Preliminary draft

STABILIZATION AND STRUCTURAL REFORM IN A FAVORABLE FINANCIAL ENVIRONMENT: ARGENTINA IN THE NINETIES.

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This paper was prepared for the Conference on Democratization and Economic Reform to be held in Cape Town, South Africa, January 16-18, 1998.

CEDES
Buenos Aires, January 1998

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> "Conventional wisdom on the time sequencing of the effects of structural reforms states that they can be painful at first, but then you grow to like them. The experience of the combined outcome of stabilization and reforms in Latin America in the nineties proves that just the opposite can be true: at first you like them, but then they hurt."
> (El Economista, Buenos Aires, forthcoming)

1. Introduction

The early nineties was a period of sudden and extensive changes for most Latin American countries. Significant structural reforms were launched -or deepened or consolidated, according to the particularities of each national case- and at times were concurrent with new stabilization attempts that turned out to be generally more successful than they had been in the dismal decade of the eighties.

These processes interacted with a major change in the financial context: at the beginning of the decade, international interest rates dropped swiftly and many countries began to receive huge capital inflows. Relieved of a previously tight foreign constraint, Latin America could simultaneously experience a sizable decline in inflation rates, as well as an acceleration in output growth, thus making room for an attenuation of some negative side-effects of privatization and trade opening.

The golden early nineties was often interpreted, at the time, as the beginning of a new and lengthy period of steady growth. Interpreters were disappointed when it became clear that the experience would have quite a different character: Instead of a steady-growth era, it was the expansionary phase of an economic cycle that peaked in 1994, when the Federal Reserve started to increase its discount rates. Immediately afterwards, several countries in the region, in particular Mexico and Argentina, had to face difficult times and the average performance of the region was impaired.

Crucial features of the cycle have been common to most countries in Latin America and the same can be said for the interactions between reforms, stabilization and the availability of foreign credit. This is why we intend to discuss here the case of Argentina by initially taking a broader Latin American perspective.

The next section of the paper briefly sketches the period from 1989 to date in Argentina. We point out some interactions between the political scenario and the economic policy-making process.

The third section depicts the main stylized facts of the evolution of Latin American economies in the nineties. Finally, the fourth section focuses on the recent economic developments in Argentina, examining the macroeconomic cycle of the nineties, as well as some outcomes of the economic reforms which can have decisive impact on the political scenario, like those observed in employment and income distribution.

2. Political scenarios, structural reforms and economic policy making in Argentina in the nineties

In the first half of the nineties, Argentina witnessed an impressive process of market-friendly reforms, centering on the privatization of a large proportion of the state-owned enterprises, as well as on both commercial and financial opening.

At the same time the country was also able to overcome a period of extreme instability in prices, which had led to two brief hyperinflationary episodes in 1989 and 1990. As from 1991, inflation rates were taken down to one-digit annual levels. This price stabilization was concurrent with a strong economic recovery.

Both the reform and stabilization processes were carried out under democratically elected governments. Like the control of inflation, most of the market-friendly reforms were effected during President Carlos Menem's first administration, between July 1989 and December 1995. Following a 1994 constitutional reform, Menem was reelected to a second term that is to end in 1999.

Three significant turning points stand out throughout these years. From the beginning of Menem's administration to early 1991, the persistence of price instability was a dominant feature of the economy and economic policy measures followed an erratic path. In April 1991 the government launched a stabilization plan based on a fixed exchange rate and the unrestricted convertibility of the domestic currency. The new program was successful at slashing inflation and initiated a long period of price stability.

A second important moment was tied to the spillover of the Mexican crisis in December 1994: in Argentina, the Tequila effect unleashed a financial crisis and a sudden recession.

The last significant episode took place in October 1997 when the official party suffered a severe defeat in the legislative elections, the first under Menem (and the first election ever to be lost by the Peronist Party while in office). A coalition made up of the two most important opposition forces carried the elections by a wide margin, making possible a Peronist defeat in the coming presidential elections in 1999.

Structural reforms

One of the main structural reforms of the nineties was the opening of the economy to international trade. It was already in 1988 that notable inroads had been made while President Alfonsín was still in office. However, under the peronist administration the previous gradual approach was abandoned and the opening was accelerated. Average import tariffs were reduced from 26.5 % in October 1989 to 9.7% in April 1991. In addition, specific duties were eliminated, as well as quantitative restraints on imports.[1]

Privatizations, for their part, began in 1990 with the transfer of the telephone

[1] Between 1987 and 1988 the average tariff dropped from 43 to 30% and quantitative restraints (import licensing ceilings or prohibitions) were reduced. In October 1989 some 807 tariff lines were subject to "transitory additional duties," 122 to import licensing and 129 to specific duties. Later, in April 1991, not one tariff line was subject either to specific duties or transitory additional duties or to import licensing. Restrictions remained in place for only 25 tariff items -corresponding to motor vehicles and spare parts - out of a total of 10,000, and special rates were also maintained for motor vehicles and electronics, which were subject to a 35% tariff. The tariff structure arrived at in April 1991 included three rates: zero for raw material and food products, 11% for inputs and capital goods and 22% for final goods. See

company and the national airlines.[2] In late 1994 the major part of the state-owned firms producing goods or services had been sold, including the most important of these, the YPF oil company, as well as the producers and distributors of electric power. This process would cover a broad range of productive areas: iron and steel works, petrochemicals, gas and shipyards. In some cases (oilfields, railways, ports, highways, waterworks and sewage, and TV channels and radio) the government resorted to concession mechanisms.[3] Income from the sales of the companies and concessions surpassed 20 billion dollars. Approximately half of this amount was received in cash, about 40 % in public bonds at market prices and the balance took the form of the transfer of firms' liabilities to the buyers or licensees.

The legal framework

Several legal norms marked the process of structural reform. First was the Law of the State Reform (August 1989) which established the legal bases for the privatization of state-owned enterprises with the capitalization of public debt.

Second, in order to improve the performance of the public accounts, the Law of Economic Emergency (September 1989) suspended several subsidy mechanisms like those implicit in the industrial and regional promotion regimes and included several norms to enable the administration to cut labor expenses. This law also established equal treatment for foreign and domestic capital that was to be invested in productive activities in the country. In this way, prior approval for foreign direct investment was no longer necessary.

In addition, in November 1991, a Deregulation Decree eliminated a wide set of regulations across diverse economic activities.

The most important legal instruments for the stabilization process were later

Damill and Keifman (1993).

[2] The first attempts at privatization also took place in the last years of Alfonsín's administration. Like the trade opening, these were impulsed by the conditionality established by multilateral organizations, specially the World Bank. These initial endeavors were unsuccessful, not only because of a lack of conviction in the official party, which evidenced serious internal disagreements over the reforms, but also because of the legislative block led by the peronists.

[3] See Frenkel and Rozenwurcel (1996) and Gerchunoff and Cánovas (1993).

passed. The Convertibility Law (March 1991) established a fixed peso-dollar parity and validated contracts in any foreign currency. It also stipulated that the Central Bank had to back 100 % of the monetary base with foreign reserves. It is also important to mention the new Central Bank Charter (September 1992), which suppressed the official guarantee on deposits and fixed narrow limits whereby the Central Bank could buy public bonds and lend to commercial banks. The law also established the autonomy of the Central Bank.

The beginnings: a dramatic macroeconomic instability

Despite the speed with which the above changes were implemented, Argentina's stabilization and economic reform processes should not be interpreted as the result of a preconceived plan which gave orientation and coherence to the policy actions.

In fact, Menem had won the 1989 presidential elections with a populist discourse that promised wage increases and also raised doubts about his intention to honor public-debt commitments once in office. He also appealed to nationalistic sentiments by promising the recovery of the Malvinas Islands from Great Britain at any cost. These economic and political elements in Menem's discourse well reflected the peronist tradition of the candidate. It should not be forgotten that the peronist party had strongly resisted the timid reforms undertaken by Alfonsín's government.

The elections took place in the throes of a hyperinflationary crisis which was triggered by a run on the exchange market in February 1989.[4] Productive activity was seriously affected; the economy fell into a deep recession. In an extremely tense social climate, supermarkets and shops were looted and riots broke out in major cities. The government declared a state of siege. In February, two of the principal business associations, the Unión Industrial Argentina and the Cámara Argentina de Comercio, had distanced themselves from the radical administration and judged null

[4] See Frenkel and Damill (1991)

the price agreement then in force.[5] Exporters were reluctant to sell their foreign currency proceeds to the Central Bank at the official exchange rate. In March the suspension of pending disbursements by the World Bank was made public. The isolation of the government dramatically increased.

An economy that was out of control and the deterioration of the social situation crushed any hope of a victory of the Radical Party in the presidential elections. In this context, the populist discourse of the peronist candidate doubtlessly helped more to feed the prevailing uncertainty than to raise confidence in the return to normality. Meanwhile, the polarization in the public-opinion surveys converted Menem into the only alternative to a ruling party that seemed unable to bring the situation under control. On the other hand, the peronists counted with the vote of its large and faithful popular base. The painful consequences of the hyperinflation, whose impact affected the lowest-income sectors of the population more severely, strengthened the opposition party. Menem was elected with 47% of the votes against the official candidate's 32%.

Following the elections, the persistence of macroeconomic instability accelerated the political developments. President Alfonsín resigned and handed over the power to Menem five months earlier than had been established.

Menem's turnaround

On taking office, in July 1989, Menem made an unexpected politico-ideological turn. In open contradiction to the tradition of his party, he unreservedly embraced the tenets of a free market and an open economy, a reduced size and economic role of the state and the redefinition of Argentina's position in the international arena. The country withdrew from the group of non-aligned countries and adopted a position of alignment with the United States.

Given the discourse and the ideas that the new president had held in the recent past, it was essential that he take very clear actions to make credible this

[5] On the business sector and politics, see Acuña (1995).

turnaround. Therefore, one of the first signals was to designate a representative of a transnational conglomerate of Argentine origin, Bunge y Born, as Minister of Economy. Additionally, the government incorporated into the administration officials and advisors from such right-wing liberal sectors as the Unión de Centro Democrático, a party with certain electoral weight, particularly in the City of Buenos Aires.

The participation of businesspeople in the Ministry of Economy had been characteristic of previous peronist governments. However, in the past they had been related to associations like the Confederación General Económica -CGE- that were mainly rooted in small- and medium-sized national enterprises and often exhibited a political behavior conflicting with the more powerful economic groups. This participation had given rise to a strong interaction between the peronist trade unions, the government and the national representatives of the business sector, forming a tripartite scheme of exercising power.

The design established in 1989 proved to be substantially different. Not only was the naming of a representative from the transnational group of Bunge y Born to lead the economic policy a clear break with the past, but the trade unions were also to play a far less significant role. In this way, there was no room for the re-articulation of the old tripartite scheme.[6]

The new government's alliance with leading representatives of the business sector and the adoption of a plain market-friendly discourse were surely motivated by the need to accumulate political capital before the threat of ungovernability which resulted from macroeconomic instability.

It is quite clear that the reformist discourse was, at that time, completely subordinated to the urgent problem of stabilization. In fact, stabilization was a pre-condition to governability. In this framework, the manifest decision to go ahead with privatization and trade opening was intended as a signal to modify the expectations of economic agents and regain the support of the multilateral organizations. This aspect was more important than any microeconomic effect that the reforms could have had.

However, macroeconomic instability was to persist well into 1991. In truth, during the first two years of his administration, Menem's government could not define a coherent approach to stabilization and advancements were interrupted by reversals. Policy changes were frequent. Nonetheless, the basic market-friendly guidelines adopted from the beginning were confirmed over and over.

A second hyperinflationary episode occurred in early 1990 and a new run against the domestic currency in early 1991 closed this phase.

During this first period, the persistence of macroeconomic instability eroded the popularity of the government, as was reflected in public-opinion surveys[7].

It was in this initial phase, however, that the first privatizations were completed. Some progress was made regarding fiscal adjustment, strictly limiting public expenditures to current resources, which, in turn, created such problems as arrears in payments to suppliers. Trade opening was deepened and the legal and political foundations for the later reform process were established. The government thus began to show its first achievements with respect to reforms, although privatizations at this stage were not precisely "tidy," and suspicions of corruption were raised.

Accumulating political power

These advancements following the novel government agenda were made possible by the consistent and successful strategy to accumulate power that Menem implemented from the beginning.

On the one hand, the Executive obtained the approval of important legal instruments like the above-mentioned Economic Emergency and Reform of the State Laws. These and other norms were easily passed in Parliament. The peronists counted with majority in the Senate and were also the leading force in the House of Deputies but without having the majority. Besides, the Executive benefited from the

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[6] See the chapter on Argentina in Smith, Acuña and Gamarra (1994).

[7] In August 1990, only a year after taking office, the positive opinions on Menem's performance had dropped from 85% (in July 1989) to 57%. The positive opinions on the economic plan fell from 59% to 33% in the same period. Source: National public-opinion survey, Estudio Mora y Araujo, Noguera y Asociados, in Gerchunoff and Torre (1996).

commitment of the weakened Radical Party not to block economic policy measures during the economic emergency. Additionally, the government secured the support of right-wing parties, like the Unión de Centro Democrático, and of several provincial parties. Actually, the Executive sometimes found it more difficult to get the support of the peronist representatives in the parliament than to bring some non-peronists over to its positions. But Menem managed to gain tight control over the Peronist Party and progressively consolidated his leadership, aligning all internal political groups, with minor exceptions, behind him.

Even so, whenever obstacles or delays arose in the parliamentary treatment of a bill, the government resorted to decrees of "need and urgency" to resolve expeditiously issues that the Constitution reserves for the legislative power.[8]

In order to avoid difficulties arising from the possible unconstitutional character of some of these decrees, as well as from certain aspects of the privatization process, among other potential problems, Menem's government proposed and won parliamentary approval to increase the number of Supreme Court Justices from 5 to 9. These new members were selected from among the judges with a political affinity with the government.

This led to a clear public perception that the Judicial Power was subordinated to the Executive, conflicting with the constitutionally designed balance of power. Despite this significant concentration of power and the consequent impairment to the quality of the democratic institutions, the government could still benefit from an image of efficacy, at least among some sectors of the population.

Before the resistance that some of the reforms generated in the business sectors and among the trade unions, the government followed strategies involving confrontation, as well as negotiation and compromises. The privatizations, in particular, gave ample room to sketch out "compensating" mechanisms.

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[8] The Constitution empowers the Executive to issue this kind of decree, but under very special circumstances. They had been used around twenty times by constitutional governments between 1853 and 1983 (the year Alfonsín took office). Alfonsín resorted to decrees of need and urgency some ten times. In marked contrast, Menem's government dictated 244 such decrees between the beginning of his first term and late 1992. He has since made use of this mechanism several times. See the chapter on Argentina in Smith, Acuña and Gamarra (1994).

Among the sectors who were negatively affected by the trade opening and the reduction of the state were, for example, several national conglomerates that had expanded in the past by benefiting from the industrial promotion regimes and that held privileged positions as state suppliers. These groups, however, had an outstanding participation in many important privatizations. One way in which they were able to access new privileged positions was by taking advantage of the transformation of some state monopolies into private ones.

Several trade unions could also gain a foothold in new businesses. The railway union took part in the privatization of one of the railway lines, while the petroleum workers purchased part of the fleet of YPF ships and shares in firms supplying equipment, among other examples.[9]

At the beginning of Menem's presidency, a trade union sector that had already played a similar role under the radical administration was chosen to head the Ministry of Labor. Trade unions that sympathized with the government were also granted the administration of the "obras sociales," the health care system for workers that has traditionally been controlled by trade unions and has constituted an important source of resources and power.

With the support of this trade union sector that benefited from a participation in state affairs and closely tied to some business sectors, the government found itself on better footing to confront the unions that rejected Menem's neoliberal policies. The state workers were decidedly influential among the latter.

The successful strategy designed to neutralize the most contentious trade unions led to an early schism in the national organization of labor, the Confederación General del Trabajo -CGT, in October 1989. One side, favoring Menem's government, received state recognition, while the other became progressively isolated.[10]

Indeed, rather than generating resistance, some reforms served as disciplinary instruments to eliminate it. In early 1991, for example, the government reacted to a railway strike not only by declaring it illegal but also by closing down some of the lines

[9] See Murillo, V. (1994).

and by accelerating the privatization process.

As was mentioned above, the accumulation of political capital by the government was important to making the reforms viable. But the so-called post-hyperinflationary “consensus” should also be taken into consideration: the 1989 and 1990 episodes of extreme macroeconomic instability made the market-friendly policies more acceptable by instilling the idea that there was “no alternative” to a clear break with the old policy regime. The old style of state intervention and hyperinflation -with its consequences of economic disorder and social violence- were perceived as inseparable.

A successful stabilization attempt

As was explained earlier, a new phase was initiated in April 1991 with the launching of a successful stabilization plan, based on the unrestricted convertibility of the domestic currency. In this period, the privatization process was deepened.[11]

Since then, two main factors can explain the significant shift in the economic setting. One of them was internal: the launching of the stabilization plan. The external factor was a favorable change in the foreign financial markets, reflected in a drastic fall in interest rates. This process was followed by a major flow of funds from developed countries into a number of “emerging markets,” among which was Argentina.

Thanks to the availability of foreign resources Argentina could stabilize while witnessing a strong increase in aggregate demand and a deterioration in its current account. So, even if this phase was the follow-up of the deep crisis of 1989-90, it cannot precisely be called an “adjustment” period.

Moreover, on a fiscal level, neither did the price stabilization follow an

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[10] See the chapter on Argentina in Smith, Acuña and Gamarra (1994).

[11] If contrasted with what happened before 1992, the quality of the privatization process significantly improved afterwards. In a clearly more stable macroeconomic environment, the government could manage the new sells more carefully, particularly considering the definition of the regulatory frameworks that was necessary to trace out for the new-born private monopolies of public services. See Gerchunoff and Cánovas (1993).

"orthodox" path. The public accounts showed a deficit at the beginning of the convertibility plan. Yet, despite the several adjustment measures initially taken, no proper fiscal reform accompanied the stabilization program. Instead, there was a "permanent fiscal reform process" from the onset of the plan to date, which attempted to achieve the elusive target of fiscal balance. Certainly the fiscal accounts showed a major improvement in 1991-92 but this was mainly the result of the expansion in the activity level, as well as of betterments in tax collection, rather than of measures of fiscal adjustment. In truth, public expenditures also registered a sharp rise in that period. However, the rise in current income and the proceeds of privatizations more than compensated for that increase.

As will be shown below, the favorable effects of the strong economic expansion tended to offset, to some extent, the negative impact on the goods and labor markets resulting from the economic opening. In that way, the benefits of the new situation appeared to be far more generalized than the disadvantages and so tended to strengthen and consolidate the coalition that supported the government. In this context, the opposition lost ground and suffered several defeats.

The Tequila effect that followed the Mexican crisis in December 1994 marked another watershed in this period. Private capital flows became negative in the first half of 1995, the domestic interest rates rose, as well as the country-risk spread. A financial crisis and a recession ensued. Aggregate output declined by 4.6% in 1995 and the unemployment rate peaked to a historic maximum above 18% of the active population. In spite of the evident impairment in the economic scenario, the government won the October legislative elections that year. The stabilization program was felt to be in serious danger by the population. The peronist candidates insistently proclaimed that a victory of the opposition parties would signify a return to hyperinflation. In the previous period, many households -as well as firms- had benefited from an increased availability of credit. These liabilities were mostly denominated in dollars and were thus subject to exchange-rate risk. Therefore, fears of devaluation and a new hyperinflationary episode generated voter support for the official party once again.

A new milestone was the October 1997 legislative elections. As was mentioned earlier and differently from what had happened in 1995, a coalition of opposition forces defeated the official party by a significant margin on a national level. High levels of unemployment and the progressive deterioration in income distribution and poverty indicators may finally have had a strong influence on voter behavior, together with the perception that macroeconomic stability was not at risk.

3. Stabilization and reforms in the nineties: a Latin American perspective

Latin America has played a leading role in recent financial and commercial globalization processes. In addition to these processes and global trends, national experiences in the region show enough common stylized facts to constitute a Latin American case.

A most important common stylized fact was the drastic and sudden change in the international financial conditions. From the early eighties -specially after the Mexican moratorium in 1982- Latin American economies were subjected to a rationing of foreign credit and were conditioned to effect significant transfers to serve the debt. In this context, adjustment and stabilization were often conflicting targets. The recurrence of instability negatively affected output and employment trends. Transfers abroad reduced available resources for consumption and diminished investment even more. Some economies like Chile and Colombia managed to break this vicious circle in the mid-eighties and recovered a positive output trend with relatively moderate and stable inflation rates. In contrast, the largest economies in the region, Argentina, Brazil and Mexico, could not. Thus, it is not difficult to understand the stagnant trend of output, the contraction in productivity and employment, the fall in real wages, the increase in poverty and the worsening in income distribution that the region exhibited in the “lost decade.”

In contrast, the nineties brought a sudden change to a completely different financial environment: free access to market credit and significant capital inflows. Just as the 1982 Mexican moratorium symbolizes for Latin America the onset of the debt crisis and the closing of the access to voluntary foreign lending, the 1990 Mexican Brady agreement may symbolize the beginning of this new phase.

The Latin American countries reacted in different ways to the new conditions. The distinct national approaches and policies will not be analyzed here.[12] To the purpose of this paper, it is enough to say that in the new financial context LA countries initiated or deepened a major set of structural reform and stabilization policies. In fact, the most important regional feature in the nineties is the conjunction of stabilization policies and reforms with substantial capital inflows. The new policies, together with the new macroeconomic regime, produced multiple effects, some positive, others negative, on employment, the labor market and income distribution.

Stylized facts of economic processes and policies in the nineties

Let's recapitulate some of the most important stylized facts that LA economies generally exhibited in the nineties. The following list is not meant to be comprehensive. For instance, we have omitted the financial developments that were an important feature of the period. The selection made here intends to highlight those aspects of the recent economic evolution that have had a most clear and direct impact on employment.

-Growth recovery. The behavior of growth rates improved significantly in comparison with the eighties.

-Lower inflation rates. In high inflation countries (Argentina, Brazil, Mexico, Peru) the new conditions paved the way for -or consolidated- successful stabilization plans. In countries with moderate inflation rates (Colombia, Chile, Uruguay) there was a progressive decline in the rates.

[12] These issues have been examined in Frenkel (1995) and Damill, Fanelli and Frenkel (1996).

-Trade opening. Trade policy reforms were developed or completed; tariffs were reduced and non-tariff barriers on imports tended to be eliminated.

-Public deficit reduction. Public accounts showed improvements, partly because of lower inflation rates and increased output, partly because of tax and tax administration reforms, and partly as the result of cuts in public expenditures.

-Privatization. The sale of state-owned enterprises was important in some cases, given the amount of resources and the employment effects involved.

-Exchange-rate appreciation. Exchange rates appreciated significantly with respect to their levels in the late eighties. The intensity of this phenomenon differed across countries, depending on the initial levels of the real exchange rates (at the beginning of the nineties) and both the varying exchange-rate regimes and policies adopted regarding capital flows.

-A negative trade balance. Trade accounts deteriorated and became increasingly negative as a consequence of a sharp rise in imports, which covered a growing proportion of aggregate demand.

The above stylized facts cannot be exclusively attributed to either the changes in international financial conditions and capital inflows, or national policies in this context. As was stated earlier, these were the result of the articulation of the context and the policies and affected employment, poverty, income distribution and the labor market indicators in different and, at times, conflicting ways.

Positive and negative effects

No doubt higher activity levels and lower inflation rates have positive effects. A greater activity level means increased labor demand. On the other hand, a drop in inflation will have a positive influence on purchasing power, given the real wage. More generally, a decline in inflation will diminish the "inflationary tax" that falls mainly on the lower-income sectors. These positive effects have been particularly important in shock stabilizations, when the launching of the program is normally followed up by a strong recovery in demand and the activity level, a rise in labor demand and an improvement in the purchasing power of lower-income sectors.

However, other effects have a negative sign. Privatizations are usually followed or preceded by restructuring processes with significant reductions in the personnel. An analogous incidence occurs with adjustments in public expenditures on a national, provincial and municipal level. These habitually imply layoffs and wage cuts. Although they may not always be significant on a national level, they can be important in specific regions or segments of the labor market. These effects on employment and wages are once-and-for-all negative impacts. Their relevance in LA in the nineties has differed across countries.

Lastly, let's refer to the joint effects of trade opening and exchange-rate appreciation. Cuts in tariffs and the elimination of non-tariff barriers to trade aim to improve efficiency and increase productivity in the tradable sectors. This should be the result of both greater competition in the domestic goods market -as a consequence of increased imports- and the access of domestic firms to lower priced intermediate and capital goods of better quality. In any case, trade opening implies the crowding out of firms and employment in the less efficient areas of the tradable sector. In a simple version of the theory, these negative effects should be offset by the concurrent creation of employment in activities that become more competitive from gains in productivity. More elaborate versions recognize that there may be an initial phase of employment contraction and negative effects on income distribution that require a public policy response.

Beyond that, the fact is that in LA countries in the nineties trade opening was concomitant with the appreciation of the exchange rates.[13] As we will see below, this

[13] These circumstances contradict conventional wisdom on the kind of macroeconomic policies that must be implemented together with trade opening. Greater opening implies less protection for domestic activities. Consequently, given the real exchange rate, this would lead to an increase in the trade deficit.

factor further weakens competitiveness in existing activities and inhibits the incentives to develop either new export or import-substitution projects. It consequently accentuates the negative effects on employment and income distribution.[14]

The negative effects of trade opening with an appreciated real exchange rate

The behavior of labor demand for industrial production can be disaggregated into three components. The first, a positive one, originates in the growth in aggregate demand (domestic demand plus exports). The greater the increase in demand, the greater the effect will be on industrial output and employment.

Given the expansion in demand, a second and negative effect reflects the penetration of imports. The higher the proportion of aggregate demand covered by imports, the lower the level of domestic production and employment will be.

In the third place, the firms are induced to make a significant reduction in labor/output ratios. Two factors lie behind this: the need to become more competitive and the change in relative prices favoring imported inputs and capital goods. Productivity gains are the result of both changes in the composition of output (for example, the specialization in a fewer number of products with an increased use of imported inputs) and efficiency gains from reorganization and substitution of machinery for manpower.

In most Latin American countries in the nineties, these processes led to negative trends in industrial employment. That is, growth in the aggregate demand of industrial goods could not compensate for the negative factors: the direct crowding-out of domestic production of manufactured goods by imports and the fall in the labor/output ratio among surviving firms. It should be mentioned that small- and medium-sized enterprises have usually been the most affected. The closing of these kinds of firms had a marked impact on employment contraction.

Exchange-rate appreciation had a bearing on each of the three above factors

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To eliminate this undesired effect, standard theory on trade opening recommends a simultaneous depreciation in the real exchange rate.
[14] See Damill, Fanelli and Frenkel (1996), and Amadeo (1996).

explaining labor-demand behavior. Let's consider the first: the rate of growth of the aggregate demand of industrial goods. The appreciated exchange rate acts as a negative factor because it inhibits the increase in exports while limiting the growth rate of domestic demand. Trade and current account balances register a deficit and the income-elasticity of imports is high. The consequent external fragility tends to deepen dangerously when the economic recovery accelerates. Therefore, even if a crisis like Mexico's in late 1994 does not occur, the economies periodically face recessionary adjustments, like Argentina in 1995 and Brazil in 1995 and at present. From a long-run perspective, it can be said that the external fragility associated with an appreciated exchange rate acts as a constraint on the growth trend of potential output.

The negative role of the exchange rate appreciation is also clear with respect to the second component. Appreciation, together with trade opening, further reduces the competitiveness of domestic activities. Therefore, given the level of aggregate demand, the direct crowding-out effects of imports on domestic output and employment increase. Manufacturing activities that would be competitive at a higher real exchange rate are inhibited.

Finally, the negative effect of currency appreciation on employment is also evident in the third component: the microeconomic process reduction in the labor/output ratio. An appreciated exchange rate exaggerates the incentives to reduce that ratio at the level of the firm, additionally diminishing the price of imported inputs and machinery relative to manpower.

The stabilization and reform cycle

All of the above effects, both positive and negative, can be observed to a greater or lesser degree throughout the region in the nineties. The size and the sign of the aggregate effects depend on their relative intensity. For example, the Chilean economy is one of the few cases in which the positive effects offset the negative ones. Thus, a high growth rate occurred together with stable unemployment rate and income distribution, while poverty levels went down.

On the other hand, the time trends of aggregate employment and income distribution also depend on how fast the different processes develop. If the positive effects are swift and intense at the beginning and the negative ones are slow and persistent, their combination can give rise to a cycle, with a first phase in which the positive effects dominate and a second phase in which the contrary happens. The Colombian economy, for example, exhibited this sequence in the nineties without having experienced a shock stabilization policy.

A particularly relevant case, considering the relative size of the countries involved, was that of Argentina, Brazil and Mexico. This case involves the macroeconomic dynamics that a shock stabilization with an exchange-rate nominal anchor generates when the program, more or less simultaneously, includes a trade opening, privatization and a fiscal adjustment. These experiences presented a cyclical pattern of employment and incomes with an initial period where the positive effects of both the economic recovery and the lower inflation rate have been dominant. In a second phase the latter lost strength and the negative effects resulting mainly from the conjunction of trade opening and currency appreciation tended to predominate.

The macroeconomic setting following the expansionary phase of the early nineties

Three main features characterize the macroeconomic setting resulting from the process of economic opening with exchange rate appreciation. They are the fragility of growth, high unemployment levels and an increased disparity in income distribution. External fragility implies difficulties in sustaining high growth rates without the danger of an external crisis. It forces the economy to follow a low-growth path, which in itself limits job creation. Behind external fragility lies a low international competitiveness of domestic activities. The aggregate competitiveness did not rise in the nineties despite major gains observed in labor productivity, because the relative prices changed in a way that neutralized its effects.[15] The third characteristic is mainly the consequence of the first two. A high unemployment rate in itself and the pressure it exerts to lower wages give rise to a greater inequality in income distribution.

4. Stabilization and reform in Argentina

The Argentine experience in the nineties is quite germane to the Latin American case that was described above in a stylized way. The observed changes in the macroeconomic performance were dominated by the favorable effects of stabilization and capital inflow in the first years of the decade. Regarding the reforms, the most notable effects have been those which can be attributed to the combination of trade and financial opening with currency appreciation. The cycle can clearly be seen in the evolution of employment and poverty indicators. This section presents some of these results.

Macroeconomic dynamics

It is useful to look at Argentina's economic dynamics in the nineties from a wider perspective. Graph 1 shows the evolution of the seasonally adjusted GDP in the eighties and nineties. GDP in the eighties showed cyclical ups and downs around a stagnant trend. The last recessionary phase in those years, associated with the acceleration in inflation and the hyperinflationary episodes in 1989 and early 1990, led the economy to a lower activity level than in prior recessions. So, in the first semester of 1990 aggregate output hit a cyclical and historic minimum. Although the end of hyperinflation in March 1990 led to a positive trend in the activity level from then on, in early 1991, a year and a half after Menem took office, aggregate output was still below the stagnant trend of the previous years.

[15] For data elaborated with similar methodology for several countries, see Tokman and Martínez (1997).

The stabilizing shock of the Convertibility Plan was implemented in April 1991. The launching of the program was followed by a strong expansion that can be seen in the graph. Econometric tests on the log series of GDP show a modification in the structure of its trend in the second quarter of that year. The HP filter in the graph indicates GDP’s new growth trend in the nineties. This new trend implies an annual growth rate of 4.7%.

The graph also presents the recessionary and recovery phases associated with the Tequila effect in early 1995. The most significant fall in GDP occurred in the second quarter of 1995 and the recessionary bottom was hit in the third quarter. Although the signaling effect of the Mexican crisis is clear, it must be observed that the series shows a striking deceleration in GDP before that crisis, from the third quarter in 1994, associated with the increase in the interest rates in the United States, the retraction of capital flows and the consequent stagnation of monetary aggregates and foreign asset holdings in the Central Bank.

The highest activity level during the first expansionary phase in the nineties took place in the second quarter of 1994. Between the first quarter of 1990 and the second quarter of 1994 aggregate output grew by an accumulated 47.6%. With the recovery of the activity level, in the second semester of 1996 GDP returned to the level it had registered in the second quarter of 1994.

Stabilization

The Convertibility Plan proved to be a powerful anti-inflationary policy. Argentina currently has the lowest rate of inflation in Latin America and ranks among the lowest in the world. Success is even more impressive when it is contrasted with the country’s previous inflationary experience. In only two of the fifteen preceding calendar years was the percentage rate of inflation less than three digits and it was never below 80%. The shock was preceded (under Menem's administration) by twelve months of a monetarist anti-inflationary policy with a floating exchange rate regime between April 1990 and March 1991. The failure of this policy was reflected in a 287% rise in consumer prices in that period. In addition to high inflation, the period exhibited high real interest rates, the appreciation of the exchange rate, and a recessive trend. The Convertibility Plan inherited from this previous experience the appreciated exchange rate prevailing at the moment in which the shock was implemented.

The shock fixed the exchange rate and Congress quickly made the measure a law. It must be kept in mind that, as was already mentioned, stabilization took place together with a strong expansion in demand, in the product, in money, and in credit - which continued for the following three years. So, it is doubtless that the anti-inflationary effect can be attributed to the anchor provided by the exchange rate.

The case stands out from other analogous experiences for the magnitude of the expansionary effects and for the length of the expansionary phase. During the 1991-94 period, the money supply, bank deposits, and domestic credit multiplied five-fold. Two specific conditions can explain these accentuated and prolonged effects. On the one hand is the domestic situation at the beginning of the program. The economy had already been exhibiting a recessionary trend since 1988 and in 1990 the activity level was extremely low. In addition, as a result of the prolonged high inflation experience and the recent hyperinflation episodes, the monetization level and the availability of credit were extraordinarily low. The initial domestic conditions combined, on the other hand, with the new international financial conditions in the nineties. Capital inflows amounted to forty billion dollars between 1991 and 1994. These capital inflows constituted the main factor for the growth in reserves, money supply, bank deposits, and credit. The high ratio between the magnitude of the capital inflows and the reduced initial level of these stocks explains the high financial expansion rate mentioned above. There is little doubt that this was the principal factor in the abrupt expansion in demand. Its intensity displaced the importance of other expansionary effects generally present in the shock stabilization programs to a secondary order.

In contrast with the features of the expansionary effects, the post-shock inflationary dynamics shows no major difference from that observed in similar shock stabilization experiences. This characteristic calls attention to two points of view. First, the fact that the exchange rate was fixed by law in order to raise credibility does not seem to have endowed the measure with a greater capacity to "anchor" prices than in other experiences: the "residual" inflation of consumer prices was not significantly lower. And second, the "residual" inflation did not turn out to be very much greater than in other analogous experiences despite the striking magnitude of the expansionary effects.

As from the impact effect mentioned earlier, the inflation rate of consumer prices showed a gradual decline. The path of the inflation rate can well be modeled as the weighted average of two terms: the past inflation rate (inertia) and the rate of the variation in the exchange rate (zero) plus the international inflation rate. The length of the period of fixed exchange rate explains the convergence observed in domestic inflation with the international rate. It can be said that convergence was reached in 1994 when the inflation rate was 3.9%, precisely at the end of the expansionary phase. At that time, consumer prices had risen approximately 60% as from the beginning of the program. Some considerations must be added in analyzing the effects of the accumulated exchange rate appreciation on the competitiveness of the economy. However, there is no doubt that the process produced a significant appreciation. This was generated both by the appreciation trend and by the real exchange rate found at the launching of the program, which was already believed to be appreciated.[16]

Two other aspects of the behavior of prices under the Convertibility Plan should be mentioned. In the first place, the measures adopted to de-index wages - a law prohibiting the indexation of wage contracts and active pressure by the Labor Ministry to reinforce it - were more effective than in other cases, but only during the first year. The average manufacturing real wage fell by about 15% as from the launching of the program, though practically the totality of the fall occurred in the first

[16] The initial real exchange rate of the program was believed to be appreciated not only by independent analysts but also by the government itself. At the time the program was implemented, the authorities estimated that the correct real exchange rate for stabilization had to be similar to the average observed in the second quarter of 1990, immediately following the second hyperinflationary episode. The authorities announced that this "equilibrium" level of the real exchange rate would soon be reached via the deflation of domestic prices.

year. The real wage showed a slight rise in the following years and was slightly reduced during the recessionary phase in 1995. The 1996 manufacturing sector average real wage was 3% higher than the 1991 average, but 23% lower than the 1990 and the 1986-90 average real wages.

The other important aspect is that the wholesale prices of manufactured goods were completely anchored by the fixed exchange rate. During the period the program was in force these prices increased by 21%, a figure similar to the wholesale USA prices inflation in the same period. Although the program implemented some measures regulating prices, by reaching agreements with some manufacturing sectors, the effect on industrial prices must be attributed mainly to the trade liberalization shock implemented together with the fixing of the exchange rate.

The fixed exchange rate

Fixing the exchange rate is an essential element in stabilizing high inflation economies. A general lesson from these processes is that the exchange-rate policy must, at a certain moment, handle the problem of the transition to a more flexible policy, with a focus on the real exchange rate. This is required to achieve the targets of employment and growth, as well as a sustainable balance in the external sector. Ideally, the initial real exchange rate of a stabilization program could be set at such a depreciated level that the later appreciation would result in a sustainable real rate from a macroeconomic perspective, and appropriate from a long-term growth perspective. In this way, the transition could be achieved without hampering stability. However, the formula is nothing more than a theoretical exercise because the experiences of stabilization policies generally show that the real exchange rate at the launching of the program can hardly be chosen, as the Convertibility Plan so eloquently illustrated.

The exchange-rate policy transition was not faced in Argentina in the early nineties when the context was more favorable. The context involved, on the one hand, the conditions of the international financial markets and capital flows and, on the other hand, domestic conditions. Obviously, the higher the accumulated external deficit, the more difficult the transition is. If this imbalance is large, the change in the exchange-rate policy target will tend to generate expectations of a huge devaluation with self-fulfilling destabilizing effects in the financial and foreign currency markets, as the Mexican crisis exemplified. Needless to say, the highest costs and risks of the change in the exchange-rate policy have to be faced when this is attempted in an extremely critical situation and is perceived as a last resort. Even under more favorable circumstances, the government generally has incentives to delay the transition. The benefits are less clear and long run, while the costs have to be faced in the short term. In this respect, it seems reasonable to suppose that the loss of credibility caused by the modification in the exchange rate policy -and more generally, in any commitment to a policy rule- is inversely related to the rigidity of the commitment.

The circumstances that make an exchange-rate policy transition particularly difficult in Argentina do not lie exclusively in the rigidity of the commitment. It is argued that the extended period of high inflation and the hyperinflationary outbursts led to an apparently irreversible dollarization in prices (a complete indexation of domestic prices to the dollar). As a consequence, any attempt to bring about a real devaluation would lead to hyperinflation. The point is impossible to test without making the experiment, but it should be pointed out that the marked variability of the real exchange rate, not only during hyperinflation but also in the following years, does not endorse such an argument.

Although the dollarization of some prices and contracts poses major challenges to the exchange-rate policy transition, the greatest difficulty seems to be in the partial dollarization of the financial system. Roughly one half of bank assets and liabilities are dollar-denominated. Although one of the convertibility plan's explicit targets was to reestablish the basic functions of the domestic currency, the economic authorities did nothing to offset the tendency to dollarization because the financial deregulation included the free election of the currency denomination in any kind of contract. This was part of the Convertibility Law. Supposedly this would contribute to a growing domestic financial intermediation. Moreover, the Central Bank adopted several measures to facilitate the dollarization of bank portfolios. As a consequence of the progressive dollarization of bank deposits, most of the consumption and mortgage credit expansion observed as from 1991 was denominated in dollars. Instead, wages and other debtor incomes are denominated in the domestic currency. The banks encouraged this tendency because in this way each financial intermediary was able to attenuate its own exposure to exchange-rate risk, but this, then, became a systemic risk. Banks do not assume individually the exchange-rate risk but become vulnerable as this develops into credit risk.

Investment behavior

The succession of adjustment waves in the eighties brought about a progressive fall in investment rates. In 1990 the rate of investment hit a historic minimum of 13.2% of GDP. In the expansionary period of 1991-94 it tended to grow steadily, but from a very depressed level. Therefore, the average investment rate of the 1991-95 period was higher than its level in 1986-90 by only one percentage point of GDP and was lower than the observed value in the first half of the eighties by three points of GDP. The highest annual investment rate in the expansionary period, registered in 1994, is comparable to the average of the first half of the "lost decade."

From a long-run perspective, the most remarkable fact of the nineties, if compared to the eighties, was the re-establishment of a positive growth trend. However, the cyclical pattern of the nineties has not differed substantially from the spasmodic path observed in the eighties. An econometric analysis of investment behavior in both decades suggests that the dynamics of investment have not experienced a significant change in the recent period. The stability of the investment function suggests that the strong dependence of this variable on the behavior of aggregate demand remained unchanged. On the other hand, although there is no available information regarding the composition of investment by productive sector, there exists some evidence -e.g. the composition of capital goods imports by sector- that shows that the composition of investment had a bias toward nontradable sectors, as was reasonable to expect given the evolution of relative prices.

The links between investment, consumption and foreign savings

The rationing of foreign credit was a severe constraint on investment and consumption expansion in the eighties. This period was characterized by the generation of significant trade surpluses to serve the debt. Consequently, domestic demand was systematically lower than output. Both aggregate and per-capita consumption levels fell following the path of per-capita output, but consumption declined at a lower rate than output, causing the consumption share in GDP to rise.

The macroeconomic scenario showed an important shift in the nineties: the prior systematic trade surplus turned into a deficit. Therefore, the “domestic demand/GDP” ratio increased. Between 1986-90 and 1991-95 this ratio rose by about 5 percentage points of GDP on average. The increased availability of resources mainly fostered consumption. Virtually all of this increment in the “domestic demand/GDP” ratio between 1986-90 and 1991-95 can be attributed to the jump in consumption. In this way, despite the sharp change in the conditions observed in the nineties, the declining trend of aggregate savings that had been observed in the eighties was not reversed. On the contrary, but for different reasons, the previous positive trend of the consumption ratio continued into the nineties and did not decline during the 1995 recession. The average savings rate in the nineties -the difference between GDP and consumption- fell below its 1986-90 level by 4 percentage points of GDP, and remained 7 percentage points of GDP below the values in the first half of the eighties.

In the nineties, consumption rates seem to be uncorrelated with output behavior and can be associated with other features of the model, particularly the new financial structure of the economy and the set of relative prices resulting form the trade opening with real exchange rate appreciation. The jump in consumption rates reestablishes the foreign-resource constraint on growth because it leads to a somewhat less rigid connection between investment and foreign savings.

External sector sustainability

The foreign savings rate followed a sustained growth path as from 1991, peaking in 1994 (between 4 and 5 % of GDP). The 1995 crisis proved that the conditions of the foreign financial markets that lay behind that feature were not sustainable on a permanent basis. In 1995-96 foreign savings was between 2 and 3 percentage points of GDP. In the recovery that followed the post-Tequila recession the deficit in the current account has climbed systematically, reaching 3 to 4 percentage points of GDP in 1997.

The current account deficit tends to soar when growth rates accelerate. This is mainly the consequence of a significant response of imports to output (the income-elasticity of imports surpasses a value of 3). The sustainability of the external sector can be explored by simulating the trend of the current account deficit under different assumptions regarding economic growth. Thus, assuming that exports keep growing at the average annual rate observed so far in the nineties (11%), on the one hand, and considering the above-mentioned elasticity of imports, on the other, it can be concluded that the growth trend observed in the nineties (4.7% a year) is not sustainable. With these parameters, the "current account deficit to exports", "current account deficit to GDP" and "foreign debt to GDP" ratios, for instance, tend to grow explosively.

The employment cycle in the nineties

A cyclical behavior of employment can clearly be observed in Argentina in the nineties. The following analysis will focus on employment categories, expressed in percentage points (pp) of the population.[17]

The graphs included in Figures 1 and 2 show some of these variables. Dates refer to the moment each survey was made and coincide approximately with the

[17] The data discussed in this section come from a survey of urban households that is made twice a year by the national statistics bureau (Encuesta Permanente de Hogares, Instituto de Estadística y Censos -INDEC).

middle of either the first or the second semester of each year.

The first graph in Figure 1 shows the aggregate employment rate. The first striking observation is the existence of a cycle which peaks in 1993:1, well before the end of the expansionary phase of output. The disaggregation by employment categories -as shown in the other graphs in Figure 1- evidence more clearly the main features of this cycle. Full-time employment (over 35 hours a week) is the main component of total employment and also depicts a cycle whose contractionary phase leads to a floor that is clearly below the prior minimum in 1990:1. The maximum of the full-time job series was reached in 1991:2. The series of voluntary underemployment (those who work less than 35 hours a week, but choose not to work more) shows a cycle that is analogous to full-time employment, with a peak in 1992:2. Employment figures include the set of involuntarily underemployed people (those who work less than 35 hours a week and would like to work more). The proportion of the involuntarily underemployed in the population shows a counter-cyclical pattern. The series tends to fall slightly until 1991:2, when it renews growth.

Two other disaggregations of aggregate employment are presented in Figure 2: by gender in the two upper graphs, and by position in household (head or secondary worker) in the lower part of the figure. It can be seen that male and head of household employment have a pattern that is similar to full-time jobs (with a peak in 1991:2), while the series of women's and secondary workers' employment behave as total employment does.

Employment variations in the cycle

We will now focus on the variations in employment evidenced in the graphs and in their disaggregation by productive sector. In the expansionary phase, until the second semester of 1992, total employment grew by 1.7 pp against its level in the first semester of 1990 (when the economy was at the bottom of a dramatic recession). Less than one third of this increase is explained by net job creation in the manufacturing sector. More than one half of the rise originated in employment increases in construction and the commercial sector. The employment rate of heads of household showed no increase. The rise involved mainly secondary workers with a slightly higher proportion of women. In this period the percentage of involuntary underemployed declined across all activity sectors.

The employment rate has gone down since 1993. Between its maximum and the second semester of 1996 it fell by 2.4 pp. Full-time jobs and voluntary underemployment declined by 3.8 pp and 2 pp, respectively. So, the aggregate of both categories dropped by 5.8 pp. Obviously, the fall in aggregate employment is not so great because the group of involuntarily underemployed increased its participation in total population by 3.2 pp in the same period.

About 75% of the contraction in full-time employment in this phase is explained by job losses in the manufacturing sector and mainly involved men and heads of household. As can be seen, this explains most of the process. Jobs in construction and the commercial sector also declined with a similar pattern -by categories- than was observed in the manufactures. A fall was also observed in “other services” where the contraction almost exclusively involved women and secondary workers. Taken together, the sectors that show a decline in the number of jobs total a 5 pp drop. The only rise was observed in full-time jobs in the financial sector and in communications and transportation with an equal distribution by gender and position in household. In brief, the most remarkable features of the employment contraction phase are: 75% of this fall originated in the manufacturing sector; two thirds of the drop involved male workers; and more than half of job losses involved heads of household.

As was mentioned above, employment contraction in the nineties appear to have been attenuated in the series of total employment by the increase in the number of involuntarily underemployed workers registered by the surveys. Half of the rise in this category is concentrated in “other services,” and mainly involves women and secondary workers. The other half is distributed across all activity sectors.

The above figures make the social consequences of the fall in employment rates more understandable and provide clear indications of the origin of the phenomenon. Employment contraction was mostly concentrated in the manufacturing sector. To a lesser extent, jobs also showed a negative evolution in construction and the commercial sector. On the other hand, several sectors that include transportation and communication activities, electricity, financial intermediation, and water and sewage showed a better performance regarding job creation. These sectors were among those most affected by privatization and deregulation. Therefore, the employment problems should be explained more as the consequence of restructuring and concentration in the manufactures than as an outcome of the reforms in the public sector.

Poverty and income-distribution indicators and the cycle

A cyclical pattern can be also observed in both the poverty and income-distribution indicators, which showed an improvement in the early nineties and a negative trend later on. The proportion of households in Greater Buenos Aires whose income was below the official poverty line was 16.4% in the second semester of 1991. The proportion dropped to 14.2% in the second semester of 1994 and then rose to 20.1% in the second semester of 1996, as shown in INDEC's survey. If the poverty index is calculated as a proportion of the population -instead of households- the levels come to be 21.8%, 19 % and 27.8% in the same periods. Similar trends are obtained with different adjustments in poverty indicators.

An analogous fluctuation is evident in the evolution of income distribution by households, considering per-capita income. In 1991, 50% of the households in the lowest-income categories perceived 24.6 of total income -in the survey. This proportion increased to 25.1% in 1994 and decreased to 24% in 1996.

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