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

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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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<sup>1</sup> 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.

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 govern-

ment 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 neo-liberal 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.<sup>2</sup>

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

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<sup>2</sup> 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.