Center for Full Employment and Price Stability
Research Archive

An Alternative View of the Argentine Crisis: Structural Flaws in Structural Adjustment Policy

Seminar Paper 12

Jan Kregel
Levy Economics Institute

An Alternative View of the Argentine Crisis: Structural Flaws in Structural Adjustment Policy

Seminar Paper
No. 12
12/2002

Jan Kregel

I. The Causes of the Argentine Crisis: The Official View[1] -- Lax Fiscal Policy

On Christmas Eve of 2001, the government of Argentina announced the suspension of payment on its debt service commitments on non-official borrowing. It joined an expanding group of Latin American and Asian countries that had once been championed as examples of the benefits of the sound economic policies implemented in the context of IMF structural adjustment programmes, but whose successes were rapidly reversed by major financial crisis.

The ongoing crisis in Argentina is of especial interest since Argentine economic policy had been supported by an IMF lending programme, and thus under continuous Fund surveillance, for the last decade. Despite the fact that during the 1980s and 1990s consolidated government expenditures in real terms grew at an average rate of around 2 per cent per annum (see Appendix) , that the share of government expenditures in GDP was between 20 and 30 per cent and for most of this period, and the share of debt to GDP and the ratio of the government fiscal deficit to GDP[2] would have been compatible with the convergence criteria set by the EU for participation in the common European Currency[3], it has nonetheless generally come to be accepted that the major cause of the problems in Argentina was inappropriate fiscal policy, and in particular the failure to achieve budget surpluses during periods of rapid growth[4] that would have reduced outstanding debt and provided space for more active counter-cyclical fiscal policy during periods of recession.[5]

II. An Alternative Interpretation -- Structural Flaws in Structural Adjustment

However, this view does not give a complete picture of the factors that led to the growth and unsustainable nature of Argentine debt because it fails to take into account one of the fundamentals of development theory that took on special relevance after the introduction of Argentina's Convertibility Law. The "two gap" approach to the constraints on economic growth in developing countries draws a distinction between the domestic "savings gap" and the external "foreign exchange gap". It implies that even if national savings are sufficient to finance a programme of domestic investment (or repayment of foreign claims), it could not be implemented unless the country earned a sufficient amount of foreign exchange through the current account surplus to pay for the required foreign capital and associated imports (or repay foreign claims) (See *Trade and Development Report*, 1999, Part II, Chapter IV). With respect to repayment of foreign claims on the government, the problem was made more acute by the fact that the Convertibility Law gave domestic holders of peso denominated debt, as well as foreign holders of dollar denominated debt, the right to demand payment in foreign exchange. Thus even if sufficient domestic savings could have been created through a fiscal surplus the repayment of internal and external claims on the government depends on the existence of a sufficiently large current account surplus.

This means that even if Argentina had been able to increase its budget surplus during its high growth years this would only have been a necessary, but not a sufficient, condition for reduction in debt. The type of stabilisation programme introduced by Argentina, with Fund support, virtually precluded current account surpluses, at least in its initial stages. The most appropriate measure of debt sustainability under such conditions is not the ratio of debt to GDP or debt service to exports, but the ratio of debt service to the current account surplus.

After the 1980s debt crisis Mexico, Brazil and Argentina all pursued IMF supported structural adjustment policies involving currency stabilization through some form of currency peg, deregulating internal markets and opening them to foreign imports, liberalizing the financial sector and privatizing most public sector assets to increase the role of the private sector decision making in the economy. All were highly successful in achieving rapid reductions in inflation and in creating improved expectations of domestic profitability in domestic markets that allowed a rapid return to international capital markets as sovereign borrowers. It was this access to external financing that allowed them to resolve the debt overhang of the 1980s through the sale of public assets to the private sector, by attracting foreign direct investment and most importantly by refinancing the debt in private international markets, rather than repaying it through current account surpluses, or defaulting on outstanding debt. However, despite a combination of restrictive monetary and fiscal policies and a reduction of state financing through privatization they were less successful in achieving sound fiscal balances and despite lower domestic absorption, external imbalances remained a major constraint in their attempts to convert currency stabilization into sustainable growth. This meant that internal and external debt positions did not improve, and in some cases continued to deteriorate, even as other macroeconomic policy indicators improved. The persistence of large stocks of external debt meant that domestic policy remained constrained by external shocks, and in particular by the necessity to maintain flows of external finance and the impact of international capital market interest rates on the carrying cost of the outstanding debt. The failure of domestic producers to become major competitors in international markets in the short period in which this liberalization of domestic markets to foreign competition took place meant that when growth occurred it was not led by expanding demand via higher net exports, but rather via higher foreign capital inflows. This has been characterized as "debt-led" growth, in contrast to "export-led" growth, and has meant that any given level of economic growth has meant a higher share of imports, creating a vicious circle of external financing crises that replaces the "stop-go" cycles of the 1960s balance of payments crises.

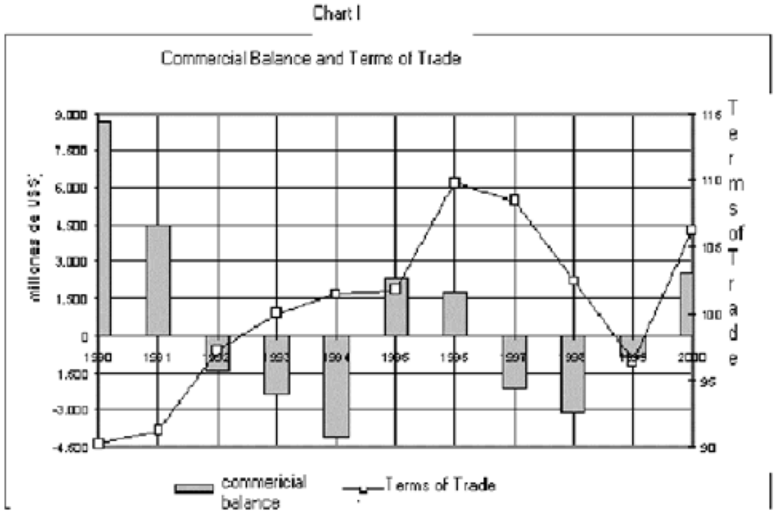
III. Argentina's Success in Fighting Inflation

Argentina's successful adjustment performance was little different from that of her Latin American neighbours. The inflation rate, which had peaked at over 3000 per cent in 1989 and remained above 2000 percent in 1990, was reduced to double digits in 1992 and eliminated by 1996. However, unlike the exchange rate bands or crawling pegs introduced in Mexico and Brazil, in 1991 Argentina passed a Convertibility Law that decreed parity between the Argentinian peso and the US dollar and a reform of the Central Bank law which required the peso currency circulation and the reserves of the domestic banking system to be fully backed by holdings of US dollar reserves.

As in other countries, the sharp fall in inflation brought increased real incomes, especially to lower income groups with higher propensities to spend, and produced a sharp improvement in domestic demand. This increase in purchasing power was accelerated by the competitive pressure of liberalised imports on domestic prices as well as by the increased availability of consumer credit. Growth, which had been negative over the lost decade of the 1980s, quickly revived and the economy expanded at rates above 5 percent until the Tequila crisis of 1995.

However, the response of the export sector to the impetus of foreign competition was much less rapid than the impact of improving growth and income conditions on domestic demand for imports.[6] By 1997 the share of imported goods and services in GDP had doubled to around a 12 percent, while the share of exports remained substantially stable around 10 percent.[7] The commercial balance deteriorated from 1992 to 1994, reaching a deficit of around $4.5 million compared to a surplus of roughly twice that amount in 1990. The result was a steady deterioration in the current account balance that reached a deficit of over 4 percent when growth exceeded 5.5 percent in 1994.

Chart I

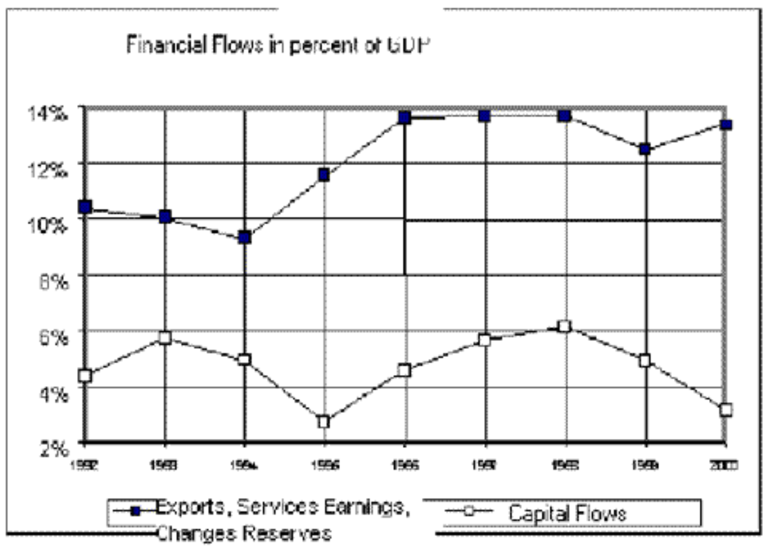


Part of the weakness in the commercial balance could be attributed to the loss of competitiveness[8] following the adjustment path to zero inflation in conditions of exchange rate stability that caused an appreciation (from what was most probably an already overvalued rate before the introduction of the Convertibility Law) in the real exchange rate of over 10 percent per annum in 1992 and 1993[9], and the associated loss in the terms of trade (see chart 1[10]). However, this was not a cause for policy concern since the currency board system was presumed to preclude the possibility of the central bank financing either a fiscal or an external deficit. Instead an autonomous adjustment mechanism was presumed to operate in which the external deficit would produce a drain in foreign exchange reserves and thus a decline in the domestic money supply that would cause domestic wages and prices to fall, restoring external competitiveness and restoring external balance.[11]

IV. The Failure of the Currency Board Automatic Adjustment Mechanism

However, this automatic adjustment process can be severely disrupted if other factors determine the quantity of reserves, and other components of the external account dominate trade in goods and services. As a result of the liberalization and deregulation of domestic goods and financial markets, capital inflows more than offset the current account deficit after the introduction of the Convertibility Law. Indeed, up to the period of the Tequila crisis non-financial private sector inflows alone more than covered the current account deficit. Although the Central Bank did not finance the current account deficit, external creditors did (see chart 2), and as a consequence the constraint on domestic money supply growth was inoperative. Indeed, the flows were so large as to create impetus in the opposite direction. There was thus no automatic adjustment to return the economy to external equilibrium.

Chart 2



Further Argentina entered the 1990s carrying an external debt-service burden accumulated in the 1980s debt crisis, the privatization programme, including the privatisation of the public pension and retirement system[12], plus the persistent fiscal and external deficits in the early 1990s caused additional external borrowing that produced increasing debt service and profits payments to foreign owners of privatized entities (see Chart 3). In addition to goods and services trade, the current account thus also included financial service transfers which already accounted for around a third of the deficit at the beginning of the 1990s and reached levels above three quarters in the last half of the decade. These financial service flows are determined by interest rates, repayment schedules and a host of other factors, none of which is linked to the international competitiveness of Argentine exports of goods and services or to domestic absorption and were of a size that could more than offset any improvement in the commercial balance.

There is an equivalent in the fiscal balance to the problems caused by large debt service flows for the automatic adjustment of the current account. Under the currency board system the central bank cannot provide financing for a government budget deficit since it cannot issue currency against government debt unless it also acquires foreign exchange. Thus, when government fiscal receipts fail to cover its expenditures it must either increase taxation or reduce expenditures unless it can borrow from the public. Any of these responses should have the same general effect of reducing domestic demand and exercising downward pressure on wages and prices. This should cause imports to fall, exports to rise and external demand to expand sufficiently to offset the fall in internal demand. However, if the external adjustment mechanism is inoperative because of external capital flows, then the internal adjustment will also be inoperative. And, just as the debt service flows in the current account may offset changes in the commercial account, the share of interest in the government budget may more than offset any adjustment in its current expenditure budget. For the first half of the decade the government could count on revenues from the sale of state-owned property[13], and in the second on a captive market for government debt created by reform of the pension system and of the banking laws. The result was an increasing share of government expenditures determined by interest on the debt, an expenditure that could not be cut through normal budget policies. Thus, although the government fiscal position on current expenditures was in surplus over much of the period, the increasing size of interest payments meant that the overall position was in increasing deficit, a deficit that was financed by increased foreign borrowing.

The adoption of the Convertibility Law was to have two major benefits for the economy. In addition to the automatic stabilization of the internal and external balance at a stable price level, it was also meant to reduce domestic interest rates and the resulting increase in investment was to support growth. During the period of hyperinflation, nominal interest rates had to compensate for the loss of purchasing power due to domestic inflation, as well as the loss of purchasing power due to devaluation of the external value of the currency. Price stability would eliminate the inflation adjustment while the currency board, by insuring that every peso in circulation was backed by a US dollar, would eliminate the exchange rate risk. A loan to an Argentine borrower would be no different than a loan to a US borrower, since pesos were backed by dollars and debt service could thus be guaranteed in dollars. It was thus expected that domestic interest rates and international borrowing rates would converge toward US levels. The convergence would not be complete since other aspects of risk associated with particular borrowers and local conditions would still differ, but the spread over dollar rates was expected to be minimal.[14] If realized this would have two important effects – reduced borrowing costs would increase investment and reduce the interest cost of government borrowing. However, investment over the decade has remained around 18 percent of GDP, and appears to be more driven by growth prospects than interest rates, while rates on Argentine debt have not been much different from those of other emerging market borrowers, such as Brazil, in the period leading up to the crisis.

Thus, the success in eliminating inflation and increasing growth along with opening domestic markets and reducing the role of government through privatization produced large capital inflows which ensured that even though the automatic adjustment process had started the slow process of increasing export competitiveness[15] and an improving commercial account through falling wages and prices, it would not have been able to restore external equilibrium in time to meet debt service commitments on a timely basis.[16] By further increasing future foreign claims on Argentina through increased capital inflows, while at the same time reducing the means of meeting those claims through the rising share of interest payments in the current account deficit, it set in motion a mechanism that could only be sustained by continually increasing foreign borrowing through a form of Ponzi financing scheme. If the Ponzi nature of the policy was detected sufficient foreign borrowing could not be sustained the only resolution would be through suspension of the Convertibility Law or by abrogating debt contracts. The automatic adjustment mechanism could not provide relief since capital flows change much more rapidly than the time required for falling domestic wages and prices and lower incomes to produce a commercial account surplus large enough to meet the debt service. If international markets continued to lend to Argentina in these conditions there must have been confident expectations that the current account would return to surplus at some date in the future or that Argentina would benefit from an international rescue package that would allow it to meet its foreign claims.[17]

Thus, through most of the decade the current account deficit did not constitute a binding foreign exchange gap, nor did it determine domestic monetary conditions, since capital inflows from privatization and foreign direct investment, as well as additional government borrowing, more than compensated. This not only diverted attention from the existence of the necessary condition for reduction in debt service in the form of a current account surplus, it meant that the performance of the economy became totally dependent on external capital flows. Only once during the period of the 1990s did the economy produce a current account surplus, in the last quarter of 1995, but this was the result of the large jump in exports, caused by the sharp expansion in import demand from Brazil after the introduction of the Real plan, combined with a decline in imports due to lower domestic income growth caused by the spillover from the Tequila crisis. When the panic passed with the organization of the Mexican bailout, growth resumed and with it the Argentine trade and current account deficits returned to their former levels. Despite the external surplus, the money supply did decline in 1995, but this was largely the result of an unexpected aspect of the Convertibility Law as domestic residents, fearing for the safety of their deposits, withdrew them from Argentine banks, producing a contraction in the money supply of over 10 per cent in the first half of the year.

V. The First Warning Signs -- the Tequila Crisis

The Tequila crisis should have been a warning of the vulnerability of the Argentine economy to changes in external flows. In 1994 the government had to resort to domestic issues to meet its financing needs as external funds and privatization proceeds fell of sharply. At the same time, interest rates rose substantially as the US tightened policy and the difficulties in Mexico raised emerging market interest rate spreads. Interest costs started to rise from this period. However, the extremely rapid recovery in growth, the very positive support given by the MFIs to the Argentine stabilization policy, the steps taken to strengthen the banking system by allowing foreign ownership to a majority of the banks[18], as well as the increased use of commercial lines of credit[19] and pre-borrowing to meet external payments[20] all suggested that Argentina would be immune to the problems that had produced difficulty in Mexico. FDI flows remained on a rising trend and in 1997 and 1998 foreign borrowing and FDI inflows more than offset the combined internal and external deficits, allowing for the net reserve position to improve from a low of around 10 billion during 1995 to around 20 billion in 1997, further reinforcing the belief in the fundamental stability of the economy and the success of its policies. Thus, just as in other cases of stabilization, external funding masked the deterioration in the fiscal and external accounts as the improving reserve position and the strong growth performance signaled reduced external risk for investors.

However, the response to the Tequila crisis produced some changes in the composition of financing flows. The recourse to domestic markets has already been mentioned. This meant that the stimulative impact of the government deficit was largely offset by the reduction of monetary growth and the rise in interest rates. Second, a policy was adopted of convincing external investors of the soundness of the economy by means of building up a war chest of currency reserves that could be shown to cover the debt servicing needs over the near future. This was done in two ways. The first was to tap international markets whenever conditions allowed, and when possible to substitute short-term debt with more expensive longer-term debt to reduce near-term debt service commitments. This peremptory borrowing only served to further increase outstanding debt and was at interest rates that were substantially higher than those incurred during the first half of the decade, thus increasing overall debt service. Second was to seek additional funds from the IMF. These funds came at the cost of increased conditionality, in particular the IMF had tightened its conditionality on the required primary surplus on the presumption that this was the best way to reassure external creditors of the soundness of the economy.[21] The programme was to produce a surplus of 2.75 percent of GDP through increases in value-added tax, import duties and government expenditure cuts. Thus, at precisely the time when weakness in the banking sector and tight domestic monetary conditions due to reversals of capital flows were already putting downward pressure on the economy, the more restrictive conditions for increased borrowing from the Fund were clearly pro-cyclical and provided a forewarning of the recession which was to dominate the rest of the decade. This might lead one to conclude in difference from the commonly accepted view that the problem was not that fiscal policy was too lax in goods times -- Argentine unemployment continued to rise during the periods of highest growth, but rather of policy being too restrictive in periods of weakness. This is especially evident after 1998.

The recovery from the Tequila crisis was short-lived as the Asian crisis, the global liquidity crisis that followed the Russian default in the summer of 1998, and then the Brazilian devaluation, all led to periods in which external markets were closed to emerging market borrowers such as Argentina, and the IMF placed increasing pressure for tighter fiscal policy to reassure foreign lenders of the strength of the economy. Joined with the tighter domestic monetary conditions this produced just the opposite impact. Even though international interest rates declined after the Russian default, the spread over international rates increased sharply and the JP Morgan index jumped by some 1000 basis points. During this period the Brazilian defence of the pegged exchange rate regime associated with the Real Plan had a sharply negative impact on Argentine exports as growth in Brazil slowed and international interest rates rose. After a further sharp decline in the spring of 1999 after the Brazilian devaluation the bilateral balance with Brazil regained its pre-devaluation position by the summer of 2000.

However, the negative impact of the Brazilian devaluation at the beginning of the year did serve to reinforce the decline in economic activity that had already started in mid 1998 and industrial and agricultural production both declined sharply in the first quarter of 1999. The fiscal position also started to deteriorate as declining growth reduced fiscal receipts while budget expenditures (in a number of cases by overriding presidential vetoes) were approved based on an official forecast of 3% growth. The outturn was closer to negative 3 percent.

Despite a continued improvement in the trade and current account balances, produced by the decline in activity, this was not sufficient to reduce the reliance on external flows and the government embarked on the only policy consistent with maintenance of the Convertibility Law -- to ensure external lenders of the soundness of the economy and the ability to meet debt service by building up a war chest of reserves through increased external borrowing. This was accomplished by accessing international capital markets whenever conditions allowed, but at increasingly punitive interest rates, and by increasing the use of IMF resources, which was achieved at the cost of increasingly punitive conditionality. None of the IMF budget targets stipulated were achieved as growth and fiscal receipts continually failed to meet the values assumed in calculating the targets, yet they produced continuous downward pressure on government expenditures. Thus from 1999 onwards the economy entered into a vicious circle in which the government continually cut expenditures in order to preserve IMF funding, but failed to meet the primary deficit targets as growth rates fell, and continued to borrow in international markets in order to supplement reserves, but at increasingly onerous interest rates which increased the interest burden of the debt, and the interest costs in the budget. In simple terms, from the onset of the Asian crisis the policy was to reassure foreign lenders that the debt burden was not excessive by increasing borrowing, and in order to reassure them of the soundness of the economy by pledging to meet deficit conditions that could only debilitate domestic production.

VI. New Government, Old Programme

That this policy was internally inconsistent and self-defeating was especially evident in the outcome of the economic programme of the new Argentine government announced in December 1999 in order to gain approval for an additional IMF standby credit. Approved in March 2000[22] the government considered it "precautionary" because it was only to serve as a sign to the markets of the ability to meet commitments. It allowed capital market borrowing to continue, despite increasing spreads, and by early September the government had raised over $14.5 billion, more than 80% of the gross financing required for the year. Yet, the economy failed to recover from the recession, and after a brief pickup in the last quarter of 1999, the economy was stagnant and growth was flat in 2000. While primary government expenditures were in fact reduced by over 2 percent, this was more than offset by the increase in interest payments, and receipts fell by more than 3 percent. By the fourth quarter the government's primary surplus had become a deficit. Although the net financing requirement of the government fell in 2000, government external borrowing in fact increased from 9.3 to 9.5 billion pesos.

While the negative impact of the fiscal tightening on domestic demand was not the only cause of the sustained recession, it certainly reinforced the adjustment to the external shocks that Argentina faced during 1998 and 1999, including a cumulative 12% loss in the terms of trade, the crises in Russia and Brazil, the appreciation of the dollar (and thus of the peso) and the downturn in demand in Latin America, as well as the deflation of domestic costs and prices which had a negative impact on both business and consumer confidence and produced a progressive hardening of financing conditions in international markets.

The resignation of Vice-President Carlos Alvarez, who represented Frepaso in the newly elected government coalition, in October of 2000 set off the withdrawal of over three-quarters of a billion dollars in peso denominated deposits from Argentine banks and started rumors of a possible devaluation of the currency or default of outstanding debt. The response of the government was increased reliance on its two policy tools – increasing the primary surplus and increasing foreign borrowing to ensure foreign creditors of its ability to meet the over $30 billion of principal repayments on sovereign debt due in 2001[23] and to build up reserves. In order to prevent additional outflows the Central Bank decided in the beginning of November to limit commercial banks use of short-term Treasury paper (Letes) as collateral for their *pases activos*.[24] It also drew on its Stand-By arrangement with the IMF and launched a revised economic plan that it presented with a request for additional "precautionary" financing.

As a result, in January 2001 the IMF increased the Stand-By Credit[25] granted the previous March to $13.7 billion, representing 500% of Argentina's quota.[26] The World Bank and the IDB also promised new loans of around $4.8 billion over two years and the government of Spain contributed $1 billion. These multilateral and bilateral funds amounted to around a third of the governments' estimated gross financing requirements of just less than $30 billion, including the rollover of the $5 billion outstanding short-term Treasury bills (Letes), in 2001. In order to meet the remainder of the debt servicing for 2001 the government negotiated with local banks the rollover of maturing bonds and purchase of new issues of $10 billion. AJFP pension funds were also expected to purchase about $3.0 billion of new government bonds. The government supplemented these funds with a six-year 500 million Euro bond issue and a debt swap of $3 million short-term debt for a new five-year treasury note and a new 11-year global bond.

While the new financing package covered the expected debt service for the year, the promised economic recovery did not appear. GDP fell by 1 percent in the first quarter as compared with the first quarter of 2000 and consumer prices fell by around 1 percent on an annual basis. The result was a shortfall in government receipts that caused the federal government deficit to exceed the IMF target of 2.1 billion pesos by around 50 %. The resignation of the Economy Minister, Machinea, and political opposition and civil demonstrations against the increased fiscal retrenching that would have been involved in the newly appointed Minister Lopez Murphy's intention to proceed with the second generation reforms of the government administration and social expenditures produced his rapid resignation and another flight of deposits from domestic banks of over $5.5 billion in March. This quickly called into question the adequacy of the previously arranged financing to meet the annual debt servicing. At the end of March all major rating agencies downgraded Argentine debt (e.g. Moody's to B2) and introduced negative ratings watch, which meant effective exclusion of Argentina from international capital markets. The two-pronged policy of more borrowing to cure over indebtedness, and more government expenditure cuts to cure a flagging economy had reached an impasse with its rejection by the international capital markets and by domestic social and political forces.

VII. Old Economics Minister, New Programme

A new approach came with the appointment of the original architect of the Convertibility Law, Domingo Cavallo, as Minister of Economy on 20 March with special powers to introduce economic measures by decree. He shifted attention to restoring growth to the economy through what in the Reagan years in the US had been called "supply-side" measures. Since the Convertibility Law precluded use of the exchange rate to influence the foreign balance, taxes and tariffs were manipulated to adjust relative prices in favor of domestic investment and to cut imports of consumption goods in a way similar to policies already experimented with little success between 1993-1995 (See Sirlin, op. cit.). In addition, the Convertibility Law was amended so as to fix the peso exchange rate to a basket composed in equal parts of the US dollar and the Euro, with the proviso that it would only take effect when the US dollar and the Euro had reached parity. Thus, while the new Law had no impact on exchange rates for financial transactions when it was introduced, it provided for an adjustment period in which commercial exchanges would take place as if $/Euro parity had been achieved. The practical impact was to give exporters a subsidy of around 6-7 percent that was paid for by a tax of the same amount on imports. To counter the decline in income and sales tax receipts due to falling activity, a tax on financial transactions, first employed in 1983 and again from 1988 to 1992 was resurrected[27], along with a new tax on capital gains on unlisted shares and the extension of the tax base for VAT. Measures were also taken to increase domestic liquidity by exempting government securities that the central bank received for its repo (paseo) lending to the banking system from the calculation of the 33 per cent limit on government dollar bonds that could be included in the calculation of the dollar backing for the domestic circulation and bank reserve deposits.[28]

However, these measures were simply the imposition of the automatic adjustment mechanism that was supposed to occur under the currency board and could not have an immediate impact on the performance of the economy or offset the problems caused by the high proportion of interest payments in the fiscal and external imbalances. Thus, despite the emphasis on growth in the new policy, the possibility of meeting debt service commitments for the year remained in question without IMF financing. The failure to meet the existing budget targets and the new economic programme thus produced a renegotiation of the IMF Stand-by agreement in May that provided for disbursement of the first installment of the IMF funding for 2001 with quarterly deficit targets revised to the actual outturns, but the annual target of $6.5 billion retained.

Having assured the continuity of the January 2001 financing package, but with no possibility of increased financing from multilateral sources and no possibility of raising additional funds in private capital markets, the only available path to avoid default was to eliminate the need for additional borrowing. At this stage it was clear, if it had not been before, that Argentina could not meet its existing profile of debt service commitments and that a choice had to be made between restructuring and default. The absence of an international mechanism to provide an orderly process for this restructuring meant that Argentina would in fact do both.

Measures were taken to increase domestic sources of funding for the government deficit on the one hand, and to decrease the required debt service payments to international lenders on the other. To achieve the latter without default, Argentina offered creditors a voluntary exchange (the so-called "megacanje") of their existing debt holdings for a range of five different bonds with longer maturities and delayed interest payments. The intention was to shift current debt service payments far enough into the future to eliminate the need for new borrowing in the short term and to allow sufficient time for the economy to recovery and attract new voluntary inflows in the medium term. The intention was to shift as much of the currently accruing interest and principal payments to after 2005, the date by which the Fiscal Responsibility Law required the budget to be in balance, and by which time it was assumed that the economy would again be growing at 5 or 6 percent.[29]

Before the swap the government's total financing requirement for 2001 was estimated at around $22.7 billion (of which 43% had been met by May) and $25.7 billion for 2002. After the swap financing needs for 2001 fell to 17.9 billion. The swap reduced principal repayments on medium and short-term debt for 2001 from $14.168 billion to $11.380 billion. However, for 2002, even with the reduction of about a quarter of its financing needs, the shortfall was still some $10-12 billion. Thus, although the swap was considered a relative success, it came at the cost of increasing the average interest rate on outstanding debt to around 15 per cent, compared to the highest rates paid on existing debt of 12 percent, and some Brady bonds with interest rates of around half that rate. Thus, the new economic policy for convincing capital markets that debt service was not excessive to the ability to pay was to reduce current debt service by increasing future debt service – paying more was substituted for borrowing more and had the negative impact of increasing the future growth rate and external surplus that would have to be generated to meet the future commitments.

The swap also allowed the government to insure IMF financing because it improved the fiscal balance, reducing the projected 2001 payments of interest of $11.5 billion by around $450 million. In addition, because $1.8 billion of Par Brady bonds, and a half billion of Discount Brady bonds were exchanged, the government recovered around $816 million worth of US Treasury discount bonds that had served as collateral for the Brady bonds.[30] The net result of the swap operation on the budget deficit was thus the combination of the reduced interest payments of $450 million and the proceeds of the sale of the US Treasury securities of around $400 or nearly a billion dollars. This brought the programmed figure for the 2001 deficit to around $5.6 billion, and made the IMF target for the full year plausible.

The short-term benefits of the swap were to create market expectations that the government could meet the IMF deficit targets for both 2001 and 2002 without new programmes of expenditure cuts, as well as to ensure the uninterrupted disbursement of the funds from the $40 billion IMF organised support package which meant that Argentina would not have to borrow from international capital markets in 2001. It was hoped that this would increase market confidence sufficiently to reduce the risk premium and permit Argentina subsequently to return to the markets to borrow the $10-12 billion that would be required to meet debt servicing in 2002. Thus, after the conclusion of the swap all that was required for the completion of Cavallo's second economic miracle and the preservation of the Convertibility Law was for the economy's performance to stabilize so that the deficit figures did not deteriorate further.

VIII. Old Economics Minister, Back to Old Programme

However, this was not to be the case. In the summer growth failed to recover and tax receipts continued to decline, and several provincial governments threatened default as a result of the failure of the Federal government to forward funds as required under the Co-participation law, suggesting that there was more to the debt problem than met the eye and that the government had only been able to meet it commitments because it was failing to make the transfers of tax receipts to provincial governments as required by the Co-participation Law. When what was expected to be a routine domestic auction of short-term 180 day bills in July produced an interest rate of 16 per cent, it became clear that even the "guaranteed" domestic portion of the financing package for the year was in jeopardy and over $5 billion of deposits were withdrawn from the banking system during the month, and sharp increases in interest rate spreads provided the background to the political campaign for parliamentary elections due in October. Unable to finance even its short-term needs for working capital at reasonable interest rates Cavallo gave up his emphasis on growing out of the crisis, and introduced a draconian policy of limiting government current expenditures to current cash receipts, the so-called "zero deficit" law, passed at the end of July that required sharp reductions in salaries and pensions in order to meet the deficit targets in the IMF financing package.[31] At this point it was clear that Cavallo's second miracle could not be produced, the Federal budget could not be balanced and the debt could not be serviced for 2001, although Cavallo was given new hope by an IMF review of the programme that concluded by making available an additional $6 billion in September and another $3 billion for an unspecified restructuring of the external debt at an unspecified future time.

In a last ditch attempt to meet the 2001 servicing requirements, at the beginning of November Cavallo announced that the government would offer holders another "voluntary" debt swap in which existing bonds would be exchanged for "guaranteed"[32] loan paper with a maximum interest rate of 7 percent. The intention of the new swap was to reduce debt service from around $14 billion to half that amount. Originally only offered to domestic holders of debt, who presumably had no choice but to accept, the result was a reduction of $4 billion in interest and a shifting of debt service on $55 billion in outstanding debt to after 2005.[33] The conditions of the new swap did nothing to increase confidence among holders of peso and dollar deposits in Argentine banks since financial institutions were among the major holders of the debt and by the end of the month withdrawals of nearly $1 billion per day were reported. With barely enough dollar reserves to cover the outstanding circulation of pesos there was no possibility of meeting the deposit claims on banks in dollars. The government thus no longer had the choice of full dollarisation and had to stop the deposit drain before it exhausted foreign exchange reserves and made the banks insolvent.[34] In mid November the IMF announced that it was suspending disbursements due to failure to meet the budget conditions and by the end of the month suspended the performance review making any further IMF funding unlikely. To avoid abrogating the Convertibility Law the banks were closed, and a limit, the so-called "corralito"[35] of $250 per week, was placed on withdrawals from bank deposits at the beginning of December.[36] The response was a middle-class uprising of housewives beating on casseroles as they marched through the streets of Buenos Aires, and politically organized violence in the form of the looting of supermarkets that produced a semblance of civil disorder and the resignation of the economy minister on December 19 and the President on December 20, soon followed by the Christmas Eve announcement by the provisory President Saà that the government could not meet any of its private financial commitments.

As a consequence of the default, by the first quarter of 2002 the Argentine banking, insurance, and pension[37] systems were technically insolvent, given the collapse in the value of their government bond investments, as were the recently privatized public utilities, most of which had borrowed the funds for their purchase price through the issue abroad of dollar denominated liabilities.[38] Nearly half of the population was living below the poverty line[39] and industrial production was declining at double digit rates while inflation was at double digit rates. Real wages had declined by 40 percent and unemployment was again above 20 percent. The devaluation of the peso peaked at over 3 pesos to the dollar in the first quarter and subsequently went as low as 4. A decade of growth was lost in less than three months. As in the Asian crisis the official position was that Argentina had only itself to blame for this disaster – that its fiscal policy was inappropriate and its politicians are corrupt and inept. This may be true, but there were a number of equally important causes. International investors who were willing to believe that a country that borrows to pay its debt service – what is normally called a "Ponzi scheme"– is a good credit risk. Multilateral financial institutions who believed that cutting expenditures to balance budgets in conditions of recession would increase international lenders' confidence in a government's ability to pay its debt service and produce economic recovery. Economists who failed to note the difference between the factors that influence the goods and the financial services flows of the current account balance, and who fail to notice that under a currency board ability to repay debt is given by the current account balance, not the fiscal balance.

IX. Assessment-- What Went Right, What Went Wrong

The Convertibility Law was clearly successful as a cure for hyperinflation. However, the failure to identify and implement an exit strategy meant that this success came at the cost of vitiating the automatic structural adjustment mechanism that was supposed to operate to ensure internal and external balance. Eliminating inflation did not automatically provide the conditions required for sustained growth and the major policy problem soon shifted to fighting deflation and recession.

One of the reasons for introducing policies such as a currency board arrangement is to take decisions over monetary policy away from central bankers thought to be excessively influenced by political considerations. Such policies are supposed to "tie the hands" of the government and create credibility amongst international investors of its resolve to pursue sound monetary and fiscal adjustment policies. However, in conditions of free international capital flows such an arrangement simply places the control over monetary policy in the hands of international capital markets. The Argentine experience indicates that giving control over monetary policy to international investors and private banks is no guarantee that it will be appropriate to produce price stability or structural adjustment. In such a regime monetary policy capable of controlling monetary aggregates to provide the basis for price stability is thus shifted from the control of domestic monetary aggregates to the control of capital inflows.[40] Just as Cavallo attempted to speed the operation of the automatic adjustment mechanism by directly influencing relative prices through changes in indirect taxes, tariffs, export subsidies and import duties, steps should have been taken to ensure that capital inflows were appropriate to the restoration of current account balance. More important than policies to ensure fiscal surpluses in times of rapid growth would have been policies to reduce external borrowing in times of rapid capital inflows.

This raises the question: Had capital inflows been lower, had fiscal policy been less stringent, had an exit strategy from the exchange rate regime been successful, might the Convertibility Law experiment have been a success? The answer appears to be no, for in the absence of the rapid capital inflows the success in reducing the inflation rate and the high initial growth rates would in all likelihood not have occurred. The combination of the Convertibility Law and open international capital markets producing large net capital inflows is not a policy that provides a homeostatic mechanism to ensure balanced growth and can only work in conditions of sustained expansion. But this is precisely the condition that it cannot assure if it is to satisfy the fiscal solvency criteria of international investors.

But the real problem is that the consequences of the crisis have been much more devastating than they might have been had there been an alternative policy to the haphazard voluntary restructuring of the debt that took place in the last year of the crisis. As already mentioned, the policy of making the government's commitment to the Convertibility Law more credible led to an ever increasing amount of external borrowing. While this was supposed to signal to the market the increased costs to the government of abandoning its policies and thus an increase in government resolve to maintain them, it also increased the profits of speculators who remained unconvinced. When international flows ceased and restructuring became necessary, instead of making the debt burden more sustainable, this policy made the burden less sustainable, first by borrowing more, then by offering to pay more future interest. The costs of probable failure soon outweighed any increase in credibility and resolve and default became the only solution. In the absence of a statutory arrangement this was probably the only solution. It suggests that it is now more than ever necessary to formulate a mechanism for the restructuring of international debt that provides a fair mechanism for dealing with debtors and creditors and with different classes of creditors in allocating the minimum losses necessary to allow the debtors to fulfill their obligations.

X. What Can Be Done?

The haphazard nature of the restructuring also had a negative impact on Argentina's performance after the effective default, even through in the absence of debt service payments the fundamentals of the Argentine economy were very solid. Before the default, despite the falling activity levels, the government was still running a primary surplus and the commercial account, in part due to the low level of activity, was in surplus. The elimination of debt service payments should have produced both a nominal budget surplus and a current account surplus. In addition, the devaluation of the currency should have produced a sharp improvement in peso export earnings given the concentration of energy and agricultural goods (in particular seed oils and cereals) exports, both of which are priced in international markets in dollars, and allowed a decrease in interest rates as the central bank recovered its ability to set monetary policy aggregates. With an improving current account and overall fiscal balance one might have expected that export led growth would have increased activity and provided possible stability for a credible equilibrium value of the exchange rate. Indeed, conditions appeared very similar to those that allowed Brazil's rapid return to growth after its 1999 devaluation.

However, productive activity could not take advantage of the improved macroeconomic conditions because the corralito made the exit strategy more difficult and effectively blocked access to financing. The Convertibility Law had only required dollar backing for currency in circulation and the banking systems' reserves with the Central Bank. Since the banks did not have sufficient dollar balances to meet their dollar liabilities and most domestic residents had borrowed dollars from the banks to finance home mortgages without dollar earnings to service them the majority of the dollar denominated deposits and loans extended to residents denominated in dollars could no longer be met. At the end of 2001 the banking system held around US$13 billion in liquid dollar assets available to meet its outstanding dollar liabilities of nearly $47 billion. The US$29 billion of credits extended to the public sector and US$54 billion to private sector borrowers were also in effective default, so that the difference between good assets and liabilities was larger than the banks' capital of some $15 billion and the banks were thus technically insolvent[41] and exporters could not get export credits, producers could not get working capital financing and households could not access their deposits to make simple day to day purchases. This was the result of a lack of an "exit strategy" from the Convertibility Law. Thus, much like the Asian crisis, recovery in the Argentine economy was blocked by the paralysis and potential insolvency of the financial system.[42]

The first steps in any recovery programme would thus have involved measures to restore the solvency of the domestic financial system. This initially involved restoring confidence in the value of the domestic currency. Finally, consultations with internal and external creditors would be necessary to give a clear structure to the way debt restructuring would be handled. As in any potential bank run the best way to stop it is to "show cash" to skeptical depositors. With the abrogation of the Convertibility Law and the Central Bank Law, the government had regained control over domestic monetary creation and the Central Bank could have lent against the government bonds and dollar loans in bank portfolios to allow banks to meet their deposit liabilities.

The real problem was not only to convince depositors to continue to hold bank deposits but to continue to hold pesos. To stop a run from the peso to the dollar, "showing cash" meant the possibility of having to meet the drain of around $50 billion in deposits excess to foreign reserves. Thus external financial support would have been crucial to any attempt to stabilise the exchange rate that would have been prerequisite to convincing depositors to continue of hold pesos. In the Mexican crisis some ten years earlier a support package had been arranged of near this amount and the package subsequently provided to Brazil came close. The policy could have involved the announcement of a large support packaged, an indication of the equilibrium rate (at the time thought to be in the range of 1.5 to 2 pesos per dollar) and the announcement that the currency would be left to float subject to intervention to avoid market excess. It is probable that the exchange rate would have rapidly depreciated, but the Central Bank would have had the possibility of selective intervention, creating bear squeezes against speculators to prevent the kinds of runs that create a market belief in a one-way bet. The mobilisation of the goods account surplus of around $1 billion per month would also have provided additional demand for pesos. It is clear that some of the outstanding deposits would be required as working balances, so that not all of the deposits would be potential demand for dollars and an increase in the bid/ask spread could make holding working balances in dollars uneconomic. Such a policy would have involved risks and it clearly would have had a higher chance of success had the corralito never been introduced. It would also have had a higher chance of success in the absence of the political instability that made action nearly impossible. But, in the absence of international support it could not even be attempted.[43] However, it is unlikely that it would have produced an outcome that was worse than the collapse of the productive and financial structure that has actually occurred.

Part of the absence of international support is due to fact that the policy discussion has concentrated on other aspects of the banking problem such as the possibility that freeing deposits from the "corralito" would allow a return to hyper-inflation as the funds were converted into dollars, producing a collapse in the exchange rate. There has thus been official international pressure to retain the banking restrictions, design an anti-inflation anchor[44] for monetary policy and to tighten fiscal policy, in particular borrowing by the provinces, to offset the inflation threat from the initial exchange rate adjustment. However, there seems little risk that hyper-inflation will return, especially if the exchange rate can be stabilised and confidence in the financial system restored. The impact of the devaluation on inflation is a once over adjustment on the prices of imported goods. There should be little propagation given the fact that wages have not adjusted to increase prices. Given the depressed state of domestic demand there seems little reason to fear inflation from fiscal stimulus.

In the event, the "corralito" restriction on deposit withdrawals was maintained and a two-tier exchange regime, a dual currency regime, and then a managed float followed in quick succession as Presidents changed. This raised the question of the rate of conversion of dollar assets and liabilities into pesos on bank balance sheets. If the conversion had been made at one to one, then holders of dollar deposits would have suffered by the amount of the devaluation while dollar borrowers would have benefited by being able to repay dollar debts in devalued pesos.[45] The banks then would have been illiquid, but not necessarily insolvent as the Central bank could have provided the required liquidity. However, to protect depositors dollar deposits were converted at a notional rate of 1.4 pesos per dollar (which was the original rate at which the commercial exchange rate was to be stabilized), with all other financial contracts converted at one to one[46] with an inflation adjustment (CER) which nonetheless made debtors' positions unsustainable as the inflation rate quickly passed 25 per cent without any increase in incomes. This shifted part of the depositors' losses onto the banking system without improving the probability of repayment of outstanding loans and preserved the insolvency of the banks that existed under the Convertibility Law. In the event, a series of legal challenges to the corralito have meant that a large proportion of the deposits have been allowed to leave the system. Thus the main problems preventing a response to devaluation similar to Brazil remain to be resolved. The multilateral institutions maintain that they must be resolved before they will provide additional funds, while it is highly unlikely that they can be resolved without additional funding.

It is interesting to note that a spontaneous financing solution seemed to be evolving after the introduction of the zero deficit law with the issue of provincial bonds (such as *Patacones* in Buenos Aires province, *Lecor* in Cordoba) which were used to pay the shortfall between tax receipts and public sector wages. The Federal government also issued its own version, the *Lecop*, which was used to pay the shortfall of the funds due to the provinces under the co-participation agreement. These bonds were convertible domestically and circulated widely as currency at par for domestic purchases because they could be used to meet tax and debt payments. They became quite popular and were applauded by some parts of the financial community and the financial press as an easy exit strategy to the Convertibility Law. Since they were only good for domestic purposes, they traded at a substantial discount against dollars and thus created an implicit devaluation without abrogating the peg. As they increased as a total of tax receipts and the wage bill, eventually only financial assets would have remained pegged to the dollar. However, since they were an uncontrolled source of liquidity and source of deficit spending by the provinces thought to be the source of the crisis, the IMF argued that they be abolished. It is interesting that they created no inflationary impact before the end of the year, although they had reached well over 20 percent of the total money stock by that time, and by mid-year they still circulate and constitute some 50 per cent of the money supply.[47]

Appendix: Average Annual Rates of Growth of Consolidated Public Expenditure
(millions of constant 2001 Pesos)

	1992-2001	1991-2001	1980-2001
Real GDP Growth	2.90	2.6%	1.15%
Total Consolidated Expenditures	2.89%	3.81%	1.27%
I. Government Administration	2.38%	3.68%	1.27%
I.1. General Administration	1.90%	3.64%	3.11%
I.2. Justice	6.09%	7.41%	5.85%
I.3. Defense and Public Security	1.77%	2.53%	-1.28%
II. Social Expenditures	2.65%	3.54%	2.34%
II.1.Education, culture, science and technology	5.05%	6.18%	3.06%
II.1.1. Primary Education	5.31%	5.85%	3.08%
II.1.2. Secondary and University Education	6.25%	8.40%	4.03%
II.1.3. Science and Technology	0.90%	0.26%	-1.14%
II.1.4. Culture	8.42%	5.26%	3.48%
II.1.5. General Culture and Education	2.02%	9.13%	3.94%
II.2. Health	2.92%	3.94%	2.60%
II.2.1. Public Health Measures	3.48%	5.29%	3.22%
II.2.2. Social Work - Health	2.96%	2.98%	1.74%
II.2.3. INSSJyP - Helath	1.48%	3.38%	3.67%
II.3. Potable Water and SewerSystems	-3.30%	-2.15%	-4.66%
II.4. Housing and Urbanism	0.23%	-1.76%	-2.97%
II.5. Social Assistance	4.72%	5.62%	2.87%
II.5.1. Public Social Assistance	5.89%	7.21%	4.17%
II.5.2. Social Work	-1.75%	-2.14%	-2.55%
II.5.3. INSSJyP - Social Expenditures	5.68%	7.22%	5.58%
II.6. Social Security	1.03%	2.04%	2.51%
II.7. Employment	7.27%	6.68%	1.57%
II.7.1. Employment Programs,Unemployment Insurance	31.08%	33.32%	14.45%
II.7.2. Family Allowances	2.89%	2.54%	-0.45%
II.8. Other Urban Services	-0.19%	1.10%	1.69%
III. Public Expenditures on Economic Services	-4.40%	-4.51%	-6.21%
III.1. Primary Production	4.64%	3.11%	-2.49%
III.2. Energy and combustibles	-14.75%	-13.04%	-10.10%
III.3. Industry	-5.15%	-6.41%	-8.75%
III.4. Services	1.03%	2.08%	-5.04%
III.4.1. Transport	0.61%	1.51%	-4.46%
III.4.2. Communications	7.69%	13.50%	-8.88%
III.5. Other Expenditures	-6.22%	-10.30%	-5.16%
IV. Public Debt Service	10.30%	12.93%	4.51%

Source: Ministry of Economics, Division of Consolidated Social Expenditures - Economic Policy Secretariat, Republic of Argentina

---

END NOTES

1 Other commentators take a more traditional approach in highlighting the overvaluation of the peso peg to the dollar and excessive foreign debt, e.g., Martin Feldstein, "Argentina's Fall: Lessons from the Latest Financial Crisis", Foreign Affairs, March/April 2002, and G. Perry and L. Servén, "The Anatomy of a Multiple Crisis: Why was Argentina Special and what can we learn from it," mimeo, World Bank, May 10, 2002 who argue for multiple vulnerabilities peculiar to Argentina, all of which involve overvaluation of the exchange rate in one way or another, and G. Calvo, A. Izquierdo and E. Talvi, "Sudden Stops, the Real Exchange Rate and Fiscal Sustainability: Argentina's Lessons," mimeo, Washington, IADB, emphasise the overvaluation subsequent to the Russian Crisis. Fanelli suggests that the high volatility of real and financial variables in the economy led to structural factors which induced market participants to errors in expectations, financial fragility, rigidities in the economy that led to a dominance of income over price affects producing a pro rather than counter cyclical adjustment. Cf. "Crecimiento, inestabilidad y crisis del la convertibilidad en Argentina," *Revista de la CEPAL*, No. 77, Agosto, 2002.

2 According to World Bank figures the ratio of debt to GDP in 1980 was 35 percent, rose to 44 per cent in 1990 and was 51 percent in 2000. The ratio of debt service to exports was 37 percent in 1980, 41 percent in 1990, but had jumped to 100 per cent by 1999.

3 The official budget figures should be interpreted with care. First, because reported figures often refer only to the Federal government and do not include the accounts of the provincial government who receive a share of Federal tax receipts through the co-participation law and are

responsible for the majority of social expenditures, second because of the use of creative accounting practices similar to those seen in the EU in the run-up to the creation of the Euro such as capitalization of interest expenses, exclusion of the accounts of public sector financial institutions, and treatment of structural adjustment loans from the MFI's as off-budget items. Estimates of such items produce an increase in the accumulated deficit for the period 1991-2000 of $54 to $70 billion which implies an outstanding indebtedness of around $200 billion at the outbreak of the crisis. See Mario Teijeiro, "Una vez mas, la politica fiscal" in Marcelo R. Lascano, ed., La economia Argentina hoy, Buenos Aires, Editorial El Ateneo, 2001, p. 270.

4 And that the IMF was not sufficiently vigorous in requiring tighter policy in these periods, see Mussa (*Argentina and the Fund: From Triumph to Tragedy*, Washington, D.C., Institute for International Economics, July, 2002 (http://www.iie.com/publications/publication.cfm?pub_id=343): "…when the Argentine economy was generally growing strongly, it is difficult to understand why the Fund did not make active use of its conditionality to press the Argentine government to run a more responsible fiscal policy. Rather, to avoid embarrassing the Argentine authorities, the Fund placed little emphasis on Argentina's transgressions of the initially specified fiscal targets, especially in public. And, the fiscal targets were significantly less demanding than they appeared to be (even allowing for stronger than expected economic growth) because they conveniently ignored substantial amounts of government borrowing that were viewed by Argentines as off budget ... In sum, the failure of the Argentine government to run a sufficiently prudent fiscal policy that effectively restrained the increase in public debt when the Argentine economy was performing well was surely a key –indeed, arguably, the key–to avoidable policy problem that ultimately contributed to the tragic collapse of Argentina's stabilization and reform efforts. The Fund's tepid efforts to press the Argentine government to run a more responsible fiscal policy appear to be more a part of this problem than a part of its solution." (p. 19). "Given the [Convertibility] Plan, failure to run a sufficiently prudent fiscal policy would likely prove a fatal error."(p. 24). See also the press conference of Anoop Singh, Director of Special Operations, IMF: "In our view, failures in fiscal policy constitute the root cause of the current crisis. "Introductory Remarks on the Role of the IMF Mission in Argentina, http://www.imf.org/external/np/tr/2002/TR020410.HTM.

5 A variant on this theme identifies the failure of the government to implement the so-called "second generation" of reforms, better know as "Reforma II del Estado", announced at the end of the first Menem government. These reforms involved "reengineering" of the public administration and social expenditures and included a reduction in the number of Ministries, elimination of the positions of State Secretary and Subsecretary, Zero-Based Budgeting and the use of private sector suppliers. They were expected to produce expenditure savings of around 3.4 billion pesos and the elimination of around 130,000 public sector jobs. The Menem government did not succeed in implementing these reforms and when Lopez Murphy made them part of his program after he replaced Machinea as Minister of Economics social unrest was so great that he resigned.

6 The policy of trade liberalization started in 1976 with the military government, was further pursued by the Alfonsin government as part of IMF conditionality, and was sharply accelerated in 1990-1 with the introduction of the Convertibility Law. Tariffs that in 1989 averaged over 30% were reduced to 0% for primary materials and machinery, 11% for intermediate inputs, 22% for manufactured goods and consumption goods, and 35% for electronics. Quantitative restrictions were eliminated except for automobiles. In 1995 with the creation of the full Mercosur customs union a common external tariff was instituted at an average nominal rate of 10, 2%; the internal tariff was 0% with exceptions for some sensitive sectors such as chemicals, petrochemicals, steel, paper and shoes. Export taxes were eliminated for the majority of products with exceptions for soybeans, peanuts, sunflower seeds and other oil seeds; skins and leather duties continued in order to support domestic industrialisation. On the other hand, export subsidies were reduced from 1991 and remained in a range of 3, 3% to 10%. From 1993 the average remained above 5%, with lower levels for agriculture and mining than for industrial goods. For industry the highest levels were for capital goods (15%) and durable consumption goods (16%), followed by construction materials (11%) and intermediate goods (8%). From 1997 the highest subsidy was for capital goods (9%) followed by parts and accessories (8%), consumption goods (7%) and intermediate goods.

7 A 1989 World Bank Working Paper had recommended that Argentina had much more to gain from unilateral trade liberalisation than through multilateral negotiations. However, the analysis was based on the assumption "that liberalization does not affect the trade balance, i.e., changes in exports equal changes in imports." See, J. Nogues, "The Choice Between Unilateral and Multilateral Trade Liberalization Strategies," WPS, 239, International Economics Department, The World Bank, July 1989. The Bank provided structural adjustment lending to Argentina to implements its trade liberalisation policy. Trade liberalisation, which was started in 1978, was in fact almost totally unilateral.

8 There is a good deal of disagreement over the overvaluation of the Peso before and during the Convertibility Law's application with some suggesting an undervaluation relative to estimates of the equilibrium real effective exchange rate before 1991 and an overvaluation of as much as 55 per cent by 2001. (Cf. "The Anatomy of a Multiple Crisis: Why was Argentina Special and what can we learn from it," G. Perry and L. Servén, mimeo, World Bank, May 10, 2002). It is clear that if the equilibrium rate is calculated relative to the sustainability of a country's net foreign asset position, the introduction of the Law produced a substantial once over appreciation which was reinforced by the continued policy of external borrowing. There is, however, some question concerning the suitability of REER as a reference point for this analysis since the point of the structural adjustment policy was to change the structure of domestic production and of the export sector. Thus appreciation can be seen in a sense as a failure of the structural adjustment policy.

9 Nonetheless, exports did grow extremely rapidly in the first half of the decade, but this was primarily due to the favourable movement of primary product and energy prices which were reversed in the second half, and the favourable treatment of transportation vehicles under the Mercosur Treaty.

10 The charts come from Dirección Nacional de Cuentas Internacionales, "Comercio Exterior Argentino 1990 – 2000".

11 Note that this mechanism applies to manufactured goods whose prices are not determined in international markets. Since Argentina had over 60 percent of its exports in primary products or manufactured products of agricultural origin and about 10 percent in energy products this left less than a third of total exports to carry the adjustment burden. The problem was thus more one of the composition of exports than the size of exports. But, the composition has barely changed -- between 1990 and 2001 the share of industrial manufactures in total exports increased by only 4 percentage points to reach 31 per cent, while energy increased by 10. The sharpest decline was in the agroindustrial exports which fell by 11 percentage points, while primary product exports fell by only 3 percentage points. After energy the largest share of exports in 2001 was residual waste from agroindustry, replacing fats and oils which were tied with combustibles in 1995.

12 In 1993 a plan similar to the one under consideration in the US was introduced -- the Sistema Integrado de Jubilaciones y Pensiones. It provided a choice between a pay as you go system based on length of service and remuneration and a capitalisation system based on the market returns of investments of member contributions, primarily in government debt, administered by private Administradoras de Fondos de

Pensiones. In the transition period government revenues fell by the amount of the contributions of those who opted for the new scheme, estimated at around 7 billion pesos in 1994., see Mario Teijeiro, “Una vez mas las politica fiscal…”, *La Econmia Argentina Hoy, op. cit* .p. 290.

13 By 1994 some 90 percent of state owned enterprises had been disposed of for around $20 billion.

14 Technically only the interest rate on currency notes would be equivalent, since they were fully backed by dollar reserves, at a zero rate; for any other financial liability interest rates would differ because of differences in credit risks between US and Argentine issuers of liabilities and these can be presumed to be non-negligible.

15 Indeed, the adjustment behaviour of the commercial balance was so discouraging by the end of 1992 that Cavallo introduced measures to partially reverse the opening of the economy, increasing duties on imports, introducing government commercial and industrial policies aimed at aiding the market process of restructuring the productive sectors towards more exports via financial support for capital goods and the introduction of the special Régimen de Especialización Industrial (patterned after a similar programme for automobile production) which reduced the duties on imports used in the production of exports. (See Pablo Sirlin, "El Régimen de Especialización Industrial Argentino", *Revista de la CEPAL*, No. 68, Agosto, 1999) There is more than a family similarity between these interventionist policies and those Cavallo would introduce when he returned to the position of Minister of Economy in 2001, see below.

16 Indeed, that external flows would cover financing needs was assumed in the structural adjustment policy designed for Argentina. The econometric model used to assess the coherence of the strategy noted that “Because of the strong relation between public sector deficits, inflation, and poor macroeconomic performance, this model differs from most Bank models by placing the public sector at the center of the analysis. The central macroeconomic issue in Argentina, especially after the assumption of external debt of the private sector, is the internal transfer problem. The model is therefore constructed so that the primary gap is in public finances rather an in the balance of payments. While the gaps are in theory closely related, positioning the gap in the public sector allows a more direct focus on public sector financing requirements, and allows the balance of payments gap to close through private capital flows that finance the residual savings-investment balance of the private sector.” See *Argentina – From Insolvency to Growth*, The World Bank, Washington, D.C., August 1993, p.259.

17 In fact, Argentina received such mini-bailout support from the MFIs from the time of the Tequila crisis, not unreasonably creating the impression that shortfalls in private external finance would be offset by funding from official sources. For example, the Public Information Document of the World Bank’s September 1998 Special Structural Adjustment Loan reads: “With markets closed and capital flows disrupted, Argentina will not be able to finance its deficit and refinance its external debt as maturities come due. In order to make these payments, there would have to be a significant contraction in international reserves, starting in the fourth quarter of 1998. Such contraction would produce a severe recession, increases in unemployment, and would result in fiscal cuts that would go beyond what is feasible or advisable given the timeframe available for making the adjustment. Such drastic action would result in the curtailment of government services and critical social programmes. The significant loss of reserves would threaten monetary and fiscal stability. The financial system would come under stress. To avoid this severe scenario, the government has requested extraordinary assistance from the Bank and IDB. ... The request is based on the country's strong track record in undertaking reforms and the quality of its macro-economic policies. It is also prepared to undertake additional measures to advance to the next stage of structural reforms. With the requested assistance, the government would be able to bridge the immediate disruption of the international capital markets and mitigate the effects of the financial crisis on the economy.“ Similar language is found in the PID for a Special Structural Adjustment Loan in August of 2001. The Bank's analysis of the consequences for the domestic economy of the lack of external finance was exactly right as events in early 2002 were to show.

18 Between 1995 and 1997 the number of financial institutions declined to 143 from 202 as weak banks were closed or merged; 18 provincial government banks were privatized, the average capital adequacy ratio rose from 18 to 20 percent and nonremunerated reserves were replaced with a system of remunerated liquidity balances held in dollar accounts equal to 20 percent of deposits.

19 To substitute for the non-existent lender of last resort function the central bank arranged for a $6.1 billion contingent repurchase facility with commercial banks in the US. The Central Bank Law already allowed dollar denominated government debt to count for up to a third of official reserves required under the Convertibility Law, making it possible for the Central Bank to increase bank liquidity via repo (paseo) operations. A Sistema de Seguro de Garantía de los Depósitos, an entity independent of the Central Bank responsible for a deposit guarantee fund was also instituted.

20 The use of periods of favourable market access to “pre-borrow” the funds required for future debt service commitments had previously been used in Mexico and called a “blindaje”. The same term was formally applied to the borrowing undertaken by Argentina in the final attempt to avoid default in late 2000 and 2001.

21 In March 1995 the IMF made the following statement on Argentina: "The Argentine authorities today announced fiscal measures aimed at a substantial strengthening of Argentina's economic programme. These new measures, together with those implemented at the end of February, are expected to yield some 2 percent of GDP and aim at generating an overall surplus of $2 billion, or 0.7 percent of GDP, in 1995 in the nonfinancial public sector. Combined with projected receipts from privatization of $2.4 billion, the surplus would be 1.5 percent of GDP. The IMF management welcomes the strong actions taken by Argentina. In the context of unsettled international financial markets, they demonstrate the firm commitment of the authorities to raise domestic savings, and to maintain fiscal and financial equilibrium and price stability.”(International Monetary Fund News Brief No. 95/9, “IMF Praises Argentine Measures, Sees US$2b Loan Increase”, March 13, 1995).

22 “The adjustment and reform programme that the IMF credit will support is based on a rate of GDP growth of 3½% in 2000, which would accelerate to 4% in subsequent years as firm implementation of the appropriate policies strengthens confidence and improved competitiveness facilitates further growth of exports. To these ends, the programme targets a 3½% of GDP reduction in the consolidated public deficit over the period 2000–02, about half of which is to take place in 2000. The primary balance of the public sector will shift to a surplus of 3% of GDP in 2002 from a small deficit in 1999. ... Primary federal expenditures are budgeted to decline significantly in relation to GDP in 2000, reflecting efforts to reduce personnel spending as well as cutbacks in a wide range of other spending programmes, all aimed at promoting cost effectiveness and reducing waste.” From “IMF Approves US$7.2 Billion Three-Year Stand-By Credit for Argentina” International Monetary Fund Press Release No. 00/17, March 10, 2000.

23 Risk spreads jumped from a range of 650-700 to near 900 basis points. The Central bank's total foreign reserves during 2000 averaged 33

billion, but by the end of November had fallen below $29 billion, suggesting that in the case of a global disturbance causing a cutback in foreign capital inflows Argentina would not be able to meet its scheduled debt servicing.

24 These are type of repurchase agreement that the Central bank uses to provide liquidity to the banking system because under the convertibility law the central bank can't rediscount commercial bank assets. Since the Bank rate was around 9% and the Letes were paying 13% there was a large incentive to increase in these transactions.

25 Although the new letter of intent provided for an increase in the deficit to 2.2 percent of GDP in order to avoid a fiscal contraction in the early stages of the economic recovery primary expenditures were nonetheless to decline by the equivalent of 0.5 percent of GDP from the 2000 level and the primary surplus of the federal government to rise to 1.7 percent of GDP in 2001. There was also a requirement to amend the fiscal responsibility law to reach aero deficit by 2005.

26 About $3 billion of the new total was provided under the Supplemental Reserve Facility. Argentina received about $3 billion immediately, with three additional drawings of about $1.3 billion each programmed for the remainder of 2001. Around $4 billion was to be disbursed in 2002 and another $1 billion in 2003.

27 A similar tax had been introduced in Brazil after the introduction of the Real. Although similar taxes are in use in Colombia, Ecuador, Peru and Venezuela the IMF has been highly critical of their use. See Isaias Coelho, Liam Ebrill, and Victoria Summers "Bank Debit Taxes in Latin America: An Analysis of Recent Trends," IMF WP/01/67 May 2001. An IMF team was in Argentina for the third review of the Stand By Loan when the tax was implemented so it presumably gave approval for its introduction.

28 With external finance no longer negating the impact of the external balance as the binding constraint forcing adjustment, it was now possible to negate it by repo lending to the banks. Dispute over this issue eventually led to the resignation of Pedro Pou as President of the central bank and the appointment of Roque Maccarone who was amenable to the change in policy.

29 Just under half of the bonds eligible for exchange were tendered and just under $30 billion were accepted, $8 billion from foreign holders. The swap will reduce total debt service in 2001 by $3.229 billion, by $4.593 billion in 2002, by $3.127 billion in 2003, by $2.455 billion in 2004 and by $2.643 billion in 2005. The total reduction in principal on the swapped bonds due to mature to 2006 was just over $9 billion, and the savings in interest payable over the period will be over $6.5 billion. For 2001 the interest component of the fiscal deficit will be reduced by around a half billion. Given the large issue discounts and the high par yields the swap increased outstanding indebtedness by $2.255 billion and is expected to increase the burden of debt service substantially after 2006 when annual interest service could increase to almost $20 billion. This is primarily because of the capitalization of interest payments on the 2018 and 2031 for five years and the fact that the 11.5 billion nominal issue of the 2008 dollar bond interest rate steps up to 15% after 2004 and starts amortising in 2006.

30 From the point of view of government proceeds their sale produces the difference between their acquisition cost and the market sale value, estimated at around $400 million.

31 Meeting the condition required wage cuts for public sector workers of between 10 and 15 per cent and the loss of their year-end bonuses, largely in provincial governments. In addition it is estimated that as much as $6 billion of government commitments were simply deferred or unpaid in the last half of the year in order to meet the "zero deficit" requirement. A large proportion of the reductions in government salaries and pensions were met by the issue of Federal (Lecop) and provincial government bonds (such as Patacones in Buenos Aires Province) which circulated alongside pesos and amount to as much as 45 percent of the total domestic circulation.

32 The principal and interest were "guaranteed" by the receipts of the financial transactions tax which was collected by the financial institutions who were the largest participants in the operation: (Decreto No 1646 / 2001, Annexo II, Contrato de Préstamo Garantizado, seccion quinta: "la República cede en garantía por este acto en forma irrevocable a los Acreedores en particular los derechos sobre los recursos del Impuesto sobre Créditos y Débitos en Cuenta Bancaria establecido en la Ley N° 25.413, con la modificación introducida por la Ley N° 25.453).

33 When a similar operation was announced for external holders of debt, several creditors charged that the exchange was the equivalent of default, since the net present value of the guaranteed paper was less than the bonds being tendered.

34 Total deposits had fallen by around $22 billion over the year, peso deposits by US$16 billion and dollar deposits by US$6 billion. At year end the domestic peso circulation was around A$11 billion and total deposits were around $60 billion, composed of $7.5 billion in current account (A$5.5b and US$2b), $14 billion in savings accounts (A$4.5 and US$9.5) and $41 billion in time deposits. Foreign reserves were around $20 billion. The goods account surplus was around $1 billion per month. Thus around $ 50 billion in deposits remained unreserved and the corralito was designed to prevent their withdrawal from the banks and conversion into dollars, while still allowing them to be used for intrabank payments.

35 Decreto 1570/2001 of 13 December 2001. At about the same time Cavallo announced that he would seek rescheduling of Argentina's IMF borrowing.

36 The official justification for the measure was that it did not create any burden or disruption of financial transactions, but would encourage financial intermediation (bancarisation) of the economy since the value of deposits could still be transferred freely within the banking system. It was also argued that it was a means of increasing the tax base for the tax on financial transactions. However, the bottom line remained that it prevented flight from the peso.

37 The banks-- as a result of the asymmetric conversion of assets and liabilities as well as their portfolio investments in government debt; the insurance and pension providers all held large proportions of government debt among their assets, but their solvency was further reduce by participation, albeit under duress, in the last swap of government paper for government tax guaranteed loans at much lower interest rates, all of which are now in default,

38 For example, the 2000 Annual Report of Aquas Argentinas, one of the first privatized water concessions in the developing world showed a net exposure in US dollars of around $700 million. It is operated by Suez Lyonnaise des Eaux, who hold over half of the equity (40 per cent directly through Ondeo and around 12 per cent indirectly through Ondeo's holdings in Aguas Barcelona), and was originally financed in 1993

with the help of loans from the IFC, IDB and the European Investment Bank. It reported losses of nearly 900 million pesos in the first six months of 2002 compared to a profit of over US$40 million in 2001. Its profitability is reported to have been twice the international average for such companies and three times the average for the UK. (See “Lessons from Argentina: The Buenos Aires Water Concession” , Alex Loftus and David A. McDonald, Queens University, Ontario, Research Series #2 at http://qsilver.queensu.ca/~mspadmin/pages/Project_Publications/Series/2.htm). It has been in default since May. Telefonica de Argentina, over 90 per cent owned by Telefonica de España reported around US$2 billion of net exposure in its Annual Report for 2000 and rates of return between 15 and 28 per cent over the previous five years. In the first quarter of 2002 it reported a loss of over pesos 2.5 billion, and its net equity was less than pesos 200 million at the end of March 2002, compared to over US$2.7 billion a year earlier. It was also unable to meet its debt service.

39 The decision to float the exchange rate and the size of the subsequent depreciation had a disproportionately negative impact on the very poor since the majority of the goods making up the subsistence basket are agro-alimentary and thus potential exports goods. Producers thus increased prices to match what they could fetch in international markets in dollars. The cost of the subsistence consumption basket increased by 45 percent in the first six months of 2002 while the cost of the basic consumption basket determining the poverty line increased by over 35 per cent. These rates of increase are more than double the estimates of consumer price increases for the entire year of around 30 per cent. With wages stable this explains why the indigency and poverty rates have risen so quickly. The Household Income Survey for May 2002 showed over 40 percent of households with incomes of only 300 pesos that was the cost of the basic subsistence basket in August.

40 It also suggests that the doctrine that a financial system will be more stable the higher the proportion of foreign banks has distinct limits.

41 This was in sharp contrast to the defensive hedging measures taken by the Brazilian banking system in the period before the devaluation that produced substantial profits. Indeed, it is interesting that given the clear signs of the impending changes in the exchange rate regime there was so little defensive action taken by the general public or the financial system. Nonetheless, official estimates of private non-financial sector assets show holdings of dollar currency in 2001 up by over US$7 billion to over US$28 billion and deposits held abroad up by around US$6 billion to over US$29 billion at the end of 2001. See “Posición de Inversión Internacional-Anexo”, República Argentina, Ministerio de Economía, Secretaría de Política Económica, Instituto Nacional de Estadística y Censos, Buenos Aires, 31 de julio de 2002.

42 It is important to note that the insolvency was independent of the new peso exchange rate and the rate at which existing dollar assets and liabilities would be converted back into pesos. It was simply due to the fact that there was no lender of last resort in the system capable of meeting the dollar asset-liability mismatch on the banks’ balance sheets. It could have been prevented had the Central Bank Law required reserves cover currency in circulation plus liquid deposits as the case *de facto* in Hong Kong.

43 This was the major difficulty behind the proposal of a dual exchange rate system which had it been introduced before the banking restrictions might have had a chance of success.

44 While the IMF continues to insist on an "anchor" for monetary policy, no one seems to ask the question of what this means in the absence of a functioning financial system which is currently the case in Argentina.

45 As far as the private sector as a whole was concerned this would have been a wash, given the $39 billion in dollar loans and $44 billion in dollar deposits. There was also an imbalance between debtors and creditors in general caused by the increasing real value of nominal contracts caused by the domestic deflation.

46 The original proposal had been to limit this relief to loans up to $100,000 to avoid bankruptcy of smaller borrowers, but it was finally extended to all borrowers including corporations who had foreign income and assets as well as others who were hedged.

47 Many authors who argue that dollarization would have been a preferred exit strategy in fact include the use of these provincial currencies in what is in effect a two-tier scheme. See, for example, A. de la Torre, E. Levy Yayati, and S. Schmukler, “Argentina’s Financial Crisis: Floating Money, Sinking Banking,” Mimeo, World Bank, June 3, 2002.

Request a copy of this publication