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Introduction

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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

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.

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

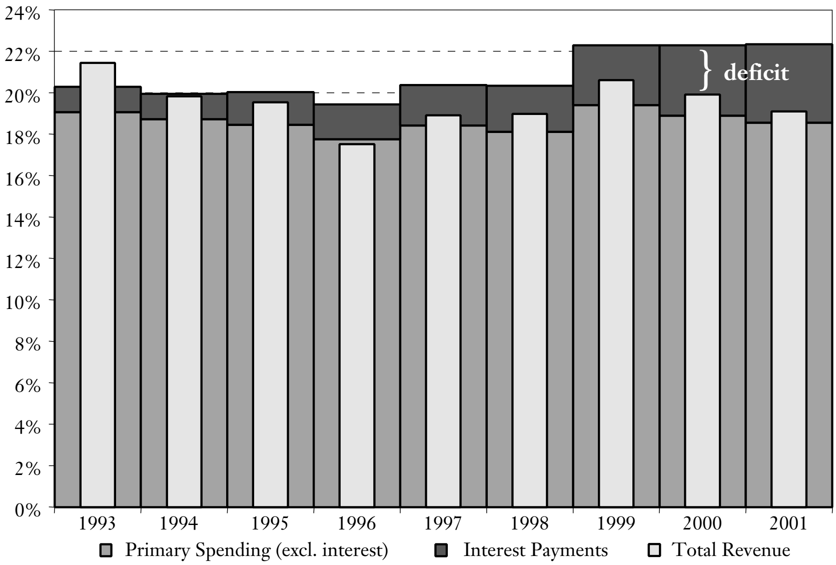
In a paper of January 2002,[4] Mark Weisbrot and Dean Baker, co-directors of the Washington-based Center for Economic and Policy Research, took a similar line as that of Stiglitz. They emphasise that Argentina got stuck in a debt spiral. According to them, Argentina's story is "the story of debt, inherited 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

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[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

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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.

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