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Mustapha K. Nabli

*After Argentina:
Was MENA Right to Be Cautious?*

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Lecture by
Mustapha K. Nabli
Chief Economist, Middle East and North Africa Region, The World Bank

After Argentina: Was MENA Right to Be Cautious?

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For further information:

Mediterranean Programme
Robert Schuman Centre for Advanced Studies
European University Institute
via dei Roccettini, 9
50016 San Domenico di Fiesole (FI)
Italy
Fax: + 39 055 4685 770
<http://www.iue.it/RSC/MED>

ABSTRACT

Argentina's economic collapse in the past few months has cast doubt in some circles on the "Washington Consensus" of economic reform programs. Until quite recently, Argentina was the darling of the international financial community, embarking on an unprecedented liberalization effort. But in a sudden wave-shock, the country became engulfed in an unprecedented institutional, political, economic and social crisis.

The countries of the Middle East and North Africa region (MENA), on the other hand, have embraced structural reform more tentatively. Despite initiating programs of macroeconomic stabilization and policy reform, these reform program remains unfinished: financial sectors remain weak, trade liberalization remains incomplete, public ownership remains high, and the regulatory framework and supportive institutions for growth have not materialized.

Looking at the Argentine crisis, the countries in the MENA region may be asking themselves: Were we right to be cautious? This reflection on the Argentine crisis reveals that while the MENA region should be cautious to factors including debt sustainability, fiscal determination, and exchange rate management, the lesson on structural reform is not to decelerate on the reform agenda to avert the type of crisis that Argentina is experiencing, but that whatever its speed, liberalization needs to be complete. Markets are keenly observant to actions, and credibility cannot be bought through "stroke of the pen" reforms. The MENA region must move now to the more challenging, issues that obstruct the development of a strong private sector, to ensure higher and sustainable growth and to avoid the type of crisis, which occurred in Argentina.

LECTURE

by

Mustapha K. Nabli

Chief Economist, Middle East and North Africa Region, The World Bank

After Argentina: Was Mena Right to Be Cautious?

So much has happened over the last few months that have served to put the Middle East region into the spotlight of international attention, perhaps most notably the events following September 11th. It is an increasing phenomenon, that we see articles in the newspapers devoted to the region, sometimes looking to understand the causes of social exclusion, but almost always trying to better understand the region's economic and social structures. On an almost regular basis, our regional department in the World Bank is called upon by some journalist seeking information about where the region stands, in terms of economic growth, its employment prospects, and political stability.

In this investigation that has heightened of late, the progress that the region has made over the last decade, in terms of both achieving macroeconomic stability and initiating programs of structural reform has become better known. Starting in the late 1980s, a handful of countries in the region – Morocco and Tunisia, and soon after, Jordan, embarked on programs of macroeconomic stabilization and policy reform. By the 1990s, nearly all of the non-GCC countries in the region followed suit, as did several of the Gulf economies. The reasoning, of course, was to create an environment in which the private sector could emerge and become an engine for higher and sustainable economic growth, crucial for employment creation as well as for social cohesion. But at the same time, it must be conceded that MENA's progress with structural reform has been incomplete. Financial sectors remain weak. Trade liberalization remains incomplete, with continuing moderate to high protection levels. Public ownership remains high. And, the regulatory framework and supportive institutions for growth have not materialized.

And so, the region has been often chastised by institutions such as the World Bank, for not proceeding more quickly and deeply with its commitments to liberalization. But juxtaposed with this sense of frustration about the region's

lack of continued progress with economic liberalization comes another event which has served in some circles to cast some doubt on what can be referred to as the “Washington Consensus” on economic reform programs: that being the recent crisis in Argentina. Until quite recently, Argentina was the darling of the international financial community. During one decade it had embarked on an unprecedented effort and had undone four decades of state interventionism. It deregulated most markets¹. It privatized most state owned enterprises, including difficult giants like the oil industry, railroads and airlines. It radically reformed its social security system, substantially strengthened its financial sector and swiftly aligned its economy to market forces. These policies revived the economy and brought stability to the country. But in a sudden wave-shock the country became engulfed in an unprecedented institutional, political, economic and social crisis. Within a few days in December 2001 it changed five presidents; its payment systems collapsed, it defaulted on its foreign and domestic debt and it violated property rights. Argentina’s real economy is imploding and the country’s social fabric is being torn apart.

Looking at the current crisis in Argentina, the countries in the MENA region may be asking themselves: Were we right to be cautious? Did Argentina commit itself to an economic model that, in the end, suffers from some fatal flaws?

Before taking the Argentine crisis as confirmation of the need for guarded steps into economic liberalization and deregulation, one needs to look at the roots of this crisis. I believe there are indeed lessons for the MENA economies from Argentina’s example. Broadly, three factors in combination contributed to the collapse of the Argentine economy: *firstly*, a strict exchange rate rule that reduced competitiveness and the capacity to grow; *secondly*, a loose fiscal policy mix that generated an increase in public indebtedness; and *thirdly*, a continuous weakening of the institutional environment. But, it was *not* caused by the liberalization of the economy. Liberalization strengthened the economy. It initially reduced economic imbalances and the economy performed remarkably well until 1997. But as I intend here to speak to the MENA economies, and if there is an additional lesson from Argentina regarding the role that liberalization played in the crisis, it is that liberalization can’t be piecemeal. The liberalization process should present domestic enterprises with heightened competitive pressures, both international and domestic, but it should also allow them to respond...both positively to new opportunities as well as to economic downturns. And in Argentina, lack of liberalization in labor markets reduced the

¹ However, deregulation of labor markets was not deep enough.

economy's degrees of freedom when the economy needed to adjust under reduced competitiveness abroad.

Let me take a few minutes to highlight the events that drove Argentina into crisis, and come back to these elements as they apply to lessons that can be taken by the economies of MENA. While all three of the factors I mentioned contributed in combination to the Argentine crisis, let me begin with the first factor:

The exchange rate regime

To understand the story we have to go back to the eighties and early nineties. During 1989 Argentina experienced hyperinflation, at the same time that its first democratically elected president since the military dictatorship had to take an early leave. The incoming authorities at first failed with several stabilization attempts. But under very difficult circumstances, in 1991, the government made a radical change. It established a currency board fixing the dollar price of the peso on a one-to-one basis, replacing its floating rate regime. This currency board, set-up by law, provided a strong and reliable anchor. It succeeded in arresting inflation and in providing price stability for the next ten years.

Fixed exchange rate regimes require different pre-conditions than floating rates in order to be sustainable. Moreover, they also require a flexible economy that can swiftly adjust to exogenous shocks. During the late seventies and early eighties, Chile implemented a stabilization plan based on a fixed exchange rate. This plan failed mainly because during its implementation the dollar appreciated substantially and Chile could not withstand the appreciation of its own currency vis-à-vis the rest of the world.

On the other hand, a few years later in 1985, Israel initiated a stabilization plan very similar to that of Chile and anchored its economy to the dollar through a fixed exchange rate. Israel's plan was successful, but this success was due in no small measure to the fact that in this period the dollar actually depreciated substantially.

The lesson of many experiments with fixed exchange rates is that *most economies adjust better to real depreciation than to real appreciation of its currency.*

During the ten-year period that Argentina kept its currency board the US dollar appreciated substantially and Argentina's main trading partner, Brazil, devalued its currency by about 40% in real terms. Consequently, Argentina's

multilateral real exchange rate appreciated substantially and this disequilibria required adjustment through deflation and unemployment.

During the early 1990s, the economy grew at very high rates driven by a surge in capital inflows, and the fact that the country was bouncing back from a deep crisis. In 1995 the economy suffered the “tequila effect” of the Mexican crisis, with a run from the banks and the sudden reduction in capital inflows. Later, in 1997 the Asian crisis led to a sharp fall in commodity prices. This meant that the Argentine *equilibrium* real exchange rate had depreciated. But instead of depreciating the actual real exchange rate continued to appreciate, first because of the dollar appreciation and later because of the 1998 sharp depreciation of the Brazilian Real.

The exchange rate could not adjust to its new equilibrium value by nominal depreciation. It had to adjust through prices and quantities. Given the inflexibility of prices to downward pressures, the adjustment to lower nominal income had to be done through quantities and real income took a dive.

It is at this point that the effects of the other factor propelling the crisis became evident:

The lack of fiscal discipline and the increasing public debt

A central issue in the crisis was the lack of fiscal discipline and its contribution to increasing public debt. During the years of massive privatization in Argentina, government expenditures were adjusted upwards with the huge influx of privatization revenues. Between 1989 and 1994, for example, expenditures kept almost identical pace to overall revenues – including privatization proceeds. Once privatization revenues began to decline, however, an adjustment of spending never took place. Spending as a percent of GDP remained almost unchanged between 1994 and 1997, despite the decline in overall revenues of about 1.5 percent of GDP.

The last three years of the Menem administration (1997-99) were characterized by excessive government spending, both at the federal and provincial levels. Government spending as a percent of GDP increased from 14% to 22%. At the time, the political system was split, between the national government (following a pro-privatization, pro-market policy) and the provincial governments (oriented to high-cost social programs). Because the provincial governors have direct control over national legislators, the Menem

regime used revenues gathered from privatization and foreign investment to shower the provinces with money to win their support for the national program².

Lack of economic growth, combined with an expansion in government expenditures, generated a fiscal deficit that grew from 0.15 percent of GDP in 1994 to 2.4 percent in 2000. To achieve fiscal balance without distorting the economy, the government could have lowered its expenditures. Instead, it chose to finance the fiscal deficit by raising taxes and incurring additional debt in financial markets and with the IMF. Raising taxes proved to be a bad tactic; it generated more tax evasion and suffocated an already hobbled private sector³.

The extra tax burden and the reduction in credit to the private sector diminished the investment rate and reduced productivity. This, in combination with the loss of competitiveness, drove the economy into recession.

The recession led to double-digit unemployment. Early in 2000, the new government made the crucial mistake of incrementing tax rates in the middle of a deep recession. Naturally, this exacerbated the recession and instead of increasing fiscal revenues, the tax hikes reduced them. The higher fiscal deficit had to be adjusted with lower expenditures and financed with higher debt issues. Lower expenditures also worsened the recession. In this setting, the country debt became very risky, and interest rates on public debt soared.

With the soaring interest rates, the burden of the debt became unsustainable. The IMF and other IFIs continued supporting the currency board with huge multibillion loans. This did not solve the underlying disequilibria. By late 2001 the government defaulted on its external debt held by domestic creditors, mainly banks and pension funds. It forced a swap of its high yielding debt for new debt “guaranteed with future fiscal revenues” and yielding only 7%. The policy to restructure on a “voluntary” basis a good part of the domestic debt improved finances in the short term but complicated the management for years to come and signaled to the markets clear problems with Argentina’s debt sustainability capacity despite the seemingly “comfortable” levels in traditional debt indicators (see Table 1). The market interpreted this as a clear sign of unsustainability which resulted in large withdrawals from the banking system.

The Central Bank issued a regulation putting a ceiling on interest rates. This was another element that helped to trigger the banking crisis. Banks had been paying a rate much higher than the new ceiling to keep deposits inside the

² Mark Reutter; News Bureau; University of Illionois at Urbana-Champaign; December 21, 2001.

³ Ana I. Eiras and Brett D. Schaefer; Backgrounder; The Heritage Foundation; April 9, 2001.

system. The fixing of interest rates was the fatal blow to stability and a full-fledged currency crisis ensued. The flawed and time-inconsistent macroeconomic policy, the price fixing, a very weak president, and this not so “voluntary” debt swap with institutional investors and banks led to a run on the banks and the collapse of the payment system. The financial fortress built over a decade had been destroyed overnight. Finally, let’s look at the third ingredient of the crisis, related to:

The weakening of the institutional environment

This component played a crucial role in destroying confidence in the Argentinean economy and its political institutions. It gradually started with President Menem’s unsuccessful attempt at reelection, which included a significant loosening of the fiscal stance. It was followed with the Alianza strategy in 1999 to defeat Menem rather than govern. Then a crisis in the Senate in 2000 associated with the mild labor reform and the resignation of the Vice President in October 2000. This crisis tarnished the possibility of a serious reform in the labor market in the future.

The weakest link was the fiscal regime, which tied the federal government and the rest of the country together, which remained discretionary and full of loopholes. Provincial governments depended upon taxes raised at the federal level, while the municipalities depended upon taxes raised at the provincial level, with no balance between the political benefits of public services and the political costs of raising revenues. As the budget situation deteriorated, transfers from Buenos Aires to the provincial governments became a matter for day-to-day political bargaining⁴.

As the situation became increasingly complex, the rescue package from the IMF in December 2000 gave some breathing room, but generated further (and excessive) loosening of the fiscal stance and culminated with the IMF losing confidence on Argentina’s capacity to adjust.

The fiscal crisis, political mess and debt overhang led the government to seek an orderly restructuring of public debt, but this proved to be impossible as regular Argentineans and foreign investors opted out of the system. The market attempt at working out the money overhang led to the controversial decision to freeze the deposits. The Public banks became a great liability during the development of the crisis and pushed Argentina deeper into its crisis as the government didn’t have the political support to deal with them.

⁴ Center for International Development; “The Grand Illusions”; Andres Velasco; 2002.

What can the MENA economies take from the crisis in Argentina? Let's begin by talking about financial system, and the relationship between the financial system and the macroeconomic fundamentals.

In 1999 Argentina had one of the strongest banking system in Latin America. This was achieved by requiring banks to hold capital adequacy ratios much higher than those demanded by the Basle accord principles. By imposing high loan-loss provisions and strict international accounting standards. By actively favoring the entrance of large foreign banks. By requiring that banks issue subordinated debt. By demanding that banks be rated by international rating agencies. By imposing reserve requirements higher than 20% on liquid deposit not withstanding their initial time structure. The lack of a lender of last resort was addressed by buying insurance from international banks: contingent credit lines that would trigger in the case of a currency run.

During its convertibility experiment Argentina increased its debt to the IFIs in an unprecedented way. In exchange for its credit, the IFIs required and agreed with the government and required the enactment of the multiple and difficult measures to strengthen its capital markets. On every aspect related to capital markets, Argentina "went by the book" as written by the IFIs and, in this way, it constructed a real financial fortress. However, one year later its banking system was on the brink of complete insolvency. The meltdown was instantaneous. The question is why? The answer is: economic shock due to the accumulation of disequilibria related to its time-inconsistent macroeconomic policies and the loss of credibility in economic and political institutions. The "books" had left out a critically important chapter.

The lesson from this recent Argentine episode as well as from others is that micro-economic reform in the financial sector is very important but not sufficient. No matter how strong the financial sector is. No matter how much expertise and confidence foreign banks may bring to the financial system and how large is their share of total lending. No matter how well the Basle regulations are put into place and enforced. If macroeconomic policies generate large disequilibria they may lead to a real systemic implosion. This is a lesson that should be learnt by other countries that are currently running significant macroeconomic imbalances.

Another lesson from the Argentine episode relates to the deleterious influence of government's debt finance on capital markets. Even during the exuberant period of the currency board experience and the substantial strengthening of the banking system, the Argentine stock exchange languished. The number of listed instruments was steadily reduced from 204 in 1989 to 125 in 1999. The number of listed companies also declined sharply. The pension

reform provided funds that were mainly used for government debt and banks CDs. The stronger companies listed in foreign stock exchanges. Liquidity was substantially reduced.

The decline of the Buenos Aires Stock Exchange (BASE) during the nineties can be directly related to the presence of the government's debt finance crowding out the private sector. During 1996-2000, as an average, 86% percent of net primary issues dealt through the stock exchange were fixed income instruments and of those 76% were government issues. The overwhelming presence of the government is more dramatic in relation to liquidity. More than 90% of trade was done on the Treasury's fixed income products

What other lessons for the MENA region have we learned from the Argentina crisis? Let me begin with the *exchange rate regime*. In the MENA region, fixed exchange rates are still pervasive. In two-thirds of the economies of the MENA region, fixed exchange rate arrangements, whether explicit or implicit, are in place... this despite the fact that worldwide, only half of economies operate under a de facto fixed exchange rate system (and only a third have official fixed arrangements). The pre-occupation with macroeconomic stability during the 1990s played a large role in maintaining nominally fixed and stable exchange rates, but it has meant that one important tool to make exports more profitable was surrendered. There are many other reasons for the region continuing to rely on more rigid exchange rate arrangements, but both debt and oil play a role. By maintaining a fixed regime, and in particular an overvalued exchange rate, the governments in the region have an easy means for decreasing their payments on foreign-denominated debt at the expense of domestic borrowers, who face tighter monetary policy, and national industries, whose competitiveness is weakened. In addition, the public sector's role as exporter of oil provides additional incentive to adopt a fixed regime, as it allows for directly subsidizing imports by the public sector.

But the lesson from Argentina on the fixed exchange rate should send a signal about what can happen when an overvalued exchange rate is maintained, and what that implies for domestic industries and laborers. In Argentina's case, the fixed exchange rate contributed to reduce the competitiveness of the economy in a period of strong appreciation of the dollar. The devaluation of the Brazilian real in 1999 deepened the competitiveness problems from which the economy never recovered. The loss in competitiveness and the sustained decline in real output since 1999 helped to destroy Argentina's credibility and increase its cost of capital. As the cost of capital increased the needed downward adjustment on wages became too much to bear, particularly when labor market flexibility was limited. For each one percent increase in the interest rate, wages needed to decline by about 3% to maintain competitiveness. Between 1990-98

the adjustment in unit labor costs came from increases in productivity that preserved the level of wages. Since 1999 the adjustments came through reduction in labor costs/wages, which depressed consumption. Since the tax structure of Argentina is based on indirect taxes, the reduction in consumption reduced tax receipts and deepened the fiscal imbalances, generating a fiscal crisis when government expenditures were impossible to contain.

Another lesson is about *debt*, and its role in the Argentina crisis. The most important is that debt, even small debt, can become a major issue once credibility is lost. In Argentina's case, debt sustainability became an issue as the economy imploded, despite what we would term moderate levels of public debt. But when the spreads increased, the capacity to rollover/refinance public debt abroad became impossible, forcing the government to impose a "voluntary" debt swap with domestic banks and other institutional investors. The policy to restructure on a "voluntary" basis a good part of the domestic debt improved finances in the short term but complicated the management for years to come and signaled to the markets clear problems with Argentina's debt sustainability capacity despite the seemingly "comfortable" levels in traditional debt indicators.

Within MENA, outside of the Gulf economies, the size of public sector debt is substantially higher than that which Argentina exhibited at the time of the crisis. At the time the crisis unfolded, public debt as a percentage of GDP was about 56% in Argentina. That compares to debt ratios of 85% in Egypt, over 60 in Algeria, Morocco, and Tunisia, over 100% in Jordan, and close to 170% in Lebanon. So, at the start, the MENA economies are saddling extensively higher amounts of debt. What is of greater importance than the debt level, however, is the maturity of these debts. It is not enough to comfort oneself into security by looking whether the structure of debt is predominantly long-term. Even long term debt at some point becomes due. And when debt becomes due, the issue of credibility becomes important. If an event makes the payment of that debt impossible, then the economy must have credibility that the debt will be repaid, so that debt restructuring or rollovers can occur. And in the case of Argentina, the lack of credibility put a complete halt to the possibility of rolling over the debt after the first "voluntary" debt swap. The problem was not how fast the debt was projected to grow, but that no one wanted to lend more resources to Argentina. The loss in credibility of Argentina's capacity to repay its debt became an anchor to the crisis, and a run on the banking system by depositors occurred.

How is credibility maintained? In the case of Argentina, a decade of credibility was ultimately lost through a combination a reluctance to address

serious reform of the labor market as well as the significantly loosened fiscal stance leading up to the 1999 elections.

What should the MENA countries take from the Argentina crisis regarding the loss of credibility? There are many lessons, but they cannot be encapsulated into a few key economic indicators. Credibility is the fusion of many factors. Certainly, though, macroeconomic stability is vital, and upholding a tight fiscal stance sends a strong signal on the government's commitment to maintaining that stability. Most of the MENA economies, embarked in the early 1990s on programs of macroeconomic stabilization and structural reform designed to bring budgets back into balance. But several economies have also let their fiscal stance loosen since then. In Egypt, the near budget balance realized in 1997 turned to deficit again by 1998, and through the late 1990s has averaged 4.6% of GDP. In Jordan, the budget surplus of 1% of GDP in 1995 also turned to deficit the following year, and by 1998 was close to 6% of GDP. In Algeria, the budget surplus of 3% of GDP in 1996 was followed by a budget deficit of 4% of GDP by 1998. While fiscal imbalances are not steadily growing in any countries in the region – which sends a signal of an impending crisis – we are seeing a laxness in maintaining fiscal determination, which is simply unsafe given the levels of debt in the region.

Secondly, credibility cannot be bought through rhetoric. Markets are keenly observant to actions. When Egypt's progress in structural reform lagged, Standard and Poor revised its outlook on the economy from stable to negative (though it did not adjust the country's risk rating), and Thomson Financial revised Egypt's sovereign risk rating outlook from positive to stable. While the comprehensive macroeconomic and structural reform programs espoused by many of the MENA economies in the early 1990s created an exuberant boost in their economic outlooks, markets will not wait forever. The MENA region must move beyond "stroke of the pen" reforms to the more serious, and challenging, issues that obstruct the development of a strong private sector. Unless the private sector begins to see itself as an independent source of growth and productivity in the economy, and society begins to underpin this change economically and politically, it is unlikely that any of the past economic reforms in themselves will be adequate.

It is not possible to go into detail about all of the issues which hinder the development of strong private-sector led growth in the region, but I will point out a few.

To begin, there is the size of the public sector. Governments may account for as much as 40-60% of gross domestic output and of employment in the region. This includes continuing high expenditures on military and social

services, which account for the large size of public sector. The big role of the state – a sector that essentially has low productivity and with limited inherent potential for productivity gain – is a drag on growth in most economies in the region. Efforts to reduce the public sector through rationalization of public employment, improving its performance through better incentives and institutions, and privatization of goods and services that could be produced more efficiently in the private sector have begun in many countries. But, by and large, these efforts remain slow and half-hearted to-date.

Secondly, there is the issue of trade reform. Trade policy in the region remains one of the most restrictive in the world with low level and speed of integration into the world economy. Tariff rates remain high and the extent of non-tariff barriers large. A number of policy moves across the region are expected to lead to greater trade openness, stimulating integration and hopefully growth, most notably the EU association agreements signed or expected to be signed shortly by Tunisia, Morocco, Jordan, Egypt, Algeria and Lebanon. This type of effort needs to be systematic.

Among the most important but lagging reforms is that of the banking sector, particularly the slow progress on privatizing state banks in countries such as Algeria, Egypt, Tunisia, Iran, and Syria. While in a number of countries the banking sectors are relatively healthy, this is not the case in most countries and financial sector development remains a principal constraint for the development of the private sector and for growth.

And finally, the region needs a virtual overhaul on its system of property rights, better legal systems and improved contract enforcement mechanisms.

I will end this talk now, going back to where I started, and ask whether the MENA countries should be cautious, given the events in Argentina. The answer, of course, is yes. Yes, they should be cautious to the factors that precipitated the crisis in Argentina, including debt sustainability, fiscal determination, and exchange rate management. And in terms of reform, yes there is a lesson of caution here for the MENA countries as well. But the caution is not to decelerate on the reform agenda to avert the type of crisis that Argentina is experiencing. If anything, the caution in terms of liberalization is that, whatever its speed, it needs to be complete. The liberalization of one sector can be undone by the lack of liberalization of another sector. An elimination of trade barriers, for example, can be turned over if the financial sector is not liberalized, and public sector banks control the financing of imports. Changes to the investment code are moot if labor laws prohibit the ability of firms to maintain competitiveness. We have learned also from the Asia crisis, and the experience of the former Soviet Union, that liberalization requires adequate

institutions and regulations. And so, I hope that the crisis in Argentina does serve some purpose for the countries of MENA in evaluating their steps forward, and that as a region, they renew their commitments to furthering and deepening the economic and structural reforms they began – so that higher and sustainable economic growth can be ensured, so that employment creation will meet the demands of a growing workforce, so that the needs are met and opportunities expanded for the poor, and so that a crisis such as the Argentines are currently facing never occurs in the MENA region. But that remains to be seen.

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