reform as they had done since 1991, they blocked any labor legislation at all. And the proposal for a reform of the sharing of federal revenue with the provinces, a reform that would have entailed a reduction in provincial revenues, ran aground on the shoals of the vehement opposition of the governors, the majority peronist. In short, as early as late 1995 peronist politicians in the congress and in the states were increasingly aware of troubles within the Menemist electoral coalition reflected in the rising worker and broader popular discontent with the socio-economic consequences of the currency
board system. They were thus less willing to follow Menem’s economic policy lead blindly. Complete subservience to the demands of the currency board were no longer seen as the best strategy for political survival, leading to expanding cracks in the edifice of peronist unity throughout 1996.

In the absence of policy tools to help cut short the post-tequila economic downturn, recession persisted well into 1996 and once recovery got underway in the second quarter of the year, it proceeded at a snail-like pace. This currency board-imposed reality ensured that 1996 would complete the destruction of the currency board coalition and deepen discontent within the peronist party.

Battles over economic policy in the administration during the first half of 1996 quickly turned into a power struggle between peronist politicians and Domingo Cavallo and his allies. The first round was a February leak of Cavallo’s tax returns showing that he had paid just $5000 in taxes on $260,000 in income. This was followed by legal moves against Cavallo allies in the government on corruption charges and a jurisdictional battle between Cavallo and the Congress over tax and provincial revenue sharing proposals. Cavallo counter attacked in early June suggesting that one of his main detractors in the cabinet, interior minister Carlos Corach, was part of an “illicit association” within the government. Cavallo also continued to battle directly with the President, this time over labor policy. In early April Menem adopted a proposal designed by his interior minister for a “social truce” with labor (a promise that the state reform would avoid layoffs and dismissals) in a successful effort to avoid the March general strike threatened by the CGT. Cavallo (and the private sector) strongly and publicly expressed his opposition to even this limited and ultimately rhetorical action needed to prevent the defection of labor from the Menem coalition. Cavallo had become a clear obstacle to what peronist politicians, including President Menem, saw as essential coalition reconstruction efforts.

In the midst of these battles, Cavallo was forced to admit that his economic recipe had not yet produced the anticipated results. Unemployment had increased from October to May (although unemployment had fallen between May and October 1995, 90% of the reduction was due to job seekers dropping out of the labor market. The May 1996 rate rose from October’s 16.4% to 17.1%) and the government missed its first semester IMF fiscal target. Given the sharp fiscal and monetary constraints imposed by the currency board and the reticence of investors, it is not surprising that the Argentine recession drug on well into 1996. Nevertheless, this lack of success reinforced peronist attacks on Cavallo. Peronists deemed his economic strategy a proven failure and blamed it and Cavallo for a peronist electoral loss in a Buenos Aires senatorial election in May. One of Peronism most senior Senators, Antonio Cafiero, seemed to speak for most peronists when he argued that the peronist party “is paying the price of public disenchantment with the social consequences of the economic model. People agree with stability but the majority. . .are finding it hard to live a dignified life” (LAWR, 18 July 96, 316). A growing chorus of peronists agreed that it was time for a few policy changes and this required that Cavallo be dismissed.

Under this pressure from within peronism and facing ever increasing public disenchantment with his administration, Menem decided to take a calculated risk. Cavallo’s image had suffered badly from more than a year of persistent upheavals within the administration in which he figured prominently. Cavallo’s approval rating had fallen to
just 25%, its lowest level since 1991, and the persistent policy uncertainty produced by the near civil-war within the administration led investors and businessmen to wonder aloud if it might be better for Argentina if Cavallo were to go. Then in mid-July, Cavallo prevailed on Menem to decree a new round of austerity measures with an eye to mid-August negotiations with the IMF on a waiver of Argentina’s fiscal targets. These measures included cuts in family allowances, cuts in tax breaks for food vouchers (an important component of worker wages), and possible cuts in health care for pensioners. Announced on the heels of the release of the May unemployment figures and a report by the government estimating that 10% of the population now lived below the poverty line, these actions provoked a fierce public reaction. Business feared that the sharp spending cuts would choke off the anemic economic recovery, and labor decried spending cuts that once again focused on the pocketbooks of workers and called a general strike for August 8 in protest (LAM, Aug96, 3). In these circumstances, Menem took a calculated risk. On 26 July 1996, he gave Cavallo his walking papers.

Cavallo’s dismissal did not lead to the policy changes many Peronists and much of the Argentine public were hoping for, however. Menem fully recognized that Cavallo retained many supporters in the business and financial communities and that the markets were not ready to transfer their full confidence to Menem. Investors still were concerned that Cavallo’s absence might permit precisely what old-line peronists were calling for—the reemergence of the populist Menem of times past. Given these realities and in the midst of an anemic recovery that would only take off once investor confidence was reestablished, Menem remained cornered. He could not afford to increase doubts about his policy intentions, regardless of the urgent maintenance needs of his political coalition. He thus chose an orthodox economist, former Central Bank chief, Roque Fernandez, to be his new economy minister, and carefully toed the orthodox policy line for most of the rest of 1996. Again he had gambled. This time he was gambling that once he had won back the confidence of investors, growth would return to Argentina and in a growing economy expanding fiscal revenues would enable him to reconstruct a viable electoral coalition well in advance of the October 1997 legislative elections. Unfortunately for Menem, the reconstruction effort would much tougher than anticipated. Indicative of this, a Gallup poll indicated that 80% of Argentines lacked confidence in the ability to the new economic team to solve the country’s economic problems. (LARR, 12S96,3) Further, with Cavallo gone he could no longer serve as a lightening rod for protests against the government’s economic policy. Protests would now be directed against Menem himself.

With his eyes focused directly on the need to cut the fiscal deficit in order to retain the confidence of financial markets, Economy Minister Roque Fernandez announces a new set of fiscal austerity measures on August 12. Fully cognizant of the fact that public opinion was strongly opposed to this action, Menem tried to soften the blow. Prior to the release of the package, he vetoed several cuts he perceived to be too costly politically (the extension of IVA to school fees, books, and magazines). For most Argentines, this was much too little, especially in light of Menem’s previous statements that tax increases were not the way to pull the economy out of recession (LARR, 12S96, 2). Not only was Menem forced to cut short a foreign trip in late August to prevent a rebellion within the peronist party against these tax increases, but the CGT confirmed that it would follow up its unexpectedly successful 24-hour general strike on August 8 with a 36-hour general
strike in late September. The attitude of labor was captured in the words of the CGT leader on 8 August: “If trade unionists had known that this dogmatic model would produce these results, nobody would have supported it.” In the future, he continued, the CGT would do everything in its power to oppose “a savage, technocratic and monetarist brand of capitalism which does not address the country’s basic needs” (cited in LARR, 12S96, 3).

Even as Menem succeeded in obtaining legislative support for fiscal adjustment in late September, events demonstrated in no uncertain terms that his political coalition was in total disarray. Meanwhile, the evident inadequacies of the policy options available to meet the conflicting demands of the currency board economic model and of its imploding political coalition produced visibly increasing frustrations in the Casa Rosada during the Argentine spring.

On September 26-27, the CGT made good its promise to carry out a 36-hour general strike to protest the government’s fiscal austerity measures. Like the August 8 strike, this one was also supported by anti-government unions and the political opposition and brought the country to a near stand-still. It was supported by 54% of Argentines and 43% of all peronist voters (LAM, Oct96, 4), and was preceded on September 12 by a lights-out protest organized by opposition political parties that also registered very high participation rates in major urban areas. Making matters worse for Carlos Menem, his sacked economy minister Domingo Cavallo refused to go away quietly. Instead, Cavallo initiated an unrelenting attack on corruption in the administration suggesting that this was the source of the country’s economic difficulties. The by now evidently extensive popular disapproval of Menem’s economic policies combined with corruption charges leveled by Cavallo and other opposition politicians to undermine Menem’s personal approval ratings. After winning the presidency with nearly 50% of the vote in May 1995, Menem’s approval ratings fell to just 18% in October 1996 (LARR, 17Oct96, 1).

Argentines had become disenchanted with Menem. This was due not only to the high unemployment, low wages, job insecurity, and the broader pauperization of the middle class he seemed powerless to resolve. It also reflected the corruption and lack of sensitivity for the plight of the common Argentine evident in the administration. Most Argentines were convinced that the Menem government would never be able to resolve the problems most affecting their lives. He had been their savior under different circumstances, but now he was merely a thin shadow of his former self. They were tired of his antics and convinced that he could do little to make their lives better. (“Politica nacional: Estamos mal…vamos bien?”, La Nación, 2 jan 97; “Un ano bisagra en dos niveles”, La Nación, 31 dec 96).

The September general strike was also described by one research entity as “the most impressive display of trade union force during the Menem administration” reflecting a new low point in government-labor relations (EIU, 4Q96, 12). Seemingly frustrated by his inability to convince the CGT to recognize the policy constraints under which the government was operating, to return to its role as loyal ally of the government, and to spare the government the political damage inherent in the September strike by calling it off, Menem went on the attack. On the eve of the strike, he announced a series of labor reform proposals certain to raise the ire of the unions, and in the wake of the general strike referred to the “organizers of strikes” as “the enemy”. The CGT leadership returned the
favor by referring to Menem as a traitor for following the dictates of the IMF rather than meeting the needs of the Argentine nation (LARR, 96-07). Labor and its allies in the legislature firmly believed that labor reform would translate into more poverty and insecurity, while Menem was convinced that more labor flexibility was the only way to lower unemployment. To get the upper hand in this dispute, Menem proposed far more than he expected to obtain (the initial proposal included replacing collective bargaining at the sectoral level with company level agreements, more flexible working hours, and the replacement of severance pay with unemployment insurance. Menem followed this up with a proposal for increased competition among union run health care programs, threatening a loss of revenues from one of the largest sources of union income). In the process he drove his relationship with the CGT to the breaking point.

As public and labor discontent rose, discipline in the peronist party quite unsurprisingly declined. Legislative approval of fiscal adjustment came only after the lower house significantly pared back its tax increases, after the first attempt to vote on the measure was blocked by peronist deputies who joined with the opposition to deny the government a quorum, and with only a one-vote margin despite the peronists’ 8-seat advantage in the lower house. Meanwhile peronist deputies, led by the deputies loyal to Eduardo Duhalde, the governor of Buenos Aires province and declared presidential candidate, blocked labor reform. Duhalde’s stance was a clear attempt to prevent a rupture between peronism and its historically most important constituency, Argentine workers. It was also a very obvious first step in his effort to build a pro-Duhalde electoral coalition, built on the promise to succeeding where Menem failed, in the fight against poverty and unemployment, within peronism and within the country. It thus constituted a direct challenge to Menem’s control of the ruling party and hence his capacity to govern.

In the midst of these torrents of bad political news during the last months of 1996 there was also some very good economic news. By October/November there were clear signs that the solid growth was beginning to return to the Argentine economy. On the heels of the IMF’s October approval of a revised agreement with Argentina, signs of growth helped to reestablish investor confidence in the economy (In early December 1996, 9 of 10 businessmen in the Greater BA area believed that the economy would improve in 1997 (“Política nacional: Estamos mal…vamos bien?”, La Nación, 2 jan 97)) which translated into renewed capital inflows and investment. The long-delayed emergence of the economy from recession had done little to improve Menem’s standing with voters by the end of 1996. Average family income fell 11% in 1996, 13.5% for the middle class; the proportion of the population able to save money fell by years end to 3% while the percentage living in poverty rose to 10%; and the release of the October unemployment figures showed that the situation had worsened slightly leading 45% to conclude that unemployment would increase in 1997. In these still very difficult circumstances, only 20% of voters in the Greater BA area in early December believed that the economic situation would improve in 1997, and only 14% approved of Menem’s job performance. (“Política nacional: Estamos mal…vamos bien?”, La Nación, 2 jan 97; LAM, April 97, 2).

Despite this lack of short term political benefits, however, the economic recovery promised greater political benefits during 1997 by attenuating significantly Menem’s policy dilemma. With renewed growth and capital inflows the Argentine government would enjoy much greater fiscal policy freedom, and this could be employed to regain
labor loyalty, to reestablish internal peronist party unity, and to rebuild popular support for
the government. This loosening of the economic policy straight jacket imposed by the
currency board would finally enable Menem to take the actions required to reestablish his
capacity to govern and to salvage what he could of his electoral coalition.

Continuing Coalitional Challenges Despite A Booming Economy:

The task before Menem was far from simple. He needed to reestablish his capacity
to govern effectively and to reconstruct a viable electoral coalition before the October
1997 legislative elections. The return of growth to the Argentine economy, however,
suggested that this task was manageable. With regard to governability, Menem needed to
reestablish his dominance in the Peronist party and regain the support of the CGT while
retaining his government’s renewed credibility with international investors and
internationally-oriented domestic business interests. Working on the correct assumption
that his orthodox stance throughout 1995/96 combined with strong growth in the
domestic economy would provide a margin of good will with investors, Menem focused
quickly on his problems with labor and within the Peronist party.

On the labor front, Memen opened the new year by sending a clear message that he
would actively support worker interests. In a mid-January 1997 meeting of Peronist party
leaders, Menem indirectly blamed employers for the lack of progress on unemployment
when he accused them of not creating jobs despite all the support they had received from
the government. (RS-01-97) He did nothing to encourage the rapid review of the
constitutionality of his December 1996 decrees curtailing the special treatment of (and
hence the profits from) the union-run health care system, leaving them instead to languish
in the legal system until November. In May after several fruitless months of negotiations
between business and labor representatives in search of a consensus solution to the
questions of the union-run health care system and decentralization of collective bargaining,
Menem sided with labor, much to the chagrin of both business and the IMF. His labor
minister announced that any additional decrees on the health care schemes would be very
unlikely until after the elections (LAM, May 1997, 3). And Menem agreed to abandon
any effort to decentralize collective bargaining. Quite unlike the events of the previous
fall, under the renewed threat of a general strike Menem capitulated to labor rather than
fight back.

To reestablish his control over the Peronist party, Menem needed to undermine the
growing support enjoyed by Eduardo Duhalde and to reassert Menem’s own influence.
Beyond efforts to regain the support of the CGT (which had begun to side with Duhalde
over Menem in 1996), this task involved blocking Duhalde’s ability to win the support of a
majority of peronist governors (and hence the votes of their national senators) and to
prevent Duhalde from selling himself to the party as the heir-apparent to Menem. As an
initial step to solidify provincial support for his administration, Menem dropped the issue
of revising the revenue sharing agreement with the provinces. The Menem government
spent the better part of 1996 attempting to rework this agreement to reduce the amount of
money the federal government was required to transfer to the provinces. Provincial
governors were strongly opposed to such moves, especially at a time when many
provincial governments were having grave difficulties meeting their payrolls leading to
unrest in several provincial capitals. After persistent battles over the issue throughout
1996, Menem suddenly reversed gears in early 1997. He decided to “postpone”
discussion of the revenue sharing agreement, a postponement that last until the end of his
presidency, leading to a 16.6% increase in transfers to the provinces during the first
quarter of 1997 (since the provinces received a fixed percentage of federal tax revenue, as
revenues increased with economic recovery and the April 1996 VAT increase, so did the
provincial take. Transfers to the provinces thus accounted for 41% of the total increase in
federal spending during this quarter). (EIU, 2/97) This about face on Menem’s part
enabled him to outflank Eduardo Duhalde’s efforts to build alliances with party leaders in
the provinces and thereby prevent Duhalde from expanding his influence in the party at the
expense of Menem. (EIU, 3Q98, 6).

Menem’s final task in the reconstruction of his governing capacity was to cut
Eduardo Duhalde down to size. It is within this context that in mid-February 1997 close
allies of Menem raised the possibility of a third presidency for Carlos Menem. Menem’s
brother-in-law proposed legislation to change the constitution to permit a third Menem
presidency while “Menem 99” posters began to appear around Buenos Aires. Although
popular support for a third term registered in the single digits and even though Menem
denied any interest in the office, Duhalde understood the seriousness of these signs. He
loudly proclaimed his opposition to the proposal, indicating that his allies in the legislature
would vote against any such proposal, effectively vetoing it (LARR, 4 March 97). He is
also thought to have ordered his legislative allies to block important legislation favored by
the government to force Menem to back down (EIU, 2Q97, 11). In the event, the two
declared an uneasy truce in advance of the October elections, but Menem’s message had
been clearly sent. Menem would not be denied the right to exercise full presidential
authority “right up to the last day, the last hour, and the last minute” of his presidency.
(Menem cited in LAM, May 97, 2) This message was reinforced in April when Menem
retook the leadership of the Peronist party from Duhalde, whom Menem had permitted to
occupy the post in Menem’s stead (EIU, 2Q97, 11).

Reestablishing his governing coalition was only half of Menem’s challenge during
1997. He also needed to reconstruct an electoral coalition that was in tatters in the wake
of a deep recession which brought economic devastation to many and inflation to none.
As the events of 1996 demonstrated, Argentines were no longer impressed by the
Menem’s government’s prowess in the battle against inflation. Voters now saw low
wages, unemployment, and government corruption as the main factors undermining their
living standards.

The rapid pace of expansion in the Argentine economy beginning in late 1996 and
lasting through 1997, however, suggested to Menem that this task would be relatively
easy. With the economy expanding at a blistering pace (8.6% for the year with every
quarter registering growth over 8%) creating the most positive economic environment in
two decades (EIU, 3Q97, 8), voters’ impressions of Menem and the peronists should have
improved markedly. A significant decline in the unemployment rate (unemployment fell
from 17.3% in October 1996 to 16.1% in May 1997 and 13.7% in October 1997) coupled
with the feel-good factor created by such a high rate of growth should have significantly
increased support for the government and its policies.

Aware of the deep, lingering discontent in the nation, the Menem government
attempted to reinforce the positive effects of growth on the employment picture through
the Plan Laura, a job creation and provincial support scheme disguised as an infrastructure construction project. Proposed in the first months of 1997 and to be financed through the sale of the National Mortgage Bank, this project was welcomed by Peronist legislators but strongly opposed by the IMF. The fund insisted that any revenues obtained from this sale to devoted to reducing the fiscal deficit and/or the public debt rather than to financing new spending projects. Although Menem initially ignored the IMF’s complaints and actively encouraged the approval of the Plan Laura legislation in the Argentine Autumn, he was forced to backtrack by August. Weak revenue growth despite a booming economy, and the decision by the IMF to condition its approval for a new loan for Argentina (an Extended Fund Facility loan) on Argentina’s dropping the Plan Laura convinced the government to capitulate. An economy dependent on capital flows simply could not afford the decline in investor confidence that split with the IMF could engender (La Nación).

The government was thus forced to rely on an automatic pilot economic strategy to reconstruct its electoral coalition. But the electoral cost of this backtracking seemed manageable. Even if in the absence of a job creation scheme the positive economic climate were to change voter attitudes only slowly, it still seemed unlikely that the Peronists would lose control of the Congress because of the weakness of the opposition. The two main opposition political parties, Frepaso and the Radicals, were deeply divided and had yet to find a way to capitalize on the government’s shortcomings.

There were two flaws in this electoral strategy. First, the Menem government sorely underestimated the damage inflicted on its electoral coalition by the long-term consequences of the currency board magnified by the immediate costs of the deep recession of 1996. Unemployment still registered double its 1991 rate while wages remained far below their pre-currency board levels. The very survival of the Argentine middle class seemed to be under siege by the negative consequences of convertibility. Further, nothing had been done to deal with the evident cronyism and corruption in the Menem administration. Such a corrupt regime, Argentines concluded, would be incapable of making the changes necessary to ensure the survival of the Argentine middle class way of life.

The second flaw in the Menem government’s automatic pilot strategy of electoral coalition reconstruction was that is seriously underestimated the opposition. In August 1997 Frepaso and the Radical party agreed to run a joint slate of candidates in the October legislative elections. The alliance won 46% of the national vote to the peronists 36%. The peronists thus lost their majority in the chamber of deputies (although they retained the largest voting bloc). Even more striking, the peronists lost in their historic stronghold, the province of Buenos Aries.

The impact of this electoral defeat woke the Menem government up to the reality that its electoral coalition was more severely damaged than realized, and that more dramatic measures would be needed to reconstruct it. Unfortunately for Carlos Menem and the peronist party, the anti-inflationary coalition in which business, workers, and consumers could coexist happily had been relegated to the dust bin of history by the very policy it had enabled—the currency board. It could not be reconstructed. Investors, internationally oriented domestic business, workers, and middle class professionals were no longer united by a shared policy interest but instead found their interests and policy
preferences increasingly in conflict. Further, the policies required to bring workers and the disappearing middle class back on board were simply beyond the reach of a government limited by the constraints of the currency board, by fiscal and current account deficits producing a deep dependency on investors and the IMF in the absence of sufficient domestic savings, and an inability to purge the perception of corruption from the minds of voters. Making matters worse, international events will put the breaks on economic growth in 1998.

International Financial Instability and the Peronist Defeat:

The electoral defeat of peronists in their Buenos Aires stronghold dramatically undercut the political fortunes of the province’s governor, presidential hopeful Eduardo Duhalde. Labor unions and governors who had previously flirted with Duhalde backed away quickly in the wake of the October polls. With Duhalde on the ropes, Menem moved quickly to mobilize his resources in order to fill the void. Menem supporters presented 34 petitions to the courts arguing that the constitution was unfairly constraining Menem’s rights by limiting him to just two terms (EIU, 3Q98, 12).

Menem’s first target continued to be reinforcing his governing coalition. In a January meeting to set party strategy (which Duhalde avoided) Menem was reassured of the backing of all but two Peronist governors, and was able to get approval for a late date for the internal party primary, giving him more time to build popular support for his run (LAM, F98, 1). He then reinforced this support by round filing all efforts to revise the revenue sharing agreement meaning that fiscal flows to the provinces would continue unencumbered. Menem then turned his attention to labor. The government proposed new labor reform legislation in March. This legislation reflected a huge step back from what it agreed with the IMF in its February letter of intent and from what the private sector had demanded. It instead reflected virtually every union demand with the clear aim of smoothing over his previous disputes with labor and thereby with their representatives and allies in the peronist party (LAM, March 98, 1).

Menem’s efforts to rebuild popular support for his administration were even more ambitious. On the assumption that the strong growth registered in 1997 would continue through 1998 and would thereby increase government revenues (a rational assumption given the minimal impact of the Asian financial crisis on the Argentine economy in late 1997), the Menem government proposed a new series of spending measures. Menem’s first move was to appoint Ramon “Palito” Ortega as social development secretary with the brief to spend money around the country on social problems. The aim was clearly to demonstrate dedication on an issue where the public saw the government as lagging. It also had the convenient side-payment of raising the profile of Ortega, a close ally of Menem, as a possible presidential candidate Menem’s reelection gambit not succeed. The government also revived the Plan Laura, now to be financed through a fuel tax, and proposed a politically very popular pay increase for teachers (the need for increased assistance to education consistently registered very high among voter concerns) to be financed by a tax on cars, boats and airplanes (LAM, May 98, 3).

Even as these spending plans were being designed and introduced into the congress problems began to appear on the horizon. First, tax revenues were increasing at a very anemic pace compared with the expansion in the economy. The Menem had been
very careful to adjust spending downward during the first four months of the year to compensate for these reduced revenues (primary spending increased 1.3% against a budgeted increase of 6% (LAM, July 98, 3)). But this fiscal situation brought into question the ability of the government to carry out its spending proposals winding their way through the Congress. Second and even more troubling, although growth in the Argentine economy had not suffered significantly from the Asian crisis, its trade balance had. Reduced Asian demand for Argentine exports, sharp drops in oil and mineral prices, and a strengthening US dollar all combined to reduce Argentine export earnings. Most importantly, the strongly negative impact of the Asian crisis on Brazil had reduced demand in a market which takes 1/3 of all Argentine exports. In the first two month of 1998, Argentina’s traditional trade surpluses with Brazil and Asia fell in to deficit. The over all trade deficit for this period measured $1.42bn, the highest deficit for this period since the adoption of the currency board in 1991, and well ahead of the government’s target of a $5bn deficit for the entire year (LARR, 21 April 98, 5; LAM, May 98, 3).

A visit by a team from the IMF in April warned that these figures demonstrated that Argentina was in a “pre-crisis” situation and should act to cool down the economy rather than pumping it up with new spending programs. The reaction of the Argentine government was a fierce rejection of the IMF’s council. Economy minister roque Fernandez argued that borrowing was “virtuous”, that the trade deficit was due to heavy capital inflows, and that any way the current account deficit would self correct under a currency board system (very reminiscent of the justifications presented by Mexican finance minister Pedro Aspe in the months preceding the 1994 Mexican peso crisis) (LARR, 21 April 98, 5; LAM, June 98, 2). From the Argentine perspective it was too soon to pass judgment on the sustainability of the economy’s current growth trajectory, especially when the reconstruction of Menem’s electoral coalition seemed to depend on this activist policy path.

Just two months later, however, lacking the hoped for turn around in the fiscal and current account numbers, the government once again made a u-turn and capitulated to economic reality. With a visit from an IMF team to assess Argentina’s performance during the first half of the year scheduled for late July, the government seems to have decided that it could wait no longer to respond to IMF concerns. It could not afford to play with the investor confidence the IMF helped ensure given the depth of its dependence on capital inflows (Guidotti Interview). In late June, the government announced $1bn in spending cuts, the shelving of the Plan Laura and the plan to raise teachers salaries, and put its full support behind an IMF requested tax reform proposal presented to the Congress in March but previously shunted aside in favor of the more politically valuable spending projects.

Without the capacity to respond directly to public concerns about limited attention to social programs, unemployment, and education, it seemed very unlikely that Menem would be able to rebuild support among Argentine voters. As Menem considered his options, troubles within his governing coalition made clear the folly of Menem’s hope for a third presidency. In July Duhalde played his veto card and the peronist party, with Menem’s poll numbers still at historic lows, evidenced increasing discomfort with the reelection idea. Following the announcement by the governor of La Rioja province (Menem’s native province and still supportive of the president) that he would hold a
plebiscite on reelection in a clear attempt to keep the momentum for reelection going, Duhalde called for a similar plebiscite in the province of Buenos Aires where polls indicated that Menem would lose. More importantly, Duhalde threatened to create a faction in the Chamber of Deputies composed of his supporters, about a third of Peronist deputies. If Duhalde had carried out this threat, Menem would have lost his voting majority in the lower house and much of his capacity to govern (EIU, 3Q98, 13).

At virtually the same time, a special congress of the peronist party gave only limited support to Menem’s bid for a third presidency. Although Menem received the backing of the majority of party leaders to continue in his position as party president, he did not receive the support from the delegates from the two largest electoral districts in the nation (EIU, 3Q98, 13; LARR, 4 Aug 98). Threats to the viability of his governing coalition embodied in this evidently luke-warm backing from the party and the threat of a Duhalde-led party split over his candidacy, and the sharp constraints on his ability to rebuild electoral support for another presidential bid imposed by an exploding current account deficit forced Menem’s hand. In late July Menem announced that he would not run for a third term.

Only weeks after this decision the Russian default and its very negative impact on Brazil strengthened the hand of the revived Menem orthodoxy. In September Menem spoke of the need for a spending freeze for the remainder of the year to inoculate Argentina from the spreading contagion. Fear of just such a contagion enabled Menem to convince congressional Peronists to approve the tax reform which had been languishing since March and to approve an austere 1999 budget without any major changes. With its eye on the Presidential elections in October, Congress still tried to push through the spending increase for teachers that Menem had abandoned in late June, but Menem vetoed the measure arguing that although the aim was very laudable the money to pay for the increase simply could not be raised (La Nación). Argentina thus met its IMF fiscal targets for the second year in a row, keeping the deficit to just 1.4% of GDP during 1998 (1.5% in 1997). This fiscal rectitude paid off for Argentina in the form of a $5.7 billion IMF loan package designed to send a signal to financial markets that Argentine macroeconomic fundamentals were sharply different from those of the other victims of the Asian/Russian crisis. (LAM, Aug 98, 2; Sept. 98, 3; N98, 3).

To say that Carlos Menem had thus abandoned his presidential bid in order to assure the preservation of “responsable” economic policies would be a serious mistake. Menem was and is every bit the political animal, but a realistic one. Cognizant of the economic and political constraints under which he was forced to operate in 1998, Menem concluded correctly that his bid for a third term was doomed. But his desire to sustain his power as president for as much of 1999 as possible, to influence the peronist party and Argentine politics beyond the end of his term, and to return to the presidency in the future persisted. The political and economic consequences of the currency board together with severe volatility in international financial markets had forced Menem to modify his tactics, but not his ultimate aims.

With Menem apparently out of the running, the way seemed clear for Eduardo Duhalde. Duhalde formally launched his presidential bid on October 17 before a large crowd in the Plaza de Mayo intentionally designed to evoke memories of Juan Perón. But Menem was not willing to allow Duhalde to move alone into the political limelight. First,
Menem was unwilling to become a lame duck and would do everything in his power to avoid this. Second, he strongly opposed Duhalde and his excessively populist politics. Third, he preferred a more malleable Peronist candidate that he could influence from behind the scenes. And fourth, he wanted to ensure his control of the peronist party through the next presidency to be able to lay the groundwork for his presidential candidacy in 2003. All of these goals demanded that Menem remain very active in national politics well into 1999. Further, Menem’s poll numbers were rising. With the economy already contracting rapidly in the wake of the Russian moratorium, the sudden devaluation of the Brazilian real on January 15, 1997 renewed fears of a revived tequila effect in the Argentine economy. For a brief period of time in early 1999, renewed fears of inflation moved many Argentines to repeat their 1995 turn toward the safety of Menemist policies. The solid anti-inflationary foundations of the currency board quickly erased this blip, but not before Menem took advantage of this window of opportunity.

In the meantime, rather that respond early and decidedly to inevitable economic difficulties a 30% devaluation in Argentina’s leading export market would bring (absent the ability to enact a similar devaluation to preserve export competitiveness), the Menem government dithered. It announced plans to fully dollarize the economy as a means to preserve investor confidence at home and abroad, but did nothing to readjust fiscal targets despite the inevitability of an economic downturn and the reduction in tax revenues it would bring. The Casa Rosada rolled the dice. The government exploited investor confidence during the first months of 1999 to finance counter-cyclical fiscal spending (the only way to finance deficit spending under a currency board) in an effort to keep the recession short and shallow in an election year (Castro interview).

Circumstances also raise the suspicion, although the economic team vehemently denies it (Rodriguez and Guidotti interviews), that the government rolled the dice in part to support Menem’s political machinations. Since his renunciation of any interest in a third consecutive presidential term, Menem had been grooming an alternative peronist candidate in the person of Ramon “Palito” Ortega. A former governor closely allied with Menen yet with a popular touch, Ortega seemed the perfect alternative to the populist Duhalde. Menem expected that Ortega would be able to exploit his position as social development secretary and Menem’s influence over the party machinery to build a viable candidacy. But the Ortega candidacy never took off. Determined to block Duhalde’s momentum, Menem turned his attention to another popular governor, Carlos Reutemann, whom Menem encouraged to enter the presidential stakes (LAM, March 99, 1-2; April 99, 1-2).

Angered by this betrayal, Ortega jumped ship in late February and agreed to join Duhalde as his vice-presidential candidate. With Duhalde’s candidacy thereby significantly strengthened, Menem took advantage of his spiking popular support and fought back. He arranged for the peronist party to postpone the party presidential primary from April to May while his closest allies revived the Menem 99 campaign (EIU, 2Q99, 8). The political-economic costs of this move were high. The majority of party leaders reacted negatively to this move (only 4 of 14 governors openly supported it) and a Mora y Araujo poll indicated that the party rank and file were not thrilled either—Duhalde led Menem by 44% to 27% (LAM, April 1999, 2; EIU, 2Q99, 8). Meanwhile, the political noise caused by Menem’s machinations combined with the continuing absence of any policy response to the expanding economic consequences of the Brazilian devaluation raised alarms on Wall Street. For the first time since 1995/6, investors began to express concerns about Argentine credit-worthiness.
Ultimately the Supreme Court rejected four law suits brought by Menem supporters testing the constitutionality of reelection and the National Electoral Court ruled that Menem could not stand in the peronist primaries either. Menem once again stepped aside, but not before he got what he wanted. The peronist party further postponed their presidential primaries until July and extended Menem’s term as party president until 2003 (LAM, April 1999, 1). But Menem’s victory was very short lived. Whatever the extenuating circumstances, once it became clear that Duhalde would be the candidate (there were no longer any challengers) lame duck status set in. With the succession struggle settled, Menem’s influence over the peronist bloc in the legislature waned.

Soon after Menem’s second withdrawal from the presidential stakes, and fully aware of the growing concern in financial markets, the government reached an agreement with the IMF. In a effort to send a delayed but strong signal to the markets of responsible economic management, the April IMF agreement called for a dramatic lowering of the government’s growth estimate for 1999 (from 3% to -1.5%) and an associated curtailment of government spending. A large portion of the $1 billion in spending cuts called for by the agreement, however, were blocked by the peronist-led Congress.

Although the Congress passed the ultimately meaningless fiscal convertibility law (sharply limiting future fiscal deficits), it did little to cut current spending. It blocked politically unpopular government proposals to cut spending for education, social programs, and transfers to the provinces. It also overrode presidential vetoes of several articles in the 1999 budget. Quite unlike the past when Menem was able to force fiscal measures through a reticent Congress, he was now unable to force congress to “behave” even in the clear presence of growing economic troubles. The government was thus unable to reduce primary spending during the year, despite the need to finance large increases in the government’s debt payments. The consequence was an explosion of the fiscal deficit (although tax revenues were also in a free fall during 1999, this was largely compensated by privatization revenues) (EIU, 2Q99, 10; EIU, 3Q99, 16; Rodriguez interview).

Yet it is difficult to lay the blame for this course of events solely on the Congress. The uncertainty created by Menem’s political machinations and the government’s calculated fiscal risk early in the year mattered enormously. Equally, it is hard to imagine that Menem really wanted to cut transfers to the provinces. Although Menem had no interest in helping Duhalde, he did very much want the peronists to retain control of the Senate. Not only did he, as party leader with future political ambitions, not want to be blamed for an electoral route in October, the Senate was the body that would hear accusations of misbehavior by former government officials in an administration beset by persistent accusations of corruption. Since it would be the new provincial legislatures that would elect the new Senate, and given the outbreak of civil unrest in several provinces during the year, it is not surprising that the second largest increase in government spending during 1999 was transfers to the provinces—a 17% increase, surpassed only by the 24% increase in interest payments (EIU, 1Q00, 19).

Managing Crisis without Popular Backing: De la Rua’s Unenviable Challenge

The victory of the candidate of the opposition Alliance, Fernando de la Rua, in the October 1999 presidential elections seemed to present a dramatic change in the Argentine
political scene. Yet lying under this facade of change were the same coalitional challenges created by the operation of the currency board that had confronted Carlos Menem since mid-1995. De la Rua would also face the economic limitations imposed by a significantly overvalued currency, a huge fiscal deficit, and Argentina’s consequently deep dependence on international capital inflows to finance economic recovery and growth. The new government thus had little choice other than to meet the demands of financial markets, but doing this while sustaining popular support would thus be a very tall order.

De la Rua’s challenge, however, was even greater than Menem’s owing to the nature of the electoral coalition that had brought him to power and the policy coalition with which he would have to govern. De la Rua’s electoral support derived from his campaign promises to root out corruption and to respond decisively to the social costs of convertibility. But this popular support was neither strong nor institutionalized. Most voters chose de la Rua not because they strongly supported him, his policies, or the alliance he led. Most voters had voted merely for something different; for a change after 10 years of peronism. They did not fully support de la Rua but were instead giving him a chance to govern. To assure their sustained support, he would first have to prove prove his capacity to govern.

Many Argentines were also concerned about the staying power of the Alliance that had brought de la Rua to power. This marriage of convenience between the center-left Frepaso with the center-right de la Rua, and the choice of a center-right candidate despite the presence of strong center-left influences within de la Rua’s Radical party, raised doubts about the Alliance’s survivability in government. De la Rua would thus have to deliver quickly on his campaign promises in order to prove his capacity to govern and thereby to retain and solidify his base of electoral support.

This would have been a very tall order to fill even if de la Rua had taken the reigns over a healthy economy. Instead he inherited an economy with an exploding fiscal deficit and persistent current account difficulties that hampered growth and thereby severely complicated his political challenge. Retaining the confidence of international investors required a reduction in Argentina’s borrowing needs and an increase in its capacity to repay its outstanding debt. This meant a reduction rather than an expansion of federal spending, just the opposite of what de la Rua’s electoral supporters had voted for.

Holding together an effective governing coalition would also be a challenge for de la Rua. Not only were his political tendencies to the right of his Alliance partner, Frepaso, but also of much of his own party including the faction led by former president Raúl Alfonsín. The Alliance also faced Peronist control of the Senate and the legal system, and a majority of Peronist governors. The political uncertainty surrounding the first transition of power in Argentina in a decade, undertaken during difficult economic times, was thus magnified further by questions regarding the capacity of the new administration to govern.

In this uncertain environment, de la Rua boldly responded to the fiscal crisis inherited from his predecessor. He proposed, and the congress quickly approved early in 2000, a serious fiscal adjustment package. De la Rua gambled that fiscal adjustment would reinforce flagging confidence in financial markets, reestablish capital inflows, and thereby reignite growth in the Argentine economy. Growth would then provide the fiscal revenues needed to respond to the demands of Argentine producers for assistance to adjust to their exchange-rate induced loss of competitiveness and of Argentine workers.
and professionals for more jobs, higher wages, and ultimately the recovery of the Argentine middle class.

Although polls indicate that most Argentines were willing to give de la Rua the benefit of the doubt and acquiesce to the short-term need for fiscal adjustment, investors did not respond as expected. The uncertainty surrounding the new government and hence Argentina’s economic future led domestic investors to hold back, undermining the pace of economic recovery. Without sustained investment, the recovery begun during the last months of 1999 turned into stagnation during early 2000. De la Rua faced the same bind as Carlos Menem in 1995/96. He needed to sustain his policy focus on regaining Argentine credibility in financial markets and deal with the electoral costs of this decision once the economy was growing once again. But de la Rua faced this challenge without the benefit of a solid governing coalition to back him up.

With growth below expectations, the fiscal deficit expanded beyond the levels agreed to with the IMF. This suggested to financial markets a reduced Argentine capacity to meet future debt payments. And without market confidence, there could be no countercyclical stimulus to entice the economy out of recession. The only tool at the government’s disposal was to cut spending further to keep its fiscal accounts in order and thereby gradually win back the confidence of financial markets. This decision did not go over well with either its governing or its electoral coalitions.

The decision in April to implement further spending cuts generated grumbling from within both coalitions and the first defections from the governing coalition. The defections involved only minor figures from the extreme left of Frepaso. The remainder of the Alliance remained loyal to the government and approved its spending cuts in the legislature. The public largely acquiesced to the decision as it had in January. But this time acquiescence was tinged with tangible increase in the level of dissatisfaction with this course of events. Events surrounding this second fiscal adjustment thus demonstrated that patience was already wearing thin within both of de la Rua’s coalitions. Cognizant of this development, the government made clear to the nation and to the IMF that another spending cut was not in the cards regardless of future events.

While de la Rua’s coalitions showed patience, albeit declining patience, with slow progress on the economic front, they would be less kind on the corruption front. In May the government won approval from the congress of a labor reform bill. As a key tool in the government’s effort to win the confidence of international and domestic investors, the reform contained most of the changes long demanded by local business and the IMF to increase labor flexibility, competitiveness, and hopefully employment. This positive policy coup was soon to become the downfall of the government.

In late August rumors began to leak about bribes paid to peronist Senators to assure their support for the labor reform bill. By the Argentine Spring, these isolated rumors had snowballed into a full-blown scandal involving de la Rua’s labor minister and his chief of intelligence. In Menemist style, de la Rua not only stood by his colleagues in the face of increasing credible evidence of their involvement in the pay-off plan, but also attempted to use the opportunity to reshuffle his cabinet and strengthen his hand at the expense of his Frepaso allies. But quite unlike Menem, de la Rua’s governing coalition did not hold together under this stress. Quite to the contrary, his vice president, Carlos “Chaco” Alvarez of Frepaso, resigned in protest. The fight against corruption was one of the founding principles of Frepaso and it was thus an issue on which Alvarez was unwilling to compromise. Although Frepaso itself did not break with the government, the perception in the public of chaos in the Alliance was a powerful one.
Although de la Rúa eventually dismissed the officials implicated in the bribery scandal, his delay gave the impression of indecision and loyalty to corrupt officials. More broadly, a corruption scandal in a government elected in large measure because of its strong anti-corruption credential was deeply disappointing to Argentines. Not only was had the government shown itself inept at pulling the economy out of recession, it was now tainted by corruption and appeared unstable. As popular support for de la Rúa imploded, supposed allies began to distance themselves from the president and his policies. Most strikingly, former president Raúl Alfonsín took advantage of the President’s weakness to make a bid to shift economic policy to the left. He began to criticize the economic policies of the government and in particular convertibility.

Weakening popular support and evident dissension within the President’s governing coalition then undermined investor confidence in the ability of the government to undertake the politically tough policies needed to preserve its capacity to meet its debt payments. Argentina had fallen into a vicious cycle from which it has yet to emerge. Without credibility, there would be no growth. But without growth, de la Rúa’s electoral coalition evaporated leading to constant instability in his governing coalition. This instability in turn further undermined investor confidence. Only two multi-billion dollar bailouts organized by the IMF, in November 2000 and again in August 2001, and a costly debt restructuring initiated in June 2001 have saved Argentina from default.

In the final analysis, the errors of the de la Rúa government can not be discounted in any explanation of why Argentina is on the verge of bankruptcy. Beyond the labor reform fiasco, the government did a very poor job of selling its policy advances to investors. But these errors in a different policy context would not have had the same, devastating effects for Argentina. De la Rúa was instead forced to govern in an environment dominated by the political-economic constraints of the decade-old currency board regime. The over-valuation of the Argentine peso produced a large current account deficit from the first days of the currency board. And although significant reductions in the cost of production in Argentina significantly reduced the size of this overvaluation over time (until the Brazilian devaluation reestablished the problem), a large current account deficit persisted throughout the decade. This deficit had to be financed through capital inflows, generating Argentina’s deep dependence on foreign investment.

Although the increased efficiency forced on the Argentine economy by the demands of an overvalued currency was a positive thing for Argentina’s trade balance, it had the very unfortunate side effect of raising unemployment and lowering wages. Argentina’s dependence on capital inflows also made the economy very vulnerable to volatility in international capital markets, a circumstance which has been the rule more than the exception since 1995. Meanwhile, the benefit that these costs had brought to the Argentine population—low inflation—no longer seemed to be a tangible benefit but an enduring reality. Thus the combination of high unemployment and declining wages, repeated recessions induced by drops in capital inflows, the end to the inflationary threat, and evident corruption in government reestablished the historic conflict in Argentine politics among different distributive coalitions all demanding that the government respond to their particular needs.

Even in an era of high growth Carlos Menem found this a difficult political sea to navigate. During periods of low growth he was forced to rely on the institutional power...
of his political party and its governing majority in the legislature, and on the privatizations and capital inflows that helped to balance the fiscal accounts. Fernando de la Rua enjoyed none of these advantages. He took power in a period of low growth at the head of an inevitably nebulous electoral coalition, and without a strong governing coalition to ensure his capacity to govern despite popular discontent in hard times. He took office without the full confidence of either international or domestic investors and with very little left to privatize to buck up tax revenues. Under these circumstances there was no room for error and unfortunately, if not inevitably in any new government, there were errors. The consequence is an economy perpetually on the verge of bankruptcy and a polity increasingly disenchanted with both the market and the democratic process.

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