Mark Allen, Onno de Beaufort Wijnholds, José María Fanelli, Ricardo Ffrench-Davis, Bernardo Lischinsky, José Antonio Ocampo, Dani Rodrik, and Rogério Studart

The Crisis That Was Not Prevented

Lessons for Argentina, the IMF, and Globalisation

Edited by
Jan Joost Teunissen and
Age Akkerman

FONDAD

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Director: Jan Joost Teunissen

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Abbreviations

BIS	Bank for International Settlements
CEPAL	see ECLAC
CPI	consumer price index
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)
EMU	Economic and Monetary Union (of the EU)
ERSP	exchange rate-based price stabilisation programmes
EU	European Union
FDI	foreign direct investment
FDIA	International Fund for Agricultural Development (Fondo Internacional de Desarrollo Agrícola)
FONPLATA	Financial Fund for the Development of the River Plate Basin
FTAA	Free Trade Area of the Americas
GDP	gross domestic product
IADB	Inter-American Development Bank
IMF	International Monetary Fund
Mercosur	Southern Cone Common Market (in Latin America)
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Cooperation and Development
PPP	purchasing power parity
RER	real exchange rate
SDR	special drawing right
WPI	wholesale price index

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Preface

The crisis that erupted in Argentina in 2001 raises many questions as to what went wrong and what lessons can be learned. No one doubts now that the Argentine authorities made serious mistakes, but the international community also bears responsibility for the crisis. The IMF backed Argentina's economic programmes with money and advice throughout the ten years that the convertibility regime (linking the peso to the dollar) was in place. Argentina was highly praised as an exemplary case of a country adopting the type of structural reforms that international financial institutions and private markets have been pushing over the past two decades. Argentina opened itself enthusiastically to world financial markets, which backed the country with significant resources. The risks involved were minimised by all these institutions and agents until very late in the process.

Argentina is not the only country in Latin America that has been affected by the mixed results of the reform agenda that came to be known as the "Washington Consensus". Indeed, the expectations raised by this agenda a decade ago have turned out to be a mirage. Contrary to the promise that economic liberalisation would generate rapid economic expansion, growth rates since 1990 have been half of what Latin America achieved during the period of state-led industrialisation. The strong recession that began in 2001 deepened in 2002, when GDP fell in Latin America by 0.5 percent, completing what we at ECLAC have called "the lost half-decade". Open unemployment reached 9.1 percent, a record figure in Latin American history. Over the past five years, the poor population has swollen by 20 million Latin Americans.

There are two causes for this widespread reversal. The first is the decision to follow the domestic reform agenda of the "Washington Consensus", despite its serious shortcomings. The second is the effect of the asymmetries between globalisation and the institutional framework in which it operates. Prominent among them is the volatility of financial markets. Periods of "irrational exuberance" in foreign lending have been followed by "irrational panics", leading to excessively high country risk premia and net capital outflows. Argentina is a case in point. New institutional frameworks at the world level must thus complement a new domestic development agenda.

Fortunately, there has also been some good news in 2002. Growth in Latin America resumed in the last quarter of the year. The use of flexible exchange rates in the region's larger economies has increased competitiveness and given, in some countries, room for counter-cyclical monetary policies. But undoubtedly the best news is that the economic debate has opened up. The dogmatism of a decade ago has started to fade. In branches of knowledge as imprecise as economics, an open controversy is essential to evaluate the strengths and weaknesses of different alternatives. Thus, pluralism in the economic debate and its reflections in the political arena are creating important opportunities for better policies.

In Latin America, the lessons learned over the past decade of intensive reforms are the basis for a reorientation of development strategies. Such reorientation should take into account three key elements: creating room for counter-cyclical policies that seek to reduce vulnerability to external financial cycles; adopting active productive development strategies that improve international competitiveness and offer greater opportunities to small firms; and implementing aggressive social policies that help ensure that the benefits of growth reach the entire population.

At the same time, the Argentine crisis and the "lost half-decade" for Latin America should be an incentive to reactivate the international discussion about ways to reform the global financial system. The Global Financial Governance Initiative's working group on Crisis Prevention and Response, co-chaired by Jan Joost Teunissen and myself, brings together Northern and Southern views on how financial crises can be avoided and better managed, as well as how the global financial system should be improved. This book results from that joint effort. I hope it will inspire those who can help transform developing countries in more stable and prosperous societies for all.

Jose Antonio Ocampo
January 2003

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1

Introduction

Age Akkerman and Jan Joost Teunissen

The financial crises in developing countries over the last two decades have resulted in an avalanche of studies explaining the origins and remedies. Thousands of articles and books have been published carrying a wide range of diverging views.[1] Why so many, and why so diverging?

It seems that, by definition, analysts and policymakers cannot agree on the diagnosis of and response to financial crises (and economic developments in general), because they are dealing with a subject matter that is the result of the politics, economics and psychology of human behaviour. Argentina's recent crisis is no exception to that rule. There is an ongoing stream of studies that try to detect the causes of the crisis and present possible remedies. As Dani Rodrik puts it in the second chapter of this book, "fingers have been pointed at enough culprits to explain the Argentine crash many times over".

Given the large number of illuminating economic analyses that have already been published on the lessons from the Argentine crisis, we thought it useful to highlight a few of them in the first part of this introduction. For this brief overview, we have selected analyses that we consider of particular importance, given the quality of their arguments and the position or reputation of their authors.

The overview includes analyses by the former chief economist of the World Bank, Joseph Stiglitz, the current chief economist for

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1 Fondad publications bear testimony of this. For a description of Fondad books, see the list of publications on the last pages of this volume.

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Latin America of the World Bank, Guillermo Perry, and the former chief economist of the Inter-American Development Bank, Ricardo Hausmann. The opinion of IMF officials is not presented in this overview, because Mark Allen (IMF staff) and Onno de Beaufort Wijnholds (IMF Board) are among the contributing authors. Nor is the view of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) included, since three other contributing authors are from ECLAC, including its head, José Antonio Ocampo.

In the second part of the introduction, we briefly introduce the chapters of the book. They are written by the two experts from the IMF already mentioned (Mark Allen and Onno de Beaufort Wijnholds), three experts from ECLAC (Ricardo Ffrench-Davis, José Antonio Ocampo, and Rogério Studart), two Argentinean economists (José Maria Fanelli and Bernardo Lischinsky), and Harvard professor of economics Dani Rodrik. We conclude the introduction with two short sections, one on the role of the IMF and the other on the politics of crisis prevention and management.

An Overview of Some Studies on the Argentine Crisis

Joseph Stiglitz

One of the most widely cited analysts of the Argentine crisis – and critic of the IMF – is the Nobel Prize winning economist and former World Bank chief economist Joseph Stiglitz. Shortly after the IMF suspended its aid to Argentina in December 2001, Stiglitz wrote an article[2] which was published worldwide. In the article, he argued that the IMF had made a "fatal mistake" in the last years, by encouraging the Argentine government to pursue fiscal austerity in the belief that this would restore confidence.

"But the numbers in the IMF programme were fiction," says Stiglitz. "Any economist would have predicted that contractionary policies would incite slowdown, and that budget targets would not be met. Needless to say, the IMF programme did not fulfil its

[2] Stiglitz, Joseph E., "Argentina's Collapse Incited the Largest Default in History", In: *The Straits Times*, January 10, 2002.

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commitments. Confidence is seldom restored as an economy goes into a deep recession and double-digit unemployment."

Since it takes two to tango, Stiglitz also looked at the mistakes of Argentina. In his view, its main mistake was the pegging of the peso to the dollar. This was "a system doomed to failure", not because of mistakes made by the country, but because of shocks from beyond its borders that were caused by the volatility of international financial markets. However, "the IMF encouraged this exchange rate system," he observes. Argentina should have been encouraged, instead, to move to a more flexible exchange rate system, or at least a system that would be more reflective of its trading pattern; exports to the United States never exceeded 20 percent of total exports.

Sticking to the peso-dollar peg resulted from a single-minded focus on inflation, without a concern for employment or growth, says Stiglitz. However, "Any government following policies which leave large parts of the population unemployed or underemployed is failing in its primary mission."

In a second article, published in May 2002,[3] Stiglitz addressed the suggestion made by many economists that the Argentine crisis could have been averted had Argentina followed the advice of the IMF religiously, especially by cutting back on government expenditures (including at the provincial level) more ruthlessly. He disagrees with this view, arguing that fiscal deficits of below 3 percent of GDP were not at all that large, and did not result from profligacy but from an economic downturn, which led to falling tax revenues. And in his view, soaring interest rates resulted not so much from what Argentina did but from the mismanaged global financial crisis of 1997-98.

"I believe," says Stiglitz, "that in an economic downturn, cutting expenditures simply makes matters worse: tax revenues, employment and confidence in the economy also decline." Had Argentina more religiously followed the austerity advice of the IMF, the economic collapse would have been more rapid, he observes. "What is remarkable about Argentina is not that social and political turmoil eventually broke out, but that it took so long."

He stresses that economic reform in Latin America resulted in low growth and disillusionment with neo-liberal style reform and

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[3] Stiglitz, Joseph E., "Argentina, Shortchanged - Why the Nation That Followed the Rules Fell to Pieces", In: *The Washington Post*, Sunday, May 12, 2002.

warns, "Argentina's experience is being read: This is what happens to the A-plus student of the IMF. The disaster comes not from not listening to the IMF, but rather from listening."

Stiglitz ended his May 2002 article with an optimistic note. "Argentina is a country rich in human and natural resources. Before the crisis, these resources, even with inefficiencies, generated one of the highest GDPs in Latin America. Those resources have not been destroyed by the financial crisis. ... we should open our markets to Argentine goods. More than anything else, it was trade with the United States that brought Mexico out of its crisis."

Mark Weisbrot and Colleagues

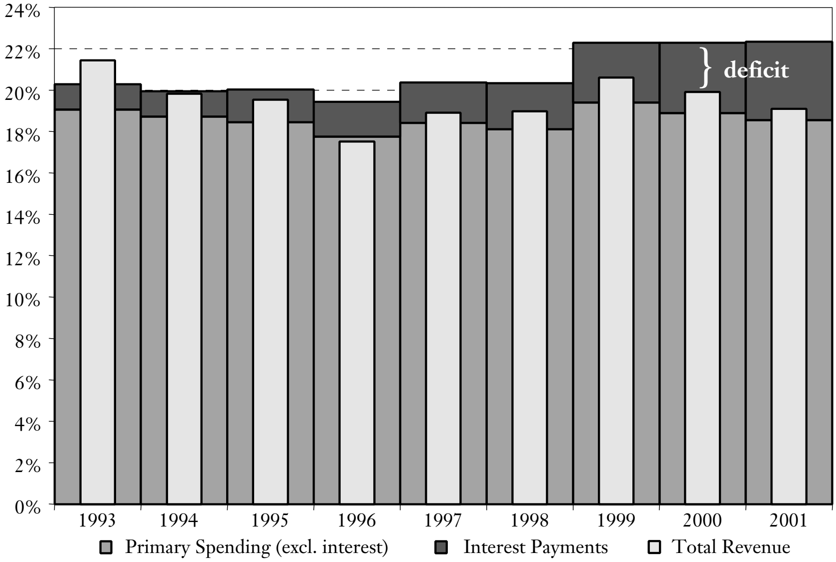
In a paper of January 2002,[4] Mark Weisbrot and Dean Baker, co-directors of the Washington-based Center for Economic and Policy Research, took a similar line as that of Stiglitz. They emphasise that Argentina got stuck in a debt spiral. According to them, Argentina's story is "the story of debt, inherited from the past, that was perhaps manageable until – through no fault of the debtor – interest rates on the country's borrowing increased. Higher interest payments, not increased spending, led to higher deficits. Growing deficits in turn created doubts about the overvalued exchange rate, which pushed interest rates still higher, creating larger deficits, in a hopeless spiral that ended in default and devaluation. ... The economy lapsed into recession in the second half of 1998 and never recovered. Repeated attempts to restore confidence in the overvalued peso through spending cuts, and loans arranged through the IMF – including a 40 billion dollar loan package in December of 2000 – could not reverse the downward spiral."

In later papers and articles, Mark Weisbrot and his colleagues continue saying that Argentina's crisis was not the result of fiscal profligacy, but rather of a decline in government revenue due to the recession that began in the third quarter of 1998. In a September 2002 paper,[5] for example, they include a table which shows that the

[4] Weisbrot, Mark and Dean Baker, "What Happened to Argentina?", Center for Economic and Policy Research, Washington D.C., January 31, 2002.

[5] Cibils, Alan B., Mark Weisbrot, and Debayani Kar1, "Argentina Since Default: The IMF and the Depression", Center for Economic and Policy Research, Washington D.C., September 3, 2002.

Figure 1 Argentina's National Government Spending and Revenues
(percentage of GDP)



primary balance of Argentina's government (revenues and spending, excluding interest payments) was never negative and that primary spending did not increase but decrease. Figure 1 represents Weisbrot's table, which is based on data from the Ministry of Economy of Argentina.

With regard to Argentina's future policies, Weisbrot and his colleagues suggest that the country should not submit itself to IMF policy conditions. "An IMF loan would not necessarily restore growth, and could even delay or abort any economic recovery." They stress that Argentina should have, above all, "a viable economic recovery plan of its own".

Weisbrot is optimistic about Argentina's capacity to overcome its crisis and believes that Argentina's export sector could play a crucial role in jump-starting a recovery. "One of the great advantages that Argentina has over other countries ... is that the country is running large surpluses on both its trade and current accounts."

Guillermo Perry and Luis Servén

In a collective World Bank study of May 2002,[6] led by Guillermo Perry and Luis Servén, these two authors examined whether the Argentine economy was more vulnerable to external shocks than other Latin American economies, and whether policy mistakes of the Argentine government were the main culprit, as is often claimed.

Perry and Servén try to answer why Argentina plunged into a protracted recession in 1999 while other Latin American countries recovered after the Asian and Russian crisis of 1997-98. They show empirically that Argentina was not hit any harder than other Latin American countries by the terms of trade decline after the Asian crisis, nor by the US and worldwide slowdown in 2001, nor by the capital flows reversal and the rise in spreads after the Russian crisis. The sudden stop of new capital flows acted more like an amplifier than a primary cause of the crisis, they argue. That Argentina did fare worse than other countries must therefore, in their view, be attributed to Argentina-specific factors: either higher vulnerabilities to external shocks, or weaker policy responses.

Examining Argentina's specific vulnerabilities as a result of its fixed exchange rate, large public debt and possibly weak banking sector (hidden behind a façade of strength), Perry and Servén conclude that although there were important vulnerabilities in each of these areas, none of them were larger than those affecting some other countries in the region, and thus there is no *one* obvious suspect. However, the vulnerabilities reinforced each other in such a perverse way that, when combined, they led to a much larger vulnerability to adverse external shocks than in any other country in the region.

According to Perry and Servén, the peg to an appreciating dollar played a dominant role in the emergence of the Argentine crisis. Because of the steadily rising dollar and Brazil's devaluation in 1999, a gap developed between the real exchange rate and its equilibrium value, resulting in an overvaluation of the peso of about 55 percent in 2001. Since the nominal exchange rate was fixed, the real rate could adjust only if wages and prices fell. Prices did fall, but not

6 Perry, G. and L. Servén, "The Anatomy of a Multiple Crisis: Why Was Argentina Special and What We Can Learn From It", mimeo, World Bank, May, 2002.

enough. However, a faster deflation would have been politically very difficult, as it would have required an even deeper recession and higher unemployment than actually witnessed in 1999-2001.

Moreover, the economic contraction made it very difficult to keep the public debt sustainable. It would have required a dramatically rising primary fiscal surplus (excluding interest payments) that would have reached 4 percent of GDP in 2000 or, ultimately, 2001. This was a highly unlikely scenario, the authors argue, given Argentina's fiscal history and institutions. Argentina's debt dynamics therefore increasingly became assessed as unsustainable.

With regard to the policy response by the Argentine government, Perry and Servén observe that the dollar peg created a harsh dilemma. "One option was to accept a painful and protracted deflationary adjustment while keeping the Currency Board ... to retain market confidence. ... The other option was a more orderly change of the exchange rate regime during the boom years before 1999." However, letting the peso devalue and float would have led to a latent corporate, banking and fiscal crisis, given the dollarised liabilities of both the public and the private sectors and the large degree of overvaluation of the currency. A more orderly exit would have required significant structural reforms and institution building.

Perry and Servén conclude that the Argentine authorities can be blamed for instituting fiscal adjustment too little and too late (it should have been done in the boom years before 1999), for hesitating on the ultimate choice of exchange rate regime, for postponing the needed public debt restructuring for too long, and for precipitating a major financial and payments crisis. In their view, a key lesson from Argentina is that economic and political institutions are needed that provide incentives to face hard policy choices and facilitate timely reforms, and in particular are less prone to amplifying economic cycles.

Ricardo Hausmann and Andrés Velasco

In a study published in July 2002,[7] Hausmann and Velasco discuss, what they call, three major views on the Argentine crisis and present their own analysis of what happened.

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7 Hausmann, Ricardo and Andrés Velasco, "Hard Money's Soft Underbelly: Understanding the Argentine Crisis", mimeo, Harvard University, July 2002.

They define the first view as "the self-fulfilling pessimism paradigm". According to this view, which was dominant before the crisis, pessimism would lead to high interest rates, depressed growth and a weakening fiscal position, complicating debt service and thus justifying the initial pessimism. The authors claim that the IMF shared this view, because it recommended a strengthening of confidence through fiscal consolidation, believing that this would initiate the opposite virtuous circle of stronger public finances, lower interest rates, and a recovery of economic activity.

Hausmann and Velasco examine some implications of this paradigm with a simple simulation in which Argentina would have had a growth rate of 3 percent between the fourth quarter of 1998 and the second quarter of 2001. They find that this would have indeed eliminated the fiscal imbalance and that the public debt would have remained stable. However, the current account deficit would then have climbed from 3 to around 5.5 percent of GDP, requiring large external funding and leading to the accumulation of an additional 12 percent of GDP in external obligations.

In a second widely held view, the accent is placed on "irresponsible fiscal management ". After the outbreak of the crisis, this became a dominant view, Hausmann and Velasco observe, pointing to its endorsement by the IMF, and others. The authors, however, do not believe that this view is supported by the facts. If one excludes the costs that resulted from the privatisation of Argentina's social security system, the government was able to generate a primary fiscal surplus in excess of 3 percent of GDP. This would have been sufficient to cover the increased cost of servicing the public debt. In fact, Argentina's primary surplus was of the same magnitude as that of Brazil, in spite of the deeper recession. Hausmann and Velasco observe: "There is no evidence of a spending boom: as a share of GDP, primary government expenditures remain roughly constant in 1993-2001." They therefore ask: "Where is the dramatic shift in fiscal outcomes between the time when Argentina was perceived as one of the safest emerging markets (say, in 1999) and its eventual demise?"

The authors argue that "the bulk of fiscal problems were a consequence, not a cause, of the overall mess". It was recession, not simple fiscal misbehaviour, that prompted a worsening of expectations and a rising country risk. Fiscal tightening was not the solution, nor did investors perceive it as such. Hausmann and Velasco find it striking that on the day (July 15th 2001) Domingo Cavallo announced the zero-deficit policy, implying an immediate cut in public sector wages and pensions of around 13 percent, Argentina's country risk spread did not improve but rather deteriorate. It rose from 1200 to 1600 basis points. "No country can be run on that basis, investors plausibly conjectured. Events thereafter proved them right.[8]

The third major view the authors discuss is the story about the overly rigid exchange rate regime that resulted in overvaluation, thus reducing the profitability of the export sector and limiting its ability to expand supply. Here Hausmann and Velasco agree, but point to the dilemma the Argentine government was facing. "At the prevailing real exchange rate even modest growth of 3 percent could only be achieved at the expense of large current account deficits and rising debt ratios. Argentina thus found itself in a bind: if it tried to grow it risked accumulating debt to the point of insolvency; if it chose to achieve external balance, it would have had to achieve strongly negative growth rates, which would also have imperiled its solvency." They doubt whether one could, reasonably, have expected the Argentina government to find a solution to the exchange rate problem, given the increasingly scarce external financing and Argentina's large private and public dollar debt.

In their own analysis of the crisis, Hausmann and Velasco focus on the interaction between two factors: the real exchange rate and the capacity to borrow abroad. They observe that after the Russian crisis of 1998 and the Brazilian devaluation of 1999, international investors lost some of their appetite for emerging country securities generally. But in the case of Argentina, external conditions worsened even more, basically as a result of its dollar peg, making the country less capable to export and grow. Lower export earnings limited Argentina's capacity to repay debt, and thus limited foreign lending. The lack of external resources resulted in a fall of investment and output, which in turn depressed demand for domestic production.

Hausmann and Velasco conclude that three coinciding factors explain why Argentina was hit so hard by the crisis: the high initial

[8] Barry Eichengreen observed in October 2001 that the cut in state salaries and pensions by 13 percent was, predictably, met "with widespread street demonstrations" raising doubts among investors about the sustainability of the zero-deficit policy. See, Barry Eichengreen, "Crisis Prevention and Management: Any New Lessons from Argentina and Turkey?", mimeo, October 2001.

debt level, the inflexible exchange rate system, and the relative low import and export levels.

The Studies in this Book

In the second chapter, Dani Rodrik compares the Argentine government, because of the pegging of the peso to the US dollar, to Ulysses, pinning himself to the mast of his ship to avoid the call of the Sirens. He recalls that Argentina's policies during the 1990s were exemplary by neo-liberal standards and that no country tried harder to endear itself to the international capital markets. Argentine policymakers pursued austerity policies even when one worker out of five was already out of a job.

Rodrik stresses that what sealed Argentina's fate in the eyes of financial markets was not what its political leaders were doing, but what the Argentine people were willing to accept. "This shows," he says, "that when the demands of foreign creditors collide with the needs of domestic constituencies, the former eventually yield to the latter." In his view, developing countries should not adopt foreign institutional blueprints (the "Washington Consensus"), but seek, instead, "enhanced state capacity to undertake institutional innovation based on domestic needs and local knowledge". He emphasises that Argentina should rebuild the credibility of its political system, not for the sake of financial markets, but for the sake of ordinary Argentineans.

In the third chapter, José Antonio Ocampo gives a succinct account of the incubation of the Argentine crisis. He stresses that with the choice of Convertibility (pegging the peso to the dollar) as the mechanism to restore financial stability in the early 1990s, the Argentine government placed itself in a position that left it with very little room to manoeuvre. He observes that the dollar peg led to a strong dependency on highly volatile external financial flows, and to a sharp business cycle. Eventually, the recessionary effects of the system led to its demise. Ocampo advocates that both the Argentine authorities and the IMF "take a highly pragmatic approach and be willing to learn as they go along".

In the fourth chapter, José Maria Fanelli examines specific features of the Argentine economy and addresses questions such as: Why did Argentina choose an exchange rate system as rigid as a currency board? Why were contracts dollarised? Why was the IMF so involved with and supportive of the country's policies under Convertibility? He concludes with a discussion of four steps to restore macroeconomic and financial stability, and wonders whether there are "hidden" resources to resume growth. One hidden resource he mentions is the large stock of foreign assets in the hands of the private sector in Argentina, representing roughly 100 percent of GDP: "As soon as the economy stabilises, this wealth effect can become a powerful incentive to effective demand."

In the fifth chapter, Ricardo Ffrench-Davis and Rogério Studart discuss the regional fallout of the Argentine crisis. They claim that the spill-over effects are related to the build-up of three vulnerabilities during the 1990s: an external liabilities overhang, a fragile domestic financial sector, and the rise of "political fatigue" with neo-liberal policies. They conclude that conventional policy responses to external shocks have become less effective, politically infeasible and highly damaging to domestic financial stability, and advocate a policy response that would mitigate the three vulnerabilities identified.

In the sixth chapter, Bernardo Lischinsky gives a detailed analysis of the evolution and characteristics of Argentina's debt, comparing it with that of other countries. He pays particular attention to what he calls, the "virtual dollar creation" under Convertibility. He concludes that the debt problem will not be solved rapidly, because it is not merely a financial problem. In his view, it can only be solved in the context of "a different development model".

In the seventh chapter, Onno de Beaufort Wijnholds, who was a member of the IMF Executive Board from 1994 to 2002, gives his view on why the actions of the Argentine authorities were leading to a dead end. He also explains why he did not support the IMF's decision in September 2001 to augment the existing Fund credit by 8 billion dollars. One of the lessons he draws is that both the IMF and the private sector paid insufficient attention to the build-up of an unsustainable external debt situation. "As borrowing from the market continued until a quite late stage and from the IMF beyond what was in Argentina's own interest, the collapse was especially devastating when the plug was finally pulled."

In the final chapter, Mark Allen reviews the lessons that the IMF drew from previous crises in Mexico, Asia and Russia, and how it viewed economic policy in Argentina in light of these lessons. He then examines the factors that precipitated the crisis in Argentina and asks whether these were obvious to the IMF at the time. Finally, he draws some lessons from the Argentine crisis that could help prevent other countries from falling into the same traps. One such trap he mentions is the (inevitable) embrace by developing countries of globalisation. Because of the volatility of private financial flows, this "can entail huge costs if not properly handled". He warns that it "will be a long way" before the people of developing countries can benefit fully from their integration in the global economy.

The Role of the IMF

The IMF has been strongly criticised for the role it has played both before and after the outbreak of crisis in Argentina. Protesters on the streets of Buenos Aires have pointed to the IMF as the main culprit, along with the Argentine authorities. Joseph Stiglitz and other economists blame the IMF for having given the wrong advice and repeating "the same mistakes" it made in East Asia. However, is it fair to shift so much blame on the IMF?

In the final chapter of this volume, Mark Allen admits that the Fund has made various mistakes. For example, he acknowledges that the Fund "failed to pinpoint the growing vulnerability of (Argentina's) economy during the 1990s… (and) did not produce a sufficiently clear analysis of the situation to catalyse an early decision to restructure the debt". He also acknowledges that "the Fund staff was overly optimistic in its assessments of underlying trends in Argentina", and observes that "the Fund was excessively indulgent in the application of its conditionality during the 1990s". He stresses however that the Fund was basically inspired by the wish to prevent the outbreak of the crisis, and that *before* the crisis it was not obvious how it could have acted differently.

Could the Fund have acted differently? Here, again, opinion diverges. Some say that the Fund's neo-liberal policies inevitably led to disaster in Argentina, whatever greater "clarity" about Argentina's underlying trends it might have had. Others argue that, by no means, could Argentina have escaped disaster. Allen seems to defend this last view when he relates the Fund's decision of September 2001 to augment a stand-by credit by 8 billion dollars. "... it is not clear that another policy package at that point – for example, one involving either fiscal stimulus or the abandonment of the exchange rate peg – would have helped Argentina escape disaster."

Should the IMF now agree as soon as possible with Argentina on a large financial rescue package of similar magnitude as that of Brazil?[9] Again, opinion diverges. Some say it should rather not, arguing either that it would give the wrong signal to foreign investors (the moral hazard argument that financial rescue leads to more imprudent lending and additional crises) or that it would continue to strangle the Argentine people by increasing the debt and pushing the wrong development policies (see e.g. Rodrik and Lischinsky). In the pages that follow, none of the contributing authors seems to consider a huge "rescue" package as the main ingredient for Argentina's road to recovery. Rather, they stress the importance of sound home-grown Argentine policies *and* sound international financial policies. This brings us to the last issue we want to discuss in this introduction: the role of politics in crisis management.

The Politics of Crisis Prevention and Management

Focusing on deeply enshrined historic weaknesses of Argentina's political and economic structure, one may hope that longer-term beneficial effects will turn Argentina's crisis into a "blessing in disguise". Meanwhile, the crisis brought unemployment and poverty for a large number of Argentineans. So the question emerges: Could more have been done to prevent the crisis? The answer is, 'yes but...'

As the preceding and following pages of this book show, the "but" can be many things. For example, one could say that the Argentine government was not really able to abandon the peso-dollar peg. Or one could say that neither the majority of the Argentine people nor the majority of the economic experts, both inside and outside the country, were aware that the peg was doomed to fail and should have been abandoned earlier. Or, to give a last example, one could say that the IMF and the foreign investors continued to give the wrong signals to Argentina. As Dani Rodrik has said, there are enough culprits to explain the Argentine crash many times over.

The highlighted studies above and the studies that follow provide a wealth of facts, arguments and policy suggestions that go far

9 On August 8, 2002 the IMF agreed to lend 30 billion dollar to Brazil.

beyond a simple search for culprits. The authors have different focuses and, often, draw diverging conclusions. That is not so sad. Even the most complete and rigorous economic analysis of the Argentine crisis could never answer in an undisputable manner the fundamental question: What would be the best economic policy for Argentina, or any other country?

In the end (and in the beginning), the answer to that question remains a matter of politics, and requires a democratic debate of the ideals and objectives one wants to achieve. Unfortunately, in most countries, including industrial countries, such a debate is hardly taking place. Some observers argue that the political angle is even more important for understanding and remedying Argentina's crisis or improving the global financial system than the economic one. But whatever view one takes, any serious and long-term solution for Argentina's and the world's economic problems requires a thoughtful and democratic discussion. This book aims to contribute to that important discussion.

2

Argentina: A Case of Globalisation Gone Too Far or Not Far Enough?

Dani Rodrik[1]

Argentina's default on its $132 billion public debt on December 23, 2001 hardly came as a surprise to its foreign creditors, who had anticipated it for many months. It had been clear to most outside observers that the country's currency board regime, which locks in the Argentine peso's value one-to-one with the US dollar, had held the peso at an unsustainable level vis-à-vis other currencies. It was also evident that the political system would be unlikely to deliver the belt tightening needed to service foreign creditors ahead of domestic payments on wages, pensions, and other obligations. So, when President Fernando de la Rúa and economy minister Domingo Cavallo resigned and the inevitable happened shortly thereafter, few other markets around the world moved.

As is usual after a debacle of such a magnitude, fingers have been pointed at enough culprits to explain the Argentine crash many times over. The Argentine "political class" was too shortsighted to reach a compromise on fiscal policy. The currency board system was too rigid to allow Argentine exporters to regain their competitiveness following Brazil's devaluation of its currency in early 1999. Labour unions were too unresponsive to demands for reform. Cavallo was too sure of himself and went for too many gimmicks to resuscitate the economy and lower the cost of servicing the debt. Foreign creditors

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[1] This chapter is a reprint of Dani Rodrik's article "Reform in Argentina, Take Two. Trade Rout", published in *The New Republic* on January 2, 2002.

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were too fickle and should not have reversed course so dramatically after their rush into Argentina in the early 1990s. The IMF should have pulled the plug much sooner. The IMF should not have pulled the plug. But the tragedy of Argentina goes much deeper than any of these explanations. The collapse offers a humbling lesson about the limits of economic globalisation in an age of national sovereignty.

Even though many in Washington would rather forget it, Argentina's policies during the 1990s were in fact exemplary by the orthodox standards that neo-liberal economists have advocated around the world. The country undertook more trade liberalisation, tax reform, privatisation, and financial reform than virtually any other country in Latin America. And no country tried harder to endear itself to international capital markets. The overvaluation of the peso was a nagging concern, to be sure, because of the loss of Argentine competitiveness. But economists have long taught that devaluation of the national currency – the common remedy to overvaluation – is of little use in a country that is financially integrated with the rest of the world, which Argentina surely was. When banks' balance sheets are dominated by dollar liabilities, devaluation wreaks havoc with the financial system. The Argentine experiment may have had elements of a gamble, but it was also solidly grounded in the theories expounded by US-educated economists, the US Treasury, and multilateral agencies such as the World Bank and the IMF. When Argentina's economy took off in the early 1990s after decades of stagnation, the economists' reaction was not that this was puzzling; it was that reform pays off.

The Too Simple Idea of Sovereign Risk Reduction

The Argentine strategy was based on a simple idea: that reduction of *sovereign risk* is the quickest and surest way to reach the income levels of the rich countries. "Sovereign risk" refers to the likelihood that a government will be unwilling to service its foreign obligations even when it has the capacity to do so. In domestic finance, the distinction between willingness-to-pay and ability-to-pay is much less important because courts and regulators can sanction recalcitrant debtors. But countries cannot be sanctioned in quite the same way, because they are sovereign – hence the term.

Sovereign risk matters because it is an important obstacle to economic convergence among nations. If investors had no fear that their lending would be expropriated, capital would move in abundance from the rich countries, where it is plentiful and yields are low, to the poor countries, where it is scarce and yields are high. In the process, incomes would equalise across borders. But in reality, capital often moves in the reverse direction – think of the bank accounts in Miami and Zürich maintained by wealthy individuals from developing nations. Yields may not be higher, but money invested in the US or Switzerland is at least safe from expropriation.

Viewed from this perspective, the challenge of economic development is reduced to three simple propositions. Economic growth requires foreign capital. Foreign capital requires removing sovereign risk. And removing sovereign risk requires a commitment not to play games with other people's money. All this made for a coherent theory, even if it did not correspond to the actual development experience of any successful country larger than a city-state. Getting rid of sovereign risk, it would turn out, requires a lot more than commitment to sound money.

The overarching goal of Argentine economic policy during the 1990s was to deliver this commitment, and even more importantly, to convince financial markets that the commitment was real and binding. The straitjacket of the currency board regime was the linchpin of this strategy: By linking the value of the peso one-for-one to the US dollar in 1991, and putting monetary policy on automatic pilot, the regime sought to counteract the effects of more than a century of financial mismanagement. Privatisation, liberalisation and deregulation further underscored the government's commitment to a new set of rules. Like Ulysses' pinning himself to the mast of his ship to avoid the call of the Sirens, Argentine policymakers gave up on their policy tools lest they (or their successors) be tempted to use them to repeat the errors of the past. Their hope was that they would be rewarded with a sharp reduction in "Argentina risk", leading to large amounts of capital inflows and rapid economic growth.

For a while, it looked as though the strategy might work. In the first half of the 1990s, capital inflows did increase substantially and the economy expanded at unprecedented rates. But then Argentina was hit with a series of external shocks – the Mexican peso crisis of 1995, the Asian crisis in 1997-98, and most damagingly, the Brazilian devaluation of January 1999. The last left Argentina's economy looking hopelessly uncompetitive relative to its regional rival. Economic growth turned negative in 1999, and foreign investors began to worry about the repayment of the huge liabilities incurred during the course of the decade. By the second quarter of 2001, Argentina's country risk was rising relative to that of other "emerging markets". This despite of the return to the helm of Cavallo, the architect of the currency board regime, in March 2001 – or as some would say, because of it. Cavallo, with his strong credibility in financial markets, at first looked like he might be exactly what Argentina needed. But his efforts to engineer economic growth through an unconventional mixture of tax and trade policies and a bungled attempt to alter the currency board regime by giving the euro a role parallel to that of the dollar were not well received by markets and cost him dearly.

By the end of the summer, the financial confidence game was in full play. Markets demanded a huge interest premium for fear that Argentina might default on its debt. But with interest rates so high, default was virtually assured. The *possibility* that Argentina would default was enough to ensure that it would.

That financial markets make only fair-weather friends is no news at all. That they turned so rapidly against Argentina requires more explanation. This, after all, was a government that had focused its priorities not on a nondescript social agenda, but on attaining investment-grade rating in credit markets and essentially little else. The commitment of the top political leadership to service the external debt could not have been, and was not, in doubt. Cavallo and de la Rúa were willing to abrogate their contracts with virtually all domestic constituencies – public employees, pensioners, provincial governments, bank depositors – so as to not skip a cent of their obligations to foreign creditors. Yet in the end, investors still wound up thinking that Argentina was a worse credit risk than Nigeria.

What sealed Argentina's fate in the eyes of financial markets as 2001 came to a close was not what Cavallo and de la Rúa were doing, but what the Argentine people were willing to accept. Cavallo knew he had to regain market confidence in order to bring the crushing interest burden on Argentine debt down. When his initial attempts to revive the economy produced meagre results, he was forced to resort to austerity policies and sharp fiscal cutbacks in an economy where one worker out of five was already out of a job. He had launched a "zero-deficit" plan, and enforced it with cuts in government salaries and pensions of up to 13 percent. Markets grew increasingly sceptical that the Argentine congress, provinces, and common people would tolerate such Hooverite policies, long discredited in advanced industrial countries: No matter how adamant Cavallo himself was to avoid default, domestic politics would eventually undo his efforts. And in the end, the markets were proven correct. After a couple of days of mass protests and riots just before Christmas, Cavallo and de la Rúa had to resign in rapid succession.

An Alternative Vision

In his ode to globalisation *The Lexus and the Olive Tree*, Tom Friedman famously declared that the "electronic herd" – the mass of lenders and speculators who can move billions of dollars around the globe at an instant – reduces domestic politics to a choice between Pepsi and Coke, with all other flavours banished. Having donned the Golden Straitjacket so enthusiastically, the Argentina of the 1990s looked like the perfect illustration of Friedman's point. The economic policies of de la Rúa and the Peronists that preceded were virtually indistinguishable. But Argentina's real lesson proved to be a different one: that democratic politics casts a long shadow on international capital flows, even when political leaders are oblivious to it. When the demands of foreign creditors collide with the needs of domestic constituencies, the former eventually yield to the latter. Sovereign risk lurks in the background as long as national polities exist as independent entities.

What one does with this lesson is less clear. Many will draw the conclusion that Argentina took a wrong turn not because it went too far in its search for the holy grail of globalisation, but because it did so imperfectly and inadequately. The solution from this perspective is to improve on the Argentina model by chipping away at national sovereignty and by further reducing the responsiveness of economic management to domestic political forces. What national governments need are *stronger* commitment mechanisms – a straitjacket made of platinum, if gold proves too malleable. This is the neoliberal vision that inspires some economists and political leaders to seek full dollarisation of their economies or to look at the prospective Free Trade Area of Americas (FTAA) as solutions to the governance problems of the region. If you were to accuse adherents of this view of wanting to turn their countries into replicas of Puerto Rico – wards of the United States in effect – they would not be offended.

But there is an alternative vision. It is to accept that separating politics from economics is neither easy nor even desirable. Proponents of this view, including myself, would not be embarrassed to claim primacy for democratic politics over the electronic herd, no matter what the implication for sovereign risk. They would concede that economic mismanagement by sovereign governments has been very costly for the developing world, but would argue that the appropriate response to mismanagement is not lack of management, but better management. This vision has no easy answers or shortcuts to offer to Argentine policymakers. It would be nice if improved governance could be acquired simply via the discipline imposed by financial markets and trade agreements. And economic development would be a lot easier if all that is required is throwing a big welcome party for foreign capital. But the historical record shows that the solution to underdevelopment lies not with the adoption of foreign institutional blueprints or the undermining of national autonomy. It lies with enhanced state capacity to undertake institutional innovation based on domestic needs and local knowledge.[2]

The tasks before Argentina's policymakers are colossal: to increase the economy's competitiveness through a devaluation of the currency without setting off an inflationary spiral; to reconstruct the financial system so that it serves the needs of the real economy; to diversify the economy and wean it from excessive reliance on agricultural products; to address the pervasive economic insecurity that afflicts the middle class through new mechanisms of social insurance. Now that Argentina has cleared the deck by defaulting on its debt, the country has to get on with the hard work of rebuilding credibility for its political system – this time not for the sake of financial markets, but for the sake of ordinary Argentines.

As governments ponder these alternatives, they would do well to consider the following astonishing fact: Despite the tremendous wave of neo-liberal reform that swept over the continent during the last two decades, only *three* economies in Latin America managed in the 1990s to outdo the performance they had experienced under the

[2] See Dani Rodrik, "After Neoliberalism, What?", Remarks delivered at a conference on Alternatives to Neoliberalism, Washington D.C., May 23, 2002.

inward-looking, populist policies of the past. Chile remains a success, in part because it has taken a cooler attitude towards capital inflows than the others. Uruguay looks shaky and is hardly an inspiring example in any case because its growth rate has been anaemic. And Argentina now lies in ruins. Its collapse reminds developing nations in Latin America and elsewhere that they cannot postpone much longer the stark choice they face. Either they will sacrifice sovereignty in a big way, or they will reassert it vigorously.

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3

The Mistaken Assumptions of the IMF

José Antonio Ocampo

Argentina's adoption of a convertibility regime in the early 1990s was a legitimate attempt to restore a viable monetary and financial system in a country that had lost confidence in its authorities' ability to manage the currency. Among all the available options, however, the system that was chosen was the one that restricted the economic authorities' manoeuvring room the most. At the time, this option was seen as the best mechanism for building credibility in a country in which economic agents had lost faith in the successive Administrations' ability to manage the economy properly. Nonetheless, it was obviously not the only option available and, in fact, none of the other Latin American countries that had been afflicted by hyperinflation in the 1980s or early 1990s (Bolivia, Brazil, Nicaragua and Peru) chose a similar system.

The new scheme worked well for a time. It was effective in bringing about a rapid recovery in the early 1990s, a fairly swift remonetisation of the economy, the reconstruction of the financial system and the reappearance of corporate and personal credit. The convertibility system did, however, have two other very closely related effects: a strong dependency on highly volatile external financial flows and, given the absence of any scope for flexibility in economic policy, a sharp business cycle. The country's heavy dependence on external financing was, in turn, reflected in a strong tendency to run a trade deficit, together with a clearly overvalued currency. Advocates of the system tended to underestimate these

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effects, and actually saw them as positive outcomes of a properly functioning market in which abundant capital flows were being generated by a highly credible economic policy.

When compared with other Latin American countries, Argentina experienced a peculiar combination of macroeconomic stability and instability during the 1990s: significant price stability coupled with large instability in economic growth rates.[1] Given the sharpness of the business cycle, it is difficult to determine what effect convertibility had on long-term growth, since any estimation of the "potential GDP growth rate" is strongly influenced by the time periods chosen for its calculation. This explains, in turn, why it was so difficult for economic agents to determine what level of income was sustainable.[2] On the other hand, restructuring the country's labour markets was painful. In large measure, this was a result of the currency's overvaluation, since the low rate of job creation in tradable sectors became a structural trait of the convertibility regime. High open unemployment – in a country that had traditionally had low unemployment levels, even during the "lost decade" of the 1980s – was its main corollary. This process was also accompanied by adverse pressure on poverty and income distribution.[3]

Significant trouble built up since the mid-1990s. Indeed, Argentina's economy was the one that was most heavily exposed to contagion from the crisis that broke out in Mexico in late 1994. As we all know, the convertibility scheme managed to survive the "Tequila effect" and generated high growth rates once again in 1996, 1997 and the first half of 1998, largely as a result of the sustained expansion of trade with Brazil. However, with the radical change in capital flows to emerging countries that came in the wake of the Asian crisis of 1997-98, the Brazilian devaluation in early 1999 and the steady appreciation of the dollar from 1998 to 2001, the overvaluation of the Argentine peso led to an outright structural crisis. As the convertibility scheme's exit costs were explicitly high (which was, in the eyes of its advocates, its main virtue), the authorities clung to the system,

1 See ECLAC (2000), vol. III, chapter 1 (see figure 1.1 in particular).

2 This also is a reflection of the difficult "learning" processes involved in the formation of macroeconomic expectations that are characteristic of far-reaching structural changes such as those experienced during these years. See the excellent essay by Heymann (2000) based on reflections regarding Argentina's situation.

3 See Altimir and Beccaria (1998) and Damill, Frenkel and Maurizio (2002).

which, nonetheless, soon collapsed. The breakdown of the scheme, like its gold-standard predecessors, was chaotic and was heralded by a run on deposits in the financial system and a loss of reserves.

The withdrawal of deposits, the loss of reserves and the collapse of economic activity all occurred abruptly and simultaneously in 2001, that is to say, while the convertibility regime was still in full sway. Just as occurred during the gold standard's collapse in the 1930s, the authorities first tried to make the system more flexible (via competitiveness plans and public debt swaps) in an effort to stave off its downfall. When this effort failed, they restricted deposit withdrawals, declared a public debt moratorium and introduced exchange controls. These measures, in themselves, signalled a reluctant abandonment of convertibility. Eventually, with the devaluation of January 2002, the regime was discarded outright. The severe deterioration in the financial system's liquidity disrupted the payment chain and fuelled a strong demand for the central bank to act as a lender of last resort.

Thus, the credibility that had been built up on the basis of the convertibility regime was more than offset by the recessionary effects that the system generated during crisis periods. In the end, the lack of confidence in the sustainability of public and private debt servicing won out, thus overpowering the system. What is more, because the exit costs were avowedly high, private agents' mistrust in the economic authorities' ability to maintain the rules of the game gave rise, at a critical juncture in this chain of events, to an explicit call for a run on deposits and thus, inevitably, to a chaotic denouement at the end of 2001.

Alternative explanations for the collapse will, of course, continue to be offered. One of them is that there was not enough price or wage flexibility. Actually, there was a moderate degree of flexibility. However, it should be recalled that, during the era of the gold standard, it became clear that flexibility is not a panacea. In fact, flexibility actually tends to exacerbate crises because nominal debt balances are not flexible and the actual burden they represent therefore increases rapidly in the presence of deflation. In other words, deflation is equivalent to a steep rise in real interest rates; for this reason, it has adverse effects on economic activity and banks' portfolios. This was also a point made by John Maynard Keynes when arguing against the orthodox formulas for dealing with crises that prevailed up to the 1930s.

Another explanation is that fiscal austerity was lacking. This is partially true – especially in the second half of the 1990s – but it is also true that the fiscal crisis of the late 1990s was, in large measure, endogenous. The contraction of production activity – as transmitted through the downturn in tax receipts, rising country risk spreads and, hence, the higher cost of public sector borrowing – set in motion a vicious circle in which primary spending cuts were invariably insufficient to offset the upward trend in the budget fiscal deficit. What is more, the authorities were faced with the paradox that, insofar as the convertibility regime was characterised by an endemic tendency to run a trade deficit and by dependence on external financing, the fiscal deficit was, in a sense, functional. It made it possible to maintain aggregate demand and economic growth while at the same time providing a portion of the necessary external financing that the economy needed in order to grow during boom periods.

Wrong Assumptions

In 2001 the International Monetary Fund handled the Argentine crisis in a radically different way than it had dealt with other episodes since the Mexican crisis and, in fact, than it had managed the crisis in Argentina itself up to December 2000, when international financial institutions had provided it with its "armour-plating". The first assumption underlying the new approach adopted in 2001 was that, in order to avoid the much-touted problems of "moral hazard", market discipline ought to be reflected both in losses for investors that have assumed excessive risk and in a severe adjustment for the country whose policymakers have erred. The second assumption was that the "contagion" of other economies in the region could be avoided or, in other words, that the "explosion" could be contained.

The first assumption was based on the mistaken idea that the international community could find a way to wash its hands of the events in Argentina. No one doubts today, either in Argentina or elsewhere, that errors were made in managing the country's convertibility regime. But it is also clear that the international financial community played a role in creating the conditions that ultimately led to the collapse of the country's monetary and financial system. Favourable expectations spurred what proved to be an avalanche of private capital, and its subsequent flight was one of the factors that triggered the crisis. This herd behaviour during both phases of the business cycle is nothing new; rather it is an intrinsic feature of private capital movements. International financial authorities were not mere bystanders either. While recognising that the ultimate responsibility for the economic policies that were implemented rests with the national government, and despite the reservations that the IMF may have had and may have voiced on different occasions, the fact remains that the Fund backed Argentina's economic programmes throughout the decade that the convertibility regime was in place. In fact, at the annual IMF meeting in 1998, the Fund's Managing Director heralded Argentina's economic policy as "the best in the world". The private and multilateral sectors of the international community had a hand in creating the crisis, and they must have a hand in its solution.

The second assumption was just as mistaken as the first. The delay in the support of IMF for Argentina no doubt exacerbated financial markets' hypersensitivity towards Latin America. Foreign direct investors' perception of risk in the region was heightened, since Argentina was one of the favourite destinations of such investments during the 1990s. There are, of course, exceptions; some countries have managed to access financial markets at reasonable spreads, but even they have had to deal with investor caution, and none has experienced rapid growth. Through the capital account, as well as through trade, tourism, the reduction in remittances from migrants living in Argentina and the losses sustained by Latin American firms that have invested in that country, the Argentine crisis has been transmitted to other countries of the region.[4] The idea that it was possible to isolate the crisis and prevent contagion thus tumbled like a house of cards. In an economic climate marked by the perception of severe uncertainty in Latin America and, it should be added, highly unstable financial markets in the industrialised countries themselves, the Fund's belated response to the situation in Brazil and Uruguay also yielded diminished returns.

4 For a detailed analysis of the Argentine crisis' regional effects, see ECLAC (2002), and the chapter by Ffrench-Davis and Studart in this volume.

Lessons

The lessons to be learned from this experience are well known. The effects of volatility in financial markets are devastating. One of their inherent features is the alternation of periods of under and overestimation of risk, i.e. of periods of "irrational exuberance" (the term coined by the Chairman of the Federal Reserve, Alan Greenspan) and "irrational panic". Just such "irrational panic" has been seen in the cases of Brazil and Uruguay in 2002. Levels of indebtedness which, shortly before, had been regarded as manageable were suddenly reinterpreted as being unsustainable. This turnaround is particularly serious because – as demonstrated by models of multiple equilibria and "self-fulfilling prophecies" and, for that matter, as recently observed by the international financier George Soros in relation to Brazil – the market sometimes has a way of imposing its own expectations on reality, even when they are irrational. It should perhaps be added that, above and beyond any errors that may have been made by economic policymakers or any mistaken decisions made by individual investors, such self-fulfilling prophecies have certainly been a factor in the Argentine crisis.

Given these circumstances, prompt action by the IMF is required to correct what are essentially market failures. Such action is also critical in order to prevent contagion, since the formation of expectations about the situation in a country cannot be divorced from the regional context. These observations therefore point to something much more profound: an international financial system that generates this type of hypersensitivity and, hence, this high a frequency of financial crises, is flawed and must be reformed.

The management of the Argentine crisis has two additional lessons to teach us that should be borne in mind as we move forward. The first is that, in the presence of great uncertainty and lack of confidence, if the parties involved – i.e. national authorities and the IMF – are to advance in the right direction, they will have to take a highly pragmatic approach and be willing to learn as they go along. This is the only way that the economic authorities can, slowly but surely, gain credibility. In Argentina, the restrictions that have been placed on financial transactions cannot be entirely dismantled until confidence in the new monetary and exchange rate regime has been built up. Production activity has to be returned to some degree of normalcy in order for tax revenues to recover so that a lasting fiscal balance can be achieved. Trying to bring about a fiscal adjustment by making even greater cuts in expenditure does not lead to fiscal equilibrium but rather to deeper recession and fiscal imbalances, as became clear in 2001. Refraining from intervening in the foreign exchange market when inflationary expectations are based largely on the exchange rate would simply open the door to hyperinflation and then dollarisation. It is important to recognise that no one knows exactly how events are going to unfold in the near future, nor has an alternative route been plotted out in detail. This is why, once the ultimate objectives have been clearly defined, pragmatism is the only possible avenue. Under present conditions, to demand a comprehensive blueprint is simply not realistic.

This points up to the final lesson. Precisely because there is so much uncertainty and because events are unfolding in a very dynamic way, the conditions for the commencement of formal negotiations between the Fund and Argentina have been subject to significant changes through 2002. This has sparked a lack of confidence on both sides. The Government of Argentina has said, with some justification, that each time it has met the stated requirements, new demands have been made. For its part, the International Monetary Fund has had misgivings as to whether those requirements have genuinely been fulfilled, and this has often been because of decisions, whether actual or potential, made by the legislature or the courts rather than by the government as such or by the central bank, which are the parties directly engaged in negotiations with the Fund. Apart from this, excessive public pronouncements by IMF authorities have heightened the two parties' mutual distrust. Under these conditions, in addition to the pragmatism mentioned earlier, the requirements for the commencement of negotiations should be clearly established, a high degree of confidentiality must be maintained in those negotiations, and whatever public statements are made by the Fund must be carefully considered (and even avoided).

Current Conditions and Outlook

The effects of the explicit abandonment of convertibility in 2002 did not bear out the more pessimistic projections that had been made. In particular, despite great uncertainty and the absence of external backing, neither the exchange rate nor inflation went through the roof. A prudent wage policy has no doubt contributed to this result. The demand for money has been stronger than initially anticipated, even in relation to the more optimistic expectations. The fiscal situation has changed for the better, although this improvement is based on factors that would be difficult to maintain over the long term (a wage freeze, a moratorium on the external debt, and export taxes).

The severe deterioration in production activity experienced in 2001, which was only exacerbated in December of that year by the paralysation of the payments system, bottomed out in the early months of 2002 and activity has normalised somewhat since the second quarter. The trade surplus has remained high, largely because of slack demand for imports. Exports have been hurt by the paralysis of credit and the contraction of intra-Mercosur trade, but some signs of a reactivation are beginning to appear. It is true, however, that it was not until mid-2002 that the country's favourable trade balance began to be reflected in a stabilisation of international reserves, which indicates that significant capital outflows continued throughout the first semester.

On the negative side, the combination of the higher unemployment levels associated with the slump in production activity and the decline in real wages was reflected in a steep increase in poverty and indigence. Nevertheless, since the collapse of production activity and the breakdown of the convertibility system both occurred in 2001, it is difficult to lay the blame for those events on the way the crisis has been managed in 2002. The main problem in the latter case has been that, even though steps have been taken to alleviate the most extreme situations by setting up a programme to provide subsidies for heads of household, the efforts to reverse these trends have not succeeded.

The recovery of production activity has been hindered by policymakers' indecisiveness regarding the distribution of the costs and benefits of the devaluation. This has given rise to varying solutions and to conflicts between the government and the central bank which have delayed the normalisation of the payments system and of credit for working capital. Court decisions protecting the rights of bank depositors and the protraction of the process of reaching an agreement with the Fund have also been part of the problem. The fiscal costs of resolving the financial crisis therefore remain uncertain, and it is possible that the prolongation of the crisis may dim the country's future financial development prospects. On the positive side, it may be said that bankruptcies have fallen and that firms have learned fast how to operate without credit.

There is still a long way to go. There is some degree of consensus as to the main things that need to be achieved, but there remains a great deal of uncertainty as to how to go about it. First, and foremost, it is necessary to restore the confidence in private contracts.[5] The normalisation of the payments and credit systems is an element in this process. This is certainly an area in which innovative solutions should be devised. Unlike earlier crises, the cost of restructuring the economy cannot be absorbed entirely by the State. Instead, it will have to be shared with debtor firms, depositors, banks and taxpayers. Explicit, active external support that will help build up the new regime's credibility must also be forthcoming.

There is also a clear consensus as to the need to put public finances in order. This includes low budget deficits, an enduring fiscal covenant between the central government and the provinces, a better tax system and, above all, an improved tax administration capacity. There is also clarity as to the need for a flexible monetary policy that can ensure low inflation and an orderly floating exchange rate regime.

The renegotiation of the external debt is another piece of unfinished business, but in some ways it is a less urgent task, since no arrangement could conceivably attract significant amounts of additional capital in the near future. Consequently, reaching a debt agreement has only short-term costs, since its benefits will only be realised in the long run. The country's dependence on multilateral financing will therefore be very marked in the immediate future. The task of remedying the debt problem may, however, be an appropriate field in which to explore innovative mechanisms for speeding the transition to the normalisation of private external financing. One possibility in this regard might be a scheme for the provision of multilateral guarantees for additional financing (i.e. "bailing in" operations with the support of guarantee schemes) in exchange for the normalisation of the servicing of their financial claims. Reducing protectionism in developed countries for temperate zone agricultural products in which Argentina has a strong comparative advantage could also be part of the solution.

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5 See the chapter by José María Fanelli in this volume.

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

In designing the new macroeconomic environment, it is important to bear in mind a basic lesson learned during the past decade: neither innovative “shortcuts” (at the moment, dollarisation) nor “no-holds-barred” liberalisation (which to a great extent is already in place) are magical solutions. It is even more evident to all observers that, above and beyond whatever economic policy can accomplish, a definitive resolution of the Argentine crisis must necessarily entail a settlement of its political and institutional crisis. There is only one possible actor capable of achieving that: the Argentine people themselves. Nonetheless, the international community, and especially the Latin American one, has an important supporting role to play in this respect.

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4

Growth, Instability and the Crisis of Convertibility in Argentina

José María Fanelli[1]

The Argentine economy is currently undergoing the deepest and longest recessionary process in the post-war period. The recession began in late 1998 and, as time passed and the successive stabilisation attempts failed, agents increasingly perceived that the country was entering the obscure realm of economic depression. The consequences of this process are proving to be devastating. In December 2001 the democratically elected president was forced to resign and the Convertibility Regime that had been implemented in 1991 was abandoned. The expected growth rate for 2002 is minus 15 percent and the inflation rate is increasing substantially. The peso has lost two thirds of its value against the dollar after the replacement of the currency board with a floating regime. Almost half of the population is living under the poverty line (in 1998, 28 percent was poor) and the country defaulted on its debt.

This dismal picture contrasts sharply and strikingly with the 1991-98 period, when the economy grew by more than 41 percent and there was a substantial privatisation-led process to modernise the

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1 A revised version of a paper presented at the Conference "Financial Stability and Development in Emerging Economies: Steps Forward for Bankers and Financial Authorities", organised by the Forum on Debt and Development (FONDAD) in the context of the Global Financial Governance Initiative, held at De Nederlandsche Bank in Amsterdam on 3-4 June, 2002. Comments by Juan José Pradelli and participants to the conference are gratefully acknowledged.

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infrastructure in the context of a programme of structural reforms. In 1991-98 Argentina was considered to be one of the most successful emerging economies and the favourable investor sentiment permitted the country to place a significant amount of bonds in foreign capital markets. In 2001, Argentine bonds accounted for as much as one quarter of J.P. Morgan's benchmark index of emerging market bonds.

The contrast between the 1991-98 and 1999-2002 periods has created a bizarre situation that is difficult for the population to grasp: Real GDP in 2002 will be 30 percent lower than in 1998, but the productive capacity is roughly the same as in late 1998 when the recession began. We frequently hear, "How can this be happening if there was no war that destroyed our productive capacity!"

In a nutshell, were we to assume that per capita GDP can be explained by the level of per capita physical and human capital accumulated, we would not be able to explain the situation in Argentina. It is thus obvious that explaining the present situation implies explaining why valuable resources are not being fully employed. But not only this, in the case of Argentina it is also critical to explain why the ratio of utilisation of these resources is so low and why the situation has lasted so long, turning into a depression. Between the third quarter of 1998 and the second of 2002, the quarterly GDP series registers thirteen quarters with no growth, while the unemployment rate is approaching a quarter of the labour supply.

In this chapter we will argue that the rate of utilisation of resources is currently so low because the institutional and contractual infrastructure of the economy collapsed as a result of the abandonment of the currency board. Under such circumstances, it is very difficult to define property rights properly and precisely. Hence, an important proportion of agents has no incentives to put available resources to their best use.

Three factors are key to understanding why the disorganisation of economic institutions was so widespread. The first has to do with the characteristics and temporal sequence of the shocks that hit the economy in 1998-99. From 1998 on, Argentina was hit by a series of shocks, which severely affected its competitiveness and financial position. These shocks include a fall in the prices of its exports and in the terms of trade, a tightening of external credit markets, the appreciation of the American dollar, and the devaluation in Brazil. In addition, a fiscal shock occurred because of the political cycle. The second factor concerns the particular features of the Argentine fiscal, monetary, and financial regimes, which contributed to the amplification of the consequences of the shocks. Under Convertibility, the set of counter-cyclical instruments was extremely limited. Prices and wages were not sufficiently flexible; the fiscal regime was rigid (especially the relations between the federal government and the provinces) and subject to political influences. The third factor is that the currency board had been in force for more than ten years and had gained credibility after having passed the test of the Tequila effect in 1995. Hence, private contractual relations had to adapt largely to the rules of the currency board. This was especially so regarding dollar-denominated contracts. The dollarisation of financial instruments introduced additional constraints to the extent that real depreciation would increase the financial vulnerability of firms and make the financial position of banks more fragile.

But even when we successfully explain why and how Convertibility and the shocks that occurred resulted in the present crisis, we can still wonder why Argentina adopted such a policy regime and why the country was so exposed to the specific configuration of shocks that occurred. These questions trigger an array of others: Why did Argentina choose a system as rigid as a currency board in the first place? Why were contracts dollarised? Why were foreign investors so foolish as to buy long-term bonds from a country that would default a few years later? Why was the IMF so involved with and supportive of the country's policies under Convertibility?

In answering these questions it is necessary to examine some specific characteristics of the Argentine economy that played a critical role in generating the macroeconomic disequilibria and adjustment dynamics that are typically observed. We consider that the following characteristics are critical.

First, the occurrence of "very big" expectational errors seems to be more frequent in Argentina than in many similar countries. We give a few examples corresponding to the current crisis and involving the presumably best informed agents: Argentine bonds accounted for a quarter of J.P. Morgan index and the country defaulted on its obligations; a significant proportion of foreign-owned banks' credit portfolios was allocated to producers of non-tradables who were unable to honour their obligations after the devaluation; a significant part of foreign direct investment in the non-tradable sector proved *ex post* to be excessive; the newly-privatised firms agreed on contracts which were impossible to meet if Convertibility were abandoned; and, the IMF supported stabilisation programmes with goals which were almost impossible to meet.

Second, the interactions between the Argentine economic structure and the shocks to which the country is exposed frequently give rise to "perverse" effects. Specifically, such interactions result in data-generating processes that are unstable (i.e. subject to frequent and unexpected structural changes) and volatile. This means that the potential for inconsistent expectations and the occurrence of "big errors" does not develop from agents' lack of sophistication but from the inherent complexity and instability of the processes that the agent must "model" in order to forecast the future evolution of the variables of interest.[2] These facts have consequences on an agent's economic behaviour. Among the most relevant for understanding the Argentine experience are the shortening of the contract's maturity and the incompleteness of financial markets.

Third, some features of the economic structure contribute to amplifying the consequences of shocks. We will emphasise three features: the type of international integration, the rigidities affecting nominal variables and the policy regime, and the lack of financial depth. Indeed, the absence of fluctuation-dampening factors is particularly apparent in the present circumstances. The financial crisis, the fall in national income, and political uncertainty gave rise to powerful destabilising forces. Without significant offsetting mechanisms at work beyond those of the markets, the economy is now in a state of depression.

This chapter analyses the macroeconomic dimensions of the Argentine crisis. Our previous discussion suggests that structural features play a relevant role. Therefore, the first section studies the problem of structural changes (breaks) and high volatility, as well as their relationship with expectational errors and the characteristics of contracts in Argentina. The second examines the 1998-99 shocks and their interactions with the country's economic structure. We emphasise the role of international integration, nominal and policy rigidities, and financial effects. The third section concludes the chapter.

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[2] See Heymann, Kaufman and Sanguinetti (2000) and Heymann and Fanelli (2002) for a discussion of these issues in the context of Latin American countries.

Structural Breaks, Volatility, and the Macroeconomy

The literature on macroeconomic fluctuations in developing countries increasingly shows that such fluctuations present some definite properties that differ from those observed in OECD countries (Agenor, McDermott and Prasad, 1999; Easterly, Islam and Stiglitz, 2000; Fanelli, 2000). This fact is often attributed to differences in economic structures. One point that is repeatedly emphasised is the higher volatility observed in the macroeconomic series corresponding to less-developed economies. A second point is the incidence of structural changes. In the case of Argentina, we believe that both factors are relevant. From our point of view, it is the very presence of high volatility and structural breaks that complicates the process of expectation formation and makes the economy unstable.

Of course, it is a very well-known fact that fluctuations in aggregate variables can always be interpreted as a result of plans deliberately chosen by agents holding accurate expectations. Under such hypothesis, the present Argentine recession would be an "equilibrium" phenomenon. But, in contrast to this view, we suggest that in the case of Argentina, agents made important mistakes and that, as a consequence, they are currently making large revisions of their perceived permanent income and are immerse in a generalised process of recontracting. Two facts call for a "disequilibrium" approach. First, it seems very difficult to account for the current deep and long-lasting recession without referring to some sort of disappointing expectations. Besides, Argentina is not only experiencing a strong fall in its activity level, it is also undergoing what we usually call a "crisis": a situation in which a large proportion of agents fail to comply with the terms of the contracts. Many firms and financial intermediaries are facing bankruptcy and, as a consequence, basic fiscal, financial, and even political institutions are under strong pressure. Second, the difference between a "crisis" and the isolated violation of a contract is that the former implies the threat of an across-the-board violation of contracts and property rights. Hence, if we were to assume away errors, we should say that when adopting decisions, agents have already anticipated and internalised the huge transactions costs that they would incur if the "bad" state of nature (namely, a state of crisis characterised by the generalised redefinition of contracts and property rights) occurred.

We would assume that, when agreeing on the terms of a contract, the private sector has fully internalised the costs of the negative "externalities" that a systemic crisis would generate.

One point that is sometimes less emphasised and is important for understanding the Argentine experience is that macroeconomic instability and big expectational errors may also provoke "mutations" in the economic structure. This may occur as a result of the fact that economic agents take into account that they live in an unstable economy and change their behaviour. A typical example of this kind of phenomenon is the shortening of contracts in contexts of high uncertainty, which may have permanent effects on the economy. It can affect financial depth and, in turn, investment and risk management. In this way, instability *per se* may induce structural breaks. Hence, it is necessary to consider the possible interactions between macroeconomic disequilibria and dynamics and the microeconomic structure (Fanelli, 2000). In this section we discuss these issues in more detail and present empirical evidence that we deem valuable to understanding the current crisis.

Volatility, Structural Breaks and Expectations

There is no doubt that Argentina is a highly volatile economy, as the data that we present below show. An additional aspect that must be taken into account is that such volatility is not constant. Periods of turbulence alternate with periods of tranquillity. This indicates that the conditional variance of the stochastic process may show heteroskedasticity. The presence of high volatility and heteroskedasticity has economic consequences because the conditional variance influences the risk premium (Enders, 1995).[3]

Structural change matters in the case of Argentina because the "deep parameters" defining the economic structure[4] tend to change

[3] Periods of turbulence and tranquillity could also be associated with a time-dependent non-stationary variance, that is, with permanent rather than temporal changes in volatility; although I am not aware of any study on the issue in Argentina.

[4] By economic structure we mean the set of exogenous variables and parameters that represents the agents' behavior, the policy regime, and the probability distributions governing stochastic processes. Hence, if we assume that the economic structure can be represented in terms of the reduced form of the model (i.e., in terms of exogenous variables and parameters) we are saying that the

unexpectedly and more frequently than, say, in OECD countries. This has a bearing on stability because, on the one hand, if the structural break is "unique," by hypothesis it cannot be known beforehand (in the sense that agents do not know the probability distribution of these kinds of shocks in advance). On the other, if a sizeable break occurs, agents must learn how the economy works under the new circumstances. This creates "model uncertainty" and makes the formation of expectations difficult. This phenomenon tends to generate "pure" uncertainty because the agent knows that "something" may occur but cannot calculate the probabilities or describe exactly how the event will impact the economy.

If even the best informed agents find it difficult to anticipate the shock and/or to determine its consequences, it is reasonable to expect it to affect the agent's behaviour. However, not all structural changes have the same potential to induce instability and problems of learning. If the structural change is fully anticipated by economic agents, it will be included in the agent's relevant information set and taken into consideration when negotiating the terms of a contract. This is not likely to be the kind of structural change that generates instability and big expectational errors. Instability-inducing structural disruptions are typically associated with the occurrence of events that have not only permanent effects on the economy but are also "unique" or "really new".

Two observational consequences are likely to result from these kinds of events. The first is that the corresponding series should present some discrete jumps and exhibit no tendency to return to the pre-break level. Consider, for example, a one-time permanent change in the mean of an otherwise stationary sequence, or of a single "pulse" that has a permanent effect on the mean value of a unit root sequence. Second, variations in the level of volatility should be observed in the neighbourhood of the points in which the process takes a sizeable discrete jump. This would result from changes in the incidence of forecasting errors. Right after the shock takes place, plans will prove to be wrong and mutually inconsistent in the aggregate. But, as learning reduces expectational errors and contracts are renegotiated, conditional variance should tend toward the

parameters and variables plugged into the reduced form change unexpectedly, following a stochastic pattern that the agent cannot disentangle properly when forming expectations. Of course, agents can learn, but in the meanwhile, their expectational errors will matter to macroeconomic equilibrium.

unconditional one after a period. Likewise, there could be permanent changes in the value of the unconditional variance. This would be the case, for example, if a stabilisation programme succeeded in reducing the variability of relative prices by deflating the economy. It is a well-established fact that there is a positive association between inflation and the variability of relative prices.

Some specific phenomena associated with this kind of dynamics are worth highlighting because they will play a role in our analysis of Argentina. First, as Heymann, Kaufman and Sanguinetti (2001) emphasise, after the occurrence of a positive or negative shock that produces a break, agents will find it very difficult to assess what the "true" growth trend of the economy is and, hence, to decide what their level of expenditures and financial exposure should be. If agents mistakenly assess their true wealth, the allocation of resources across time and states of nature will not be efficient and will generate aggregate inconsistency of plans.

Second, to the extent that the real value of assets used as collateral depends on the state of the economy, the change in perceptions about future prospects will influence the conditions of credit markets. Likewise, if the level of volatility changes, the perception of risk will change, as will asset prices, to the extent that they will be negatively related to their conditional volatility. This is especially important if markets are incomplete. Under such conditions risk is difficult to diversify away and hedging possibilities are reduced. Hence, if producers are risk averse, conditional price variability will affect product supply and producers may reduce their exposure by withdrawing from the market in periods of substantial risk. At the aggregate level, if national risk is difficult to diversify away and to hedge in international financial markets, higher volatility means higher risk premium, which in turn affects the allocation of resources and hence growth.

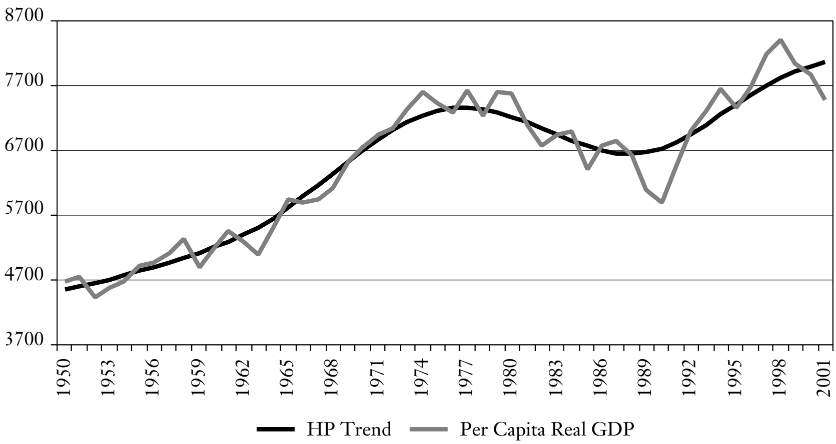
Third, under volatility and structural changes, bygones may not be bygones. Past expectations will affect the present to the extent that they are built into the terms of the contracts signed in the past, which are still in force. If past expectations proved to be "very" wrong *ex post*, one of the parties may be unable to meet the contracts' terms and it will be necessary to redraft the contract. Hence, when making decisions, agents will take into consideration that the probability of being "very" wrong is not nil and, also, that other agents' perceptions about the future may change suddenly. *Ceteris paribus*, one would expect that the higher the uncertainty about the "true" shape of the multivariate distribution generating the data in the relevant information set, the shorter the contracts will be. In economies subject to pure uncertainty, we should observe a lower average duration of contracts as agents try to hedge against unique "bad jumps" in the economy's stochastic trend. We should also observe situations of systemic crash in which contracts are violated across the board because of the occurrence of unexpected changes in the economy's stochastic trend and hence in cash flows and collaterals.

Fourth, liquidity has a premium under uncertainty because recontracting is costly and the need to recontract is higher as the probability of having wrong expectations rises. We think that this is one reason why, under the highly uncertain circumstances which precede a permanent shock like the launching of a stabilisation programme, whose consequences are difficult to disentangle, the "wait and see" or "be flexible and liquid" attitudes will be highly profitable, to the extent that the value of the waiting option has higher value. An increase in liquidity preference will be the norm.

Trends and Macroeconomic Instability

Do the properties of the Argentine data-generating processes indicate the existence of volatility and structural breaks that may give

Figure 1 Per Capita Real GDP
(Constant Pesos 2000)



rise to the kind of instability discussed above? That is, are there sudden changes in the growth trend and sparks of volatility? Is the average duration of contracts affected by macroeconomic instability? Are there interactions between credit conditions, shocks, and aggregate fluctuations?

Figure 1 shows the evolution of the Argentine per capita GDP over the last fifty years and the corresponding H-P trend. As can be seen, the average growth rate is low and the trend shows marked changes. Important shifts in the trend are associated with macroeconomic and financial crises, and/or regime changes (1975-76; 1980-81; 1988-89; 1991; 1999-2001). Likewise, large events inducing sharp "kinks" in the activity level and discontinuous jumps in the growth rate are very frequent. If we compared this time series with a typical OECD country, we would see that Argentina shows more ups and downs and that large events are more frequent. In fact, this stylised fact is not peculiar to Argentina. Easterly, Islam and Stiglitz (2000), show that non-OECD countries are far more likely to experience growth downturns (i.e. negative growth) than industrial economies. They maintain that non-OECD countries experience a downturn 22 percent of the time, while OECD countries are in a downturn just above 9 percent of the time. The frequency of downturns in Argentina (36 percent) is well above the developing country's average.

Table 1 Inflation and Growth Instability in Argentina

	1950-1974	1975-2000	1950-2000
Average Inflation Rate (CPI, %)	24.30	94.70	60.90
Coef. of Variation Relative Prices (WPI/CPI)	0.08	0.34	0.27
Average Growth Rate Per Capita GDP (%)	2.02	0.13	1.04
Frequency of Downturns (%)	21.00	52.00	36.00
Coef. of Variation Growth Rate Per Capita GDP	2.08	37.27	4.55

Source: Based on ECLAC (1998, 2002) data.

It is interesting to note that the 1975 crisis represents a key breaking point concerning both instability and the economic regime. After 1975, Argentina definitively abandoned its rather unsuccessful import substitution strategy and adopted a much more market friendly approach to economic policy. The level of volatility is very different before and after this point. Between 1950 and 1974 the probability of a downturn was more or less in line with the one corresponding to developing countries (21 percent). But, in the 1975-2001 period this probability augmented to 52 percent. This means that GDP per capita fell more years than it grew. As a consequence, the average GDP per capita growth rate is much lower while the coefficient of variation skyrockets (see Table 1). Likewise, even though the second period includes the 10 years of Convertibility, during which inflation was very low, the inflation rate and relative price variability were significantly higher in this second period. Very large downturns and steep accelerations of inflation, however, are observed in both periods.

Owing to the abundance of jumps and large events, this dynamic behaviour has been called a "stop-and-go" pattern of growth. One characteristic of the stop-and-go pattern is that all macroeconomic aggregates tend to show marked variability; the volatility of Argentine investment, consumption and GDP growth is high even if we take developing countries as the standard of comparison. Table 2 shows the volatility of such variables in Argentina and in similar Latin American countries.[5]

Table 2 Volatility of Macroeconomic Aggregates

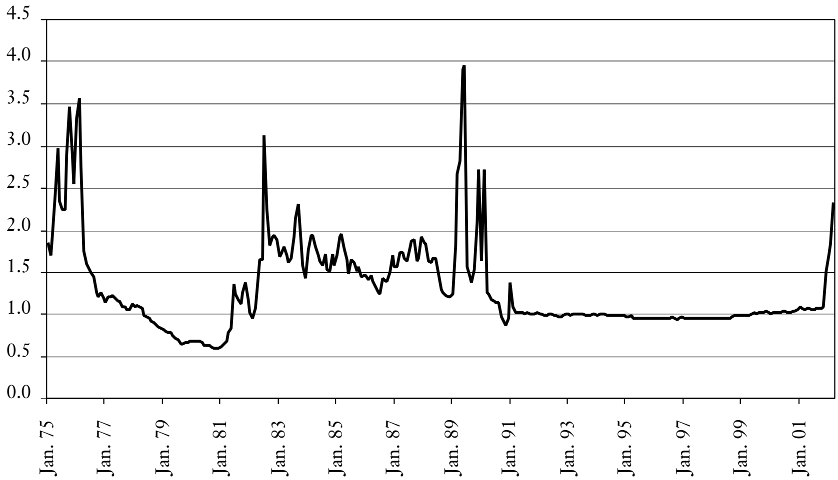
	Coefficient of variation		
	Investment Growth	Consumption Growth	GDP Growth
Argentina	7.1	2.4	1.8
Brazil	2.4	0.9	0.9
Chile	2.6	2.3	1.1
Mexico	3.5	1.0	0.9

Source: Based on World Bank (1999) data.

5 For more evidence on this issue see, IADB (1995).

Notice that consumption growth is more volatile than GDP growth. This suggests the existence of important failures in capital markets which obstruct consumption smoothing, and indicates that the welfare costs induced by market failures in financial markets may be significant. It also indicates that Argentina faces severe constraints to diversify national risk.

Figure 2 Real Exchange Rate (WPI) US - Argentina
(Index 1993 = 1)



Periods of tranquillity and turbulence can also be identified in the Argentine economy. The presence of volatility sparks is especially apparent in relative price series. To illustrate the point, Figure 2 shows the evolution of the real exchange rate (RER) over the last 25 years.[6] Note, first, the relationship between breaks and volatility: sharp upward jumps in the RER are followed by variations in the volatility level. In a more formal analysis using ARCH and GARCH models, Fanelli and Rozada (1998) showed that the variance of the real exchange rate presents conditional heteroskedaticity. That is, the conditional variance depends on the past realisations of the error process and, hence, "big" errors induce "big" variance in the neighbouring observations. A second characteristic is that jumps in the RER and radical changes in volatility tend to be associated with

6 RER is defined as the US wholesale price index times the nominal exchange rate over the Argentine wholesale price index.

regime changes. The more marked jumps in the RER tend to coincide with the sudden ends of currency pegs of some type or other after balance of payments crises with significant capital flight. Such regime changes (in 1975, 1981, 1989, and 2001) were associated with major swings in economic policies. The two periods of lowest volatility in the series correspond to systems where the exchange rate was used as the nominal anchor: the "tablita" 1978-1981 and the decade of convertibility (1991-2001). We interpret this as evidence that the monetary and exchange rate regime may not be neutral, namely, that different regimes will have dissimilar effects on the real side (Fanelli and Heymann, 2002).

The importance of regime changes is also suggested by the studies on Mercosur. During the 1990s, the transmission of macroeconomic impulses between the Mercosur countries grew more important as the volume of trade expanded, starting from quite low levels. In consequence, the bilateral real exchange with Brazil became an increasingly significant variable for Argentina. Chudnovsky and Fanelli (2001) examined the properties of the series using GARCH models. This study found significant volatility in the variable, with strong effects of regime changes such as the launching of the Argentine convertibility in 1991 and the floating (*cum* devaluation) of the Brazilian currency in 1999.

The instability in the RER compounds with variations in real GDP to determine wide fluctuations in the dollar value of GDP. The coefficient of variation of the Argentine real GDP in constant dollars is almost twice the coefficient corresponding to real GDP in constant pesos (0.66 and 0.36, respectively). The contribution of the tradable and non-tradable sectors to the variance, however, is very different. The fluctuation in the dollar value of the non-tradable sector is much higher. Figures 3 and 4 show the evolution of total output, tradables and non-tradables in constant dollars and pesos. Note the sizeable and increasing gap between the dollar value of tradables and non-tradables under Convertibility (1991-2000) and, also, under the "tablita" (1978-81). It appears that the dollar value of non-tradables tends to inflate under systems that peg the nominal exchange rate. The appreciation in the dollar value of non-tradables, nonetheless, disappears together with the peg systems. This may be a source of financial fragility if, under a peg system, inflated non-tradable productive assets are used as collateral by firms to demand dollarised credit in the domestic banking system and/or in foreign credit markets.

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Figure 3 GDP, Tradables and Non - Tradables
(Millions Constant Dollars 2000)

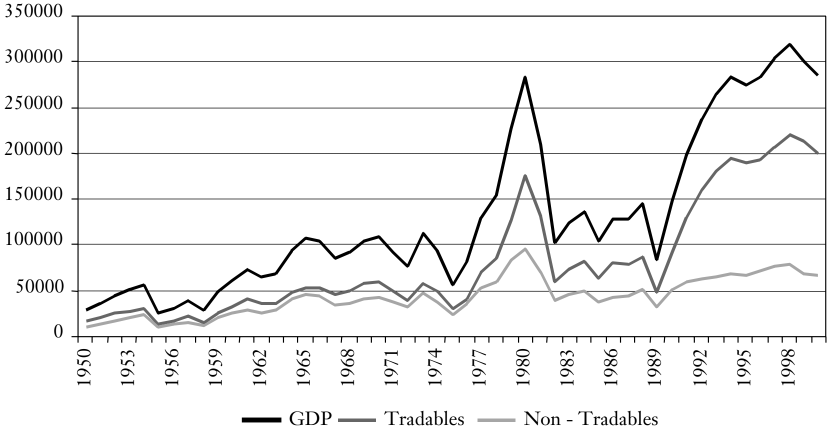
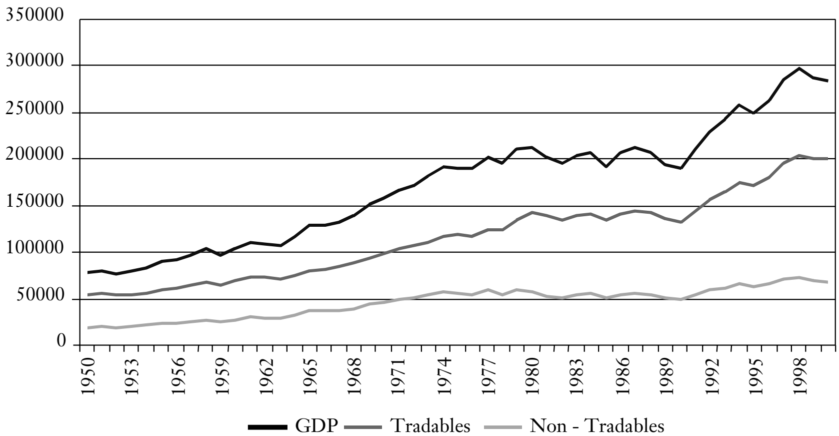


Figure 4 GDP, Tradables and Non - Tradables
(Millions Constant Pesos 2000)



We have already pointed out the higher macroeconomic instability of the 1975-2001 period. The figure clearly shows that the fluctuation in the dollar value of GDP and, particularly, in the dollar value of non-tradables is wider in this period. This fact may also have a bearing on the recurrence of financial crises in the last 25 years. For one thing, unlike the 1950-75 period in which capital flows were not important and dollarisation unknown, from the late seventies on capital movements became increasingly important as Argentina began to open its capital account. At the same time, there was a persistent tendency for the domestic financial instruments to be denominated in dollars. In this way, firms producing products with highly volatile dollar prices faced a gradual disappearance of peso-denominated credit instruments. We are not implying a simple causal relationship exists between capital account liberalisation, dollarisation, and instability. Rather, we stress the perverse interactions that may take place in such a context.

Fanelli and Heymann (2002) stress that, in a highly dollarised economy such as Argentina, this fact may severely affect financial stability. The difficulty in determining sustainable levels of spending can deteriorate the quality of decisions (Heymann, Kaufman and Sanguinetti, 2001). With a shifting trend, agents may learn at some point that their expenditures have been in fact highly pro-cyclical and that they had been "living beyond their means". The problem of identifying permanent incomes cannot be bypassed when making decisions dealing with production, spending, and asset holding. In post-1998 Argentina, the realisation that wealth estimates had been exaggerated caused an extremely traumatic adjustment and the current crisis was the ultimate result. The system of mostly dollarised financial contracts that developed under the convertibility monetary regime was highly vulnerable to fluctuations in the dollar value of incomes. This resulted in the breakdown of contracts, which was itself a source of economic disorganisation to the extent that it triggered a financial crisis. Likewise, we must consider that, for an indebted country with a dollar-denominated debt, the dollar value of its GDP is relevant because it is utilised in the assessment of the country's ability to pay. There is a widespread use of the debt to GDP ratio as an indicator of ability to pay. To the extent that the dollar value of GDP directly affects creditworthiness there is a linkage between the expected trend of country's income expressed in dollars and the evolution of the country risk premium. The abandonment of Convertibility in December 2001 and the ensuing steep depreciation of the peso revealed that dollar incomes would be much lower than expected.

Contract Maturity and Financial Deepening

According to the hypothesis concerning micro-macro interactions that we discussed above, the stop-and-go pattern and the changing level of volatility should permanently have affected the agents' behaviour and, hence, should have induced structural changes in the economic system. We think that there is evidence that important innovations have effectively occurred. It seems that macroeconomic instability has induced important changes in the agents' preferences regarding key aspects of the terms of a contract. In the context of high instability in the period that began in 1975, it is possible to detect substantial changes concerning the maturity, currency denomination, and risk characteristics of contracts. This has had permanent and non-neutral effects on the economy, which are relevant to understanding the current situation.

In the case of Argentina, the maturity of contracts is affected by changes in inflation and volatility and by changes in the monetary regime. After the inflationary spurts in 1975 and 1989, there were significant across-the-board permanent shrinkages in contract duration in the goods, labour, and financial markets. Although maturity length increased in the context of low inflation under Convertibility, the phenomenon of contract shrinkage proved to be very persistent.

Some evidence of the preference for flexible short-term contracts has to do with studies on purchasing power parity property (PPP). In the case of developed countries, the PPP-property does not hold in the short run but seems to apply after a long adjustment period; there is no evidence of this behaviour for developing countries due to lack of data (Froot and Rogoff, 1995; Edwards and Savastano, 1999). In the case of Argentina and Brazil (perhaps because of the comparatively weaker price inertia in economies with inflationary experience) the variance around the mean is larger than for other economies, but deviations have smaller mean durations. In fact, the presence of a unit root is rejected more easily for the Argentina-Brazil bilateral real exchange rate than it is for the exchange rates of developed countries (Chudnovsky and Fanelli, 2001). That is, the historical experience shows a bilateral exchange rate that has varied a great deal, but does not seem to have a "permanent" drift. This suggests that the lower inertia reflects shorter contracts under high volatility.

The relationship between macroeconomic instability and contract duration can also be detected by examining financial intermediation. After years of very high inflation, in 1990, the M3 to GDP ratio was around 5 percent and the maturity of credits and deposits was extremely short. The fall in inflation and volatility under Convertibility encouraged financial depth and the lengthening of contracts, although the process was slow. In 2000, after nine years of Convertibility, the average maturity of 70 percent of the banks' assets and 82 percent of banks' liabilities had a maturity of less than 90 days. But, in any case, these developments were not firmly rooted. The current financial crisis is completely erasing the positive financial developments of the 1990s and, in fact, the bank run was facilitated by the short duration of deposits.

Low financial deepening has been a permanent problem in Argentina and the history of macroeconomic instability and repeated financial crises greatly contributed to this result. Lack of financial depth is a source of inefficiency and a deterrent to growth as some firms may forgo profitable opportunities because they do not have fluent access to credit markets and because of financial market failures. Likewise, when financial failures are pervasive, macroeconomic fluctuations affect the financial position of the firms making it very difficult to manage risk and the consequences of cyclical downturns.

The results in Bebzuck, Fanelli and Pradelli (2002) support this hypothesis. They used a panel of Argentine corporate companies and GMM estimations both to trace the effects of financial market imperfections on the investment process and to test whether the firm's financial structure was dependent on the macroeconomic situation and the evolution of financial deepening. To examine the importance of macroeconomic disequilibria they introduced the country risk premium and the private credit to GDP ratio into the right-hand variables in an investment equation and in two financial structure equations in which the dependent variables are the proportion of long-run debt and the proportion of dollar-denominated debt, respectively. Regarding financial development, the hypothesis states that increasing financial deepening and capital inflows increased credit supply in the 1990s, thus allowing firms to elevate their leverage after a long period of tight rationing. They found that both the macroeconomy and financial deepening matter to debt composition in terms of maturity and currency denomination. Specifically, the country risk coefficient is significant and negative (implying a negative association between the proportion of long-term debt or dollar-denominated debt, and country risk) while the influence of the credit to GDP ratio is significant and positive. In these two financial structure regressions, the variables that reflect information and agency problems, such as firm size, and tangibility also have a significant effect. Concerning the investment equation, cash flow and the country risk are also significant. In sum, this suggests that financial imperfections matters and that there is a direct link between aggregate variables and decisions at the micro level.

The coexistence of free capital mobility and lack of financial deepening may be a source of macroeconomic and financial uncertainty as international capital flows into "emerging" countries are far from stable. At the same time, the tools in the hands of authorities to smooth the consequences of sudden changes in the intensity and direction of flows are rather limited. In the case of Argentina, under convertibility and free capital movements, there was a close association between capital flows, the generation of credit, and the activity level. After late 1998 this association resulted in a perverse macroeconomic dynamic that ultimately led to external and domestic default.

Under convertibility, external shocks, both positive and negative, influenced the cost of domestic credit. In this regard, the main link between external and domestic credit markets is the country risk premium. Changes in the conditions in emerging countries' capital markets and/or in the domestic macroeconomic scenario are reflected immediately in changes in the country risk premium. The volatility of domestic and external conditions echoed in the evolution of the country risk. Via its influence on the cost of credit, this volatility increased the variance of aggregate demand. Figure 5 shows the evolution of the country risk premium – as measured by the Emerging Markets Bond Index (EMBI) spread – and compares it with the economy's quarterly rate of growth. Both variables show high volatility and there is a marked and negative association between changes in the country risk premium and changes in the growth rate of quarterly GDP.

Another important feature is the close association between the supply of credit and the activity level. Indeed, given capital market imperfections, it seems plausible that changes in the availability of credit does matter to the level of activity. Using an error correction model, Fanelli and Keifman (2002) find results that are consistent with the hypotheses of a relevant positive association between credit and output in the short run and of a negative correlation between the country risk premium and the evolution of the macroeconomy.

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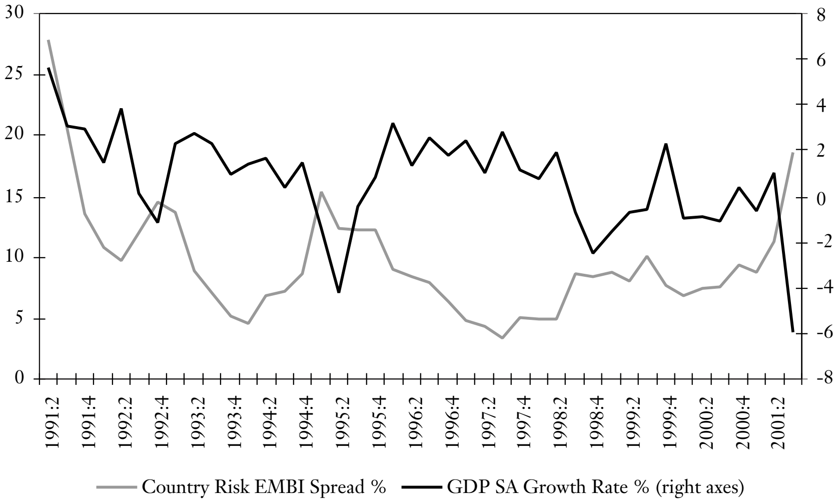
Figure 5 Country Risk and Economic Activity



Asymmetries, Rigidities, and Dynamic Effects as Sources of Instability

Developing countries tend to be volatile. But the evidence analysed suggests that Argentina is more volatile than one would expect on the basis of its per capita GDP. We do not have any *a priori* element to assume that the shocks hitting the Argentine economy are *a priori* more volatile than those hitting similar developing countries (although we can argue that the specific sequence of shocks in 1998-99 was particularly stressful). This implies that we should look for internal sources of instability. The best candidates are, on the one hand, features of the economic structure (rigidities, asymmetries) that may amplify the impact of shocks and, on the other, dynamic and feedback effects that may leverage shocks such as fluctuations in terms of trade, fiscal impulses, or sudden reversals in capital inflows.

We will focus on two issues. In the first place, we analyse three aspects of the economic structure that have played a crucial role in amplifying the shocks that preceded the fall of the Convertibility Regime and contributed to generating the current state of economic disorganisation: first, the asymmetries in Argentina's integration with world trade and financial markets; second, the constraints posed by nominal and fiscal rigidities and differences in speed of adjustment;

and, third, the lack of financial depth and dollarisation. In the second place, we analyse the 1998-99 sequence of shocks.

Asymmetrical International Integration

The integration of Argentina with the world economy shows two fundamental asymmetries between the real and the financial side. First, while the economy's degree of openness is very low when measured on the basis of trade, its openness to capital flows is much higher. Second, trade flows between Argentina and the US are very low but the bulk of Argentina's external debt is denominated in dollars and domestic financial intermediation is largely dollarised. An additional asymmetry and possible source of instability is that the public sector is heavily indebted, while the private sector holds substantial amounts of foreign assets.

Figure 6 Opennes, Latin America Argentina Brazil Mexico Chile
(Exports plus imports as percentage of GDP, market prices)

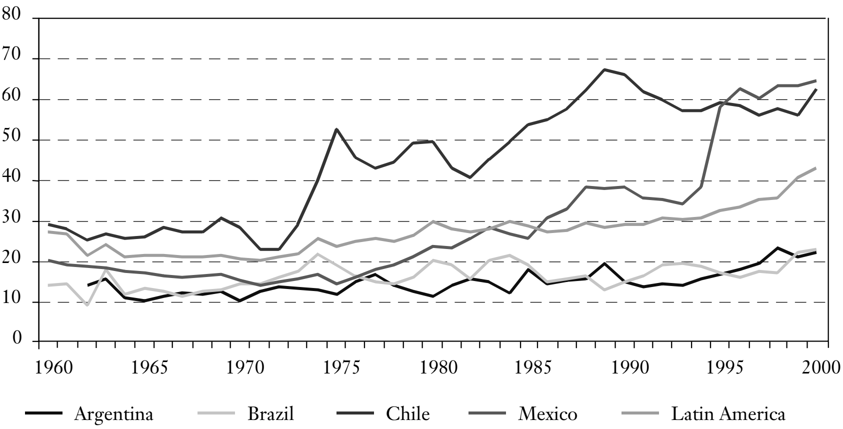


Figure 6 shows the openness of Argentina, other selected Latin American countries, and the region as a whole. The coefficient of openness as measured by the relationship between exports and imports and GDP is one of the lowest in Latin America. This can be partially explained by the fact that the country followed an import-substitution strategy of industrialisation for a long period. However, it is also true that as part of the structural reforms of the 1990s, the authorities implemented aggressive policies to open the economy, including the participation in a regional agreement in Mercosur. The difficulties that Argentina face to open its economy, nonetheless, are not surprising if we take into account that Argentina's factor proportions determine that the country's comparative advantages are in the "wrong sectors". That is, the possibility of fully exploiting "natural" comparative advantages is severely limited by the Mercantilist agricultural policies implemented in the developed world. Another factor that is not favourable to openness is that its most important neighbour and partner, Brazil, is a rather closed economy while Latin America is also a relatively closed region.

The picture is completely different if we look at capital movements in terms of both stocks and flows. In the 1990s, when the markets where open to the country, Argentina was a privileged recipient of foreign direct investment and capital inflows (see Table 4). The external debt to GDP ratio, in turn, is one of the highest in the region. In a sense, one could say that developed countries acted irrationally: They lent heavily to a country whose products they did not want to buy as revealed by the level of subsidies and protectionism. It can be expected that a country facing severe protectionism may have problems to meet its financial obligations.

This asymmetry between the real and the financial side is a source of financial instability because the economy is highly leveraged in terms of tradables. If we use the foreign debt to exports ratio as a proxy of such leverage, it is clear that Argentina is overly leveraged. Table 3 shows the ratios corresponding to Argentina, Brazil, Chile, and Mexico. The Argentine ratio is the highest and shows an increasing trend in the 1990s, in spite of the privatisation process, which helped to finance the external disequilibrium without augmenting the external debt. Note the highly positive evolution of this indicator in the case of Mexico. There is one main force behind this result: the signing of NAFTA. In the first place, the regional integration with the US resulted in a much higher openness coefficient and, second, the agreement also contributed to incrementing FDI flows. Hence, after the Tequila crisis Mexico's external debt did not increase and the country financed its current account deficit based on FDI flows. This result suggests a secure and sustainable way to reduce external overexposure and financial instability.

Although Argentina's degree of integration with capital markets was much higher in the 1990s, it was also highly imperfect. One important characteristic was the instability of flows, which were

Table 3 External Debt to Exports Ratio

	1980	1985	1990	1995	2000
Argentina	3.4	5.9	5.1	4.7	5.5
Brazil	3.2	4.1	3.9	3.4	4.3
Chile	2.4	5.4	2.2	1.4	2.1
Mexico	2.8	3.7	2.6	2.1	0.9

Source: Based on ECLAC (2002) data.

affected by contagion and sudden stops. The incidence of these factors was critical during the Tequila crisis and after the Russian crisis. A second flaw of the Argentine integration is that the country did not substantially improve its capacity to diversify the national risk away. We have already called attention to the high volatility of aggregate consumption. Fanelli (2000) also shows evidence on the lack of correlation between Argentina's and the world's consumption (proxied by US consumption).

The difficulties to manage national risk create a link between macroeconomic uncertainty and the demand for foreign exchange. In the case of Argentina, "bad" macroeconomic states of nature are typically characterised by a steep depreciation of the currency and recession. Low consumption states correlate positively with high real exchange rates. Hence, under incomplete markets, agents demand foreign assets as a hedge against this "bad" state. It follows that the desire to cover open foreign exchange positions augments, especially when "pure" uncertainty increases.

Table 4 Financial Flows to Argentina in the 1990s
(percentage of GDP, yearly average)

	1991-1995	1996-2000	1990-2000
Foreign Direct Investment	2.4	3.1	2.8
Increment in Foreign Liabilities	3.6	4.2	3.9
Increment in Foreign Assets	3.2	2.8	3.0
Deficit of the Current Account	2.5	3.9	3.0
Accumulation of Reserves	0.3	0.8	0.6

Source: Based on ECLAC (2002) data.

The role of foreign assets as a hedge can be traced in the balance of payments and the stocks held by the private sector. Concerning the stocks, the hedging motive is reflected in the fact that Argentina's net external indebtedness is very low. Argentina, as a whole, is not a heavily indebted country: foreign assets in the hands of the private sector represent around 75 percent of the stock of external debt, which is largely held by the government. The relationship between the stocks of assets and liabilities is consistent with the evolution of the capital account of the balance of payments in the 1990s. Table 4 shows that the flows of financial assets and liabilities are practically matched in the 1990s. This means that FDI flows would have been sufficient to finance the disequilibria in the current account. This fact suggests that there is a purely financial dimension in the "debt problem" that has more to do with risk hedging and moral hazard (see below) than with the demand for foreign savings to finance domestic investment. In net terms, the increase in foreign debt went to finance asset accumulation and not real investment.[7]

This picture of stocks and flows seems to be at odds with the picture of the present financial crisis. One main cause of the crisis was the existence of large positions in foreign exchange that were not effectively covered. This is true. But there are several factors that must be considered. First, it must be taken into account that it was not the private sector but the government that had the largest uncovered position. Second, there may have been a moral hazard problem. Many firms that were heavily indebted in dollars may have assumed that the government would implement a "pesification" of dollar liabilities in case of a generalised crisis originating in an abandonment of the currency board. *Ex post* they were right. Third, mismanagement of risks may have played a role. Specifically, bank managers may have ignored the phenomenon of risk migration from currency risk toward credit risk.

Rigidities and Dynamic and Financial Effects

It seems that open economies are more volatile but grow faster (Easterly, Islam, and Stiglitz, 2000). Argentina, however, is rather closed, grows little, and is volatile. We will now briefly examine some

7 Note that the same happened in Chile, a country whose economic policy is of much better quality than Argentina's.

rigidities, and dynamic and financial effects that may have bearing on this and that played an important role under Convertibility.

Typically, the market imperfection that breaks neutrality and incorporates monetary problems into the analysis is some kind of rigidity in the adjustment of nominal prices. Under nominal price inflexibility, monetary policy can have a real impact not only on aggregate demand but also on the real exchange rate.[8] We have already commented that price rigidities and different adjustment speeds have certainly had a role in explaining the high volatility of the observed real exchange rate (see Figure 2).

Easterly, Islam and Stiglitz (2000), nonetheless, call attention to two points that generally have not been sufficiently emphasised. First, there are the differences in adjustment speeds, as well as the distributive effects that arise from price changes, especially those against which individuals cannot be insured (reflecting incomplete contracts). Under these circumstances, income effects can overwhelm substitution effects arising from price changes. Second, there are dynamic effects arising from firms' and financial institutions' wealth and cash flow constraints.

Income and financial effects are relevant in the Argentine case. This was especially evident in the interactions between fiscal adjustment, tax collection, and the activity level from 1998 on. At the beginning of 2000, when the economic recession was well under way, the new Administration made important efforts to reduce the fiscal deficit. They assumed that the reduction in the deficit would restore confidence and foreign investors would bring the much needed funds. However, the results tended to be just the opposite. Tax collection did not increase and the economy went into deeper recession. This kind of destabilising effect is typical of the Argentine economy and is generated by the conjunction of strong income effects and the pro-cyclical behaviour of capital markets. Everyone would agree that it is not all that wise to increase taxes during a downturn and that the income effects of tax increases should be avoided. However, to avoid adjusting during a downturn, the government should be able to finance the deficit. And this was not the case of Argentina in 2000. Obviously, the best way out is to have prudential fiscal policies. For example, one of the important sources

8 In the literature on developed countries this imperfection is supposed to be the most relevant empirically (Basu and Taylor, 1999; Taylor, 2000).

of the budget disequilibrium was the ill-designed reform of the social security system that generated a sizeable deficit. The excesses during the electoral process in 1998-99 were also relevant. In this regard, one negative feature of the Convertibility system was the assumption that a currency board would automatically discipline the government. The government could not print money and the markets would not lend to governments with soft fiscal policies. These arguments assume away expectational errors, and this does not seem prudent in the context of a volatile economy.

The concern over the firms' and financial institutions' balance sheets is also warranted in the Argentine case. Credit conditions can react quickly to changes in investor sentiment and, hence, the evolution of overall volatility and national risk is highly relevant. The evidence in Bebzuck, Fanelli and Pradelli (2001) shows that, when the macroeconomic setting worsens, there is, simultaneously, a shift toward the demand for foreign exchange and a mounting demand for short-term financing. Hence, economic downturns create pressures on both foreign exchange and domestic financial markets. When the exogenous macroeconomic shock is strong enough, this combination of events can trigger the so-called twin crises which, in fact, have occurred in Argentina.

Negative shocks reduce the firms' net worth, increasing the probability of financial distress. A regression exercise shows that a one-percentage-point increase in the country risk premium reduces the value of firms listed on the Buenos Aires Stock Exchange by 2.2 percentage points (Fanelli, 2000). Under such circumstances, creditors react by shifting their demand toward assets with short-term maturity to better monitor the behaviour of debtors and because the liquidity premium rises in uncertain environments. But, if we assume that the duration of assets is somewhat constant throughout the cycle, when the shortening in the term to maturity of debt occurs, the firms' financial position further deteriorates and default becomes more probable. This increase is perceived by creditors as an upward movement in the costs of financial distress (if we calculate these costs as the probability of default times its cost). Under these circumstances, a logical result is that creditors will try to shorten maturity to better monitor and discipline debtors. If this reasoning holds, there are endogenous factors which tend to reduce maturity and increase financial duress during recessionary periods.

The phenomenon of risk migration is closely related to this issue.

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Risk tends to migrate in the financial system because hedging does not reduce systemic risk. It only transfers the exposure elsewhere or transforms the type of the exposure. Because of risk migration, activities such as hedging do not reduce the amount of systemic risk. This is very important in the case of Argentina. When the level of perceived systemic risk increases, banks hedge against currency risk and seek a better matching of the duration of assets and liabilities. The counterpart of this is that firms' liquidity falls and the duration of their liabilities shorten during downturns. This augments the firms' vulnerability, increasing counterparty risk. The ultimate effect of the banks' attempt to hedge is that risk migrates from currency risk to credit risk. And the greater the amount of risk mitigation by banks, the more likely it is that unforeseen losses will migrate quickly from one market to another. As risk migrates through the system it tends to emerge in its most basic form, as credit risk (Kimbal, 2000). When one takes into account the phenomenon of risk migration and its effects on banks solvency, the Calomiris and Powel (2000) argument about market discipline seems weaker. They argue that tight credit supply during downturn is a sign of the financial system's strength because tight credit supply in the face of a recession and high loan losses is precisely what one would expect from a banking system that is subject to market discipline. The Argentine case suggests that in the context of a generally weak economic system, a financial sector is no more healthy if it simply transfers its risk to firms, because this too rebounds on it.

Simultaneous Shocks and Financial Distress

We have already called attention to the striking differences in the economic performance of Argentina between the 1991-98 and the 1999-2002 periods. The breaking point can be situated in the third quarter of 1998 when the current long-lasting recession began. The various external shocks that severely hit the economy in 1998-1999 played a critical role. Any of these shocks would have been enough to induce significant macroeconomic imbalances. But their occurring almost simultaneously compounded their effects and the economy was ill prepared to absorb and manage the consequences. We have identified weaknesses in the economic structure and dynamic mechanisms that may have substantially amplified the impact of the shocks.

Another factor that contributed to aggravating the downturn and exacerbated financial fragility was the poor quality of economic policies in a context of political instability. The counter-cyclical instruments in the hands of the authorities were rather limited. Hence, it is clear that Argentina would have suffered an important recession under any post-shock scenario. But the point is that the available instruments were not used efficiently. The influence of political factors was a determinant in this regard. In the pre-election 1998-99 period the authorities followed inconsistent fiscal policies which resulted in public sector over-borrowing, disarray in the relationship between the Federal and the Provincial governments, crowding out of the private sector, and rising financial stress. The policies implemented by the politically weak Administration that took office in December 1999, in turn, did not reverse the situation.

The appreciation of the dollar and the global financial crisis of 1997-98 played a critical role in generating the shocks. They triggered various events that negatively affected the Argentine economy. Table 5 shows the most relevant effects corresponding to the 1998-1999 period.

Table 5 The 1998 – 1999 Shock

Fall in the Terms of Trade (variation in percentage)	11.1
Fall in Export Prices (variation in percentage)	20.0
Fall in Exports to Brazil (variation in percentage)	30.0
Brazilian Real Depreciation (vis-à-vis the peso, WPI index)	18.4
Dollar Appreciation (vis-à-vis the euro, percentage)	10.0
Net Capital Outflows (percentage of GDP, FDI excluded)	1.4
Increment in Interest Payments (public sector, in percentage of GDP)	1.0

Source: Based on ECLAC data.

Under Convertibility, the dollar appreciation directly affected the competitiveness of Argentine exporters because the bulk of the country's trade does not target the United States. Given that the Argentine peso was pegged to the dollar, a strong dollar meant an overvalued peso. The strong dollar had another important consequence. In 1998, Brazil was using the nominal exchange rate as an anti-inflation device and the real was more or less pegged to the dollar. Under such circumstances, the stronger dollar increased pressure on the Brazilian real exchange rate and the country ultimately adopted a floating system in January 1999. With the elevated depreciation of the Brazilian real, it was much more difficult for Argentina to compete with its neighbour's exports. This was aggravated by the fall in the domestic global demand in Brazil. Argentine exports fell substantially in the two years following the devaluation (See Table 5). The asymmetry between the direction of trade flows (toward Europe and Mercosur) and financial flows denominated in dollars also played a role. As Table 5 shows, the deterioration in the terms of trade was accompanied by a fall in the nominal value of export prices. *Ceteris paribus*, this increased the real debt burden in terms of Argentine exports and deteriorated the debt to exports indicator. Argentine creditworthiness was affected by these developments to the extent that the country's solvency was put under severe scrutiny.

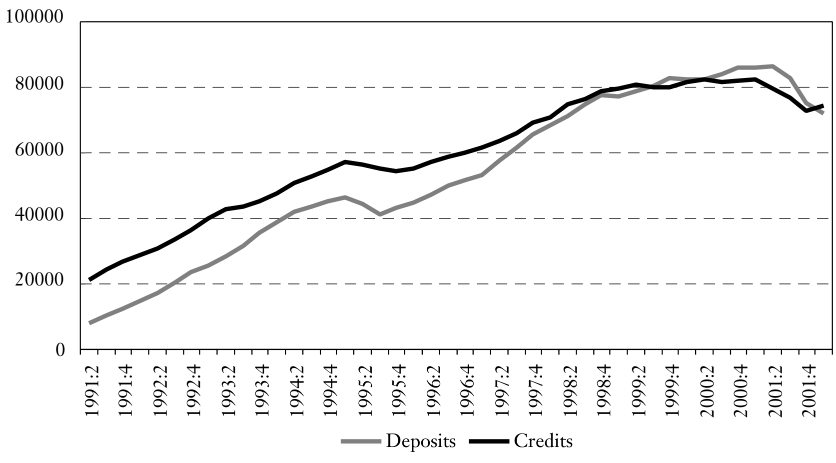
In the period that began with the Asian crisis, and especially after the Russian episode, the interest rates that Argentina paid to its foreign and domestic creditors increased substantially. Table 5 shows that government interest payments augmented by one percentage point of GDP in 1998-99. However, this was only the beginning. In 2000, the interest burden would reach 3.3 percent of GDP (from 1.8 percent in 1997). Likewise, net capital inflows fell by more than one percentage point of GDP. Soaring interest rates and tight liquidity constraints quickly eroded solvency.

Argentina's level of debt was not high in terms of GDP. The debt to GDP ratio was 43 percent in 1997. This ratio was in line with Latin American standards. Other Latin American countries like Argentina in this respect did not default on their external commitments. This fact, however, conceals the role played by some of the structural destabilising mechanisms that were discussed above. Namely, the elevated debt to exports ratio – which was increasing because of the fall in exports – and the fact that investors may have anticipated that the dollar value of GDP and, hence, government revenues, would plunge if the Convertibility system were abandoned. Under these circumstances, macroeconomic disequilibria triggered feedback effects. As the likelihood of devaluation grew, borrowers had to offer higher interest rates to compensate lenders for the increasing credit risk. The increase in interest rates, in turn, contributed to elevating the risk of default, which led to even higher interest rates and so on.

Although this dynamic represented an increasing threat to the banks' financial position, in the first stages of the crisis the banking system could confront the pressures well. After the Tequila crisis, bank reserves increased substantially and tighter prudential regulations based on Basel Accords were implemented, which resulted in stronger bank capitalisation (11.5 percent of assets at risk). But even bank assets of reasonable quality and liquidity can deteriorate heavily when the economy experiences a resilient recession, risks migrate, and financial contracts tend to be short.

As "pure" uncertainty about the future rose steadily in 2001 – hand in hand with the increasing likelihood of a regime change and the deepening of the recession that deteriorated banks' assets – depositors quickly cashed their deposits. In 2001, total deposits in the financial system fell by 16 percent. This gave rise to mounting liquidity problems, in spite of the high reserves ratio and the strong capitalisation of private banks at the beginning of that year. Figure 7 shows the evolution of deposits and credit under Convertibility.

Figure 7 Deposits and Credits
(millions of pesos)



Another disturbing consequence of the continuous deepening of the crisis was the persistent deterioration of the budget equilibrium. To a certain extent this was an endogenous consequence of the recession-driven fall in government revenues. In mid-2001, the tight international and domestic credit rationing obliged the government to launch a "deficit zero" policy that quickly failed. As a consequence of this failure, the IMF refused to disburse the funds corresponding to a previous agreement. Under these circumstances, the government had no choice but to default in January 2002.

In December 2001, several banks showed an unsustainable liquidity position while the deposit drain accelerated. To stop the drain, the Government implemented the so-called "corralito". It prohibited the withdrawal of deposits from the banking system, although it was possible to transfer deposits between banks. There was, however, a continuous "trickle-down" of liquidity from banks because some depositors found legal ways to overcome the prohibition and because of some exceptions to the 'corralito' (the so-called wage accounts). The restrictions were later tightened in order to restrain liquidity and stop the continuous depreciation of the peso, but the authorities only partially succeeded.

Another key initiative to manage the crisis was the "pesification" of private credits. The stock of private credit in the banking system is now denominated in pesos and partially indexed to inflation. The pesification created a sizeable gap between the value of banks' assets and liabilities that, in practice, completely eroded the banks' net worth. The situation is currently at a sort of standstill. Private banks are claiming 12 billion dollars as compensation for the pesification. The government intends to replace the deposits in the corralito with government and bank bonds. In this context, the credit supply has evaporated and it is very problematic to finance working capital, not to mention investment. There also exist huge problems to re-establish a fluid payment system. In sum, after the implementation of the corralito and the adoption of a floating system, the economy is undergoing severe financial, fiscal, and inflationary problems.

Concluding Remarks

Argentina has no choice but to face the future. If we assume that the government's or the IMF's actions are not completely useless as a way

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to dampening the effects of shocks and crises, we should conclude that better domestic policies may be designed and that a deeper involvement of multilateral organisations would greatly help Argentina. Better policies may prevent Argentina from experiencing further destruction of its productive capacity than is necessary and its population from quickly falling below the poverty line.

Although the obstacles may appear insurmountable at first sight, we can make educated conjectures on the sequence of policies that the country should implement to restore macroeconomic and financial stability. Specifically, we will discuss four steps.

Restore Institutional Order and Fiscal Stability

The imposition of the "corralito", the default, and the depreciation of the peso induced an across-the-board violation of contracts and property rights. This fact, together with the acceleration of inflation and the sudden change in relative prices exacerbated pure uncertainty. Given the link between uncertainty and the demand for foreign assets that we discussed above, these events have been continuously pushing the demand for foreign assets to the right. This resulted in a mix of repeated reserve losses and exchange rate overshooting. Under these circumstances, the authorities face the dilemma of letting inflation skyrocket or letting reserves drop to zero.[9]

The first step, then, is to attack uncertainty which is at the core of this dilemma. To reduce uncertainty it is critical to restore and reinforce the institutional and contractual infrastructure that collapsed after the fall of the currency board. Under fuzzy property rights it makes no sense to invest efforts if it is not clear who has the right to claim the future return of assets. In this sense, a minimum level of institutional order is crucial for the activity level to recover. This is no exaggeration. The financial system is in a mess. Nobody can tell what the value of banks' assets and liabilities is. The contracts of newly-privatised firms supplying basic services like water, energy,

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[9] There is a vicious circle between banks' financial fragility, budget imbalance, inflation, and depreciation. If the government helps the banks via rediscounts or prints money to finance the deficit, it will increase the monetary base and feed the demand for foreign assets. If the government lets the nominal exchange rate adjust, inflation will accelerate. If the Central Bank sells foreign exchange to accommodate the increase in the demand, reserves will quickly dry up.

and communications need to be renegotiated after the abrupt change in relative prices, and some of these firms have defaulted on their debt obligations. The government also defaulted on its external debt, as did a good part of private agents. In addition, the law regulating bankruptcy is now being changed. This suggests that institutional building and transparency are key inputs to any consistent economic policy.

Undoubtedly, the place to begin with the reconstruction of institutions and the macroeconomy is the financial system. To avoid hyperinflation it is necessary to stop the Central Bank from assisting the banking system. Likewise, the banking system is critical to restoring the payment system, to financing working capital, and to advancing in a more precise definition of property rights. The restructured banking system, nonetheless, will not be able to generate a substantial supply of credit. It will resemble a system of narrow banks. This means that Argentina will have to develop other capital market segments. In the current situation, nonetheless, the priority is to restore the capacity to provide basic services associated with transactions and working capital.

The restructuring of the banking system is no easy task from the political point of view. Under the present circumstances the government cannot afford the costs of the financial crisis in full, as was the case in previous financial crises. This suggests two *sine qua non* conditions to solving the crisis. First, the costs of the restructuring must be shared by tax payers, banks, and depositors alike. Second, the financial position of the public sector is so weak that it will not be able to implement a credible restructuring without some sort of explicit and active external support.

If the government succeeds in eliminating the corralito and avoiding hyperinflation at the same time, it is likely that the nominal exchange rate will stabilise together with the activity level. If these circumstances materialise, it might be possible to take a second step: to focus on the stabilisation of public revenues and the negotiation of a new agreement with the provinces.

Restore Monetary Stability

The third step toward stabilisation should be to consolidate a sounder monetary and exchange rate regime. This is crucial to restoring the ability to contract. The economic system needs a nominal anchor to denominate the contracts. Under conditions of instability in the demand for domestic assets, it seems reasonable to concentrate on the stabilisation of the inflation rate. We have discussed this issue in depth in another paper (Fanelli and Heymann, 2002). In any case, if the country avoids dollarisation, the "monetary regime" in the near future will be characterised by a more or less "dirty" management of the exchange rate, including capital controls.

One privileged policy goal should be to avoid "big" mistakes in the management of the exchange rate or the design of the exchange rate regime. Argentina's goals should be modest but firm in this respect: the country should avoid economic policies that combine a rigid exchange rate system, external over-borrowing, and fiscal flaws, as was the case of the Tablita and Convertibility. These policies allow the country to approach "first world" per capita GDP and to reduce volatility artificially for a while, but only at the cost of an inflated dollar value of the non-tradable sector output. Sooner or later, agents revise their expectations and recalculate their permanent incomes on sounder bases and, as a result, the economy collapses. We believe that Argentina should not implement full dollarisation. Dollarisation would probably lead to problems like those of the currency board (Fanelli and Heymann, 2002).

Another important goal should be to implement "long-run" policies of macroeconomic stabilisation, namely, policies that seek to transform the economic structure so as to eliminate the features and deactivate the mechanisms that make the economy volatile. In the chapter, we illustrated at length the fact that volatility and structural breaks matter in Argentina and matter a lot. In fact, given the country's history of perverse interactions between growth and instability, the building of macroeconomic buffers should be one of the most important elements in a sustainable growth policy.

Solve the Debt Problem and Restore Growth

The fourth step to stabilising the economy is to reach an agreement with foreign creditors. This step, however, cannot be taken before the others. It would be difficult to negotiate with a government that cannot collect taxes or guarantee basic social institutions as property rights and contracts. The alternative to overborrowing, nonetheless, is not zero borrowing. This is why Argentina needs to solve its debt problem as soon as possible. The country needs to access international capital markets. In addition to the need for foreign savings, we have seen that there is a diversification motive. In this regard, Argentina has a lot to learn from the Chilean pragmatism.

What about growth? Are there "hidden" resources that could be mobilised to restore growth? Let us conclude the paper with some conjectures on this issue. A first not-so-hidden resource is that Argentina is reasonably rich in human and natural resources. To keep these stocks from deteriorating further it is vital to solve the crisis and to implement, simultaneously, policies that mobilise the resources. In this regard, Argentina should take full advantage of the current increase in the tradables' relative prices and complement it with aggressive policies to improve the non-price dimension of competitiveness and to open new markets.

Developed countries that invested heavily in Argentina in the 1990s and have lately witnessed the value of their bonds and physical assets plunge could greatly help both Argentina and the recovery in the value of their investments. As part of an emergency package they might soften trade protectionism in specific sectors for Argentina to gain market access. In this sense, Argentina could offer "more rapid debt repayment for market access". In the end, not only Argentines but consumers and investors in the G-7 countries would be better off. Argentina has the rod, and knows how to fish. The problem is how to get the ticket to the fish market. The Mexican experience is very important in this respect. After joining NAFTA, Mexico's external indicators improved substantially. The improvement was driven by the spurt in export and foreign direct investment.

A second hidden resource is the stock of foreign assets in the hands of the private sector. To a great extent, the accelerated accumulation of these assets in recent years was the counterpart of increasing economic uncertainty. Valued at the current exchange rate, the stock of financial resources held by the private sector is sizeable. They represent roughly 100 percent of the current GDP. The real peso depreciation must have had an important positive wealth effect. As soon as the economy stabilises, this wealth effect can become a powerful incentive to effective demand. Besides, we must take into account that after a long recession there will likely be an increase in the demand for capital goods and consumer durables that had decreased during the downturn. Likewise, the existence of liquid financial assets held by firms means that investment projects could be financed with owned funds.

A third resource that can be mobilised is Mercosur. The agreement has the potential to supply many of the inputs that Argentina needs to sustain the growth process: new markets for exports, the attraction of FDI, and the development of larger and deeper capital markets at the regional level.[10]

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5

The Regional Fallout of Argentina's Crisis

Ricardo Ffrench-Davis and Rogério Studart[1]

Until very recently, many economists from the financial market and from multilateral institutions were confident that the spillover effects of the Argentine crisis were limited. In a speech made in May 7, 2002, IMF deputy managing director Anne Krueger echoed this view when she attributed the assumed small spillover effect to five factors: increased sound macroeconomic management in most of the countries in the region, limited financial and commercial links between Argentina and its neighbours, the fact that the Argentine default was widely expected by the market, the existence of more timely economic information available for international investors, and the search for increased portfolio diversification in an environment of ample global liquidity.

Even though macroeconomic management in many Latin American economies is indeed more solid now than in the beginning of the 1990s, the above analysis misses three important vulnerabilities of these economies, which can create spillover effects in confidence crises: (i) external liabilities overhang; (ii) domestic financial fragility; and, (iii) political tension.

Due to the external liabilities overhang, the sustainability of economic fundamentals depends heavily on a few short-term

1 Thanks are due to Hubert Escaith, Jan Joost Teunissen, Age Akkerman, Jurgen Weller, Lavinia Barros de Castro and Rodrigo Carcamo for useful comments. The usual caveats obviously apply.

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economic parameters (the risk premia, exchange rate and domestic interest rates) that are very sensitive to shifts in investor confidence. The resulting vulnerability has meant that the real economy has been extremely unstable, with negative implications for growth, equity and domestic financial stability.

Domestic financial systems are very sensitive not only to this macroeconomic instability, but also to abrupt changes in exchange rates and to capital outflows.

Because of the deteriorated domestic social situation, conventional remedies to deal with confidence shocks (which very often cause lower economic activity and higher unemployment) are suffering from "political fatigue", leading to (understandable) resistance by several sectors within the economies in the region.

We claim that the spillover effects of the Argentine crisis are greater than originally thought and are related to these three vulnerabilities, which were built up along the 1990s. We will show that, despite the diverse fundamentals and the limited "purely" economic links between Latin American countries, the association of these vulnerabilities underpins the potential "domino effect" created by the Argentine crisis. The next section will discuss the characteristics of the build-up of the three vulnerabilities while the last section summarises and presents conclusions.

Building Up Vulnerabilities

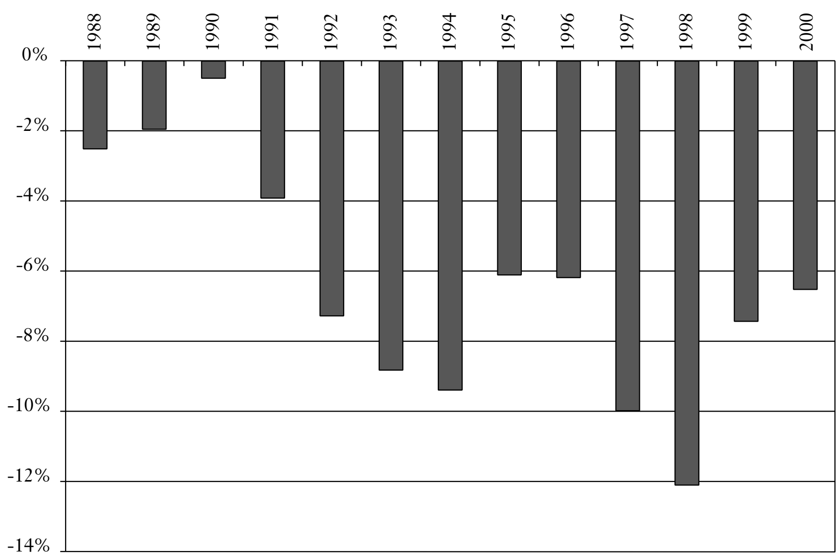
Nowadays, few would doubt that the surges of capital flows to Latin America were strongly associated with a "wave of optimism" and the buoyant liquidity of external markets: private capital was flowing abundantly to the so-called emerging economies, some of which (such as Brazil) were facing hyperinflation and other significant macroeconomic disequilibria in the beginning of the 1990s (Ffrench-Davis and Ocampo, 2001).

The surge of capital inflows *cum* capital account liberalisation eliminated the binding external constraint for the expansion of domestic demand and imports. Not surprisingly, in the early 1990s the policy regimes in the Latin American economies, albeit with distinctive features, were highly influenced by the opportunity offered by such excessive external flows. Policymakers adopted exchange rate-based price stabilisation programmes (ERSP) based on fixed or pegged exchange rate regimes and trade liberalisation, which were effective in reducing inflation. The combination of the above-mentioned "wave of optimism" and the policy regimes adopted thereafter lies, in our opinion, at the heart of the regional vulnerabilities that were, almost invisibly, created.

The Ponzi-like Expansion of External Liabilities and the Absence of Correcting Forces

The surge of external capital flows significantly surpassed the needs to finance the current and the capital account, generating rising external deficits and exchange rate appreciations, notwithstanding systematic accumulation of reserves in the region (on this see e.g. Ffrench-Davis, 2000, chapters 5, 6 and 10). The process was indeed a typical "Ponzi" scheme (Kregel, 2002): as indicated by Figure 1, the ratio of current account balance and external debt – a straightforward indicator of the capacity of an economy to repay its external liabilities – not only was negative throughout the period, but also declined rapidly from 1990 to 1994, and again from 1996 to 1997, both clearly periods of "over optimism".

Figure 1 Latin America: current account deficits as a share of external liabilities



Source: Elaborated by the authors based on ECLAC figures.

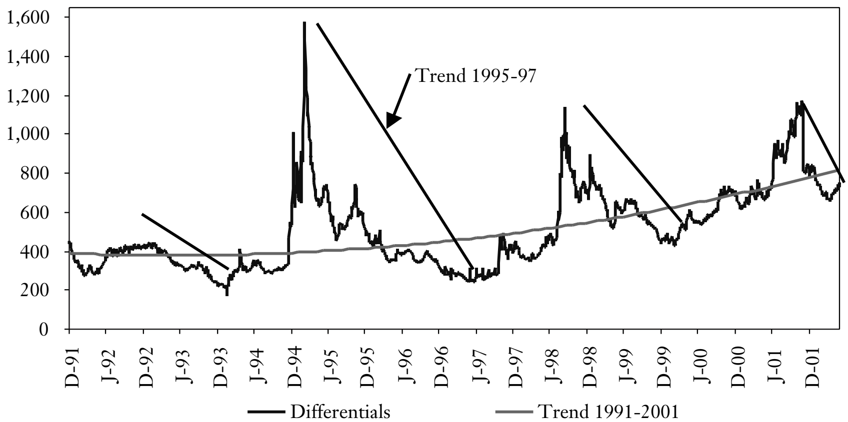
The build-up of external liabilities in the region was a disequilibrium process, which in principle should have set in motion at least two self-correcting forces. On the financial front, excess capital inflows should have led to increased liquidity in the host economy, which in a fixed currency regime should normally have produced a rapid reduction of the domestic real interest rates and thus to a reduction of the interest rates differentials. On the productive front, trade *cum* capital account liberalisation should have led to an increase of the productivity of the sectors with competitive advantages and thus to an increase of net exports, which would have allowed the external liabilities to decrease with time.

Neither from the financial side, nor from the productive side, did these self-correcting forces take place. First, despite the success of ERSP, the differentials between domestic and international borrowing rates remained significantly high during the whole decade – leading to overvalued real exchange rates. The need to maintain high levels of reserves as the "macroeconomic collateral" required for ERSP and the nature of the financial reforms, stimulated short-term borrowing and consolidated this unhealthy process.

Concerning the potential productive correcting force, it only functioned partially. A significant part of the Latin American economies indeed observed improvements of the productivity of labour, partly due to closing of less productive enterprises and the laying-off of less trained workers. But unfortunately, a significant part of the dynamic exports in the region are primary goods whose prices in the international markets suffered a downward trend in the late 1990s. So there was not the necessary increase of net exports.

Moreover, because of the volatility of capital flows – a major characteristic of financial globalisation in the 1980s and 1990s (see Ffrench-Davis and Ocampo, 2001) – external shocks became increasingly frequent, particularly after 1994, with ups and downs of the spreads charged on Latin American bonds (Figure 2). Every decline of such spreads – in 1992-94 and 1995-97 – was followed by abrupt reversals of investor confidence, shorter intervals between the peaks and higher levels of the spreads. Indeed, a trend line (as shown in Figure 2) of the whole period would indicate that at each reversal in the wave of optimism, a lower degree of trustworthiness of foreign investors in the sustainability of the external liabilities of the region became apparent.

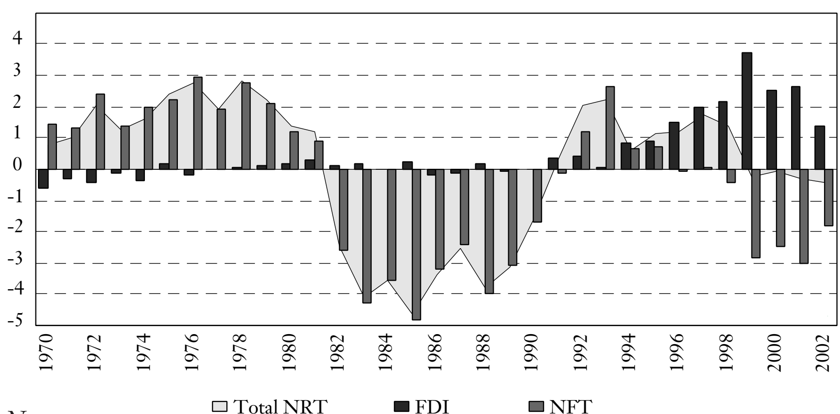
Figure 2 Latin America: Eurobond Differentials, 1992-2002
(Basis points over the yield of US ten-years Treasury bonds)



Source: Based on ECLAC (2002).

As indicated by Figure 3, 1994 marks the beginning of a significant reversal of portfolio flows to the region and an increase in foreign direct investment in most countries (except for Chile, since FDI had been growing rapidly before that year) – largely based on privatisation and the sell-off of domestic public and private assets.

Figure 3 Net Resource Transfers in Latin America, 1970-2002



Note:
Net resource transfers (NRT): foreign direct investment (FDI) and net financial transfers (NFT) as percentage of GDP.

Source: Elaborated by the authors based on data from ECLAC (2002).

Evidently, this rising flow of FDI helped to finance the balance of payments and the domestic fiscal deficits. But FDI could not provide a sustainable solution for dealing with the problem of increasing external vulnerability, because, on the one hand, privatisation can only last for as long as attractive public assets were available. On the other hand, foreign investments could only be sustained if the long-term expectations of growth of the economies in the region were maintained. However, since 1997-98, growth expectations deteriorated as a result of the monetary and fiscal policies that were adopted to sustain "credibility" and investor confidence.

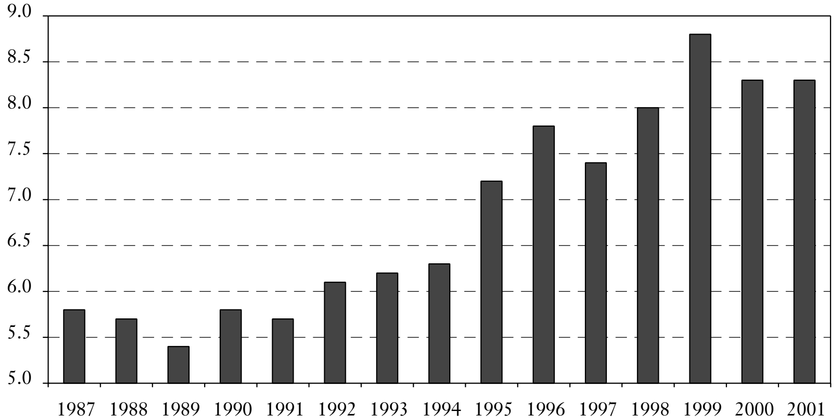
If self-correcting market forces were not in place, maybe policies could have changed the course of external vulnerability. An obvious option would have been to introduce policies to expand exports, to substitute imports and to attract more foreign "Greenfield" investment. But with each round of external shocks, the degrees of freedom that domestic policymakers had to reverse the situation were reduced. The need to avoid capital flight often prompted policy packages to defend the (often overvalued) exchange rates by raising domestic interest rates and promoting further fiscal adjustment. As the Argentine case clearly showed, these tough adjustments depressed domestic activity, which simultaneously made fiscal discipline politically infeasible and worsened long-term expectations (needed to attract Greenfield foreign investment).

Along with this financial vulnerability, two other important vulnerabilities were building up inside the economies of the region: political vulnerability and the increasing fragility of the domestic financial sector.

The Rise of Political Fatigue with Conventional Policies

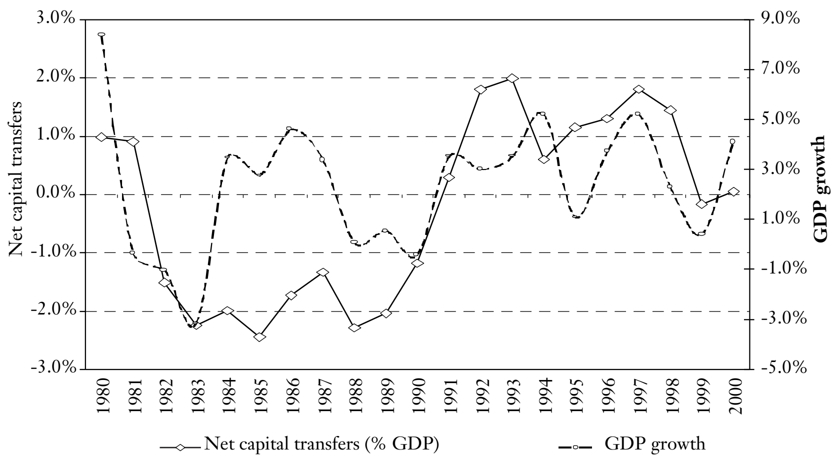
In the early 1990s, the "demands of the market" and the "demands of the domestic political forces" were generally convergent, since the policies required to improve foreign investment sentiment were in line with those required to achieve price stability. However, by the end of the 1990s, this situation had clearly changed. The reason was simple: in the second-half of the 1990s, unemployment increased (Figure 4), while, at the same time, the quality of employment deteriorated in many parts of the region (Weller, 2001). It would be unfair to put all the blame for the currently sensitive political climate on the economic policies adopted in the 1990s, because the region

Figure 4 Open Unemployment in Latin America
(as percentage of the economically active population)



Source: Elaborated by the authors based on data from ECLAC (2002).

Figure 5 Latin America: Net capital transfers as percentage of GDP and GDP yearly growth



Source: Elaborated by the authors based on data from ECLAC (2002).

has a long history of high wealth and income inequality, political exclusion, poverty and poor social protection mechanisms. However, the excluding character of the policies of the 1990s was a central factor in the deterioration of the social tissue.

In this context, the conventional policies to overcome confidence shocks, often limited to recessive measures,[2] were not only increasingly ineffective (due to the reasons already explained), but were also suffering from "political fatigue".

In sum, the deteriorated social situation in many economies made the conventional policy responses to external shocks – if applied for a sustained period of time – not only regressive, but also politically non-feasible and non-credible. As for foreign direct investors, such policies worsened their long-term expectations and made them less willing to maintain and expand their investments in the region.

Another interesting characteristic of the current crisis is its high association with domestic financial stress and crisis. We believe that this is partly due to the incomplete character of reforms implemented in the 1990s and especially after the Tequila crisis – even though these reforms were, paradoxically, meant to strengthen the domestic financial systems.

Currency Mismatches and Domestic Financial Vulnerability

Avoiding crises in the banking sector is important, first, because they often imply high fiscal costs, which make the maintenance of fiscal discipline even tougher; second, because the restructuring of the banking system was normally associated with opening up the domestic financial sector to foreign investors; third, because these regulatory and supervisory changes are affecting the way banks and other financial institutions intermediate loanable funds in the economy – a factor that is important for long-term growth perspectives. See, for instance, Stallings and Studart (2002) for a discussion of this issue.

The Tequila crisis of 1994-95 had profound effects on the financial systems in Latin American economies. In many economies the Mexican crisis hit hard the banking sectors, and the fiscal burden

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[2] The recessive nature of the conventional policy package to deal with shocks related to reversals of capital flows partly explains the increasing relation between these reversals and downturns of economic activity – as seen in Figure 5.

of the bailouts proved very high. It clearly indicated that in order to avoid the "twin crises" that characterised the Mexican (and, later, the Asian) debacle, the soundness of these systems had to be improved substantially.

The Tequila crisis marks the introduction of significant reforms in the domestic financial systems including important improvements in prudential regulation and supervision,[3] transparency and governance as well as sizeable increase in the participation of foreign banks. Why are domestic financial systems still so vulnerable?

One key to the problem is the increasing currency mismatches during the 1990s that resulted from the build-up of external liabilities. This build-up was partly due to the way these economies opened themselves financially, which can be characterised as "integration of uneven financial partners" (Studart, 2002). Indeed, Latin American financial systems are very shallow and under-developed. Because of the concern with the fragility of domestic financial institutions and of the instability of exchange rates, high-income savers and financial institutions have a revealed preference for assets denominated in foreign currencies – and not surprisingly the demand for dollar-indexed bonds and deposits increased in many of the regional economies. In addition, since credit rationing and high lending rates are a reality in Latin America (Barajas *et al.*, 2002), the opening created incentives for enterprises and even governments to finance their deficit through the issuing of securities in the more sophisticated and liquid global markets.

A second key is the increased sensitiveness of domestic financial systems to policy responses to external shocks that result in economic contraction. This has to do with the fact that surges of capital flows to the region often resulted in surges of domestic credit. In turn, domestic credit expansion took place in a period of high macro-economic uncertainty and low investment, and was used to finance consumption and import booms. This made the domestic financial

[3] This is an important issue for several reasons: first, such processes were often with fiscal costs that made the maintenance of fiscal discipline even tougher; second, because the restructuring of the banking system was normally associated with opening up the domestic financial sector to foreign investors; third, because these regulatory and supervisory changes are affecting the way banks and other financial institutions intermediate loanable funds in the economy – a factor that is important for long-term growth perspectives. See, for instance, Stallings and Studart (2002) for a discussion of this issue.

sector very sensitive to changes in economic activity – and in particular to increasing unemployment.[4] Not surprisingly, periods of economic contraction have brought about rapid hikes of default rates, which fed into higher spreads between lending and borrowing interest rates and increased domestic financial fragility.

In the context of high maturity and currency mismatches, raising domestic interest rates, devaluing exchange rates or rapid falls in economic activity are recipes for financial instability. However, most policies to face external shocks of confidence include a hike in interest rates, a devaluation of the exchange rate, fiscal retrenchment and a drop in economic activity – notwithstanding the exchange rate regimes adopted in the region (floating regime with inflation targeting or dollarisation).

In sum, initiatives introduced after the Tequila crisis to enhance banking sector stability were grossly insufficient given the macro requirements needed to mitigate domestic financial fragility. Moreover, the rising danger of the hampering process of dollarisation of assets and liabilities of the banking sector was grossly underestimated. Dollarisation became increasingly risky as exchange rates were, generally, too over-valuated when the Asian crisis reached Latin America.

With the move towards more flexible exchange regimes (in order to reduce the external vulnerability by expanding net exports), the trade-off between the potential gains of devaluation and its harmful effects on domestic financial stability became evident. Not surprisingly, even in countries adopting floating exchange rates, domestic authorities developed a "fear of floating".

Investor Confidence, Domestic Policies and External Support

We have shown that for the Latin American region, the build-up of external liabilities was a Ponzi-like scheme – only justified by the waves of optimism in 1990-93 and 1997-99. This process led to other disequilibria, as under the policies adopted in most countries, only

[4] Currency mismatches could have been mitigated if the domestic capital markets expanded and increased the supply of funds denominated in domestic currencies. However, the volatility of prices of domestic assets rose, whereas domestic primary markets shrank (see e.g. Dowers *et al.*, 2000).

recessive measures were available to respond to deteriorating investor confidence. In addition, we have shown that these same regimes induced the dollarisation of assets and liabilities of domestic financial systems and thus increased currency mismatches and domestic financial fragility.

The three vulnerabilities have led to perverse links between changes in investor confidence and macroeconomic fundamentals. It has turned out that, due to these vulnerabilities, changes in investor sentiment and traditional policy responses can affect domestic fundamentals rapidly, and in a self-reinforcing way. For instance, increasing interest rates or abrupt devaluations can lead to domestic financial instability and economic activity contraction simultaneously; this in turn can affect investor sentiment of long-term foreign direct investors, thus increasing external vulnerability.

In addition, due to the deteriorated social environment and the lack of social protection networks, conventional policies for dealing with a deteriorating investment climate – which lead to unemployment and real income loss – understandably face increasing political resistance.

The existence of the three sources of vulnerability explains the domino effect caused by the Argentine crisis. The spillover mechanism differs from country to country. For instance, even though all three Mercosur partners did suffer from the decline in intra-bloc trade, Uruguay and Paraguay were certainly hit hardest by the fall of exports to Argentina. Given the need to rapidly adjust their external imbalances, their "adjustment" had profound recessive effects – and it is not surprising that they are facing serious political difficulties. Uruguay, in addition, has been suffering from financial spillover due to the size of deposits of Argentine citizens in its offshore banking sector.

In the case of Brazil, the spillover effect is mainly financial, for at least two reasons. First, the decline of the volume and increasing costs of capital flows to the country have put into question the sustainability of its external debt. Second, given the high levels of domestic public debt, maintenance of high interest rates is raising questions about the sustainability of its domestic debt. Other economies of the region – such as Venezuela, Peru, and Ecuador, to name a few – face similar increasing difficulties associated with the reversal of investor confidence, increase of risk premia and so on. Given its lower external and domestic vulnerability, Chile so far stands as an exception.

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In sum, for a significant number of economies, a change of investor confidence towards one country leads to preventive policy responses in other countries, which in turn may set in motion a process of financial instability and/or political stress – irrespective of the economic links between the economies in question. In addition, the "political fatigue" of conventional (recessive) measures, associated with a highly deteriorated domestic social environment, makes the attempts to face the crisis with such measures not only little effective but increasingly less credible. Market participants are aware of this lack of credibility, and therefore changes in the mood of the market can easily lead to self-fulfilling prophecies.[5]

In this context, conventional policy responses to external shocks have become less effective, politically infeasible and highly damaging to domestic financial stability. If our assessment is correct, two conclusions follow.

First, one possible way to avoid a domino effect (that is characterising the regional fallout of the crisis) would consist of significant external support. This view seems to be shared by the IMF, as the recent financial aid packages to Brazil and Uruguay indicate. The prevalent view about the "moral hazard" effects of such support to crisis-stricken regional economies, and the insistence on "more macroeconomic discipline" is incorrect and misleading. The commitment of most domestic policymakers to sound macroeconomic management is a well-established political fact in the region.

Second, it is important to understand, however, that the external support is not a solution *per se*. Mitigating the three vulnerabilities mentioned above requires policies that reduce the external vulnerability (by improving systemic competitiveness and promoting additional net exports) and domestic fragility (especially by reducing the currency mismatches and short-termism in domestic financial markets). Implementing such vulnerability reducing policies takes time, which means that the external support, in order to be effective, may have to last longer than hoped for by multilateral agencies.

Given the political orientation that is predominant in key international players, overcoming the conventional views may be one of the main obstacles to a lasting solution for the crisis.

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5 This concept is nowadays called "reflexivity", after Soros (1998), but can be found in the economic literature of the past, e.g. from Fisher (1933) and Keynes (1936) to, more recently, Obtsfeld (1985).

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6

The Puzzle of Argentina's Debt Problem: Virtual Dollar Creation?

Bernardo Lischinsky

Since the debt crisis of 1982, external debt continues to be one of the hot economic issues in Argentina. Argentina has the highest per capita income in Latin America – but also the highest per capita debt in South America. Unfortunately, Argentina's debt did not improve the living conditions of the majority of Argentineans; on the contrary, only a very small group of families, companies and banks benefited.

The debt is no longer comprised primarily of loans contracted through the international banking system, and as a result, the default has affected them less than in the past. Currently, the funds are placed in bonds held by unknown creditors, many of whom are Argentinean. Another important part of the debt has been contracted with multilateral banking organisations such as the Inter-American Development Bank, the World Bank and the IMF.

As a consequence of a deep economic and social crisis since 1998, recession has been transformed into depression. As a result, the unemployment rate has risen to a 25 percent of the economically active population. If underemployment is added into the equation, unemployment reaches 50 percent of the economically active population. If poverty is defined as less than 4 dollars per day, it extends to more than half of the total population.

In the first part of this chapter, I outline the composition of the Argentine external debt by comparing it with other countries. An explanation of how and why the external debt has become a problem

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

follows. In the third section, I examine the debt in relation to the main problems of the Argentine economy. And I draw some conclusion about how to solve the external debt issue in the fourth section.

Composition and Evolution of the Argentine Debt

The Argentine external debt is comprised of the external debt of the public sector and the external debt of the private sector. In turn, the external debt of the public sector, along with the domestic debt from the public sector, constitutes the total public debt. Paradoxically, the major portion of the domestic debt of the Argentine government was contracted in dollars (although it was receiving pesos) as a manner of increasing the security to local lenders vis-à-vis the possibility of a currency devaluation. These local lenders were banks and pension funds. The operation was possible due to the bi-monetary Convertibility system, established simultaneously with the currency board. The fact that the local debt was contracted in dollars and received in pesos was one of the main factors that triggered the crisis of the late 2001.

By late 2000, the total external and domestic Argentine public debt represented 45 percent of GDP (see Table 1). The external public debt equalled 30 percent of GDP; the servicing of external public debt amounted to 2.4 percent of GDP and 23 percent of exports. The annual public and private external debt service amounted to 41 percent of total exports, and the total public and private external debt stock was equivalent to almost 5 times the annual exports.

This level of foreign debt does not appear dramatic if compared with that of other countries in the region or OECD countries. However, the high share of short-term external debt arouses a certain degree of concern.

Debt in Non-Existing Dollars

Ninety-eight percent of Argentine public sector debt consists of medium and long-term debt; 68 percent of the debt is made up of bonds and almost 30 percent is comprised of loans B the majority of which is owed to official bilateral creditors (Paris Club and others)

Table 1 Some Ratios Regarding the Argentine Debt
(as of December 2000)

	Percentage of GDP	Percentage of Exports of Goods and Services
Gross Public Debt	44.9	
Net Public Debt	41.8	
National Government External Public Debt	30.1	278.7
Net National Government External Public Debt	29.5	273.3
Gross External Debt	51.8	475.7
External Debt Service	4.4	40.6
External Public Debt Service	2.4	22.6
Short-Term External Debt	8.0	74.2

Source: National Public Credit Office, Ministry of Economy, Argentina.

Table 2 Argentine Public Debt
(as of September 30, 2001)

	Gross Balance (thousands of dollars)	Percentage
Total Public Debt	141,252,377	100.00
Medium and Long Term	138,010,419	97.70
Bonds	95,787,915	67.81
Local currency	2,269,830	
Foreign currency	93,518,085	
Loans	42,222,504	29.89
International Organisations	*33,141,660*	*23.46*
IADB	8,768,516	
World Bank	9,746,928	
IMF	14,592,372	
FONPLATA	27,792	
FIDA	6,052	
Official Creditors	*4,826,919*	*3.43*
Paris Club	2,038,589	
Other bilateral	2,788,330	
Commercial Banks	*2,765,666*	*1.95*
Other Creditors	*1,488,259*	*1.05*
Short Term	3,241,958	2.30
Treasury Bills	3,241,958	

Source: "Quarterly Estimates of the 2000 and 2001 Balance of Payments and Foreign Assets and Liabilities", Ministry of Economy, Argentina, March 2002.

Table 3 Evolution of Argentine Public Debt, 1997-2001
(by holder residence, in billions of dollars)

	1997	1998	1999	2000	2001 June	Sept.
Public Debt	101	112	122	128	132	141
External	73	81	82	81	79	87
Domestic	28	31	39	47	53	54

Source: "Quarterly Estimates of the 2000 and 2001 Balance of Payments and Foreign Assets and Liabilities", Ministry of Economy, Argentina, March 2002.

and international organisations like the IMF, World Bank and the Inter-American Development Bank (IADB). The full picture of the composition of the public debt as of September 30, 2001 is presented in Table 2.

Public sector debt can be divided into domestic and external debt. As shown in Table 3, the debt grew some 40 percent from 1997 until 2001. Sixty-four percent of this growth was contracted locally, implying that the domestic debt of the government almost doubled. The domestic debt was also contracted in dollars, and this is one of the key mechanisms that brought about the late 2001 crash, when the government was unable to reimburse dollars. In Brazil, the government was strongly indebted in reales and with devaluation it liquefied its debt; in Argentina, on the other hand, the devaluation aggravated the situation.

How did Convertibility work with respect to contracting public debt? Locally, the government offered dollar-denominated bonds while it received Argentine pesos at the standing rate of exchange, which was one dollar for one Argentine peso. With those Argentine pesos, it cancelled its local obligations, the pesos were circulated again, and finally they were deposited in dollar bank accounts or were used to buy new dollar-denominated public debt bonds. Thus, an accounting and debt in dollars arose, from dollars that never existed. There was a virtual dollar creation.

Debt Evolution

In the last 20 years, the external debt has grown at a much higher pace than the growth of the national product, as shown in Table 4.

In the 1980s, the debt more than doubled while economic growth for the period was negative. During the 1980s, Argentina did not

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Table 4 Growth of Argentina's GDP and External Debt, 1980-2001
(percentages)

	Debt	GDP
1980-1985	81.5	–1.4
1985-1990	26.1	0.0
1980-1990	129.1	–0.7
1991-1995	61	20
1996-2001	32	2.8
1991-2001	139	15

	Debt	GDP
1995	15	–2.9
1996	11.3	5.5
1997	13.6	8.0
1998	12.6	3.8
1999	3.4	–3.4
2000	0.6	–0.6
Sept 2001	17.5	–4.5

Source: ECLAC, December 2001 LC/G.2153-P/E, and Secretaria de Programación Económica (various issues), *Informe Económico*, Ministry of Economy, Argentina.

have a policy of debt reduction. On the contrary, in 1986, Argentina failed to pay the debt for several months in a sort of concealed default until ultimately the debt was renegotiated with the creditor banks. Moreover, there was no analysis of which part of the debt was still valid and which part had already been cancelled.

As posed by Singer (1989), the 1980s witnessed a change in the paradigm of developing strategies; growth and development with employment, redistribution of income, satisfaction of the basic needs and a reduction of poverty were replaced by adjustment, stabilisation, structural change, and the opening up of the economy to the market. Argentina complied with this neo-liberal model, opening its economy, reforming the State, making adjustments, and engaging in privatisation; but the debt could not be reduced. Rather, it continued its climbing trend, as did unemployment and social unrest.

During the 1990s, in spite of economic growth reaching 15 percent, the debt grew even more than in the preceding decade, some 139 percent. The level of debt increased in spite of two sources of

Table 5 Stock of Foreign Direct Investment in Argentina
(balances at the period end, in millions of dollars)

	Private Financial Sector[b]	Private Non-Financial Sector[c]	Total	Index 1991 = 100
1991	1,334	10,190	11,524	100
1992	1,393	14,910	16,303	141
1993	1,748	16,772	18,520	160
1994	1,955	20,473	22,428	194
1995	2,528	25,463	27,991	242
1996	3,001	30,556	33,590	291
1997	4,507	37,506	42,087	364
1998	5,671	42,126	47,903	414
1999	6,403	55,523	62,037	537
2000	7,205	65,730	73,087	632
2001	7,012	68,986	75,998	659

Notes:
a Provisional figures.
b At book value.
c Book value estimates. As from the year 2000 the payments balance of flows were updated.

Source: "Quarterly Estimates of the 2000 and 2001 Balance of Payments and Foreign Assets and Liabilities", Ministry of Economy, Argentina, March 2002.

significant non-debt-incurring external funds income. One source was the privatisation of state-owned companies, and the other source was the entrance of foreign direct investment (FDI). From 1991 until 2001, FDI increased its stock by 559 percent (see Table 5). During the 1990s, Argentina was one of the favourite destinations for FDI flows to developing countries. For the international organisations, it was a "star" country that had followed all the policies recommended by the so-called "Washington Consensus".

An analysis of the debt evolution in the last 10 years (Table 6) shows that at the beginning of the 1990s, the public sector owned some 86 percent of the foreign debt, while in 2000 this share was reduced to 57.8 percent. The external debt of the public sector grew approximately 60 percent in the 1991-2000 period, while the external debt of the private sector reached as much as a 618 percent increase. The public external debt grew in spite of the fact that it was consolidated by the application of the Brady Plan in 1992. This plan converted the debt with banks into 30-year bonds secured by US

Table 6 Total External Debt per Sector, 1991-2001
(in millions of dollars)

	Non Financial Public Sector*, Central Bank	Per-centage of total	Non Financial Private Sector	Financial Sector (excl. Central Bank)	Total
1991	52,739	86	3,524	5,074	61,337
1992	50,678	80	5,774	6,520	62,972
1993	53,606	74	9,938	8,882	72,425
1994	61,268	71	13,842	10,799	85,908
1995	67,192	68	18,203	13,752	99,147
1996	74,113	67	20,841	15,659	110,613
1997	74,912	60	29,551	20,589	125,052
1998	83,111	59	36,512	22,306	141,929
1999	84,750	58	36,911	23,628	145,289
2000	84,615	58	36,949	24,775	146,338
Sept, 2001	90,957	62	35,671	20,222	146,850

Note:
* Including National and Local Governments.

Source: "Quarterly Estimates of the Balance of Payments and Foreign Assets and Liabilities", Ministry of Economy, Argentina. March 2002.

Treasury bonds that the Argentine government purchased using new debt, this time with international organisations.

Until late 1998, private external debt was concentrated in very few companies, 75 percent being held by 59 companies and 90 percent being covered by 100 first-tier companies, most of them subsidiaries of transnational companies. The liabilities of the privatised companies accounted for a significant 39 percent.

Maturities Schedule

The maturities schedule of the external debt is highly concentrated. In 2001, two refinancing facilities had to be obtained to avoid default. However, the maturities schedule for the next years remains highly concentrated. For both 2002 and 2003, the repayment of principal exceeds 80 percent of the exports. Adding interest payments of about 12 billion dollars, total debt servicing largely exceeds annual exports. The Argentine government has to purchase the dollars in the market,

Table 7 Medium- and Long-Term Debt Amortisation of External Debt
(as of September 2001, in billions of dollars)

	Total amount	Share	2002	2003	2004	2005	2006	2007	2008	2009 and +
Total	147	100%	22	22	18	11	7	10	10	22
Non Financial Public Sector and Central Bank	91	62%	14	16	13	9	6	6	6	20
Non Financial Private Sector	36	24%	6	5	4	2	1	3	3	2
Financial Sector	20	14%	2	1	1	0	0	0	1	0

Source: Undersecretary of External Financing, Ministry of Economy, Argentina.

while the Chilean and Mexican governments obtain a significant portion of the dollars for the debt payment directly from the exports made by their state-owned copper and oil companies respectively.

The public sector has greater amortisations than the private sector. Public sector amortisations even exceed 16 billion dollars in 2003. The devaluation of the peso at the beginning of 2002 made repayment of the public debt even more difficult. If the debt service accounted for 20 percent of the budget in the past, it is now more than 60 percent, while tax revenues are falling.

Comparison of Argentina's Debt with that of Other Countries

Argentina's public sector debt in relation to GDP has been lower than that of other countries such as Japan, Italy, Greece or the debt of the European Union member countries as a whole (see Table 8).

The debt to GDP ratio does not explain why the crisis broke through in December 2001. Nor does a comparison of Argentina's external debt to GDP ratio with other Latin American countries present a dramatic picture. Argentina's debt to GDP ratio is lower than that of Chile but higher than that of Brazil and Mexico (see Table 9). However, Argentina's debt to exports ratio clearly exceeds that of its neighbours Brazil and Chile. One of the reasons why Chile has a much lower debt to exports ratio is that its exports represent

Table 8 Public Debt of Selected OECD Countries and Argentina, 1999-2000
(as percentage of GDP)

Country	1999	2000
Japan	105	112
Italy	115	111
Belgium	116	110
Greece	104	103
EU	68	64
Spain	63	60
Holland	63	56
Argentina	44	46

Source: NewCronos: theme2/gov/gen_govt/gengovt/gengov95 and theme2/gov/gen_govt/pub_fin; "Quarterly Estimates of the Balance of Payments and Foreign Assets and Liabilities", Ministry of Economy, Argentina, March 2002.

approximately 23 percent of GDP, while Argentina's exports represent only about 9 percent of its GDP, and Brazil's 11 percent. Since 1999, the debt to export ratio has been improved for both Brazil and Argentina.

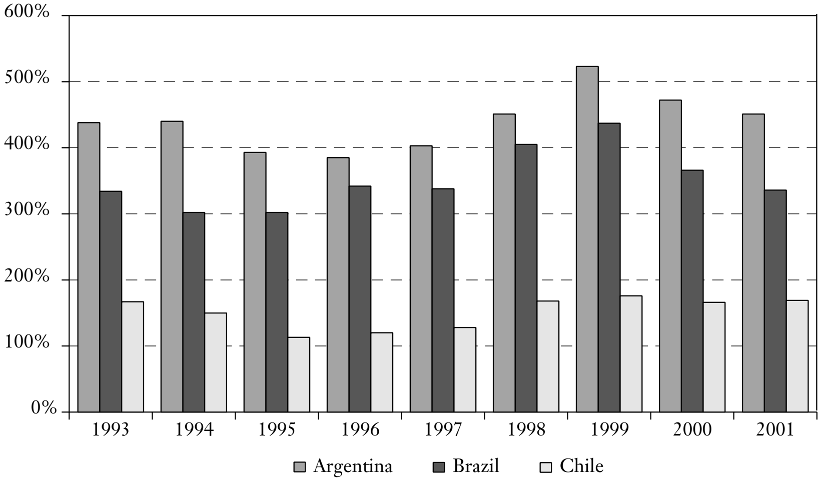
There is an important additional reason why Argentina's debt to exports ratio is so much higher than that of its neighbouring countries. Argentina has been charged extremely high interest rates due to the increased country risk. Interest payments as a proportion of exports increased from 23 percent in 1993 to 41 percent in 1999 and 38 percent in 2000 and 2001 (see Table 10). The incidence of this high interest rate is one of the main causes for the public sector deficit and its advancing trend after 1997.

Table 9 Total Foreign Debt of Major Latin American Countries, 1999-2000
(as percentage of GDP)

Country	1999	2000
Chile	50.5	52.2
Argentina	51.5	51.8
Brazil	45.6	39.7
Mexico	34.7	25.9

Source: ECLAC, 2001.

Figure 1 External Debt as Share of Exports of Goods and Services, 1993-2001



Source: ECLAC, 2001.

The Argentine government has to purchase the dollars in the market, while the Chilean and Mexican governments obtain a significant portion of the dollars for the debt payment directly from the exports made by their state-owned copper and oil companies respectively.

Table 10 Total Interest Accrued from the External Debt as a Percentage of the Export of Goods and Services, 1993-2001

	Argentina	Brazil	Chile
1993	23	22	10
1994	27	18	8
1995	27	22	7
1996	28	23	7
1997	30	26	7
1998	35	27	8
1999	41	32	8
2000	38	26	8
2001	38	25	9

Source: ECLAC, 2001.

A Closer Look at Argentina's Virtual Dollar Creation

As a special feature of Argentina's financial system after the introduction of Convertibility in 1991, it became possible to make dollar-denominated deposits and loans, thus creating a real bi-monetary system. From 1991 to 2001, the total of deposits grew by almost 350 percent. During this period, the dollar-denominated deposits grew over 600 percent reaching some 71 percent of total deposits by 2001.

If we consider that the accumulated deficit of the current account of the balance of payments was 93,587 million dollars from 1991 to 2001, that the deficit was covered by direct and portfolio investments on the one hand and bank loans and public bonds on the other, and that during that same period the international reserves were substantially increased, the question is: where did the dollars come from to make deposits of 46,734 million of dollars possible, as shown in Table 11?

The answer is simple. In Argentina, there was an important creation of book or virtual dollars born from the credit multiplier and the possibility, under Convertibility, of establishing dollar-denominated deposits just by delivering pesos to the bank. When the crisis broke out and the customers tried to withdraw their deposits, the banks were unable to respond because there were no dollars available.

The naive explanation given by the banks to justify their lack of liquidity is that they had lent at longer terms than those of the deposits they had taken. So they admit that they failed to comply with one of the golden rules of the banking system. Moreover, the foreign banks attracted customers by advertising the support given by their head offices in developed countries. But when the crash occurred, there were few head offices that backed up their Argentine branches.

To stop the run against the banks, the government tried to freeze the deposits early in December 2001, by placing a curb on the deposit holders and not allowing them to withdraw their money, the so-called "corralito".

With regard to loans (Table 12), the growth process is similar to that of the deposits, but since bank reserves required by the Central Bank increased, their multiplier was restricted. The government is a large borrower of internal credit; in 2001 it borrowed some 30 percent of the total credits of the system and 36 percent of the

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

Table 11 Deposits in the Banking System in Argentina, 1991-2001
(in millions of dollars)

	Total	Pesos	Dollars
1991	14,624	8,064	6,580
1992	24,407	13,665	10,742
1993	37,863	19,770	18,093
1994	44,866	21,859	23,007
1995	42,595	19,182	23,414
1996	52,258	24,564	28,194
1997	68,500	31,796	36,704
1998	76,794	34,831	41,963
1999	78,662	32,607	46,055
2000	83,913	32,004	51,909
2001	65,601	18,867	46,734

Source: National Administration of Macroeconomic Policies Coordination, *Economic Report*, Ministry of Economy, Argentina.

dollar-denominated credits. The banks preferred lending to the government because it borrowed larger amounts and paid higher interest rates than other borrowers did.

By the end of 2001, the loans to deposits ratio was almost one to one, and had been reduced significantly since 1991 when credit facilities more than doubled deposits. The banking system had become more solid. However, when the crisis came, it was not solid

Table 12 Banking System Lending, 1991-2001
(in millions of pesos and dollars)

		To the Public Sector		To the Private Sector	
	Total	Pesos	Dollars	Pesos	Dollars
1991	30,940	6,088	2,794	12,485	9,573
1992	42,635	4,643	4,400	17,659	15,933
1993	51,391	5,640	3,528	20,746	21,477
1994	52,275	1,721	3,429	19,743	27,382
1995	52,388	2,088	3,544	18,233	28,523
1996	57,592	1,926	4,432	19,549	31,684
1997	66,935	1,766	5,244	22,032	37,893
1998	76,406	1,479	7,837	24,241	42,350
1999	77,232	1,676	10,316	24,385	40,856
2000	76,986	826	14,134	23,286	38,740
2001	72,004	1,006	20,837	14,046	36,116

Source: National Administration of Macroeconomic Policies Coordination, *Economic Report*, Ministry of Economy, Argentina.

enough due to the lack of "real" foreign currency instead of the "virtual" dollars created in the system.

When and Why did Argentina's Debt Become a Problem?

The figures of the debt alone cannot explain the magnitude of the impending Argentine crisis. Many factors combined to cause a long awaited crisis in December 2001. On one hand was the tightened schedule of debt repayments and the high interest rates that had to be paid for each renewal and refinancing of overdue debts. Risk-grading companies began increasing the country risk of Argentina from market information that the banks themselves manipulated when entering and leaving the bond market, thus causing an interest rate hike, which they then charged for refinancing facilities. On the other hand, there was the so-called "blindaje" (shielding), a shielding system with a significant funding from the IMF, and the so-called "megacanje" (mega-exchange), a significant exchange of public bonds.

Another cause of the crisis was the reduction of capital flows to Argentina after the Russian crisis. Capital flows quickly decelerated as recession advanced and uncertainty increased as a result of the unclear political situation when the Argentine vice-president resigned. No less important in the emergence of the crisis was the recurrent deficit in the current account balance. This deficit was due in part to the high interest payments and to higher imports. Although exports doubled from 1993 to 1998, the fixed and overvalued rate of exchange fostered imports, which more than doubled in those years.

At the same time, tax revenues fell with the recession of the economy. To fill the gap, the public sector incurred dollar-denominated domestic debt. The results of this policy were aggravated by the increasing dollar-denominated deposits generated in the financial system. The account holders opted for dollar deposits to protect themselves in case of a devaluation or Convertibility drop off. The attitude of delaying consumption aggravated the recession. One other factor that is often mentioned as a cause of the crisis, the fiscal deficit, remained within reasonable limits and cannot be blamed as a direct cause of the problem.

The Convertibility Trap

One of the reasons the Argentine crisis was not avoided was that nobody could provide a consistent and timely exit from the Convertibility regime. The IMF failed as well as those who departed from the Convertibility regime without having a clear plan of where to head or how to handle the problems that would arise. The Convertibility model may have been useful during the first period when it was necessary to achieve stability after two hyperinflation processes in 1989 and 1990. But not only was the exchange rate fixed, also a bi-monetary system was established that allowed depositors to make local deposits in dollars, and to contract and rent in dollars. It allowed the government to assume internal debt in dollars in exchange of pesos.

Since no money could be issued internally to provide liquidity, the monetary restrictions imposed by Convertibility were overcome by issuing debt bonds. Provincial authorities, in turn, issued internal debt bonds in the manner of bank bills of legal tender to create liquidity.

Hausmann is one of the few analysts who proposed one of the most coherent manners of abandoning the Convertibility regime before the crisis. His solution had two main ingredients; on the one hand de-dollarisation of dollar-denominated bonds, both in the domestic financial system as well as in the pension system and all types of internal contracts. On the other hand, a floating exchange arrangement anchored by inflation targets. The objective was that Argentina would be competitive again and, at the same time, avoid the problems generated by dollar liabilities in the event of a devaluation.

Amid the crisis, Gaba (2001) proposed three alternatives to exit the Convertibility regime: 20 percent devaluation and further dollarisation, devaluation and flotation, keeping the bi-monetary system as in Peru, and free flotation and de-dollarisation as Hausmann proposed. Devaluations would imply relative changes in prices, which foster exports and discourage imports, resulting in an improvement in the balance of payment, but at the same time devaluation might imply a greater capital flight thus neutralising the effect of exports improvement. Therefore, some kind of control to capital movements and possibly exchange controls would be necessary.

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

In the end, however, the worst solution was chosen: devaluation with flotation, asymmetric devaluation of deposits and credits with a fixed exchange rate and controls to deposits withdrawals, converting short-term deposits into medium and long-term bonds.

Inoperable Solutions

During 2001, different solutions that ultimately did not prevent the crisis were attempted: the most important ones were the so-called "blindaje" and "megacanje".

"Blindaje"

In March 2001, the Argentine government announced an agreement with the IMF, approved in May of the same year, with a significant disbursement. Together with contributions by the Inter-American Development Bank, the World Bank, the Spanish government and others, this would secure a principal amount that would allow meeting future amortisation. At that time, the government said that thanks to the "blindaje", Argentina would be in a position to meet future commitments without having to place more bonds in the international market. However, a few months later a new refinancing transaction was announced, the "megacanje".

"Megacanje"

By mid-2001, the economic authorities, initiated a process by means of which bonds with maturities in the short and medium term were exchanged with others with maturities in 7, 15 and 30 years, held by banks in Argentina and pension funds. The objective was to improve the maturities by extending them in an attempt to decrease the fear of default and also to decrease the country risk and thus alleviate the burden of interests in the debt service by securing lower interest rate credits.

This transaction was officially estimated to amount to 20,000 million dollars, hence it was called the "Megacanje". The government thought this transaction would be a financial relief in terms of repayment of principal and interest payments of around 4,500 million dollars annually and that they could thus avoid default.

For a number of reasons, this transaction was not successful. First,

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the interest rates were not decreased significantly, which became evident less than a month after the events of September 11, 2001, with the steep decline of international interest rates. Second, the transaction itself lacked public support and served to deepen the crisis of confidence in the government. A group of banks selected by the economic authorities collected such substantial amounts of money in commissions on the exchange transaction that even the United States government offered to assist Argentina in future exchange transactions free of charge.

The transaction was guaranteed, for the first time after the Second World War, with tax collection thus opening the possibility for foreign banks to collect and intervene in the domestic economy. A similar situation had occurred in the province of Catamarca, Argentina, in the 1930s when a foreign bank intervened in the tax collection board to secure repayment of a loan.

Debt in the Context of a New Development Agenda

When Argentina's debt was rescheduled according the Brady Plan in 1992, it was expected that this would be the last rescheduling of Argentina's external debt. However, starting from the Brady Plan, the debt continued growing until it doubled again in less than 10 years. It became necessary to reschedule amortisations every year.

In spite of privatisations, proposed by the so-called Washington Consensus grounded on the belief that these would decrease the external debt, the debt continued to grow. The other argument in favour of privatisations was that it was believed that they would decrease the public deficit by removing subsidies paid by the government to maintain inefficient public utilities. The railway system, for example, was subsidised by the government at 2 million dollars per day. However, after the privatisation and after reducing one of the world's largest railway networks to half its size – leaving several towns with no communications, severing thousands of persons from service, and resulting in worse service – the government continues to grant the licensee a two-million dollar daily subsidy, equal to the previous one.

Another target of the privatisation process was the pension system. This privatisation anticipated the development of a capital market that would allow financing growth. But, once privatised, the largest portion of these pension funds was loaned to the government at high interest rates, worsening the fiscal deficit. Prior to privatisation, these funds were directly collected by the government.

Yet, another neo-liberal measure taken in 1996 to recover the economy and employment level was the reduction of employers' contribution to the pension system. This reduction represented 10 percent of tax collection. But employment did not grow and the government, being deprived from this contribution, increased its fiscal deficit.

The Brady debt agreements and liberalisation and privatisation measures were expected to bring about a growth that would reach the entire society, but income inequality and unemployment rose, resulting in resentment and the feeling that the policy change and the debt incurrence did not help the country develop, but rather it caused it to regress.

Argentina's external debt cannot be separated from its economic development, therefore it must be treated within a model of development that improves the Argentine standard of living, generates employment and prevents economic stagnation. Argentina needs a debt rescheduling that relates debt service to public and private sectors' income. This would allow starting an investment process leading to a sustained human development process.

A new development agenda is required. It is also necessary to revive the economic objectives that existed prior to the neo-liberal policies, i.e. growth, full employment, income distribution and internal and foreign account macroeconomic stability.

How can one start a growth process in a country like Argentina that has not experienced growth since 1998? Why has the growth dynamic been exhausted? Last year's dynamic growth resulted from investments made in privatised companies and some industrial sectors with particular sector policies, such as the automobile sector. But the income concentration dynamics tightened the internal consumption market constantly and deprived productive investment from incentives.

The functional distribution of income in the US in 1990 meant that the return for labour was 74 percent of domestic income while the return for capital reached 26 percent of income. In Argentina, the opposite is true, i.e. workers receive 26 percent of income and non-salary earning people receive the remaining 74 percent. This means that the wage earners' market does not represent an attractive market for domestic or external investors. In a growth process based on investments oriented to lower income sectors, progressive income distribution is necessary. Some countries, like Japan and Korea, have shown that it is possible to distribute before growth starts. Waiting until you grow and then distributing does not generate any enthusiasm because that time never arrives.

Income distribution is also necessary to address the difficult social situation. The crisis has widened the gap between rich and poor from 1 to 30, thus increasing the country's economic social heterogeneity. This means that, in addition to getting smaller, if markets increase heterogeneity, production increases its heterogeneity and the old scale problems that appeared at the commencement of the industrialisation process crop up again. The road toward a more participative social economic process becomes more difficult to journey in view of the loss of balance of internal sectors. There is no opposition with enough power to balance the unbalanced "market" decisions of big players in the market, like the financial sector and large local and foreign economic groups.

The alternative to the present policy led by the "Washington Consensus" in Argentina is the creation of those counterweights so that a more equal society and economy can be developed with alternative economic and social policies. Stiglitz says that "one of the most important elements in any economy is the social capital and whoever ignores this does not understand how a modern economy functions."

Argentina and Globalisation

Argentina's debt grew in the last 10 years as a result of Convertibility. Neither the privatisations nor the large increases of foreign direct investment were enough to provide the system with the necessary dollar liquidity. The fiscal balance deteriorated, due to rising interest rates paid on both the internal and external debt. The fiscal deficit was not the direct cause of the crisis, but a consequence of the economic situation.

The possibility of having deposits stated in dollars generated an important amount of such deposits that multiplied from credits made in dollars, even though pesos were used in these transactions. When depositors tried to withdraw their deposits, the dollars were not there

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because they had never existed. They were virtual dollars. The passive role given to the Central Bank due to the Convertibility system, sped up the crisis.

Argentina's external debt default was a rapid, insufficiently analysed measure that worsened the general situation. A general rescheduling with an interest rate, maturity and debt service revision, should have been posed and negotiated on the basis of the actual payment possibilities of the country. Otherwise, a new rescheduling would be necessary year after year with the problems generated by "blindaje" and "megacanje".

The problems that Argentina is facing will not be solved rapidly. Since the problems are not only financial, it will be necessary to propose a development model different from the existing one and define the country's involvement in globalisation. The external debt policy should accompany this process and the international financial institutions that share responsibility for errors made by Argentina, should understand that.

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7

The Argentine Drama: A View from the IMF Board

J. Onno de Beaufort Wijnholds[1]

"Soft physicians cause festering wounds"
(old Dutch saying)

My vantage point for having a view on Argentina's economic woes is the Executive Board of the International Monetary Fund, of which I was a member during 1994-2002, and in which I participated in the decisionmaking on Fund financial support to member countries, including Argentina. During the course of this period, I developed serious misgivings about the economic and financial policies that Argentina was following, which were basically supported by the IMF for most of that time. I felt that not only were the Argentine physicians too soft in their approach, leading to insufficient adjustment and reform, but also that the external specialists from the Fund that were called in on a regular basis, were not always prescribing the right medicine or in the right dose. The result has been in my view an unnecessary prolongation of agony for the population, and a steeper collapse of the economy than would have occurred had the Fund forced a showdown earlier.

In view of my concerns with developments in Argentina and the Fund's role in it, I took the unusual step in September 2001 of explicitly abstaining from voting in the Executive Board on the proposal to augment by $8 billion the existing Fund credit to that country. In what follows I will attempt to explain why I considered

1 I wish to thank James Boughton, Graciana del Castillo and Jacques J. Polak for their valuable comments, while absolving them from responsibility for any remaining errors.

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that the actions of the Argentine authorities were leading to a dead end. After a look at some of the earlier history of Argentina and the IMF in the second section, an analysis is provided in the third section of the operation of the currency board which was introduced in 1991. The fourth section treats the 'end game' leading up to the disastrous collapse of the Argentine economy. Lessons to be drawn are discussed in the final section.

Argentina and the IMF: 1980-1991

It seems useful to take a step back and briefly review the main economic developments in Argentina during the 1980s, in particular in relation to the IMF. Most helpful in this regard are the passages on Argentina contained in Boughton's history of the IMF during 1979-1989 (Boughton, 2001). What stands out is the large number of programmes that were negotiated with the Fund, all of which failed. The period is characterised by a recurrence of new plans, implementation problems, by pleas for leniency by the largest shareholder of the Fund and, each time, willingness in the end by the IMF Management to provide resources again, despite serious misgivings by some members of the Executive Board.

In December 1983 Raúl Alfonsin was elected President of Argentina, bringing to an end to the military dictatorship that had lasted seven years. This brought new hope to the country that the return to democracy would also bring a return to economic stability. Under the military regime there had been considerable problems, after the relatively stable years 1976-78. Fiscal deficits started to climb again and the external debt rose dangerously, tripling in a mere three years (Boughton, 2001, p. 329). Efforts to stem the problems by a new economic team came to naught when Argentina occupied the Falkland Islands (or Malvinas) in 1982 and came into conflict with the United Kingdom. The result was a massive depreciation of the peso, serious domestic inflation and accumulation of sizeable external arrears. After Mexico stunned the financial world in August 1982 with its announcement of its inability to service its external debt, Argentina soon approached the Fund for financial assistance, as it too was in serious difficulties. After complicated negotiations with the Fund, the BIS – for a bridge loan – and the foreign banks, who were Argentina's main creditors, an agreement was finally reached for a total credit package of just over SDR 2 billion. While developments looked rather positive for a while, a staff team visiting Buenos Aires in August 1983 discovered a variety of problems, particularly a loss of control over wages affecting both the budget and external competitiveness, and the programme failed.

Under Alfonsin, negotiations started on a new programme with the Fund. They led to nothing at first whilst the economy deteriorated.[2] In the meantime the relations with Argentina's creditor banks deteriorated and the sceptre of default hung in the air. In March 1984, four Latin American countries[3] lent Argentina $300 million for three months, followed by a similar amount by the United States.[4] This provided some breathing space as it was not before late September 1984 that an agreement was reached between the Fund and Argentina on a programme. The programme was soon endangered, however, by substantial wage increases. Nevertheless, after fresh negotiations, including with the foreign banks that came up with $6 billion to cover the large financing gap, a new credit from the Fund was agreed on.[5]

Then there followed a series of plans by the Argentine authorities in an attempt to get the economy in reasonable shape and to keep the Fund programme on track. The first was the Austral Plan of 1985, designed as a 'shock' programme. Its centrepiece was the substitution of the austral for the discredited peso, lopping off three zero's in the process. Other elements included a temporary price freeze, a declaration of intent to end central bank financing of the fiscal deficit and a reduction of the deficit itself. In a breach with the past, contracts were to be indexed. The plan did not last long, as fiscal policy was undermined by large off-budget spending and an easy

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2 It is interesting to note that when the Fund's chief negotiator returned to headquarters to report to the Managing Director, senior US officials were also present at the meeting (Boughton, 2001, p. 388). This also happened at later debriefing meetings.

3 Brazil, Colombia, Mexico and Venezuela.

4 In May 2002, Argentina made a similar request for bridge financing from neighbouring countries, but there was no follow up.

5 The Fund package consisted of a stand-by arrangement plus a drawing under the Compensatory Financing Facility (export shortfall). The CFF element was dubious, and was only agreed to by the Managing Director "in desperation" (Boughton, 2001, p. 396). The Dutch Executive Director, J.J. Polak, did not support this part of the package.

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monetary policy. Argentina once again fell out of compliance with a Fund programme.

During 1986 and 1987 the Austral Plan faded away. After renewed tortuous negotiations a new Fund arrangement was reached in July 1987, Argentina again getting the benefit of the doubt from Management and the Executive Board. The doubts expressed did prove to be founded, however, since after much patchwork, including a secret meeting between President Alfonsin and Fund Managing Director Camdessus in Madrid, the new programme collapsed in March 1988.

The next move by the authorities was to launch the Plan Primavera in August 1988, consisting of a so-called heterodox package of measures aimed at breaking the momentum of seriously mounting inflationary expectations. Again the programme foresaw too little fiscal adjustment, and this time the Fund, in the absence of firm policies, refused to resume lending to Argentina.[6] Only six months after its introduction, the Plan Primavera collapsed leading to a slide into hyperinflation. These were the circumstances under which the Peronist Carlos Menem was elected president in May 1989. He immediately announced a new shock programme, this time with more fiscal adjustment in view of the size of the huge government deficit (16 percent of GDP for 1989). Importantly, the central bank was given more independence by not having to finance the government anymore. In November 1989 agreement was reached on yet another standby with the Fund, but again the arrangement was eclipsed prematurely as political obstacles blocked a strong adjustment and reform effort. After another bout of debilitating hyper-inflation, which reached 12,000 percent per year, Domingo Cavallo, the minister of finance, introduced a real shock effect in April 1991 by introducing a currency board, fixing the value of the dramatically eroded peso at a rate of one per US dollar.

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6 During this period a serious rift developed between the IMF and the World Bank, which was negotiating separately with Argentina on new loans. The Bank expressed strong doubts about the Fund's insistence on fiscal adjustment, while the Fund staff felt undercut by their Bank colleagues. At a time the Fund was still negotiating with Argentina, the Bank went ahead with providing loans to the country. This highly unusual state of affairs burdened the relationship between the institutions (see Boughton, 2001, pp. 522-23).

Argentina's experience in the 1980s and the Fund's role in it shows that the authorities produced a host of initiatives and plans, initially usually inadequate, which led to a series of Fund programmes, usually after drawn-out negotiations, and about which the Executive Board showed increasing apprehension, yet each time giving the country the benefit of the doubt. The plans tended to fail relatively quickly as a lack of discipline led to Argentina missing its targets time and again. This pattern can be seen as a precursor to that under the later stages of the currency board, to which I now turn.

The Currency Board

The introduction of the currency board was a drastic measure which swiftly led to disinflation and a robust turnaround of the economy. On the basis of the initial success, both the author of the convertibility law, minister of finance Domingo Cavallo, and the president that appointed him, Carlos Menem, could look upon their decision with considerable satisfaction. There was also a show of enthusiasm from the international community, especially since Argentina was at the same time embarking on a large-scale privatisation programme that was drawing in substantial amounts of foreign capital. In this rather euphoric atmosphere, more sceptical views of the wisdom of sustaining a currency board in a country that surely does not constitute an optimum currency area with the United States, that had one of the most closed economies in the Western world and where structural reforms, including in the essential area of the labour market, were very difficult to put in place, did not hold much sway.

There needs to be little doubt that in 1991 shock therapy was what was needed in Argentina, and the introduction of a currency board was probably the most convenient way of administering it. What seems to have fallen by the wayside, however, is the insight that the conditions for a sustained maintenance of a currency board – as distinct from administering a temporary anti-inflationary shock – are very stringent. Following Larraín and Velasco (2001, pp. 10-11) a number of requirements can be listed: the criteria for an optimum currency area need to be satisfied, implying among other things, that large countries are less likely to qualify; the bulk of the pegging country's trade should be conducted with the country to which it pegs its currency; inflation preferences should not diverge much between the pegger and the 'main' country; the need for a flexible labour market to help avoid rising unemployment; strong institutions and a consistent application of the law. To this list I would add the need to conduct a stringent fiscal policy, especially when the currency board is primarily intended as protection against inflation – as was the case in Argentina.[7] Keeping up with increases in labour productivity in the country whose currency serves as the peg can also be considered necessary for the longer-term viability of a currency board. Usually this requires a sustained effort in the area of structural reform. It is quite clear – of course the more so with the benefit of hindsight – that practically none of these conditions were met by Argentina. That the currency board continued to function as long as it did, had much to do with the lack of an exit strategy, or the willingness to contemplate one, and the unattractive prospect of having to introduce a different monetary approach fraught with short-term political risk.

The literature recognises the need for an exit strategy for most currency board regimes. A thorough analysis of the exit problem is contained in Baliño and Enoch (1997).[8] It is useful to keep in mind that there are no instances of relatively large countries with relatively closed economies successfully operating a currency board over an extended period of time. After its initial success in bringing down inflation in Argentina, the currency board introduced in 1991 increasingly constituted a drag on the economy, especially since the authorities allowed it to function more as a suppressor of symptoms than as an engine for fundamental change in the economy. What was especially damaging was that the authorities took insufficient action to bring Argentina's perennial fiscal problems, including with its provinces, under control.[9]

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[7] Blejer and del Castillo (1998, p. 460) state that: "A policy of utilising the exchange rate policy as an anti-inflationary instrument can only succeed if the authorities stick … to a fiscal policy compatible with the exchange rate …".

[8] It is interesting to note that Argentina twice exited from a currency board before, i.e., in 1914 after 12 years (onset of World War I) and in 1929 after only two years (depression), both instances leading to a strong loss in the value of the peso (Baliño and Enoch, 1997, p. 26). See also Eichengreen and Masson (1998) for an analysis of exit strategies from fixed exchange rate regimes in general.

[9] While Stiglitz (2002) correctly mentions the wrong exchange rate regime in Argentina as a major reason for its woes, he fails to recognise the contribution of the lack of fiscal discipline. By saying that a 3 percent of GDP fiscal deficit is not an

In its programmes with Argentina, the IMF concentrated only on the budget deficit of the central government, whereas the focus should have been on the general government. Equally undermining the currency board was the continuation of external borrowing which eventually led to an unsustainable situation, a development that was recognised too late not only by the country itself but also by the international financial institutions and the international capital markets. Hence, it is too simple to only blame the currency board for having brought about a seriously overvalued exchange rate and consequently an eventual economic collapse. It was the fact that the conditions for a sustained operation of the currency board did not exist in the first place, in combination with an endemic lack of fiscal discipline,[10] and a penchant for excessive borrowing that led to Argentina's slide into the morass of default and depression. This combination of a closed economy, with exports of goods and services amounting to no more than 9 percent of GDP (the average for Latin America is 19 percent; for emerging Asian countries 50 percent) which remained closed in part because of the overvalued exchange rate, and the high level of external borrowing by the government proved to be unsustainable.[11] Argentinean claims, made right up to the end, that its government debt position was sound since at 57 percent of GDP (at end-2001) it was not higher than that of many OECD countries, completely missed the point. The fact that Argentina's external debt to export ratio had climbed to the astounding level of around 500 percent and that by 1999 it needed to use around 40 percent of its export proceeds to pay interest on its external debt (see figure 1) was what should have set alarm bells ringing not only on Wall Street and in Washington (as it eventually did), but also in Buenos Aires.

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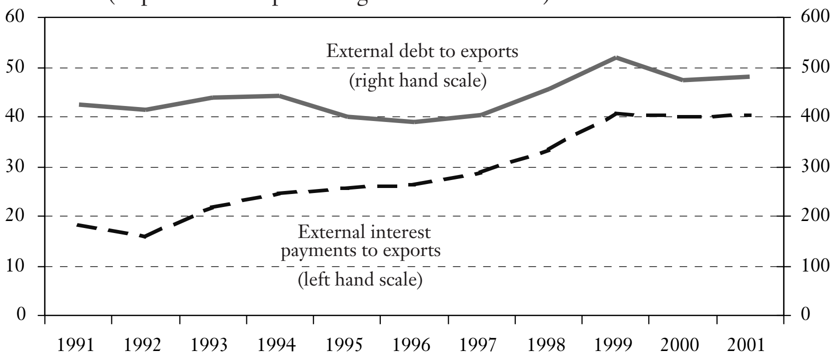
outrageous number, and that the United States has had bigger deficits, he forgets that Argentina's deficits had to be financed through – increasingly expensive – external borrowing in foreign currency; a very different situation than the one facing the United States.

10 Mussa (2002, p. 6) notes "...the chronic inability of the Argentine authorities to run a responsible fiscal policy."

11 See "Debt Crises: What's Different About Latin America?", in chapter II of IMF (2002). This excellent section explains in considerable detail how the combination of a low export base and a high degree of openness to international capital markets importantly increases a country's risk of default.

Figure 1 External Debt Indicators

(in percent of exports of goods and services)



Source: IMF.

Argentina's serious problems did not come to the fore until a few years ago, but as described at some length by Mussa (2002), earlier signs of trouble were discernable to those willing and able to see them. The country got through the Tequila crisis of 1995 quite well, but most probably would have been better off today had it had the foresight in the 'good' years up to 1998 to abandon its currency board and to float its currency in combination with establishing an inflation targeting regime as an anchor. Politically, this was a non-starter, however. But it is precisely what Brazil did in early 1999, after waging a futile battle against overwhelming capital outflows in attempting to maintain an overvalued exchange rate. Since the real effective exchange rate of Argentina had already appreciated quite considerably since 1991 and the plunge of Brazil's currency added significantly to that, any exit strategy – had it existed – should have called for abandoning the currency board in Argentina at that time.[12]

Failing that, a second-best solution may well have been to devalue within the currency board regime. While this would have been highly unusual it would appear to have been possible with some clever political manoeuvring. However, the solution that Cavallo,

[12] Blejer and del Castillo (2001) pointed to the failure of Brazil to address its chronic fiscal deficit as a major reason for this exit. They also expressed the view that the crisis in Brazil, the leading economy in Latin America, had "…set the stage for a new phase of instability, protectionist pressures, social distress, and political changes in Latin America."

who returned as Economy Minister in June 2001, pursued was to adjust the parameters of the currency board[13] and to manipulate tariffs and introduce export subsidies. This was a serious miscalculation, as was the dismissal of the central bank governor under not very clear circumstances, as it served only to undermine confidence and convince the markets that Argentina's currency board was doomed, or that the country would default, or both.

The role of the Fund during Argentina's initial, apparent, success and its subsequent swift decline is described in considerable detail by Mussa (2002), who was Director of Research at the IMF until 2001. I concur with his main conclusions that (a) the Fund failed to press Argentina hard enough on fiscal policy, especially during the period of rapid economic growth from 1995-97,[14] and (b) that it went on too long providing financial support to Argentina.

I am not convinced of his view, however, that whereas the Fund had been sceptical initially concerning the currency board, it was right to support Argentina subsequently in its decisions to maintain the peg. The argument for this position has been that the choice by a government as regards the exchange regime it wants to operate should be respected by the Fund, and supported with financial programmes as well if it is requested to do so. I have during my eight years on the Executive Board continuously taken a different view, arguing that while a country has the freedom to choose or maintain its preferred exchange rate regime, the Fund has no obligation to financially support an unviable exchange rate. In fact, it is doing a disservice to both the member country with an unsuitable exchange rate and to itself and its creditor members by lending under such inauspicious conditions. Indeed, the pendulum is lately swinging toward this view. I therefore do not expect a recurrence of the spate of large-scale IMF-led financing packages that were put together in recent years for emerging market countries, several of which – in the end unsuccessfully – tried to maintain clearly overvalued exchange rates.

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[13] The peso was to move with both the US dollar and the euro in equal weights, once the euro reached parity again with the dollar. In the event, the dollar appreciated further against the euro raising expectations of a devaluation of the peso.
[14] Mussa (2002, p. 12) asserts that waivers were granted to Argentina for missed fiscal criteria on many occasions and that "…violations … were simply ignored by the Fund and effectively swept under the rug."

The End Game

I will now briefly review the end game of the Argentine tragedy, as it can provide useful insights for the future. The first clear signs of trouble emerged in 1998 as Argentina slipped into a recession out of which it was unable to extricate itself. As depicted in figure 2, declining output led to an increase in the already substantial rate of unemployment, which reached nearly 18 percent in 2001 (and is likely to have increased substantially since then). As the recession became more drawn out, fiscal adjustment became increasingly difficult, with the tax ratio showing no improvement instead of the increase that was desirable,[15] and shrinking since 2001. Tax evasion – an endemic problem – probably increased and bouts of capital flight resumed.[16] While initially the financial system was considered to be sound, residents started to convert their peso into dollars and later also took out their dollars in large amounts from the banks as they started to doubt their solvency. Kiguel (2001, p. 29) has asserted that because Argentina was operating a fixed rated regime, it was better prepared to deal with financial shocks than under alternative systems. This has proved to be not true. Once confidence wanes under a currency board regime, the risk of a crisis is probably (much) greater than under a system of floating exchange rates. Argentina's international reserves, which were adequate in relation to the formal requirements of the currency board,[17] declined sharply after reaching $26 billion in 1999, to a mere $14 billion by the time of the abolition of the currency board in December 2001. In the meantime Argentina continued to borrow from international capital markets, except for an interlude after the Russian crisis of the summer of 1998 when it could not access these markets unless it was willing to pay a huge premium. It is this combination of inadequate fiscal adjustment and (external)

15 Argentina's ratio of tax revenue to GDP has remained at around 18 percent in recent years, which is low compared to around 30 percent for Brazil.

16 Estimates of the amounts of assets held abroad by Argentineans are as high as $100 billion (see The Economist, 2002, p. 28).

17 That is in relation to base money. Reserves fell considerably short of covering short-term external debt, which according to Guidotti (Deputy Minister of Finance of Argentina until 1999) was the amount that was minimally needed, as it allowed a country to go without borrowing for a year. If one adds an estimate for potential capital flight, Argentina's reserves were clearly inadequate already in 1999 (see de Beaufort Wijnholds and Kapteyn, 2001, pp. 22, 23).

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borrowing in foreign currencies which in the end proved so damaging for Argentina's attempt to maintain the currency board and avoid default.

While Argentina's policies were clearly inadequate, and the international financial institutions were often insufficiently critical of them,[18] its problems were aggravated by unfavourable external developments. The dollar, to which the peso was pegged, kept appreciating, thereby further weakening the Argentine competitive position which had already been dealt a severe blow by the Brazilian devaluation of 1999.[19] But instead of exiting the currency board, albeit under unfavourable conditions but in order to avoid worse, the Argentine authorities stubbornly continued along what Mussa describes as "the road to catastrophe". Markets were starting to contemplate the likelihood of an Argentine sovereign default, as during the course of 2000 the economic malaise worsened and the administration of President De la Rúa demonstrated a lack of decisiveness. In early 2001, the IMF once again came to the aid of Argentina with a huge financial package. It provided $14 billion (around 500 percent of Argentina's quota in the IMF, for which the general rule is that it can surpass 300 percent only under exceptional circumstances), the World Bank and the Inter-American Development Bank contributed $5 billion of what was essentially balance of payments financing for which they are not ideally suited, and the Spanish government provided $1 billion. The private sector was to provide an additional $20 billion or so, but the details of this part remained vague and seemed to serve mainly to be able to announce a total package of around $40 billion.

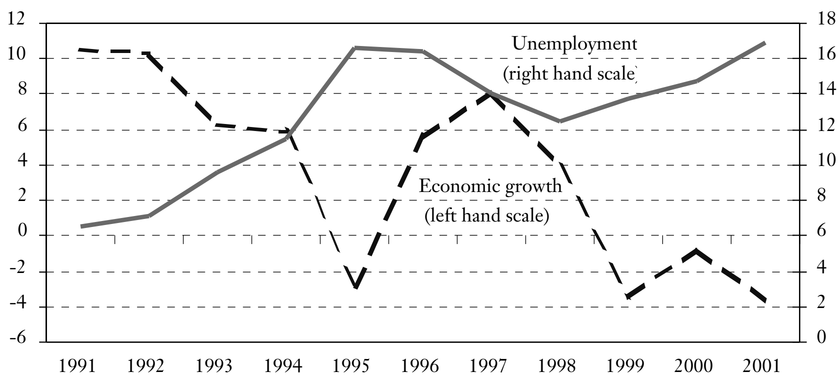
Other possible options in lieu of a large bailout package orchestrated by the IMF would have been a large-scale restructuring of Argentina's sovereign debt or full dollarisation. Much has been written about the pros and cons of these choices, and I will emphasise only one point here, i.e. that adopting the dollar without a sizeable devaluation would have solved nothing. In fact it would have provided only some short-term solace, but would have locked Argentina into a weak competitive position for a very long time, from

[18] This is also the view of Guillermo Perry, Chief Economist for Latin America and the Caribbean at the World Bank; see Perry and Servén (2002, p. 6).
[19] Perry and Servén (2002, p. 24) estimate the overvaluation of the peso to be about 55 percent in 2001.

which it could only exit by means of prolonged austerity. Adopting an irrevocably fixed exchange rate while suffering from lack of competitiveness condemns a country to long-term high unemployment, especially in the face of low mobility of the labour force and other labour market rigidities.[20]

As matters became worse for Argentina, it came to fall on Domingo Cavallo in March 2001 to assume the role of *deus ex machina*. Starting off energetically, he introduced a financial transactions tax to generate much-needed government revenue. Less well received was his decision to change the terms of the currency board, as mentioned earlier, and his firing of the central bank governor. After all the rigid application of the rules of the currency board and the independence of the central bank had been main pillars of the success of the board of the early 1990s. Another desperate act aimed at staving off default at all cost was the massive operation designed to swap a huge amount of Argentine government bonds for paper with longer maturities so as to lighten the debt service in the immediate years ahead. Although it is very difficult to ascertain how costly the swap was, Mussa (2001, p. 27) notes that the operation led to a lowering of the debt service of $12 billion between 2001 and 2005, while adding a staggering $66 billion to the payment of interest

Figure 2 Growth and Unemployment



Source: IMF.

[20] Pastor and Wise (2001, p. 64) state that "...Argentine labour markets are anything but flexible ...".

and amortisation in the years after 2005. Market interpretation generally was that a default was imminent.

Still it took another six months before the final showdown came. During this period the Argentine economy went from bad to worse, with growth falling more rapidly and unemployment nearing 18 percent (see Figure 2).

Against this background Cavallo unveiled a 2002 budget deficit plan which envisaged substantial budget cuts, especially in salaries. The plan was not realistic, however, in view of falling revenue caused by the recession and widespread tax evasion. Moreover, the assumptions underlying the budget (a positive rate of economic growth) were unrealistic.[21] When it became clear during the summer of 2001 that Argentina's efforts were proving futile, as for instance indicated by a rise in spreads on its bonds to risk premia levels that indicated a virtual certain default, the IMF once again made a rescue effort. To be sure, this was a very difficult decision to make for the Fund's Management, as well as for the Executive Board. The proposal put before the Board was to augment the ongoing programme with $8 billion (300 percent of Argentina's quota), of which the bulk was to be disbursed up front. While there was considerable unease about the operation, the Board adopted it on September 7, 2001. Having reached the conclusion that this augmentation was the wrong response to Argentina's plight, I stated that I could not support Management's proposal.[22]

In motivating my position I stated that I considered most of the assumptions underlying the revamped Argentinean programme unrealistic. For instance, the programme foresaw an increase in the primary (i.e. non-interest) fiscal balance to a surplus of 6 percent, which I considered a leap of faith in view of the fact that in the previous 10 years the primary surplus had never been higher than 1.5 percent. Besides, I expressed doubts about the wisdom of such a severe fiscal contraction and the austerity it would bring about in the

[21] As late as November 2001, in a meeting with the Dutch authorities at the margin of the IMF ministerial meeting in Ottawa, minister Cavallo expressed confidence in reaching a zero deficit outcome, while the Fund staff was already expecting economic growth to fall by at least 3 percent, with a concomitant fall in revenues.

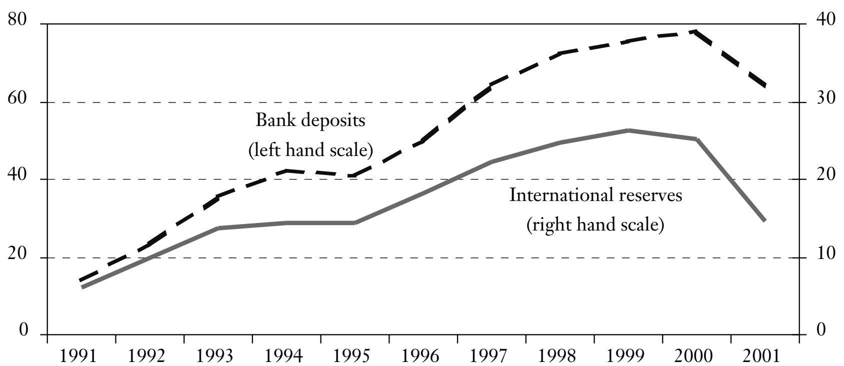
[22] My Swiss colleague made a similar statement and our abstentions were recorded in the minutes.

midst of a long drawn-out and deep recession. The export assumptions I also considered much too optimistic in view of the overvalued exchange rate and the weakness in the world economy. Moreover, the programme assumed that Argentina would be able to regain access to international capital markets, while it was actually on the brink of default. I concluded by saying that I did not believe that a virtuous circle would be achievable for Argentina, as matters had been allowed to deteriorate for too long, and I expressed concern that under the programme the Argentine people were going to be condemned to years of stagnation, if not negative growth, with no real prospect of a medium-term solution.

In October 2001, after it became abundantly clear that the additional $8 billion provided to Argentina had made very little impression on markets, Cavallo announced that a rescheduling of sovereign debt was needed, but that it would be a voluntary operation and market friendly. Again the rhetoric proved to be inaccurate. As the downward spiral of the Argentinean economy continued, and deposit withdrawals from the banks became a flood, a bank closure was ordered and cash withdrawals limited (figure 3 demonstrates how the fall in bank deposits affected official reserves).

The resignations of first minister Cavallo and then president De la Rúa soon followed amidst widespread unrest and violence. A declaration of sovereign default by the new regime was the next step in the drama, soon followed by the flotation of the peso by President

Figure 3 Bank Deposits and International Reserves
(in billions of dollars)



Source: IMF.

Eduardo Duhalde, who had taken over the reigns on December 30, 2001. New negotiations were started with the IMF on a programme that could be supported by a credit, but months elapsed as political differences, including a great reluctance by the provinces to agree to restrict their fiscal autonomy, delayed decisive action. In the meantime the banking system was showing increasing signs of strain and depositors subject to the corralito – the restriction that had been imposed on the withdrawal of deposits – became increasingly upset.

Indeed, the economic challenges facing the present government in Argentina are of a magnitude seldom seen in modern times and perhaps best compared to what occurred in the countries in Eastern Europe and the former Soviet Union after the fall of communism. A steep fall in the standard of living is taking place and economic uncertainty has increased dramatically, while the country has fully lost its creditworthiness. It is likely to take years for these developments to be reversed. It is widely recognised – except in Argentina itself, where opinion appears to be divided – that under these circumstances there is no real alternative for Argentina but to come to an agreement with the IMF, unless it chooses to turn its back on integration in the world economy.[23] Since at the time of writing negotiations are underway between Argentina and the Fund, I will refrain from commenting on what policies need to be followed. The analysis in the foregoing should, however, provide some clear pointers as to what should be done, and perhaps more importantly not done, for Argentina to engineer a turnaround from the dire straights in which it finds itself.

Lessons from the Argentine Drama

The main lessons to be drawn from Argentina's present predicament, as well as from its earlier experience, and the Fund's involvement in both, can be formulated as follows:

Soft physicians cause festering wounds. By not consistently conducting policies aimed at bringing about a more permanent improvement in the economy, Argentina never progressed to the point where reforms became ingrained. While the political class in

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[23] Experience with such an approach has generally been disastrous, as for instance borne out in Peru under President García in the mid-1980s.

Argentina is rightly blamed for the major part of this state of affairs, the IMF played some part in it by being insufficiently vigorous in its approach to the Argentine programmes which it financially supported, often for large amounts. Too often a blind eye was turned to serious deviations from agreed performance criteria. Financial support went on too long, in effect prolonging the agony unnecessarily since deep-seated adjustment was inescapable in the end. The IMF, like truly independent central banks around the world, should not be concerned about popularity, but aim solely for objectivity and consistency which in fact may earn it (grudging) respect in several quarters. Political pressure from member states should be resisted as much as possible.

A lack of strong institutions, including a dysfunctional judicial system, insufficient protection of property rights, inflexible labour markets, inadequate central control of government finances, weak tax administration and insufficient respect for the independence of the central bank, has made it very difficult for Argentina to gain the confidence of investors for longer than a few years at a time. Argentina has a rich potential in natural and human resources, but is in dire need of a strong framework for increasing investment, both from foreign and domestic sources. Institution building should figure prominently in future reform efforts.

Large-scale external borrowing can be very dangerous for a country's economic health, especially if denominated in foreign currency as is usually the case in emerging market economies.[24] While Argentina's currency board precluded monetisation of the persistent fiscal deficits, the massive borrowing by the government on international capital markets provided an alternative escape route from the fiscal discipline that is an essential requirement for the successful operation of a currency board. The combination of a quite closed economy, with a rather modest export sector, and a very significant openness with respect to international capital markets, constituted a major element of external vulnerability. Both the IMF and the private sector seem to have paid insufficient heed to the build-up of an unsustainable external debt situation. When international reserves started dipping below short-term external debt

[24] Horiguchi (2001) argues that one of the most salient lessons from the Asian financial turmoil in 1997-98 is that excessively high external indebtedness helped precipitate the crisis and greatly complicated its resolution.

outstanding, and the sceptre of default started to appear, a more resolute reaction from creditors could have been expected. As borrowing from the market continued until a quite late stage and from the IMF beyond what was in Argentina's own interest, the collapse was especially devastating when the plug was finally pulled.

Stringent conditions apply for the successful operation of a currency board on a sustainable basis, i.e. beyond its temporary application aimed at combatting hyperinflation. Currency boards constitute an extreme in the continuum of exchange rate regimes and are not suitable for everyone; in fact they constitute an optimal regime for probably only a handful of countries. Quite a few policymakers as well as academics were blinded by the initial results of the Argentine currency board, apparently forgetting about the lack of fiscal discipline, the lack of labour market flexibility, as well as the fact that Argentina does under no definition constitute an optimum currency area with the United States.[25] It is also important to keep in mind that changing the rules of a currency board arrangement is bound to be bad for confidence.

One of the most debated questions concerns the optimal currency regime for Argentina, and other emerging market countries. This is a complex matter as countries differ sufficiently in their economic structures and institutions to make generalisations hazardous. In a world of increasingly mobile capital flows there is, however, a clear shift in the direction of floating rates for emerging market countries.[26] In recognition of the need for some intervention in the usually thin foreign exchange markets in these countries, a managed float is increasingly seen as the appropriate policy. In order to provide an anchor against inflationary excesses, managed floating has been combined in a number of cases with an inflation targeting regime.[27]

[25] A country like Canada, which conducts the bulk of its foreign trade with the United States and which has other close economic and financial ties with its southern neighbour, does seem to fall clearly within the definition. However, Canada decided several decades ago to decouple from the US dollar.

[26] This constitutes something of a return to a view already expressed some 40 years ago by McKinnon (1963), who stated that: "Freely floating exchange rates are always preferable to fixed rates in the presence of substantial monetary instability of the kind associated with, say, Latin America."

[27] See Goldstein (2002) who calls this combination "managed floating plus", which he considers a superior approach for most emerging market countries.

In adopting such an approach, Argentina would follow in the steps of countries such as Brazil, Chile, Mexico and Turkey (which has agreed to but still has to adopt the inflation targeting framework). However, the situation seems to be more complicated in Argentina, where the dollarisation, particularly of liabilities, plays an important role and the preference of the population for dollars appears to be extraordinarily strong.[28] It is not surprising therefore that full adoption of the US dollar by Argentina, as done recently in Ecuador and El Salvador, is considered by quite a few observers to be the best – or perhaps the least bad – regime for Argentina. It is worth emphasising, however, that whatever exchange rate regime Argentina chooses to operate, there is no escaping the need for sound economic policies, both macro and structural. Without strong and consistent policies economic results are likely to be unsatisfactory, whatever the exchange rate system.

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[28] Calvo and Reinhart (2001) have pointed out that a case against floating rates can be based on the prevalence of dollar debt; this "fear of floating" has undoubtedly been a long-standing consideration in Argentina.

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8

Some Lessons from the Argentine Crisis: A Fund Staff View

Mark Allen[1]

In December 2001, Argentina was forced to abandon the peso's peg to the US dollar, to default on its sovereign debt, and to impose restrictions on the use of bank deposits. The crisis now facing the country is as profound as that which has faced any of countries that have suffered capital market crises over the last seven or eight years. The crisis is intractable and is causing enormous social and political tensions in Argentina and suffering to the Argentine people. Nevertheless, the catastrophic nature of the crisis in Argentina does not come as a surprise: the Fund's financial support was given to Argentina in the period up to late 2001 in an attempt to avoid precisely the outcome that has occurred.

The Argentine crisis is only one in a series of crises that has affected emerging markets since the mid-1990s. Following the crisis in Mexico, there have been crises in Korea, Indonesia and Thailand, Russia, Brazil in 1999, Turkey and then Argentina. Nor, as events in Uruguay and Brazil indicate, was the Argentine the last of that series. These crises have been remarkable for their virulence and often their unexpectedness. Following each crisis, there has been a concerted effort to analyse its lessons and to direct the Fund's Article IV surveillance towards applying those lessons to help other countries

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reduce their vulnerability. Nevertheless, each crisis has new elements, and when analysed, each throws light on its predecessors. In this way, we are gradually coming to a better understanding of the demands placed on governments whose countries are integrated into the global system. However, acquiring such knowledge and the will to apply it comes at a considerable cost to the people of those countries struck by crisis.

This chapter reviews the lessons that the International Monetary Fund drew from previous crises, and how it viewed economic policy in Argentina in light of these lessons. It then examines the factors that precipitated the crisis in Argentina and asks whether these were obvious to the Fund and its staff at the time. Finally, it draws some lessons from the Argentine crisis that may be helpful in assisting other countries from falling into the same traps.

Background to the Argentine Crisis

Argentina's history since the Second World War, and maybe for most of the 20th Century, has been one of decline in relative position in the world. A country that seemed destined to progress in step with Australia and Canada, countries of similar resource and human capital endowments, has instead gradually lost ground.[2] While analysing the roots of this disappointing long-term performance are beyond the scope of this chapter, inadequate macroeconomic policies have played a major role. Persistent inflation, punctuated by bouts of hyperinflation, and usually reflecting fiscal indiscipline, had so discredited economic management by 1990 that the prospects for reversing this secular decline looked bleak.

In this situation, the Convertibility Plan offered a way out, and for a considerable time delivered on its promise. The plan adopted in 1991 centred on the establishment of as firm a nominal exchange rate anchor as possible, i.e. a currency board peg to the US dollar, macroeconomic policies consistent with this anchor, and a sweeping structural reform programme. This plan delivered growth of 6 percent a year over the period 1990 to 1997, virtually unprecedented for Argentina and among the highest in Latin America. The authorities' strategy gained further credibility when Argentina

2 See Colin Clark, *Economics of 1960*, MacMillan, London, 1942.

showed itself able to withstand the market pressures emanating from the Mexican crisis of 1994-95, and the subsequent Asian crisis. This relatively strong overall performance during most of the 1990s cautions against attributing the Argentine crisis solely to fecklessness.

What Were the Lessons of Previous Crises?

Mexican Crisis Lessons: Exchange Rate Policy

The first lesson of the Mexican crisis of 1994-95 was that fixed or pegged exchange rates are dangerous in a world of free capital movements. This lesson should already have been apparent from the EMU crises of 1992-93 and has been repeated in subsequent crises.[3] Almost all these capital account crises have involved as a major element a battle to defend the exchange rate. One initial, if superficial, lesson was that a fixed exchange rate provides the market with an easy target and the opportunity for making a killing out of the authorities' foreign exchange reserves. The markets are able to mobilise more ammunition in attacks on an exchange rate than is available to the authorities to defend it, even with large financing packages from the Fund and bilateral sources. However, the pros and cons of fixed exchange rates are much more complicated than this conclusion implies.

Fixed exchange rate systems were viewed at the end of the 1980s and the start of the 1990s as being important tools for controlling inflation and creating a stable environment. They provided a nominal anchor to macroeconomic policies and, if credible, could reduce the costs of disinflation. This rationale was particularly important in Argentina, in light of its history of monetary mismanagement, culminating in hyperinflation at the end of the 1980s. The Convertibility Law, involving most of the elements of a currency board, was central to driving inflation out of the Argentine system and rebuilding confidence in the currency. It was associated with strong economic growth in the early 1990s, a phenomenon that also accompanied other exchange-rate-based stabilisations. However,

3 A theoretical explanation is Mundell's concept of the "impossible trinity": free capital movement, a fixed exchange rate, and an effective domestically oriented monetary policy.

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exchange-rate-based stabilisations have a number of costs, including the danger that the residual inflation will push the real exchange rate to a point that it endangers competitiveness. If changing the exchange rate is ruled out, any adjustment in relative wages and costs has to come from domestic price adjustments and wage cuts, and these can be politically and socially painful. So, in addition to presenting a target for speculation, a pegged exchange rate runs the risk of overvaluation.

The third main danger of a fixed exchange rate system was less apparent at the time of the Mexican or EMU crises, and has only become clear as the Asian crises have been more extensively analysed. That is that a fixed exchange rate can allow serious weaknesses to develop in economic agents' balance sheets. The more successful the authorities are in convincing domestic residents that the exchange rate is immutable, the less inclined residents will be to hedge their exposure to the currency of the peg. If interest rates are higher on domestic currency instruments than on those denominated in the currency of the peg, as will typically be the case for an emerging market, especially one undergoing disinflation, residents will tend to become more exposed to foreign exchange risk, with their liabilities increasingly in the currency of the peg and assets in the home currency. Should the exchange rate then be changed, contrary to initial expectations, residents will have large losses on their balance sheets.[4] While sound prudential regulations can limit the extent to which the financial sector runs an open foreign exchange position, there is no such prudential mechanism to discourage the corporate sector taking on such risks, and banks often miscalculate the risks run by their clients. Indeed, data may not be available to the authorities to show how large this risk is.

One lesson that was drawn from the crises was that, while pegged exchange rate regimes offered an unnecessary hostage to market attacks, it was possible that a really strong peg, such as that which a currency board gave, could withstand speculative attack. Countries with currency boards seemed in general to be less subject to successful attack, and Hong Kong, Estonia, and Bulgaria's currency boards survived earlier crises, as had Argentina's. However, when the currency board arrangement came under attack, as the Hong Kong board did during the Asian crisis, the authorities had to be prepared

4 See Allen *et al.* (2002).

to accept the impact on the domestic economy of the sharply higher interest rates that its defense required. This was the corner-solution model, leading to the recommendation that countries either float or adopt very hard pegs, and which was in vogue in the second part of the 1990s.[5] The sense was that every time the country ran a successful defense, and the more money the speculators lost in the process, the greater the credibility of the arrangement and the lower the subsequent costs of any attack. However, if the country is to establish the needed credibility, it must ensure that the structure of domestic balance sheets is such that the costs of defending the peg through higher interest rates remain politically acceptable. Argentina indeed showed itself willing and able to defend its currency board when it came under attack in 1995, and again during the Asian crisis.

Mexican Crisis Lessons: Financial Systems

Another lesson of the Mexican crisis, and reinforced by the Asian crisis, was the need for strong financial systems. In this respect, Argentina made a very creditable showing. As part of the reform strategy at the start of the 1990s, the authorities had liberalised their financial system and strengthened prudential supervision. An open environment was established for foreign banks to operate and to acquire Argentine banks, and as a result, a good part of the Argentine banking system was owned by non-residents.

The advantages of this were thought to be several. Firstly, widespread foreign ownership meant that the higher operating standards in the banks' home countries would also be applied in Argentina, with a consequent increase in the stature and probity of the financial system. Equally important, extensive foreign ownership was thought to be particularly consistent with Argentina's currency board. One major drawback of a currency board arrangement is that the system lacks a true lender of last resort. The authorities no longer have the ability to print the additional money needed in connection with the extension of liquidity support to banks in trouble, and so can only give support if a domestic public agency has accumulated very large reserves in addition to those committed to backing the currency. Foreign ownership of banks was thought largely to overcome this problem, since the banks' headquarters could provide their own

[5] Stanley Fischer (2001).

subsidiaries with dollar liquidity when needed. Thus the lender of last resort for the Argentine banking system would be the US Federal Reserve, and not the Argentine central bank.

Argentina's own response to the Mexican crisis and to pressures on its banks also served to generate confidence. There was a massive withdrawal of funds from many countries in Latin America in early 1995, and in Argentina this led to the collapse of a bank, Banco Extrader. This failure, as well as the absence of a lender of last resort under the currency board, fueled further runs on deposits in both pesos and dollars, amounting to about a fifth of deposits by May 1995. Accompanying the run was a shift in deposits from local to foreign-owned banks, and the activity of several of the former had to be suspended. The authorities' response also included the release of some reserve requirements, the provision of emergency liquidity through limited rediscount and repo operations, and the onlending of some excess international reserves to distressed banks. Once confidence had been restored later in 1995, bank supervision was strengthened, stricter liquidity requirements were introduced, a deposit insurance fund focusing on small deposits was established, and steps were taken to privatise the provincial banks.[6]

As part of the programme to strengthen international financial architecture, the Fund was called upon to step up its surveillance of members' financial systems to ensure their soundness and stability. This resulted in a joint Fund-World Bank initiative launched in May 1999, the Financial Sector Assessment Programme. An assessment was undertaken of Argentina in the first half of 2001 and found that the main risks to the domestic financial system arose from the macroeconomic situation, rather than from institutional or regulatory weaknesses. Indeed, before Argentina was forced into default, the banking system was strong as conventionally measured. Banks had strong capital ratios and liquid balance sheets. There had not been any asset price or credit bubble whose bursting might have been expected to put pressure on the banking system, indeed bank assets were quite low by international standards at 30 percent of GDP in 2001. As far as direct exposure to currency risk was concerned, banks had long positions in US dollars, and would be expected to benefit from a devaluation. However, the indirect impact of devaluation on the balance sheets of their customers and the

6 See Michel Camdessus (1996).

resulting credit losses more than offset this. And when the crisis occurred, the banking system was affected by its claims on an insolvent sovereign and by the loss of confidence in the issuer of the domestic currency, neither of which could be averted by measures taken by the banks themselves. In general, however, Argentina had learned the lessons of earlier crises as far as the banking system was concerned, and its financial system was a source of strength, not of weakness in the economy.[7]

Mexican Crisis Lessons: Data Standards

The suddenness and virulence of the Mexican crisis was attributed in part to the surprises that the market had received when the true state of Mexico's economic situation was revealed. In response, the Fund was asked to do more to ensure that all its members published reliable and prompt data on key macroeconomic variables. This resulted in the 1996 Special Data Dissemination Standard initiative, to which Fund member countries, and in particular emerging market countries were invited to subscribe.[8] Argentina was one of the first countries to subscribe, and its record of compliance is among the best. And it is clear that data deficiencies were not an issue in the case of Argentina. The markets were not surprised by Argentine developments and there were no sudden discoveries that the situation was worse than thought: the crisis occurred as a consensus grew as to the meaning of the available information.

Mexican Crisis Lessons: Domestic Savings

One reason adduced at the time of the Mexican crisis to explain why the Asian countries had not been hit by the contagion threatening Latin America was that savings rates in Asia were much higher. These higher savings rates were thought to give Asian countries a considerable cushion, since they gave greater scope for domestic financing and allowed the countries to be less subject to the whims of international capital markets.

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7 Subsequent actions to lower the cost to the budget of servicing debt held by local pension funds and insurance companies weakened parts of the non-bank financial sector.

8 http://dsbb.imf.org/

This lesson was an important one, but may have contributed to a lack of vigilance in Asia. The subsequent Asian crises made it clear that high savings rates did not make emerging markets immune from capital account crises. Vulnerabilities can arise from the structure of sovereign, bank, or commercial sector balance sheets, even when domestic savings are high. The lesson should have been reformulated to read that high savings rates may be necessary, but are not sufficient, to eliminate vulnerability.

Argentina, with much of Latin America, continues to suffer from relatively low savings rates, and this has been a source of vulnerability. Low domestic savings rates may contribute to shallower domestic capital markets and increase dependence on foreign capital. Domestic residents are less likely to be willing to keep their assets denominated in domestic currency, and thus can provide less domestic currency finance to domestic borrowers. Non-residents supplying capital, on the other hand, have shown themselves generally unwilling to accept the exchange rate risk that lending in domestic currency entails. Evidence shows that their aversion to exchange rate risk is such that they even try to hedge the exchange rate exposure of foreign direct investment. Thus an economy relying on foreign savings is inevitably exposed to considerable exchange rate risk. Should the exchange rate depreciate, the balance sheets of domestic borrowers in aggregate will suffer losses, as discussed above. This may cause great distress in the corporate sector, may threaten the solvency of the banking system, and may worsen the debt position of the sovereign, from its own foreign exchange liabilities or because contingent liabilities emerge in these circumstances.

Asian Crisis Lessons: Transparency, Standards and Codes

Weaknesses in banking systems and corporate balance sheets were central to the Asian crises. These weaknesses were known anecdotally to some market participants, but the full extent of the problems only became clear as the crises developed. As investors lost confidence in the creditworthiness of local banks and their corporate clients, credit lines were cut and exchange rates came under pressure. One important lesson drawn from these crises was that, if banking and corporate sectors were to be integrated safely into international capital markets, investors needed to be given the same sort of assurance about the standards met by their counterparts as they would have with counterparts in industrial countries. (Of course, this lesson was drawn before the round of corporate scandals in the United States).

To implement this lesson, the Fund and World Bank established a transparency initiative, under which member countries would be encouraged to adhere to international standards and codes, and the quality of their adherence would be assessed. Under this initiative, some eleven areas were identified for which adherence to standards was considered essential to reduce the risk of crisis.[9] The Fund and Bank established a mechanism to assess members' adherence to standards in these areas, Reports on the Observation of Standards and Codes (ROSCs). The areas fall into three broad groups: those related to macroeconomic transparency (data standards, fiscal policy transparency, and monetary and financial policy transparency); those relating to the financial sector (banking supervision, securities market supervision, insurance supervision, and payments systems); and those related to the corporate sector (corporate governance, accounting, auditing, and insolvency and creditor rights).

In 1999, Argentina was one of the first three countries to volunteer to have a comprehensive report prepared on its adherence to standards.[10] While some weaknesses were identified, Argentina received generally high marks for the standards it applied. This impression was shared by other observers. A study done by Oxford Analytica, commissioned by the important institutional investor, CalPERS, put Argentina first of 27 emerging markets on basis of eight criteria: political stability, transparency, avoidance of abusive labour practices, market liquidity and volatility, market regulation and legal system, capital market openness, settlement proficiency and transaction costs.[11]

Russian Crisis Lessons: Debt Dynamics

While during the Asian crises there was no serious concern about the solvency of the sovereigns, such concern was the main feature of the

[9] A twelfth area relating to money laundering and the financing of terrorism was added later.

[10] The report can be found on the IMF web site, www.imf.org. The report used experimental procedures, and the Fund and Bank have refined their approach since Argentina was assessed.

[11] http://www.oxan.com/columns/wkcol_28022002.html

Russian crisis. The crisis occurred because the Russian government's ability to service its debt was growing less rapidly than the costs of debt servicing. The debt servicing capacity was constrained by low tax mobilisation and the poor prospect of improvement in tax administration. As concerns about debt servicing grew, the maturity of the debt shortened and the interest premium increased, thus raising the costs of the debt. In this situation of unstable debt dynamics, international financial support to Russia, primarily through the International Monetary Fund, was intended to give a breathing space until measures to improve tax collections and reverse debt dynamics could work. But the effort failed, the debt dynamics spun out of control, Russia was obliged to default, and the economic programme collapsed.

Russia's default was not seen immediately as a typical capital account crisis, since there was a tendency to see events there through a *sui generis* political prism. However, the problem of sovereign debt dynamics has also been central to the crises in Turkey, Argentina, and most recently Brazil. The Fund staff was rather slow to focus on the importance of making sound judgments on debt sustainability in the context of its ArticleIV surveillance work and in its lending decisions. Only following the controversy connected with the augmentation of Argentina's stand-by arrangement in September 2001 and the Argentine default did the Fund staff present new analytic tools to help make these judgments.[12]

Lessons from the Argentine Crisis

As the previous section has shown, Argentina not only grew strongly during much of the 1990s, experiencing its best economic performance for many decades, but in many ways it learned from the lessons of other crises. Nevertheless, things went badly wrong, and this section discusses what those things were, and how they were viewed by the Fund. The main problems were the exchange rate regime, fiscal policy, the sustainability of the sovereign's debt, and the stagnation of the reform effort.

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12 IMF (2002).

Exchange Rate Policy

The fixed exchange rate policy, which had served Argentina well during the first part of the decade, was not able to withstand the shocks at the end of the period. While the attack on the currency board in 1995 took place at the time of a weakening of the US dollar and thus a strengthening of Argentina's competitive position, this good luck ran out at the end of the decade. The balance of payments was subject at that point to three serious shocks: the collapse of Brazil's *real* plan in 1998 and the subsequent Brazilian devaluation, the unexpected strengthening of the US dollar against the euro, and the economic slowdown in industrial countries in 2001. When these shocks combined with periodic uncertainties in the access of emerging markets to international capital, the costs of maintaining the peg increased sharply. Restoring competitiveness then required tightening macroeconomic policies to an extent that the authorities were unable to deliver. And even if the targeted fiscal adjustment had been achieved at that point, it would have placed yet more pressure on the public debt dynamics as discussed below.

Why did Argentina not abandon the exchange rate peg earlier? With hindsight, it would have been best to have exited in 1996 or 1997, in the aftermath of the successful weathering of the Mexican crisis. One reason for maintaining the peg was an unwillingness to jeopardise the confidence in the currency that had been achieved through the Convertibility Law. Given the undoubted successes that the fixed rate regime had achieved, it was very popular politically. There was a risk that a change in the peg could result in a sharp reduction in demand for the currency and that the economy could quickly revert to rapid inflation. The ideal time for leaving such a currency peg would be when macroeconomic conditions were such that the exchange rate could be expected to appreciate. However, these ideal conditions never materialised. And in addition, it is human to wish to avoid taking a possibly risky action, abandoning the peg, in times when there was no pressure on the exchange rate. The Argentine currency arrangements had been buttressed by legislative and constitutional provisions designed to make changing the peg difficult. While this framework helped ensure the initial success of the Convertibility Law, it also made it that much more politically onerous to change it. In the circumstances, the authorities were not keen to take on these political labours.

Another reason why abandoning the peg was inopportune was that the private sector had accumulated large open foreign currency positions. A move in the exchange rate would damage the balance sheets of many private sector companies, cause problems for the banks with credit outstanding to those companies, and lead to a contraction in output. Events subsequent to the abandonment of the peg show that these concerns were well founded. At the same time, given the inflexible structure of Argentina's exports, a devaluation would have done little to improve export performance, although it might have reduced the amount of deflation Argentina had to face.

What should have been the attitude of the Fund? Michael Mussa makes the point that the Fund's Articles give to its members the explicit right to follow the exchange rate regime of their choice.[13] The Fund must accept the member's choice, but in its Article IV surveillance it should make clear the economic policies that are needed to support the member's choice. Argentina's currency board imposed a number of requirements on policy, particularly in a world of open capital markets. It required very tight supporting fiscal policies, low public debt, a much more flexible labour market, and an opening of the economy. In Mussa's view, the Fund should not have given its support to Argentina and its fixed exchange rate without a credible commitment by the authorities to such policies. It is hard to argue with this judgment in the light of events. But the corollary is that, if the Fund had been realistic about Argentina's capacity for adjustment, then it should have argued for abandoning the peg, rather than supporting inadequate policies.

From the vantage point of 2002, it seems that the authorities should have shown the foresight in 1996 or 1997 to abandon the peg. To do so without setting off inflation and sudden depreciation would have required a tightening in fiscal policy. Having failed to abandon the peg at that point, the series of shocks the country faced in the next few years almost guaranteed a crisis. A crisis might have been avoided with good luck – for example, had the dollar depreciated against the euro, had Brazil not been forced to devalue, or had international capital market conditions not deteriorated – but Argentina's luck ran out. But the judgment that 1996 or 1997 was the moment to abandon the peg is only evident with hindsight. At that point, the peg seemed to be serving the country well, it was politically

[13] Michael Mussa (2002).

Table 1 Argentina: Consolidated Governments Operations
(in percentage of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Revenue	**20.1**	**23.4**	**24.6**	**24.1**	**23.2**	**22.2**	**23.2**	**23.7**	**24.3**	**24.7**	**23.5**
Tax	13.6	16.2	16.1	16.2	15.6	15.8	16.8	17.4	17.5	18.1	17.5
Social security	4.6	5.1	5.9	5.7	5.3	4.4	4.2	4.0	3.8	3.7	3.6
Other	1.8	2.1	2.5	2.2	2.4	2.0	2.2	2.3	2.9	2.8	2.5
Non interest expenditure	**20.6**	**21.9**	**23.1**	**24.1**	**23.7**	**23.3**	**22.9**	**23.2**	**25.1**	**24.2**	**25.0**
Wages	8.0	8.4	8.8	8.9	8.9	8.3	8.2	8.3	9.4	9.5	9.9
Pensions	5.4	6.0	5.6	5.9	6.0	6.2	5.9	5.8	6.2	6.1	6.2
Other	7.1	7.5	8.8	9.3	8.7	8.8	8.8	9.0	9.5	8.6	8.9
Primary balance	**–0.5**	**1.4**	**1.5**	**0.1**	**–0.4**	**–1.1**	**0.3**	**0.5**	**–0.8**	**0.4**	**–1.5**
Interest (accrual)	3.0	1.9	1.4	1.6	1.9	2.1	2.3	2.6	3.4	4.0	4.8
Overall balance	**–3.5**	**–0.4**	**0.0**	**–1.5**	**–2.3**	**–3.2**	**–2.1**	**–2.1**	**–4.2**	**–3.6**	**–6.4**
Other debt-creating operations	0.0	0.1	0.3	0.4	0.8	0.5	0.3	0.4	0.5	0.0	0.0
Overall balance, incl. off budget	**–3.5**	**–0.5**	**–0.3**	**–1.9**	**–3.1**	**–3.6**	**–2.4**	**–2.5**	**–4.7**	**–3.6**	**–6.4**
Memorandum items:											
Consolidated debt											
Arg. peso, billions	65	69	78	90	101	108	112	124	134	145	172
percent of GDP	38.8	32.9	32.8	35.1	39.2	39.8	38.1	41.3	47.4	50.8	64.1
Real non-interest expenditures (1995 = 100)	31.5	73.9	82.5	98.5	100.0	103.8	106.2	105.3	104.3	96.2	98.5

Source: http://www.imf.org/external/np/speeches/2002/071702.htm popular given Argentina's tradition of inflation, and with the Asian crisis still dominating markets, floating might have precipitated a crisis. The Fund certainly did not have the prescience to push for abandoning the peg at that time.

Fiscal Policy

Argentina's fiscal policy throughout the 1990s was at first sight not conspicuously profligate (Table 1). The primary balance was close to zero and the average overall deficit was about 2.5 percent of GDP in the years up to 1999. The debt ratio grew from 32.9 percent of GDP in 1992 to 41.3 percent in 1998, not because of current fiscal deficits, but because judicial decisions added 10 percent of GDP to the debt over this period.

Nevertheless, Argentina should have done much more to strengthen its public finances. As Mussa points out, in the years of exceptional growth, Argentina should have run a surplus, if it was going to have room for a fiscal stimulus in the event of a downturn. Only substantially larger primary surpluses would have reduced the vulnerability posed by the debt stock. And the importance of a strong fiscal position and a resilient tax system had long been recognised in Argentina. Nevertheless, the government was unable to strengthen public finances sufficiently, and the central authorities lacked the ability or the political will to enforce discipline on the provincial governments. Thus deficits were run throughout this period, and the markets were content to finance them.

By the time the economy fell into recession at the end of 1998, there was no scope for letting automatic stabilisers work, as the markets were beginning to have doubts about the sustainability of the debt. Thus it became necessary to try to reduce the deficit at precisely the most difficult time, when fiscal consolidation would have a negative effect on output. By this point the dilemma was virtually insoluble: worsening debt dynamics called for much higher primary surpluses, but higher surpluses, by worsening growth prospects, would exacerbate the debt dynamics. The authorities introduced fiscal responsibility legislation, aiming at a zero deficit, but it proved impossible to get the support of the provincial legislatures, which were often in the hands of the political opposition. The attempt to meet the demands of the law by expenditure cuts in the face of declining revenues proved politically unsustainable.

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

The fundamental fiscal problems in Argentina relate to revenue mobilisation, the structure of expenditure, and the finances of the provinces.

The Argentine tax system failed to deliver the resources to finance the state, with the overall revenue to GDP ratio at about 23 percent lying well below comparable countries. The system was complex and inefficient, and it was not able to respond by mobilising more revenue when needed. Relatively well-designed value added and income taxes were undermined by exemptions, the cross-crediting of taxes and payments, and the consequences of tax amnesties. The system became more distorted with Economy Minister Cavallo's Competitiveness Plan in 2000, which introduced a highly distortionary financial transactions tax, as well as establishing a system of taxes and subsidies to mimic the devaluation that the exchange rate peg precluded.

Tax administration has been a chronic problem in Argentina, leading to notoriously low tax compliance with relatively high administrative costs. This was partly a consequence of the distorted tax system just described, but also reflected organisational and resource deficiencies. Taxpayer databases were not properly coordinated, legislation did not provide for adequate disclosure, particularly by banks, and neither the government nor the judiciary showed a full commitment to tax enforcement. To a large extent, these deficiencies have to be attributed to lack of will, since there was no shortage of technical assistance from the Fund and others in this area.

Public primary (non-interest) expenditure in Argentina has been dominated by wages (40 percent of expenditure in 2001), pensions (25 percent) and other transfers, often wage related (20 percent). Thus public outlays for goods, services and investment were less than 15 percent of the total. This expenditure structure was inflexible and not consonant with Argentina's needs. The agenda for reform in public expenditures encompassed staffing levels, the wage bill, social security, social welfare, and education, especially at the university level.

Public sector wages were an important source of expenditure pressures. The public sector accounted for about 12.5 percent of employment in Argentina in 1999, about the level of a typical European country. This is a much higher level of public employment than is found in most emerging markets, and can be compared with

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

levels of 7.3 percent in Brazil, 7.1 percent in Chile, and 4.5 percent in Mexico.[14] During the 1990s, this level of employment stayed approximately constant, with a reduction in federal employment, but an increase in employment at the provincial level (Table 2). The wage bill, already high, was made more burdensome by an upward creep in public sector wages. While the average wage in the private sector remained virtually unchanged between 1994 and 1999, as did that for provincial employees, the average wage of federal employees rose by 22 percent.

Much of the wage bill and staffing pressures originated at the provincial level, with considerable growth from about 1997. The autonomy of the provinces is such that the federal government does not have the authority to require the introduction of sweeping reforms. The provinces have spending authority, combined with the ability to borrow directly, and the system contains complicated tax-by-tax arrangements for the transfer of revenues to the provinces. The revenue-sharing arrangements cannot be modified without the unanimous agreement of provincial governments.

The system failed to deliver a hard budget constraint at the provincial level, and Economy Minister Cavallo's fiscal strategy and the credibility of the Fiscal Responsibility Law foundered on his inability to impose discipline at this level. Rather than make spending conform to the level of revenues, provinces tended to borrow excessively, receive bailouts from the federal government, or even at the end, issue their own currencies. Missing reforms in this area included a more efficient revenue-sharing and interprovincial transfer system, the development of local tax sources, and statutory limits on provinces' borrowing capacity.

The Fund clearly took too accommodating a position with regard to Argentina's fiscal targets in its adjustment programmes during the 1990s. Starting in 1994, Argentina failed each year to meet the fiscal objectives of its programmes. The slippage on the revenue side was never because growth was lower than projected, but because of the failure to mobilise revenue and to reform the tax system. Expenditures were also greater than targeted in every year except 1995. The Fund sought a tightening in fiscal policy, but did not insist on it. It pushed the time horizon for the correction of slippages into the future, where it was overtaken by events.

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14 Anne Krueger (2002a).

Table 2 Argentina: Public Sector Personnel Expenditure

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Wage bill, in percentage of GDP												
Total		**7.63**	**7.98**	**8.82**	**8.89**	**8.87**	**8.35**	**8.25**	**8.33**	**9.39**	**9.47**	**9.87**
Federal		2.97	2.70	2.83	3.03	3.01	2.93	2.91	2.70	3.02	2.96	2.91
Provinces		4.66	5.28	5.99	5.86	5.86	5.42	5.34	5.63	6.37	6.51	6.96
Public sector workers, in thousands												
Total	**1,801**	**1,753**	**1,675**	**1,608**	**1,629**	**1,653**	**1,720**	**1,731**	**1,739**	**1,780**	**1,815**	**1,815**
Federal[1]	694	646	556	500	515	518	496	482	465	462	462	462
Provinces	1,108	1,106	1,119	1,108	1,114	1,135	1,223	1,249	1,273	1,318	1,353	1,353
Public sector workers, in percentage of total labour force												
Total		**13.6**	**12.8**	**12.2**	**12.2**	**12.2**	**12.5**	**12.4**	**12.3**	**12.5**	**12.6**	**12.4**
Federal[1]		5.0	4.3	3.8	3.8	3.8	3.6	3.5	3.3	3.2	3.2	3.2
Provinces		8.6	8.6	8.4	8.3	8.4	8.9	9.0	9.0	9.2	9.4	9.3
Average annual wage, in Argentine peso												
Total		**7,266**	**9,971**	**12,972**	**14,049**	**13,845**	**13,211**	**13,953**	**14,329**	**14,936**	**14,875**	**14,609**
Federal		7,671	10,165	13,389	15,143	14,980	16,065	17,654	17,354	18,503	18,269	16,934
Provinces		7,030	9,874	12,783	13,544	13,327	12,054	12,526	13,224	13,686	13,716	13,815
Private Sector					12,103	12,220	12,012	11,856	11,999	12,181	12,246	12,090

Note:
1 Excludes public enterprises.

Source:
http://www.imf.org/external/np/speeches/2002/071702.htm

From: The Crisis That Was Not Prevented: Argentina, the IMF, and Globalisation, FONDAD, January 2003, www.fondad.org

Debt Sustainability

The increase in the ratio of debt to GDP during the 1990s was modest and its level did not appear particularly high. As mentioned above, the increase was largely caused by judicial decisions recognising obligations to various resident groups. The growth in the ratio was not seen as worrying, partly because of its one-off nature, and partly because the economy was now believed to be on a new, higher growth path. But underneath the surface, the debt was becoming unsustainable.

The dynamics of the debt-to-GDP ratio depends on the rate of growth of GDP, the interest rate on the debt, and the rate of accumulation of new debt. A country's debt is sustainable if the debt ratio is projected to stay within bounds in the foreseeable future under all reasonable assumptions, or if the domestic adjustment likely to be needed to keep it in bounds is moderate.[15]

In Argentina's case, the economy was struck starting in 1998 by a series of shocks which plunged it into recession, a recession from which policymakers had no way of extracting the country. This meant that taxes, the basis for servicing debt, only grew slowly. In any case, Argentina's tax collection effort was not impressive, and the tax system was not capable of generating large additional resources rapidly. Debt service as a share of exports was high, because the Argentine economy was relatively closed, with exports hovering around 10 percent of GDP. Given the structure of exports, a devaluation would have done little to stimulate exports in the short run, and would immediately have had a negative effect on companies with open dollar exposure and would have increased the debt-to-GDP ratio. Thus a devaluation would have done little to ensure debt sustainability.

With the resulting reappraisal of growth prospects, Argentina's future capacity to service debt began to look more worrying. As this problem became clearer to market participants, spreads rose on Argentine paper and maturities shortened, creating increasing difficulty in rolling over the debt and increasing debt-servicing costs. This again worsened the debt dynamics, making it likely that Argentina would default on its debt.

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15 IMF (2002).

In an effort to stave off the immediate crisis, the authorities took a number of policy actions that would create problems for them in the future. In June 2001, the authorities tried to arrange a comprehensive exchange of their debt with the aim of lengthening maturities. The exchange succeeded in doing this, but the price of the exchange was very high, as the market demanded a substantial premium for the lengthening of maturities. The additional breathing room in 2002 was to be paid for with very much higher debt payments in subsequent years. And in order to increase the rate of take-up for the debt exchange and to ensure current financing of the budget, the authorities exerted moral suasion on domestic financial institutions, in particular pension funds and insurance companies to take up more government paper. This exploited a captive market, but at the cost of making these institutions even more dependent on the state of Argentine public finances.

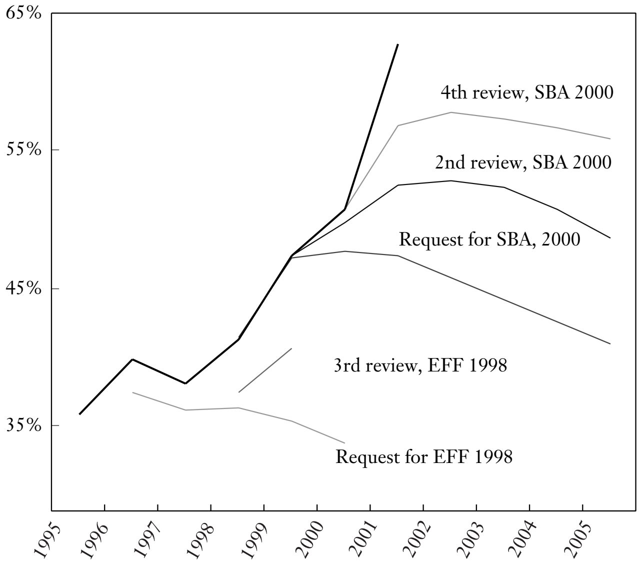
The prudent ratio of government debt to GDP for an emerging market is lower than many had thought. The Maastricht criteria, which rather arbitrarily set a 60 percent debt-to-GDP ceiling for EU member countries as the condition for entry into the euro-zone, may have acquired an unwarranted normative status. Some EU members, such as Belgium and Italy, had successfully coped with debt to GDP ratios double this level for a number of years. In addition, many developing countries have much higher ratios of debt to GDP than this as a consequence of decades of development assistance. Research done subsequently in the Fund suggests that for emerging markets the probability of a default increases quite sharply at a debt-to-GDP ratio of 40 percent.[16] For an emerging market with a debt-to-GDP ratio below this level, the chance of a default or major balance of payments crisis in a given year is only 2-3 percent; above this level, the default probability rises to about 20 percent, or a one in five chance of a crisis. In any case, it is clear that the higher the debt-to-GDP ratio, the more difficult it is for the government to run a counter-cyclical policy in the event that credit dries up.

The Fund did not foresee the inevitability of Argentina's restructuring its debt. Indeed, in its internal analysis it presented a remarkably consistent series of optimistic scenarios for the debt-to-GDP ratio. Figure 1 shows how consistently the Fund staff expected a small rise in the debt ratio for the year ahead, but then a smooth

[16] *ibid.*, page 19.

return to lower levels. These forecasts were based on the assumption that growth would be resumed, that the fiscal deficit would be on target, and that interest rates would fall to more normal levels. Of course, they also assumed that the currency board peg would remain in place indefinitely.

Figure 1 Argentina: Projections of Public Debt to GDP Ratio



Source: IMF (2002).
http://www.imf.org/external/np/pdr/sus/2002/eng/052802.pdf, page 19.

While there were those who predicted disaster for Argentina at an early stage – as early as 1995 in some cases – the consensus that the authorities' strategy could not work only solidified in July-August 2001.[17] The disaster looks much more certain in retrospect than it did at the time. Indeed, if by late 1998 it was too late to abandon the peg without disaster, careful analysis at that time would have shown

[17] An indication of this can be found in the movement of Argentina's bond spreads. After jumping from 500 to around 1,000 bp at the time of the *real* crisis in late 1998, spreads returned to the 500 bp level in the course of 1999. They resumed their upward movement in May 2001, shot up to 1,500 bp in August, and have subsequently risen to almost 7,000 bp.

that the probability of unsustainable debt dynamics was already so high that a restructuring was probably needed. However, a restructuring, even at that relatively early stage, would have been associated with very severe disruption in the domestic market, and could have had spill over effects to other emerging markets facing problems. By September 2001, when the Fund agreed on the final augmentation of the stand-by arrangement, the chances of bringing the debt dynamics under control were very small.

Structural Reforms

In addition to the currency board arrangement, fiscal policy, and debt sustainability, failure to continue with structural reforms was another key shortcoming in Argentina. After a spurt of deregulation and privatisation at the start of the 1990s, the steam went out of the structural reform agenda. Two areas stand out where deep reforms might have made the Argentine economy more flexible, have boosted growth, and allowed it to cope with the strains that emerged, labour market reform and trade liberalisation.

Argentina has a tradition of giving extensive protection to individual employed workers, with high barriers to dismissal, and extensive fringe benefits. Collective bargaining is done at the industry level, a mechanism that is not generally conducive to wage moderation. Reforms to the labour market were introduced in 1991 and again in 1995, but the attempt to introduce more sweeping reforms in 1996 foundered on the rock of political resistance, and in 1998 there was some backtracking. As a result, the labour market remained quite rigid. Unemployment rose at the start of the reform programme in 1991-92, and failed to fall thereafter, despite the strong growth.

The low ratio of exports to GDP in Argentina (about 10 percent) hampered performance in a number of ways. The low ratio meant that the foreign trade balance could only play a limited role in cushioning swings in domestic demand, thus making the economy less flexible. It also made Argentina dependent on borrowing to supplement export receipts and thus vulnerable to swings in investor confidence. It also meant that the debt-to-export ratio was at the high level of about 400 percent, despite the more comfortable debt-to-GDP ratio. By the late 1990s debt service was absorbing some three quarters of export earnings.

The structure of Argentina's exports also served to make the country more vulnerable. Exports are concentrated in primary, especially agricultural, products and manufactures derived from them. These are subject to relatively large international price swings, as well as import barriers in importing countries. During the 1990s, the share of exports going to Mercosur markets rose from around 20 percent to about 45 percent, of which 30 percent went to Brazil. Thus Brazil's difficulties in 1998-99 hit Argentina particularly hard. Mercosur is also believed to have had a strong trade diversion effect, promoting the growth of regional trade in uncompetitive capital-intensive goods.

Unlike the Fund-supported programmes for the Asian crisis countries, the series of programmes with Argentina were remarkable for how little formal structural conditionality they contained. Thus the 1992-95 stand-by arrangement only had two formal elements of structural conditionality: tax reform and reform of the social security system, of which the latter was postponed. The programme contained no formal conditions relating to the labour market. Similarly, in the 1996 arrangement, while the Fund indicated the importance it attached to the legislation on labour reform then before congress, it did not attach formal conditionality to it. And again in 1998, it did not go further than expressing concern about the lack of progress in this area.

How Should the Fund's Role in Argentina Be Judged?

The Fund cannot be considered a bystander in Argentina, since it had successive arrangements with the member for virtually the entire period preceding the default.[18] But neither can it be considered to be responsible for all that was done and not done in Argentina. But it can be held responsible for its judgments and its advice, given both in

[18] Stand-by arrangement November 25, 1989 to March 25, 1991;
Stand-by arrangement June 29, 1991 to March 31, 1992;
Extended arrangement March 31, 1992 to March 30, 1996;
Stand-by arrangement April 12, 1996 to January 11, 1998;
Extended arrangement February 4, 1998 to March 10, 2000;
Stand-by arrangement March 10, 2000 to March 9, 2003.

public and in private. Was Argentina the poster child for the Washington Consensus, or was the Fund aware of the difficulties facing the country and the risks it was running? What did the Fund actually say?

While the Fund initially cautioned against the Convertibility Plan in 1991, once it was adopted and supported with structural reforms, the Fund became very supportive. This set of policies seemed to be a decisive break with the past and the initial results were very promising. In the immediate aftermath of the Mexican crisis, the Fund publicly praised Argentina's quick response to emerging pressures, firstly the tightening of fiscal policy, and then the way the authorities had taken advantage of the crisis to press ahead with needed measures, in particular rectifying the situation of provincial banks.[19]

The 21-month stand-by arrangement approved on April 12, 1996 focused largely on fiscal reform and privatisation, together with labour market reform. In announcing its support of this programme, the Fund flagged that it was crucial that fiscal developments, particularly revenue collections, be monitored closely and that implementation of structural reforms was essential for a sustained increase in employment.[20] While the programme agenda seems to have been the right one, the Fund did not withdraw its support when fiscal targets were not met, nor did it set programme conditionality on the key reform of the labour market.

Immediately following the approval of this arrangement, the Managing Director visited Buenos Aires and gave an assessment of Argentina's achievements and the challenges ahead.[21] He stressed the need for consistent and stable macroeconomic policies, especially a disciplined fiscal policy. This should encourage increases in domestic saving and provide room for a well-targeted social safety net and a satisfactory level of public investment in basic infrastructure and human capital. Argentina needed to maintain international cost competitiveness, which meant further consolidation of the fiscal position, both to underpin the Convertibility Law and to enhance confidence, with the aim of reaching over the medium term a balanced fiscal position for the entire public sector, including

19 See Michel Camdessus (1995).
20 IMF Press Release Number 96/15.
21 Michel Camdessus (1996).

provincial governments. Much reform work would have to be done on provincial finances, as well as directing government expenditure to more productive purposes, including more effective social spending and employment generation. Under the heading of structural reform, he emphasised the need for privatisation, both to raise resources and to allow the government to concentrate on its proper functions; labour market reform, and in particular reform of the labour code to increase market efficiency, together with a reduction in payroll taxes once the fiscal situation permitted; trade liberalisation, and measures to increase domestic competition. With hindsight, this diagnosis still seems correct: if the Fund is to be criticised in this context it is in not having made its assistance conditional on its implementation.

At his press conference on September 18, 1997, in response to questions about the scope of negotiations with Argentina on a new arrangement, the Managing Director again listed the priorities for Argentina as the Fund saw them. He stressed measures to promote greater flexibility in the labour market; reforms to make the tax system more equitable and more efficient; financial market reform; and a solid macroeconomic framework. While this agenda was the right one as far as it went, the new arrangement was not effective in persuading the authorities to implement the necessary structural measures. With hindsight, as discussed earlier in this chapter, this might have been the time to abandon the currency board, but this did not figure in the Fund's advice, nor were there concerns about debt sustainability.

The views of the Fund Board at that time on Argentina's policies were expressed in the summing up to the 1997 Article IV consultation.[22] Directors were complimentary about the way Argentina had coped with the financial pressures of the Asian crisis, and drew attention to the need for action on the familiar structural reform agenda. Their main macroeconomic concerns at this point were connected with the external sector, the increase in the current account deficit and Argentina's vulnerability to changed international capital market conditions. They stressed that the authorities should take further fiscal action should a revenue shortfall materialise, or should financing prove difficult in 1998. They welcomed the

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22 Press Information Notice (PIN) No. 98/9 February 23, 1998. http://www.imf.org/external/np/sec/pn/1998/pn9809.htm.

authorities' commitment to restrain domestic demand, should the current account deteriorate further or prospects for external financing worsen. They also called for action to diversify export markets with a view to expanding exports, in light of the high ratio of external debt service to exports.

The increase in the current account deficit became a growing worry for the Fund as 1998 continued. Thus at a press conference in April 1998,[23] the Managing Director flagged that Argentina had to be careful with current account developments, and that there was a case for moderating the rate of economic expansion, and for postponing certain less urgent fiscal expenditures, for instance on highways. He also noted that Argentine measures to reform the labour market were not in line with the spirit of the Fund's recommendations and would worsen labour market rigidities.

In his press conference on the World Economic Outlook in September 1998,[24] Michael Mussa, the Fund's Economic Counsellor, drew attention to the rapid growth of Argentina's trade and current account deficits over the previous two years. He pointed out that financial markets saw the current account as a major source of vulnerability, and that the financing environment for Latin America was deteriorating. He noted the large trade flows between Brazil and Argentina, and that "if an accident happens in Brazil," it would have a serious effect on Argentina. As a consequence of the change in external circumstances and the reduced access to external financing, Argentina was pursuing a somewhat tighter fiscal policy than before, and this would inevitably cause a slowdown in the economy.

In reviewing Argentina's policies again in March 1999,[25] Executive Directors were clearly concerned about the impact of the Brazilian crisis and the devaluation of the *real* on Argentina's growth and foreign trade, and noted that the current account deficit had widened in 1998. They were clearly aware of the dilemma facing fiscal policy in the slowdown, calling for "an appropriate balance"

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[23] Press Conference of Michel Camdessus, Managing Director, IMF, April 14, 1998, 9:00 a.m., Washington, D.C.
http://www.imf.org/external/np/tr/1998/tr980414.htm.

[24] Press Conference of Michael Mussa, Economic Counsellor, on the World Economic Outlook, September 30, 1998, 9:00 a.m., Washington D.C.
http://www.imf.org/external/np/tr/1998/tr980930.htm.

[25] Public Information Notice (PIN) No. 99/21, March 11, 1999.

between using automatic stabilisers to support output, and the need for fiscal policy to be oriented to preserve external credibility. Directors endorsed the continuation of the currency board, noting "that the currency convertibility plan has served Argentina well, and continues to be an adequate framework for stable growth." Nevertheless, competitiveness needed to be improved and external debt kept under control. They thought that a reduction in payroll taxes, together with labour market reform, might stimulate competitiveness, and called for steps to increase domestic saving through further medium-term fiscal consolidation and financial deepening to reduce Argentina's vulnerability to adverse financial market developments.

With hindsight, by early 1999, Argentina was in a recession that policies proved unable to reverse, and debt sustainability was to become more and more difficult. This was not fully evident at the time, however. In his press conference on the World Economic Outlook in April 1999,[26] Michael Mussa considered a forecast of a 3 percent growth in Argentina for the year 2000 to be an entirely reasonable expectation. He noted that the capital market financing of emerging markets had improved considerably since the previous autumn, and that should the recovery continue, Argentina would not have problems in terms of accessing private international capital flows.

It seems clear that the Fund's analysis of developments in Argentina failed to pinpoint the growing vulnerability of the economy during the 1990s. In addition, once the economy moved into a recession at the end of 1998 and capital account pressures mounted, the Fund did not produce a sufficiently clear analysis of the situation to catalyse an early decision to restructure the debt. In mitigation it could be pointed out that our knowledge and understanding of capital account crises has been growing crisis by crisis, and the wisdom of experience is that which one gains immediately after one needed it. Nevertheless, the Fund staff was overly optimistic in its assessment of underlying trends in Argentina, and did not sufficiently stress the growing weakness of the sovereign's balance sheet.

[26] Press Conference of Michael Mussa, Economic Counsellor, on the World Economic Outlook, April 20, 1999, 9:00 a.m., Washington, D.C. http://www.imf.org/external/np/tr/1999/tr990420.htm.

Another criticism is that the Fund was excessively indulgent in the application of its conditionality during the 1990s. Since the lack of openness of the Argentine economy, the inflexibility of the labour market, the weakness of the tax base, and the lack of fiscal consolidation ultimately made the policy mix unsustainable, the Fund should have only supported programmes that addressed these issues. In practice, there was relatively little conditionality linked to progress in structural reforms, and while the Fund expressed concerns about slippages, it did not allow these to interrupt disbursements. On fiscal policy in the narrow sense, targets were frequently missed and subsequently waived. It is clear now that fiscal policy should have been more ambitious and the Fund should not have acquiesced to slippages.

Finally, the Fund's actions once the crisis was unfolding can be criticised. Again with hindsight, the Fund seems to have placed excessive weight on the hope that Argentina's luck would at some point turn for the better. While this may have been a reasonable judgment in 1998 – and the Fund must be prepared to take some risks to help its members when they are making serious adjustment efforts – by September 2001, it was clear that Argentina almost certainly had to reschedule its debt. At that point, a case can be made that the Fund should have made such a rescheduling a condition for further financial assistance. Apart from this, it is not clear that another policy package at that point – for example, one involving either fiscal stimulus or the abandonment of the exchange rate peg – would have helped Argentina escape disaster.

Costs and Benefits of Globalisation

The Argentine crisis is only one of a series of crises that can be loosely linked to the process of globalisation. Why has there been this series of crises over the last decade, and what more general lesson can be drawn from them? The succession of capital market crises in the more advanced developing countries is a sign that the world has changed. Many developing countries have sought to benefit from the open international trade and financial system that is so helpful to the industrial countries. They have opened their economies to inward and outward investment and financial flows, without fully appreciating the constraints that this puts on the policies they can pursue. The learning process, which is also a learning process for the International Monetary Fund and the international community as a whole, is a painful one for several of the countries involved.

The liberalisation process for emerging markets has been pushed, not so much by the agenda of the industrial countries or by the International Monetary Fund, but by forces working within the emerging markets themselves. From the government's point of view, the deepening of domestic financial markets and the access to international bond markets has relieved its own financing constraints by presenting it with abundant and cheaper financing, at least for a time. The domestic corporate sector has pushed for financial liberalisation so that it could have access to the same financial services and terms of financing that were available to its competitors abroad. The banking system has been able to expand and offer more attractive products thanks to the deepening of its financial links abroad. And also important has been the demand from the population, at least that part of the population with financial assets, to invest that money where it wants and to borrow abroad when it chooses.

A government has little choice than to respond to some of these pressures for liberalisation. Keeping the economy closed can inhibit development, particularly of more dynamic sectors. Restrictions on the freedom to transact with non-residents has a political cost, the more so when people travel more freely and have access to more information than ever before. Even where technology does not allow the circumvention of restrictions, the restrictions create opportunities for corruption. Still, the incidence of crisis, and Argentina's experience, shows that liberalisation can entail huge costs if not properly handled.

Emerging market economies are exposed to losses of confidence by creditors. The latter may lose confidence in the state's ability to service its debt, as in the case of Argentina, or the loss of confidence may be in the solvency of the banking system or the corporate sector. The creditors who lose confidence are not restricted to foreign creditors, but include domestic creditors too, who may actually lead the pack. Once confidence in a debtor is lost, a liquidity problem rapidly turns into a solvency problem and domestic creditors of the debtor face problems in their turn. The attempt by domestic and foreign creditors to protect their assets rapidly turns into a run on the currency in the search for safer havens abroad, and the whole economy can be plunged into catastrophe.

These crises can be avoided, but only by great vigilance. Proper supervision of financial institutions can help ensure that banks do not become dangerously overexposed. Transparency for the corporate sector can help markets monitor increases in vulnerability and correct for them. But financial markets are always prone to crises, and it is ultimately the responsibility of the government to ensure that its own finances are in good enough shape so that it can help resolve a crisis and not be itself the cause of one. This means that governments have to resist the blandishments of bond salesmen and ensure their own balance sheets are strong by keeping their debt and vulnerability low. Experience shows that prudent level of debt for an emerging market sovereign is closer to 20 percent of GDP than to 60 percent, although other factors, such as maturity and currency composition, are important.

The very severe constraints that globalisation places on fiscal policy are part of Thomas Friedman's "golden straitjacket".[27] While the benefits of globalisation are very real, and the costs of crisis very high, remaining within the confines of the straitjacket poses huge problems. For an emerging democracy, with enormous social needs and a population well aware of the gap that separates its living standard from that to which it aspires, maintaining the needed fiscal restraint is a very difficult task. It is made more difficult for politicians by the ready availability of financing in the good years. Nevertheless, to avoid Argentina's path, such discipline has to be internalised, supported by high domestic savings rates and strict supervision of financial institutions.

The process of helping to get emerging markets to the place where their people can benefit fully from their integration in the global economy will be a long one. The world has an interest in providing sufficient financing to the International Monetary Fund to ensure that it can give countries the financial support they need when they run into problems, and the experience of recent crises shows that such support may have to be very substantial. However, once a country's position becomes unsustainable, further financing cannot resolve the problem without direct action being taken to reduce the country's debt. The decision that debt reduction is needed will always be a difficult one, and even if better mechanisms are put in

[27] Thomas Friedman (2000).

place to restructure debts more smoothly,[28] the process will cause considerable distress to the domestic economy.

Looking further ahead, there need to be mechanisms for transferring capital from capital-rich industrial countries to capital-poor developing countries which do not serve to make the recipient countries more vulnerable to crisis. In the current system, as capital is transferred, the creditor tries to avoid currency risk. Thus emerging markets can, in general, only borrow in foreign currency and so have a large cumulative open foreign exchange position. Attempts by individual banks, corporates, or the government to hedge against that risk only serve to transfer it from one domestic debtor to another. This open foreign exchange position leaves the country vulnerable to the foreign exchange crises discussed in this chapter. It is therefore time to look again at direct investment and the development of local currency capital markets as vehicles for the transfer of resources to support the development process.

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