POLICIES TO REDUCE INSTABILITY

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RESUMEN

La actual política de estabilización adoptada por muchos países latinoamericanos exige una política monetaria restrictiva aunada a una política fiscal conservadora. Aunque estas políticas han sido adaptadas para aliviar fragilidades financieras, no han sido capaces de mejorar significativamente los niveles de pobreza y desempleo estructurales, lo cual hace que el enfoque sea vulnerable a riesgos políticos. Mediante el estudio del caso de Argentina, este trabajo argumenta que la presencia de estos riesgos obliga al gobierno a adoptar un heterodoxo, ecléctico y muy flexible sistema de formulación de políticas que puede maximizar sus posibilidades de lograr objetivos sociales de largo plazo.

PALABRAS CLAVE: Inestabilidad financiera, contagio, política monetaria y fiscal, riesgo político, formulación heterodoxa de políticas.
CLASIFICACIÓN JEL: E61, E62, E63, E65.

ABSTRACT

The current stabilization policy adopted by many Latin American countries demands a restrictive monetary policy coupled with a conservative fiscal policy. While these policies have been adapted to suture financial fragilities, they have not been able to significantly improve the levels of structural poverty and unemployment, rendering the approach vulnerable to political risk. By exploring the case of Argentina, this paper argues that the presence of such risk forces the government to adopt a heterodox, eclectic and very flexible approach to policy formation that may maximize its chances to achieve long term social objectives.

PALABRAS CLAVE: Financial instability, contagion, monetary and fiscal policy, political risk, heterodox policy formation.
JEL CLASIFICATION: E61, E62, E63, E65.

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There is little doubt that emerging economies are vulnerable to global economic fluctuations. In the last week of May, 2006, rumors doubting the degree of commitment of the then recently appointed Chairman of the Federal Reserve System of the United States, Ben Bernanke, to keep inflation at bay, as his predecessor Alan Greenspan had, coupled with the uncertainty generated by the designation of Henry Paulson as the new Treasury Secretary, were enough to send a ripple of fear through the channels of the global financial system that were felt in stock markets across the world.

In Latin America, analysts were busy trying to explain why the repercussions were different among neighbors. Some countries experienced a mild shock mitigated by timely monetary intervention, while others were less able to cushion the blow. For example, while on May 30, 2006, the Dow Jones fell by 1.63%, Argentina's index fell by 3.53%, Mexico's by 3.38%, and Brazil's by 4.54%.[1] All and all, however, the impact, compared to previous shocks, was mild. Various analysts argued that most countries in Latin America today have been able to accumulate enough reserves to absorb mild exogenous changes. They also argue that a solid financial position, with twin surpluses, low inflation, growing economies and increasing levels of investment were, along with capital controls and a healthier debt structure, significant factors to protect the real economy when the funds began to flow out during the last week of May. However, further uncertainty during May and June led to a fall of 18.9% in the stock market in Turkey, 14.6% in India, 13.9% in Brazil, 10.7% in Mexico, 10% in Argentina and 6.3% in Chile.[2]

[1] Clarin.com, "Temor en la City: caen la Bolsa y los bonos, y el Central frenó el dólar," May 31, 2006, at www.clarin.com

[2] Clarin.com, "El mal clima financiero le costó 1.100 millones de dólares al país," July 13, 2006, at www.clarin.com.

Exogenous shocks give rise to financial instability which may contribute to derail the development program of a government. And while, according to Schinasi (2004, p. 3-8) "…there is no single, widely accepted and used definition of financial stability", he argues that "[a] financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events." According to Mishkin (1999, p. 6) "…[f]inancial instability occurs when shocks to the financial system interfere with information flows so that the financial system can no longer do its job of channeling funds to those with productive investment opportunities". But, in a broader sense, financial stability implies monetary stability, employment levels close to the natural rate, confidence in the operation of key institutions and markets, and stable relative prices of real and financial assets (Foot, 2003).

However, exogenous shocks are just one of the problems facing emerging economies, where a certain degree of monetary and fiscal policy autonomy is needed to address the pervasive and often chronic problems of unemployment and poverty. Hall and Taylor (2002) argue that "[d]omestic policy –particularly the scope for adjustment to shocks through fiscal, monetary and exchange rate polices– can also influence the impact of transmitted shocks. For example, active and pre-emptive policy responses appear to have had a material impact in reducing spillovers in some countries in previous EME crises," (p. 129).

Hence, governments that attempt to reduce external vulnerability may have to give up certain policy autonomy whereby social objectives and financial stability may mutually constrain each other within a multi-objective policy set. Shielding the economy from external risk may inhibit the attention to

domestic social problems, perhaps leading to greater political risk arising from social discontent.

With this problem in mind, this paper studies the case of Argentina. Its Central Bank has been implementing an anti-inflationary policy, while maintaining a devalued currency to promote exports and tourism, accumulating foreign reserves, sterilizing interventions, restructuring its public debt towards longer maturity terms, applying some capital controls and developing an anti-cyclical fund. Simultaneously, it has been trying to decrease unemployment and poverty, two variables upon which much of the program's credibility depends.

The main conclusion of this paper is that the political risk that may arise from relatively high levels of unemployment and poverty must be treated as any other risk factor. As such, the government's main objective should be to weigh all risk factors appropriately so that total risk is minimized or financial stability is maximized. Within this analytical framework, the paper argues that for any such policy to be successful over time it must pay close attention to the social welfare of all social classes, in particular that of the lower income groups. This requires a constant monitoring of the economy and an adaptive dynamic and eclectic approach to policy formation.

By setting the forthcoming analysis largely within the theoretical framework of macroeconomic financial stability and buttressing its development on the relevant empirical literature, this paper sits at the vortex of both and tries to contribute to the literature by exploiting the benefits afforded to case studies; an in depth analysis of a single economy whereby more effort can be dispensed to empirical details and subtle arguments. Hence, the paper contextualizes one of the central dilemmas of current monetary policy; its opportunity cost.

The paper proceeds by characterizing the mechanism for contagion. Then, it proposes various ways to conceptualize and

measure macroeconomic financial fragility. Next, it introduces some data from Argentina and discusses the various policies used to shield the country from shocks. The following section discusses political risk and introduces data on poverty and unemployment in Argentina to show why political risk is an important problem there. In the discussion section, the paper tries to characterize the main issues confronting Argentine policy-makers and proposes some policy guidelines. The last section summarizes the main points of the paper and suggests research extensions.

PROPAGATION CHANNELS

Changes in monetary and fiscal policy abroad, changes in expectations, unexpected political and social events, shocks to natural resources, natural disasters and other changes affecting economic variables, real and financial, will find their way into the economies of less developed countries, affecting them in various ways.

There are direct and indirect, or secondary, channels of transmission or contagion. For example, a restrictive monetary policy in the United States may induce greater capital outflows in, for example, Brazil and Argentina, as funds seek higher returns in dollar denominated deposits. This is the direct channel.

The secondary channels that have proven to be significant may be more complex to conceptualize because their profile depends on the following factors: the level of bilateral trade among the affected countries, the degree to which they share a common creditor or creditors, the degree in which they share common trade markets, and the exposure of investors to their economies (Hall and Taylor, 2002, p. 128-134; IMF, 2006, Ch. 3, p. 30-5).

De Alessi Gracio *et al.* (2005, p. 96-97) argue that the behavior of institutional investors contributes to propagate crises

as they are forced to sell some of their instruments in various markets to cover their margin calls, reduce their portfolios' risk or reduce the risk arising from their exposure to other markets when a crisis erupts in at least one market where investors are significantly exposed. The problem is further complicated by a combination of herd behavior and rational ignorance. When some of the largest investors, presumably better informed, begin to pull away from one market, the rest may follow without spending the effort to research the fundamentals, amplifying the effect of the shock in the original and connected markets. The momentum may be exacerbated by risk-averse managers whose remuneration is based on performance comparisons to other fund managers. Calvo and Mendoza (2000, p. 81) support these arguments, and Chui *et al*. (2004, p. 14) find that "(s)mall rumors can trigger herd behavior among investors, and shift an economy from a good equilibrium to a bad one, with large capital outflows unrelated to economic fundamentals."

Kaminsky *et al*. (2003, p. 56-72) provide empirical evidence from five crises, showing that common leveraged creditors play a significant role while propagation via trade links seems nonexistent. The data also shows that the degree of propagation depends on how markets were anticipating crisis episodes. Canova (2005, p. 231) also finds that the trade channel is not important but monetary policy in developed countries, a direct channel, is. Villar Frexedas and Vayá (2005, p. 15) and Van Rijckeghem and Weder (2001, p. 305) show, additionally, that the common lender factor is a significant propagation channel.

Contrary to other authors, Glick and Rose (1999, p. 604) argue that "...trade is an important channel for contagion, above and beyond macroeconomic influences. Countries who trade and compete with the targets of speculative attacks are themselves likely to be attacked."

As the literature suggests, emerging economies are exposed to the outside world via trade and financial markets. Both, particularly the latter, will develop new channels as the markets for commodities and securities evolve. By their own nature, as countries become more developed, these markets will offer more complex instruments and greater depth, allowing agents to trade greater risk. Presumably, then, these economies will have to enhance their monitoring efforts in an attempt to reduce the impact of future crises in order to support a stable path of economic development.

ASSESSING MACROECONOMIC FINANCIAL FRAGILITY

All countries are vulnerable to exogenous shocks. Emerging economies may be more vulnerable because their fundamental structures are, or may be perceived to be, weaker and their regulatory systems may lack some of the controls needed to deal with sudden capital flows. There are a series of economic variables that could be used to monitor the fundamental macroeconomic health of a country.

In the face of an exogenous shock, funds will tend to flow out faster from those countries perceived *ex-ante* to have a greater risk of collapsing and a longer period of recovery. The status of the current account, the government's budget, the level of employment, investment and saving, foreign currency reserves, anti-cyclical fund accumulation, the level and structure of public debt, the functioning of the financial regulatory institutions, the degree of enforceable capital control mechanisms and the political and social situation will be used by banks and non-bank financial institutions to gauge the reliability of the system at the time of the shock. Like a person who contracts a virus, the healthier the body, the shorter the time of recovery.

According to Hilbers *et al*. (2000, p. 53), "…data on aggregate and sectoral growth, trends in the balance of payments, the level and volatility of inflation, interest and exchange rates, the growth of credit, and changes in asset prices, especially stock and real state prices…", along with information regarding the vulnerability of the financial system and indicators of contagion and investor behavior, are all relevant macroeconomic indicators to asses the country's ability to cope with capital flow reversals and currency crises. The quality of regulatory institutions, including the legal infrastructure, should also be part of the analysis. And the authors add that "…[a]ssesments need to be based on a comprehensive set of indicators, taking into account the overall structure and economic situation of a country and its financial system" (p. 53-54).

Grabel (2003, p. 252-3 and 2004, p. 28-30) argues that an exogenous shock leading to a rapid devaluation of the domestic currency may have a significant effect on the ability of domestic borrowers to repay foreign-currency denominated debt. This, in turn, may amplify the initial effect of the shock, giving rise to a massive sell-off of assets as panic ensues and possibly promotes and amplifies the initial contagion effect. Hence, exposure to the risk of foreign currency fluctuations needs to be continuously assessed by the monetary authority.

The International Monetary Fund's Global Financial Stability Report introduces a series of variables to assess financial fragility: volatility measures, debt cross correlations, equity indexes, returns on bonds and global yield spreads, and other financial soundness indicators for emerging markets (2006, Statistical Appendix, p. 163-195).

SOME DATA FOR ARGENTINA[3]

This section presents a series of variables in an attempt to assess the financial vulnerability of the economy of Argentina.

Consumer prices increased from an annualized index of 3.7% in 2003 to 12.3% in 2005 and have remained stable within a range of between 9% and 12.3%. Monthly data to June, 2006, shows low monthly variations around 1%.

Gross domestic product, GDP, increased at an annual average rate of 9% between 2003 and 2005 and is expected to grow by around 7% in 2006. Consumption has been increasing at an average rate close to 8.5% of GDP and has remained stable. Investment has increased to about 21% of GDP and remained stable as well. The unemployment rate has been steadily decreasing, reaching about 10.1% and has stabilized by the end of 2005. Average capacity utilization has reached the 70% mark and has been stable for over a year. Both indexes measuring consumer and producer confidence have been stable for over a year as well.

The country's foreign debt has fallen from 128.6% of GDP in 2003 to 52.5% in the first quarter of 2006, while the government's budget surplus has increased from 2.3% of GDP in 2003 to 3.7% in 2005 and 3.6% as of May, 2006. Meanwhile, the current account surplus has decreased from 6.2% of GDP in 2003 to 2.4% in the first quarter of 2006, while the average for the period has been above 3% of GDP.

[3] Unless indicated otherwise data reported in this paper was obtained from official sources in Argentina, the Central Bank (http://www.bcra.gov.ar/) or the statistical division of the ministry of economics, INDEC (instituto nacional de estadísticas y censos, http://www.indec.mecon.ar/).

International reserves were 3.7% of GDP in 2003, 4.3% in 2004 and 5.2% in 2005. The implications of its use to stabilize currency fluctuations will be discussed below.

The Central Bank of Argentina has been implementing policies to gradually reduce the exposure of the financial sector to public sector debt. This exposure decreased by roughly half in two years, to an average of 27.7% of total assets of the entire financial system and 24.3% of total assets of private banks.

By law, starting in July, 2007, no bank can hold more than 35% of its assets in public debt, down from 40%. This will free up to about 12 billion pesos into the credit stream and will also reduce the exposure of the financial sector to foreign-currency denominated assets.[4] According to the Central Bank there has been a tendency in the financial sector to reduce its overall exposure to dollar-denominated instruments.

Data published by the Central Bank shows that the value of net assets for the entire financial system increased from about 22 billion pesos in 2003 to 29 billion pesos as of April, 2006, or about 31%. The return on assets grew from -2.9% of net assets, in 2003 to 1.5% in April 2006. Return on equity grew from -22.7% in 2003 to 11.1% in April, 2006. And the percentage of irregular accounts fell from 17.7% to 4.8% in the same period. These tendencies still hold even if the data is disaggregated into public and private institutions.

Data from the 2006 IMF Global Financial Stability Report shows that the equity market index in Argentina grew by 98.5% in 2003, 24.6% in 2004 and 59.7% in 2005, after exhibiting

[4] Clarin.com, "El central busca que los bancos den más crédito al sector privado," July 10, 2006. And Comunicado N° 48576 from Banco Central de la República Argentina, available at www.bcra.gov.ar.

negative growth in each of the three previous years. For the 2003-5 period, the global total returns index has been increasing and the global yield spread decreasing. This, in part, may be explained by the fact that the country has been restructuring its debt into longer terms, thereby reducing its risk factor (Chapter 3, p. 29-30). For the same period the bank regulatory capital to risk-weighted assets ratio has been increasing, the nonperforming loans to total loans ratio has been falling, and the bank provisions to nonperforming loans ratio has been increasing (Appendix, p. 163-195).

The information above suggests certain degree of macroeconomic stability. Inflation has increased since 2003 but remained stable, investment has increased and stabilized, and a corresponding picture emerges from the unemployment and capacity utilization figures. The twin surpluses, together with an increasing level of international reserves, depict an economy standing on more solid ground than four years ago, as the falling spreads and increasing stock market index suggest, although this is a short run position. That this is understood as such is partly supported by the reluctance of new investment to expand installed capacity.

The financial sector is reducing its exposure to the fluctuations of foreign currencies and is shifting its resources from the public to the private sector as well. The sector's assets have increased over time and it is becoming more profitable, while its asset composition is becoming more solid, sending a signal of some strength to current and potential investors. This stability, however, depends in a significant fashion on a relatively calm global economy. Hence, investors can see a firm commitment from the monetary authority to continue along the current policy path, but the imminence of external shocks may partly explain the resistance of direct investment to further expand industrial capacity.

POLICIES TO DEAL WITH EXOGENOUS SHOCKS

The importance of having an economy that seems to be in good shape or that, at least, is able to project an image of strength to the world has been established earlier in this paper as an important factor in shaping the expectations and, consequently, the behavior of economic actors, in particular institutional investors, in the face of an exogenous shock. Obviously, the government of Argentina is not only concerned with the cosmetic aspects of the model, as the fundamental variables do change partly in response to its workings rather than to intended manipulation.

Aside from reaping the benefits from window dressing, the government has engaged in various explicit policies in an attempt to isolate the economy from external changes. The accumulation of international reserves to defend the currency during periods of capital flight, along with the limited use of capital control tools, may have contributed to partly shield the economy from exogenous shocks. The Central Bank has also implemented a policy to change the structure of the public debt towards longer maturity, along with the emission of debt denominated in pesos in an attempt to decrease the exposure of public finances to currency fluctuations. For instance, Central Bank data (July, 2006) show that the average duration of government instruments has increased from about 250 to 370 days between April, 2005, and July, 2006, while over half of the stock exhibits maturity dates of at least one year and over 75% of the total stock has maturities of no less than 6 months.

Additionally, 10% of the public debt instruments are indexed by an inflation coefficient. The Central Bank has stopped their issuance and is retrieving them because the demand for other instruments without indexation can absorb the entire debt structure, a benefit from a stronger position and a greater external

risk appetite, thereby allowing the government to insulate future debt from price volatility.

The international reserves have increased from 14 million dollars in 2003 to more than 25 million as of June, 2006. These reserves have been used to maintain the value of the dollar stable within a band and these interventions have been sterilized in order to control the inflationary pressures from domestic currency emission. For example, during the first semester of 2006 the Central Bank sterilized 13 billion pesos, 65% of which was done with earlier cancellations of public instruments.

A problem arising from sterilization is the effect it might have on interest rates as the monetary authority offers successive instruments in the money market (Lee 1997, p. 1-2; Christensen 2004, p. 26). For example, the call money rate increased more than 300% since 2003, from 1.7% in 2003 to 6.7% in 2005 and 7% in June, 2006. Two public instruments increased 30% and 95% for the same period of time, while 30-day deposits earned an increase of 78%. Upward pressure is expected for 2006 and 2007 because the government has requested the Central Bank to meet future obligations with new emissions in order to maintain the current levels of reserves in an attempt to send signals of strength to market players.[5] Hence, sterilization may induce a sort of restraint on other economic indicators via its impact on the expansion of consumer and producer credit and may also induce additional capital inflows (Stiglitz 2002, p. 224). Sterilization also means that the central bank "...acquired low-yield foreign-exchange reserves and issued high-yield sterilization bonds" (Kaminsky 2005, p. 20), adding some extra cost to the

[5] Página 12, "Estrategia de pagar deuda sin merma de las reservas," July 26, 2006, http://www.pagina12.com.ar/diario/principal/index.html

policy. The spread between yields could be considered a social cost (Rodrik 2006, p. 2).

To deal with the destabilizing effects of short term capital inflows the government implemented a series of measures. One measure allows exporters to extend the time requirement to deposit their dollar earnings in the country. This would mitigate, to some extent the sterilizing effort during seasonal liquidations of primary commodities. Banks can also hold an additional 5% of their reserves in dollars. In addition, all speculative capital, of at least two million dollars per month, excluding purchases of public instruments, must remain in the country for a year while 30% of it will become a non-remunerated deposit that cannot be used for collateralization or any other purpose.[6] Similar measures were taken by Chile, Colombia and other countries (Williamson 1998, p. 66 and Ocampo 2005, p. 12-15). Capital controls also mitigate the effects of the externalities arising from financial instability (Stiglitz 2002, p. 230).

In order to increase the degree of liquidity in the private financial system the Central Bank has implemented a law allowing banks to offer improved incentives to longer fixed deposits. At present financial entities are allowed to offer 180 days fixed deposits with a variable interest but with a minimum assured rate and preferential rates for deposits above one million pesos.[7] Peso denominated fixed deposits of at least 180 days will no longer have to have reserves with the Central Bank.[8] This new credit structure is complemented by an increase in the reserve requirements on short term deposits, from 17% to 19%, and

[6] Resolución 365/2005 entitled Mercado Cambiario (foreign Exchange market), available at www.bcra.gov.ar.

[7] Comunicado (law) N° 48566, 6/27/2006.

[8] From Clarín.com, July 21, 2006, "El central modificó los encajes."

the elimination of interest yield to them, as well as to the excess liquidity from investment funds. In other words, it is a concerted effort to promote the reallocation of funds to productive uses by allowing for an increment in the reward for long term savings and simultaneously penalizing short term deposits. This increases the degree of liquidity, thereby diminishing, to some extent, the fragility of the system by allowing for better risk management within financial institutions.

As of August 2006, a plan to use local currencies to pay for bilateral trade flows between Argentina and Brazil was being contemplated as a first step towards the formation of a regional common currency. If successful, this may protect the region from future dollar fluctuations, depending on the initial conditions of each country at the time of the shock.[9]

In sum, the data suggests that Argentina's monetary authority is adopting a battery of measures, consistent with the current literature, to minimize the impact of exogenous shocks on the financial and, ultimately, the real sector of the economy. However, shocks could also be generated internally as a consequence of unstable socio-economic conditions leading to political instability. This source of risk is important and must be taken into consideration by policy-makers.

POLITICAL RISK

It is an accepted fact in the literature on financial risk that the political and social situation of a country is at least as important as the state of its finances. Lensink *et al*. (2002) find a robust correlation between political risk and capital flight. Kashiwase

[9] From Página 12, July 25, 2006, "Propuesta para borrar el dólar de las operaciones del MERCOSUR."

and Kodres (2005, p. 43) incorporate government stability, socioeconomic conditions, external conflict, internal conflict, corruption, military in politics, law and order and bureaucratic quality among the political risk-rating variables used in their regression analysis. Erb *et al*. (1996, 1999) include political risk in the analysis of bond spreads and Bilson *et al.* (2002, p. 1) argue that "…political risk is important in explaining return variation in individual emerging markets…" Along with the IMF's Global Financial Stability Report, the papers use the data provided by the Political Risk Services. Le and Zak (2006, p. 308) submit that "…political instability is the most important factor associated with capital flight."They also argue that political risk is captured by socio-political instability and regime change (p. 314). Both of these are pertinent factors in the case of Argentina. The former is affected by the levels of poverty and unemployment and the latter by the impending presidential election of 2008.

An unstable social situation, such as high unemployment and chronic poverty, may promote political instability leading to uncertainty about the government and its economic plan (Tokman 2003, p. 95-6; Holzmann and Jorgensen 1999, p. 22-3; Stiglitz 2003, p. 27-8). As analysts revise their risk factors, the speed and direction of capital flows may vary, thus affecting the real economy via changes in currencies and interest rates and amplifying the effect through the country-specific sentiment component. The length and gravity of the ensuing crises following a shock will depend on the initial economic and political conditions at the time of the shock, internal and external, and the history of the country.

Moreover, in Argentina chronic poverty levels and high unemployment and underemployment may give rise to political opposition leading to decreasing support from the more disadvantaged sectors of society. Hence, policies addressing

poverty and unemployment, above and beyond those that favor market-based incentives for direct investment, should become a *de facto* component of a complex set of policy measures within the larger framework of prudent risk management.

The next four sections attempt to explain in some detail the reasons behind the persistence of relatively high levels of unemployment and poverty in Argentina.

THE DATA ON POVERTY

In the first semester of 2005 about 38% of the total population and 28% of households were below the poverty line, while 13% and 10%, respectively, were below the indigent line. The numbers have been improving since the first semester of 2003, when 54% of the population was under the poverty line.

In the second semester of 2003, 63% of children below the age of 14 were poor and 30 % were indigent. The numbers were slightly lower for the 14 to 22 year old group. The data shows no difference by gender. By the first semester of 2005 these numbers had fallen to 55% and 22%, respectively. In the 23 to 64 age group, 32% are poor and 10% are indigent. By and large, poverty deals its strongest punch to the population below the age of 14.

In the second semester of 2004 an average of 4.5 people lived in poor households and 4.68 in indigent ones. On the average, poor households had 1.5 children below the age of 14, while indigent households had 1.79 children below that age. In other words, more children lived in indigent conditions. On the other hand, on the average, each household above the poverty line had only .5 children.

Between the second semester of 2003 and the first semester of 2004 the number of households below the poverty line fell by

3%. The same number repeats itself between the second semester and the first in 2004. In terms of individuals, the rate of poverty fell by 7% between the first and second semester of 2003, by 3.5% in the first semester of 2004 and by 4% in the second semester of 2004. In the first semester of 2005 the number falls by 1.7% for the entire country. However, the annual change for Buenos Aires, and surrounding areas, where about one third of the population lives, did not show an improvement.

Data on the socio-economic structure, and per capita income by household since May 2003 reveals that, aside from minor fluctuations, the top 10% of the population earned, roughly, 30% of national income and that the group of people who are below them and above the poverty line received about 52% of the pie. These numbers do not show a trend but rather exhibit minor fluctuations from one quarter to the next, suggesting that, in spite of the impressive growth rate of the economy, the ongoing policy of the current administration has not managed to alter in a significant fashion the underlying socio-economic structure that existed in 2003. Other data classifying income by individuals shows similar structural rigidity.

Data disaggregated by region yields a more revealing picture of the socioeconomic structure in the first quarter of 2005. While the average poverty rate is 38.5% for the country, two regions are particularly extreme cases: the northeast and the northwest. In the former, over 56% of the population is below the poverty line; in the latter, 49.5%. In the two regions the percentage of children living under the poverty line is 71% and 63%, respectively, compared to the 55% national average. In a couple of places the numbers reach 75%. The north region includes 11 provinces, out of a total of 23, and about one third of the land surface, where, according to 2006 estimates, nearly a quarter of the population resides.

In sum, the data suggests that during the Kirchner government some people have managed to escape poverty. However, the rate of improvement is decreasing over time, suggesting the presence of a plateau. The rigidity displayed by the underlying socioeconomic structure presents another battle front for the administration. The numbers also reveal an alarming number of children living below the poverty line, many being indigent. This is a serious problem because these children are not receiving adequate nutrition and education. And they will be competing with cohorts all over the world for jobs that are being outsourced to the most productive workers. Clearly, these youngsters will have a diminished intellectual capacity stemming from deficient nutrition during their formative years and a lack of a competitive education, as many of them must work or beg for sustenance. Finally, policies to mitigate poverty need to incorporate regional differences in order allocate resources proportionally to the problem and to design programs addressing local needs.

The internal dynamics of the momentum propelling the inertia of chronic poverty may map itself into decreasing policy credibility and ultimately political resistance leading to greater political risk.

EMPLOYMENT AND WAGES

The economy experienced an ascending trend in unemployment since 1998, peaking in May, 2002, and descending thereafter. Moreover, the rate of unemployment has been in the two digit range since 1993. According to Lindenboim et al. (2005), in 1993 40% of national income went to wages. By 2004 that share fell to 24%.

In the third quarter of 2005 the level of unemployment was 11% and the level of underemployment was 13%. Roughly,

a quarter of the people in the labor market had problems finding employment. This represented an improvement of 2% in both categories relative to the same period in 2004. The unemployment level fell by 5% beginning in the third quarter of 2003 and by almost 10% after the first quarter of the same year. However, the levels of underemployment fell by just 4% in the same period.

The government reports two different numbers to account for the statistical impact that a subsidy program has on the levels of unemployment: plan Jefas y Jefes de Hogar (female and male head of household plan). The downward trend does not change by excluding the impact of this program, but the levels change by about 3%. In other words, the actual number of unemployed people increases to 14 % without the program.

Since 2002, among those who found new jobs, 72% did so in the private formal sector while 20% found jobs in the private informal sector and 8% found employment in the public sector. The formal sector of the economy encompasses about half of the labor force. The other half works in sectors that generate lower paying and unstable jobs, particularly in construction. This may be one of the reasons why the levels of poverty are decreasing but at a decreasing rate, reaching a plateau. The other reason could be related to the levels of capacity utilization in the industrial sector. The average rate, roughly 70%, has been stable for the last two years and over 70% of the firms do not anticipate changes in capacity utilization for 2006.[10]

Also, about half of exports originate in the agricultural and manufacturing of primary products sectors of the economy that together only generate 18% of total employment. The

[10] From "Utilización de la capacidad instalada", page 1, January 2006, INDEC.

manufacturing sector has also contributed to exports, but once disaggregated it is evident that, for instance, while automobiles are a significant component of exports, the transactions are just intra-firm due to Argentina's integration in MERCOSUR, the regional market. In addition, the metal-processing industry (aluminum, iron, and plain tubes) contribute to economic growth as well but, all are capital intensive.[11] Disaggregated data by sector for 2002 shows that about 4.9% of the workers in the industrial sector worked in the automobile sector, about 3.7% worked in metals, and 5.4% in the production of goods made with metal, including tubes, but not exclusively.[12]

Data for 2004 shows that gains in employment between the third quarter of 2003 and 2004 were strongest for hotels and restaurants, 56.5%, construction, 21.7%, other services, 22%, and lagging behind them and other sectors came manufacturing, 7.3%, confirming that its growth does not necessarily generates employment.[13]

In other words, gains in income, in particular for those below the poverty line, may be obtained through a gain in real salaries rather than a gain in the number of jobs available to them. In particular, the construction sector may also slow down as speculative capital that entered the sector in recent years begins to shift to other assets. Real wages are also affected by inflation which in turn is connected to the composition of aggregate demand, economic concentration, price setting behavior and government policy. These issues will be discussed below.

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[11] From Página 12, October 5, 2005, "Boom exportador (primario)": http://www.pagina12.com.ar/diario/principal/index.html

[12] From Ministerio de Economía, 2006, http://www.mecon.gov.ar/peconomica/basehome/infoeco.html, asalariados por rubro.

[13] From "El Nuevo Entorno Macroeconómico: Revirtiendo las tendencias de los indicadores sociales", Ministerio de economía y producción, 2004.

In terms of real wages, on the average, those who work in the informal sector earn about half as much as their peers in the formal sector. Most of these jobs are unstable, low-paid and seasonal.[14] Data for the last quarter of 2004 clearly shows that workers in the informal sector earned substantially less.[15] Data released in February, 2006, reveals that since the government took power, in May, 2003, until December, 2005, the nominal wage in the formal sector increased by 45% and by 26% in 2005. The respective numbers for workers in the informal sector were 38% and 12.5% and for the public sector, 19% and 12.8%.[16] For the same two periods inflation was 21% and 12.5%, respectively. The annual growth rate of jobs in the informal sector has been greater than in the formal sector, as measured by quarterly data in three out of the four quarters between 2003 and 2004.[17]

The empirical evidence presented in this section suggests that, under current conditions, gains in the labor market will only occur in sectors that require relatively low amounts of capital to expand, mainly tourism and services. That expansion may or may not have a significant impact on the levels of poverty because by their very nature these activities can be rendered in the informal sector of the economy where wages are substantially lower. Tokman (2003, pp. 84) supports these findings and argues that "...services associated with globalization and modernization, although increasingly important, are still not significant." The hotel and restaurant sector is extremely sensitive to currency

[14] From Clarín, September 28, 2005, "El empleo en negro subió en la Capital y en Rosario": http://www.clarin.com/

[15] From "El Nuevo Entorno Macroeconómico: Revirtiendo las tendencias de los indicadores sociales", Ministerio de economía y producción, 2004.

[16] From "Índice de salarios y coeficiente de variación salarial," INDEC, 2006.

[17] From "El Nuevo Entorno Macroeconómico: Revirtiendo las tendencias de los indicadores sociales", Ministerio de economía y producción, 2004.

fluctuations. This means that the gains in the poverty levels are tied to the ability of the government to maintain a competitive exchange rate and are also tied to external factors, regional and global conditions.

Conceptually the policy-maker faces the ongoing dilemma of having to choose between allocating resources to obtain additional units of risk insurance versus diverting funds towards improving social conditions. Ironically, both policies can increase political risk if implemented outside a sort of "optimally balanced range." Finding this "balance" requires a continuous close reading of the local economy contextualized by the global conditions.

SOURCES AND INCIDENCE OF INFLATION

The average inflation rate in Argentina was 14.8% in 2003, 4.4% in 2004 and 9.6% in 2005. In 2005 the annual inflation rate was estimated to be 12.3% in December. Disaggregated data shows that food and beverages, clothing, shelter, education and health services displayed the greater levels of inflation. With the exception of health services, the aforementioned categories exhibited annual inflation rates above the average for December 2005, for both education and food and beverages of 15.7%. On the other hand, the cost of entertainment, transportation and communications increased by 9.4% and 7.5%, respectively.[18]

The price increase in food, shelter and education indicates the regressive nature of the structure of inflation in Argentina. Data released in February, 2006, shows that the price of the basic basket of goods for a household, the one needed to be above the poverty line, increased by 12.3% in 2005, practically matching

[18] From Secretaría de Política Económica and INDEC, 2006.

inflation. In other words, inflation has a greater incidence on those goods consumed by poor and lower income families. The regressive effect is accentuated by the fact that many children live under the poverty line.

There are various channels within the current system by which prices increase. One way is via the price setting behavior exhibited by concentrated groups of producers in the agricultural and manufacturing sectors. Another way is by the effect that imported intermediate capital goods have on the cost structure of companies. A third way is via the demand for imported consumption goods, durables and non-durables, most noticeable automobiles. And a fourth way is via the increase in compensation to labor.

The government has been explicitly dealing with various groups of producers of tradable goods who, according to the government, fuel inflation by passing on to the consumers price changes that are not consistent with their cost structure, thereby allowing them to capture greater profits and fueling greater inflation expectations. From the producers' perspective the international prices are the reference signals to them, and anything below that is cutting into their profit rate. To change the incentives the government has imposed a series of tariffs on exports designed to equalize the post-tariff price to the desired domestic target. The plan has worked only partially because in practice it has been difficult for the government to control domestic prices and to convince some groups to sign agreements.

The case of the beef producers is emblematic of Argentine history. There are two associations that represent two different type of producers, the Sociedad Rural (SR) and the Confederaciones Rurales Argentinas (CRA). The former represents the old moneyed class, the traditional families with

political ties and influence. The have large holdings, from 1,500 to 20,000 hectares and more, and the owners live in the plush neighborhoods of Buenos Aires, far away from their source of income. SR has about 8000 members. CRA, on the other hand, has about 100,000 members with average land holding of 300 to 1,500 hectares. They live close to their land and supervise the daily operations. Both associations are fighting with the government over the issue of export tariffs. Former officials of both associations are working as consultants for the more reactionary parties in Congress today. Through them the two organizations are able to channel political pressure on the government.[19] The negotiation along the entire production and distribution chain varies significantly and demands a case by case negotiation by the government with representatives of different groups that may oscillate among various postures, depending on the circumstances around the negotiation process.[20]

The government has also been attempting to control prices on a basic subset of the consumption basket by negotiating with a group representing supermarket chains and also large producers. There are nine supermarket chains divided into two associations that represent their interests. An example of this is an agreement signed by Colgate-Palmolive and Reckitt Benckiser to control the prices of 22 articles for personal hygiene and household cleaning. The government has also announced that it will seek an agreement with other large corporations in the area of textiles.[21] Negotiations are also taking place with producers of

[19] From, Página 12, February 5, 2006, "Del mismo pedigree que Martínez de Hoz."

[20] From, Página 12, February 5, 2006, "El quién es quién de los ganaderos."

[21] Clarin.com, February 2nd, 2006, "Los supermercados y el gobierno prorrogaron el acuerdo por 10 días."

goods purchased by elementary and high school students in order to mitigate the effect on the budgets of low income families.[22]

The importation of intermediate goods has also been a source of inflation. In 2005, the prices of oil lubricants increased by 54%, those of intermediate goods to service and upgrade capital increased by 32%, and those of both capital goods and transportation equipment increased by 33% and 34%, respectively. The increase in value can be explained by a 7% increase in the volume of intermediate goods and a 13% increase in their price, while the numbers for oil and lubricants are 10% and 39%, respectively.[23] The reliance on intermediate goods during a period of expansion, coupled with a general increase in their price level, is channeled to consumers via their effect on the price of final goods.

The demand for consumer durable and non durable imports has also had an impact on prices. The value of consumer imported goods increased by 27% in 2005. Medications, refrigerators, shoes and their parts, and motorcycles led the pack. Disaggregated data shows that durables and non durables increased by 39% and 32%, respectively. Automobiles increased by 34%. It should be noted that cellular telephones and computers are not considered final consumer goods, but they also increased significantly, 33%, and should be counted as part of this category, to some extent. By and large, most of these goods were consumed by the middle and upper classes. This is particularly true for automobiles, the purchase of which normally requires incomes high enough to have access to credit. This means that the effect these imports

[22] Clarin.com, February 7th, 2006, "Intentan cerrar hoy un acuerdo por los guardapolvos, zapatillas y útiles."

[23] From, "Intercambio comercial Argentino," January 2006, INDEC.

had on the prices of basic goods and services becomes an implicit inter-class tax or transfer.[24]

The government has been also negotiating with organized labor in order to achieve an agreement on wages to be paid by large corporations. While the unions demand an increase of at least 15% and preferably 35%, according to them to recover and maintain their purchasing power, the government is hoping that a 20% increase would be an acceptable offer. They hope to get inflation expectations under control.[25] Currently the government is acting as a mediator between 13 different labor organizations and representatives from various production sectors.

In sum, while the current literature, e. g. Choudhri et al. (2005), on pass-through effects ascertains that changes in exchanges rates have little effect on consumer prices, inflation partially induced by imported goods, nonetheless, erodes the real wages of consumers through various channels in the economy. It is clear from the data that the structure of inflation punishes the lower classes more than the rest of the system. The government is trying to control the level of prices by engaging producers and distributors of goods, in particular of those goods that are important components of the basket of low income households, but the battle is being fought industry by industry denouncing the level of market power enjoyed by producers in each sector of the economy and their informal connections to the spheres of power. And according to the IMF's *World Economic Outlook* (2006, pp. 39) inflation in Argentina is expected to be 12.9% in 2006 and 15% in 2007.

[24] Ibid.

[25] Clarin.com, February 5, 2006, "El gobierno intenta que los sueldos no suban más del 20%."

The regressive nature of inflation in Argentina could contribute to increased political risk via its deleterious effect on the living standards of a large number of people. This is why the government is trying, via formal and informal means, to control it.

CONSTRAINTS TO GROWTH AND JOB CREATION[26]

Data capturing the supply side of the economy suggests that its ability to absorb more labor is beginning to decline. Since 2003 average capacity utilization in the manufacturing sector has increased from 64% to 73% and remained stable around the 70th percentile. Meanwhile, investment increased from 15% to 19% of GDP between 2003 and 2004 and has remained at around 20% since then.

Data on annual growth in 2005 shows that the automobile sector has grown by 26.7%, cement producers by 21.7%, and other construction materials by 21.4%. Data available for 2002 reveals that about 4.9% of the work force was producing automobiles, and data for 2004 indicates that about 5% of the labor force works in the construction sector, the latter earning relatively low wages. In other words, the more dynamic industrial sectors do not demand much labor and the construction sector not only pays lower wages but is, by its very nature, one that typically recurs to informal work.

Data shows that the boom in construction is mostly concentrated in relatively expensive real estate. Out of 48 neighborhoods in Buenos Aires, a city of more than three million people, about half of the construction took place in the five more

[26] Data for industrial activity comes from monthly reports by INDEC.

expensive areas. And there is a consensus in the sector that while the demand will continue to grow for a while it will eventually satisfy the needs of the top earners. The lack of credit for middle income consumers also has a negative effect on demand, although credit has been growing in 2005.[27]

Additionally, while the automobile industry is operating below 40% capacity, 72.5% of the official survey's respondents in the sector thought that there would be no expansion in 2006. Capacity fell from 53.5% in November to 34.4% in December, 2005. And while the numbers could be reflecting seasonal effects it is likely that producers are going to wait before expanding investment and employment in the sector.

In 2002, about 30% of the labor force was engaged in the manufacture of food products and beverages. Except for the obvious seasonal changes, capacity utilization in the industry has remained between 70 and 75%. Hence, changes in labor demand at this point tend to be seasonal in an industry where informal work is easy to conceal and salaries tend be lower than average and probably much lower than what the official data shows when the formal and informal sectors are combined.

Another industry that has exhibited greater capacity utilization during 2005 is the manufacture of non-metallic minerals. The industry is working at almost 60% capacity and is relatively capital intensive. Its impact on the demand for labor will be insignificant, and, since it is approaching levels of utilization requiring some investment, the industry is likely to postpone making plant changes. Additionally, the wages in this industry are below average for the sector.

[27] From Clarín.com, February 23, 2006, "La construcción de viviendas, concentrada en pocos barrios."

In 1993, 161 (32%) of the 500 largest firms were controlled, partially or totally, by foreign owners. The number increased steadily and reached 286, or (57%), by 2002. In 1993 they captured 65% of profits compared with 85% in 2002. In 1993 they hired 22% of the workers in the industrial sector, and by 2002 that percentage had increased to 55%. This means that labor demand is more sensitive to changes in these large firms. Foreign ownership suggests that direct investment and technological innovations are more likely to enter the plant after the value added has been incorporated elsewhere in the world because the owners do not have a personal interest in developing local suppliers when these are already established abroad and may be part of the same financial umbrella. Therefore, demand for labor may be limited not only by the amount of investment but also its type. If innovations are introduced elsewhere in the world then higher wages may be captured by workers abroad limiting productivity, and real wages, growth at home. Hence, domestic workers do not have an incentive to obtain additional technical training, thus limiting their capacity to signal potential investors of their ability to work with new technologies.

Data on capital imports suggest that by the time capital goods are imported they have a significant component of value accrued outside the country. In 2005 the importation of capital goods increased by 33%. That growth was led by cellular phones, computers, and inputs for the metallurgic and plastic industries. In terms of total imports, 25% were capital goods, in particular for the automobile industry, 36% intermediate goods and 17% for parts and accessories for capital goods. In other words, 78% of imports were for goods that accrue value added before reaching the country. The corresponding jobs were created elsewhere.

According to the IMF's *World Economic Outlook* (2006, pp. 39), the country's growth rate will slow down in 2006 and 2007

to 7.3% and 4% respectively, which seems to be consistent with the data presented in this paper. In other words, under these conditions unemployed and underemployed workers will face a difficult market and one that does not pay that well. About 70% of an official survey's respondents did not anticipate any hires or an increase in hours for the first three months of 2006. And data shows that about 38% of labor works more than 46 hours per week. The various pieces of evidence together explain, partially, why the improvement in unemployment figures is decreasing and reaching a plateau over time.

In sum, expansion of labor demand seems to face two different structural constraints. On the one hand, the more dynamic sectors of the economy tend to demand less labor than other sectors and are not planning to expand their productive capacity unless the market signals change in the future. On the other hand, the productive structure and managerial interest will continue to demand capital and intermediate goods produced largely outside the country, thus preventing the transfer and adaptation of new technologies with a significant value added component from labor. Hence, labor demand will be constrained by the demand to fill positions for workers whose increase in salary will mostly depend on added hours and marginally on increases in productivity because industries where technological innovations are developed will not establish their operations in Argentina for the time being.

This may send a negative signal to young workers planning to improve their technical skills in order to compete with workers elsewhere. They may correctly perceive that the marginal return on additional education is lower than consumption of leisure or other forms of training. Tokman (2003, pp. 90) argues the same point for other countries. The internal dynamics of the situation –its momentum– is reinforced by the fact that roughly 65% of households in Argentina are below an income threshold

associated with significant high school desertion rates, about 46%. Meanwhile, data shows that about 40% of the jobs requiring secondary-level skills go unfilled, thereby cementing the bases for further social exclusion potentially leading to lower levels of policy credibility.[28]

Potentially, the above situation may generate a contradiction within the system. If profits continue to accrue to the current stock of net investment but social indicators do not improve sufficiently to support a stable social and political environment, then the risk factor may push a portion of investment away from productive and into more speculative or transitory assets. Under certain conditions this shift will not only aggravate social tensions, through lower expectations, but may breed inflation into the system via the real estate sector or some other asset, just as recently happened in the United States. Or it may migrate towards other markets to fuel a bubble there. Ultimately the direction of the financial flows will partly determine where and how the redistributive effects are accrued. It is possible, as argued elsewhere in this paper, that secondary effects could be felt in Argentina via contagion if the bubble erupts in a country that has intense financial and trade links with Argentina.

Once more, the policy-maker's dilemma shows its face. Policies to create more jobs may be inhibited due to the need to stabilize the financial sector and maintain it stable over time. The next section discusses this and other issues.

DISCUSSION

The data and discussion presented above suggest that current monetary policy in Argentina has been hijacked by its own

[28] From Página 12, August 14, 2006, "Crece la curva de deserción."

purpose away from its expansionary capacity to accomplish the dual goal of simultaneously stabilizing relative prices and minimizing their impact, and in turn on the real economy, from the impact arising from exogenous shocks.

Fiscal policy is constrained by the fact that over time a greater percentage of the national product is being allocated to the accumulation of international reserves and a smaller portion to a newly formed anti-cyclical fund. This means that, in spite of the fact that the country has been growing at a fast pace and that tax revenues have increased, the government's ability to redirect the newly created wealth is limited by its own stabilization policy.

The limited ability of monetary and fiscal policy to reduce the levels of unemployment and poverty above and beyond what the market mechanism and the structure of the economy can bear essentially characterizes the central problem being faced by the Argentine government. The internal dynamics of the system suggest that for the current policy to be successful in the long run it must yield enough improvement in the unemployment and poverty indexes to mitigate a political backlash and ensuing risk that may arise from it otherwise. This demands constant monitoring of the social and political conditions of all social classes in the country in order to manage political risk appropriately. In other words, this risk needs to be managed and characterized like any other risk.

All said, it seems that Argentina is purchasing a sort of stability insurance at a rate of roughly 6% of GDP, reserves and stabilizing fund, plus the policy-bound externalities arising from unemployment and poverty resulting from a conservative approach to fiscal policy and the opportunity cost arising from currency sterilization. This suggests that a tradeoff exists, that some aspects of the current policy could be altered to mitigate the long run political risk associated with the negative externalities.

A slight modification of the current policy may include a more dynamic conception of internal financial flows whereby resources do not sit idle, or earning nominal fees, but rather flow sporadically to nodes in the system where risk factors are beginning to mount above prudential levels. For example, a portion of the fiscal surplus could be used as temporal collateral to extend credit to small domestic ventures that are labor intensive in order to reduce unemployment in an impoverished locality without increasing risk in the banking system. In other words, credit could be extended to higher risk groups without affecting the integrity of the banking system. This would amount to a sort of macroeconomic prudential risk management technique where the market provides signals and incentives and the public sector acts as a backstage catalytic instrument, thereby minimizing distortions.

Similar arguments have been used, whereby the optimality of reserve accumulation has come under scrutiny. The main argument is that many developing countries have been accumulating more than traditional benchmarks, measured in terms of months of imports, for example, and that the excess could be put to better use. The literature, including this paper, disagrees on benchmarks and measurements, but agrees that developing countries can do better than simply hold dollars or highly liquid low-yield instruments.

Rodrik (2006) argues that there is a social cost to pay for holding excess reserves and posits that capital controls may be used as a tool to stabilize flows without sacrificing the opportunity cost of holding foreign currency, but acknowledges that capital controls are politically less feasible. The government of Argentina has both but has been dubbed as "interventionist" in some quarters for its capital controls policy only. Summers (2006) also believes that reserves are too high in many developing countries and

calls for a reform in their strategies. Hauner (2005) attempts to measure the opportunity cost of holding reserves and argues that countries should diversify their holdings into instruments with longer maturities. Aizenman and Lee (2005) argue that most developing countries hold excess reserves mostly as a precautionary measure, a self-insurance. This may be the case in Argentina.

With a slightly different approach, García and Soto (2006) argue that the levels of reserves need to be compared to the potential costs of a crisis. From their perspective most countries are holding adequate levels. Their method controls for the quality of political institutions and they conclude that it is better to be liquid than to depend on the technocrats to solve a shortage of cash. To some extent, this may also be a sentiment at the Central Bank. Their argument supplements the agency problem argued in Summers (2006). The President of any Central Bank may take a riskier approach and allocate some of the reserves into higher-yield instruments. However, they will not do so because the public recognition from earning greater returns on the bank's reserves is significantly lower than the derision they will get if they earn negative rents. Then it becomes a rational choice to act conservatively unless the terms for chairmanship become long enough to provide additional incentives for them to take additional risks, but this may introduce moral hazard problems. Higher returns may be earned in the long run, but the President's tenure may not coincide with the business cycle. Whether the creation of an international fund may contribute to smooth out the volatility of returns to reserves is an interesting issue outside the scope of this paper.

The combination of extreme precaution, fear of corruption and agency issues may partially explain why monetary policy in less developed countries seems to be overly conservative to

the point of becoming either irrational or suboptimal. But the importance of all these factors should be assessed on a country by country basis. In the case of Argentina, given its long history of corruption and sudden economic upheavals, a conservative policy may very well be optimal and rational.

A crucial question then arises: Can, or will, the government deviate significantly from the current policy without increasing the risk of provoking more financial instability?

This paper argues that, according to the data presented, the answer is no. The cost of the policy is not negligible, but it is not clear at this point that reallocating these resources to other uses would yield greater payoffs to the country. A more aggressive redistribution policy may alleviate the pain of some parts of the population for a limited time but may expose the country to the eternal cycles of volatility and capital outflows, sudden stops, thereby defeating the policy's main objective and setting the basis for greater levels of political risk. Additionally, without the proper complementary policies, fund transfers could amount to nothing more than dumping money and harvesting corruption and expectations of future transfers leading to greater political risk as the government is unable to meet expectations.

One option is for the government to identify those programs that affect groups that pose a higher political risk. That may be amoral but it is rational and may lead to long term effects of greater inequality. By caving in to the demands of those groups that have greater political clout and stronger lobbies, the government may implement policies that could increase poverty and unemployment, thereby defeating it own agenda. Woo (2003) supports this view. On the other hand, by attempting to implement a program without, al least, enough support from the political establishment, it may promote enough political risk to bring the program to a standstill.

This suggests that, once political risk is considered, the political feasibility of a program may play an important role in shaping the dynamics of it. In other words, the effect of the program on the socio-economic structure of the country endogenizes, among other things, the political risk. Implicitly, the policy-maker will be continuously searching for a set of policies that would minimize risk while simultaneously attempting to achieve multiple and linked objectives. However, this paper does not suggest that risk analysis should dominate industrial policy and its complementary policies, it rather suggests that risk analysis should complement policy formation in order to asses its feasibility, particularly in the long run or for a time horizon long enough for a set of policies to yield some tangible results.

While the real world is a lot messier than clean theoretical statements, it seems clear that the government of Argentina, via a very complex web of subtle and dynamically adapting negotiations with different groups in the country, has been doing precisely that. It has attempted to keep the economic program alive while patching problems as they appear on the horizon. In this scenario risk control, or financial stability, has become a priority at every step of the way. According to Martin Redrado, Chairman of the Argentine Central Bank, "monetary policy can not be defined by strict quantitative rules. Therefore, we must build structures to mitigate vulnerabilities in the face of adverse scenarios, before we try to delineate and follow an optimal path of uncertain outcome".[29]

[29] Part of his address during the 2006 conference on monetary and banking policy held in Argentina during June 5 and 6. The actual text in Spanish read: La política monetaria no puede aferrarse a reglas cuantitativas estrictas. Por lo tanto, debemos construir estructuras para mitigar vulnerabilidades frente a escenarios adversos, antes que pretender delinear y seguir un sendero óptimo de resultado incierto.

Kaminsky (2005, pp. 21) argues that "...there is no optimal policy to deal with the risks of volatile international capital flows, as policies that may work in the short run may have adverse effects in the long run." And Bernanke (2006) states that "...a robust approach to policymaking requires the use of multiple sources of information and multiple methods of analysis, combined with frequent reality checks."

For instance, a patchy but relatively effective way to maintain inflation under control via coercion and constant negotiation has not acted as a total detractor for new investment and has had progressive distributive effects. The emission of government financial instruments to support its competitive currency may have had some effect on the expansion of credit via the upward pressure exerted on interest, but other measures had been implemented, lowering the requirement on collateral, for example, to foster credit at the same time. Of course, changes in collateral's rules may in itself increase risk, but the balance sheets of the financial system seem to be solid enough at this point. In other words, prudential risk management, whether intended or accidental, seems to characterize current policy-making in Argentina.

Another example is a conflict between the Central Bank and the private banking system that sits precisely at the core of this paper's argument. As explained above, the Central Bank has changed the norms on reserve requirements for different types of deposits, whereby preference was given to the longer term in an effort to foster liquidity and reduce fragility. Simultaneously, the government is trying to extend mortgage credit to renters so they can become home owners. This would involve a system of subsidies so borrowers can obtain lower interest rates. But representatives from the banking sector have argued that the new reserve requirement structure prevents that from happening.

Hence, the dilemma between safety and expansionary fiscal policy arises once again at the center of the political discussion that directly affects the profit rates of the financial system, thus underscoring the need for a prudential risk management approach to policy.[30]

All said, however, there has not been enough time to judge with some degree of fairness the ability of such an approach to the maintenance of stability. As understood here, given that political risk is taken into account, long run stability cannot be achieved if the fundamental social variables do not improve over time. In the case of Argentina, the limited evidence suggests that, along with financial stability, political risk may loom as an important variable sometime into the future.

How long can the less favored groups wait before they act upon their frustrations? That is difficult to tell and, as argued earlier, it should not be a relevant question; it may actually be a self-defeating one. Instead, the government ought to, as it may have already, recognize that the welfare of the entire society must be taken into consideration when designing a set of policies that aspire to achieve long run objectives. This may be done by giving appropriate weights to the various sources of risk so that, in the process, the set of dynamically adaptive policies may be able to fluctuate about a range of motion such that risk or the perception of it is thereby minimized. Following previous arguments, the greater the degree of social exclusion and the longer it exists, the greater the weight that should be attached to the problem. Hence, the conclusions may be generalized to other countries but the weights may vary from one system to the next as social structures and histories differ.

[30] From Clarin.com, August 13, 2006, "Lanzan un plan con facilidades para impulsar los créditos hipotecarios."

In other words, the government of Argentina may need to implement a dynamic approach to policy-making by continuously adapting to the internal and external changes, while attempting to minimize the total risk so as to maximize its chances of achieving its various and simultaneous policy objectives. In the final analysis this may be the only real option available –the eclecticism embraced by the current administration– to be able to dismount themselves from the historical rollercoaster of political and economic eruptions upon which the people of Argentina rode for at least the last century.

CONCLUSIONS

The main objective of this paper is to characterize the dilemma faced by many governments in developing countries when trying to maintain financial stability and simultaneously decrease poverty and increase employment before their policies lose credibility and, consequently, political support.

By conceptualizing the problem as one where chronic levels of poverty and unemployment lead to political risk, the paper argues that such risk should be part of the overall risk management approach. Hence, monetary and fiscal policies do not have to fall prey to stabilization goals, thereby inhibiting their ability to address social problems, but rather should be used to minimize financial and political risk.

To illustrate the point the paper examines the current situation in Argentina. The government is implementing various stabilizing policies and attempting to shield the country against exogenous shocks and internal instability potentially arising from relatively high levels of unemployment and poverty. The data shows that the government is taking a sort of adaptive dynamic approach to policy formation, whereby economic and political

problems are constantly being addressed so as to minimize the total risk, financial plus political, to the economic system or to maximize economic stability. The approach is eclectic but consistent with the current literature on financial stability and political risk.

Given that many threats to the region loom in the horizon it seems natural to extend this line of research to discuss to what extent emerging economies can survive significant exogenous shocks alone or if they should begin taking steps towards forming common financial markets, as the MERCOSUR countries are beginning to do, and how that would affect individual and regional risk. Some of the threats are the instability of the United Sates economy and the lack of regulation of financial flows, as was evident from the unwillingness of the SEC and the Courts in the United States to increase the control of hedge funds in the light of serious allegations of corruption.[31] This is particularly important now because, as financial markets in developing countries become more complete, some of the new instruments may piggy bag with them hidden risks: the political effect that a change of power in Cuba may have on Latin America; the never ending conflict in the Middle East; impending conflicts between the United States and Iran and North Korea; the ongoing political situation in several countries in Africa; the failure of the WTO to reach stable agreements on tariffs and subsidies and the effect this will have on relative prices, employment and poverty in emerging economies.

Thus, there is a need to evaluate alternative designs of international institutions that would regulate the flow of funds,

[31] From the *New York Times* online, June 23, 2006, "Ruling sets back effort to regulate hedge funds."

provide countercyclical relief and administer global funds to optimize returns. This should provide more than enough fuel for many new papers.

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