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.

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

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

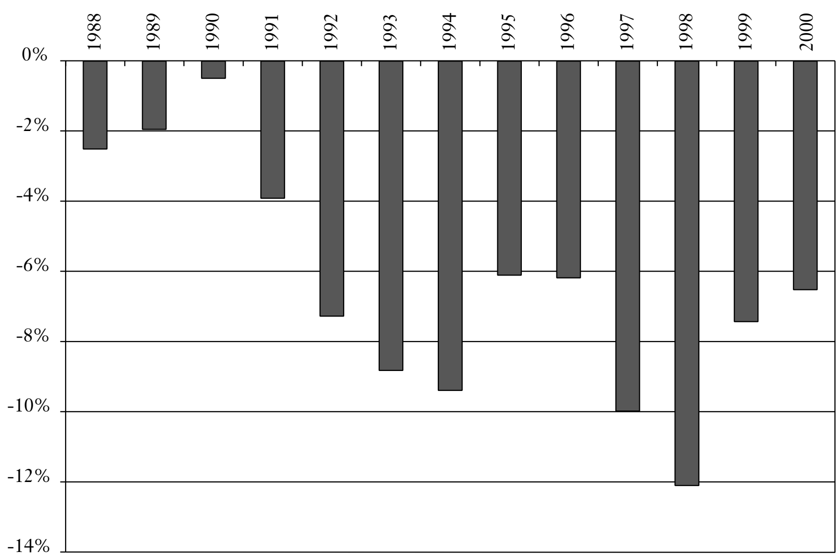
Nowadays, few would doubt that the surges of capital flows to Latin America were strongly associated with a "wave of optimism" and the buoyant liquidity of external markets: private capital was flowing abundantly to the so-called emerging economies, some of which (such as Brazil) were facing hyperinflation 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.

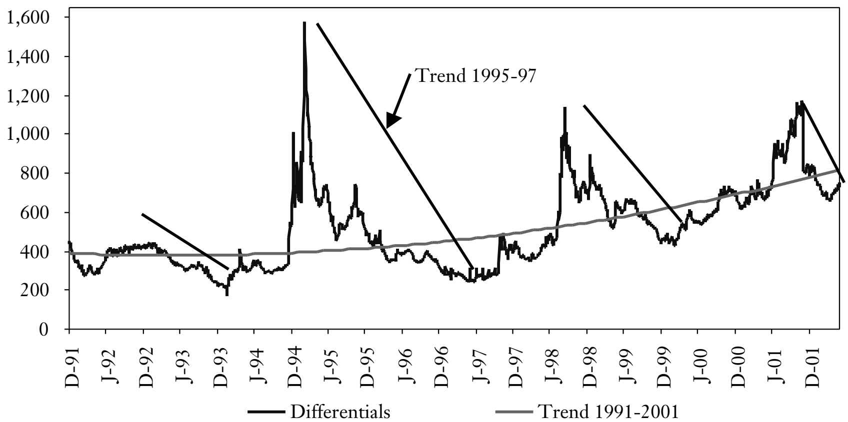
The build-up of external liabilities in the region was a disequilibrium process, which in principle should have set in motion at least two self-correcting forces. On the financial front, excess capital inflows should have led to increased liquidity in the host economy, which in a fixed currency regime 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.

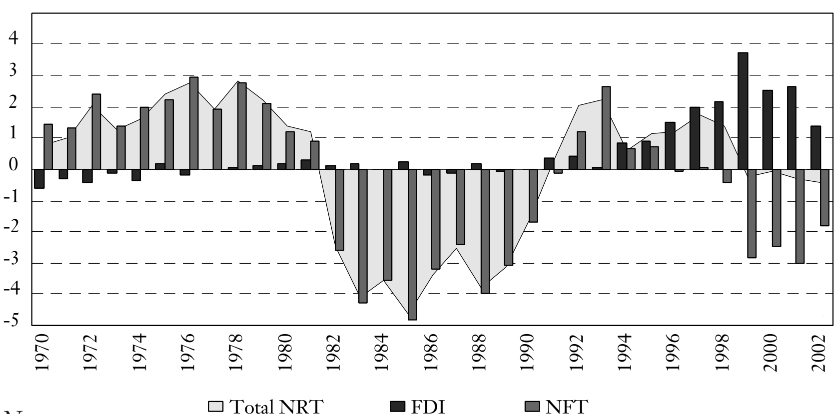
Figure 2 Latin America: Eurobond Differentials, 1992-2002
(Basis points over the yield of US ten-years Treasury bonds)



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.

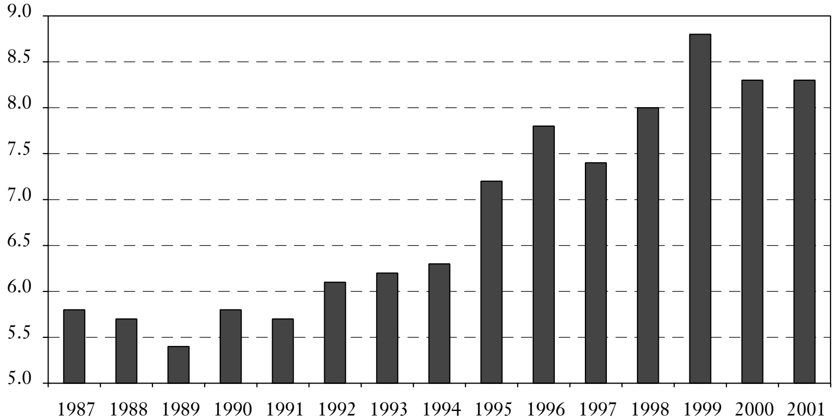
If self-correcting market forces were not in place, maybe policies could have changed the course of external vulnerability. An obvious option would have been to introduce policies to expand exports, to substitute imports and to attract more foreign "Greenfield" investment. But with each round of external 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

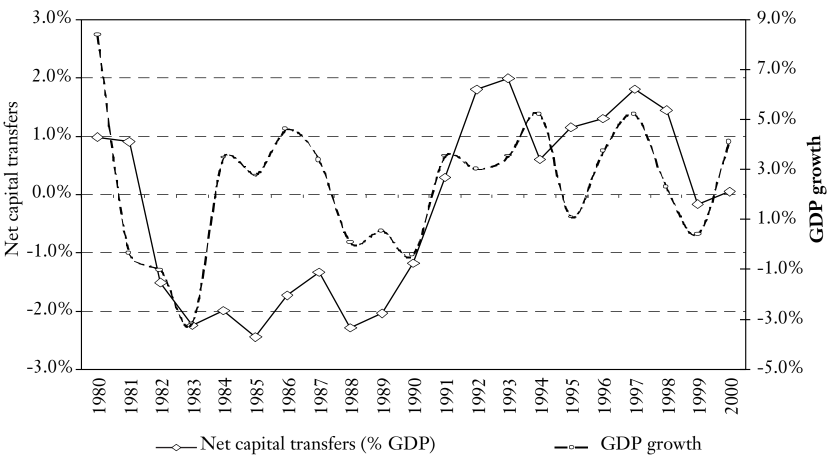
In the early 1990s, the "demands of the market" and the "demands of the domestic political forces" were generally convergent, since the policies required to improve foreign investment sentiment were in line with those required to achieve price stability. However, by the end of the 1990s, this situation 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).

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

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

---

[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.

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

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.

---

[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).

References

Barajas Estrada, A. and R. Steiner (2002), "Credit Stagnation in Latin America", IMF Working Paper No. 02/53, IMF, Washington D.C.

Dowers, K., F. Gomez-Acebo and P. Masci (2000), "Making Capital Markets Viable in Latin América", In: *Infrastructure and Financial Markets Review*, Vol. 6, No. 3, IMF, Washington D.C., December.

ECLAC (2002), *Estudio Económico*, *2001-2002*, ECLAC, Santiago de Chile.

Ffrench-Davis, R. (2000), *Reforming the Reforms in Latin America: Macroeconomics*, *Trade*, *Finance*, Macmillan/St. Anthony's College, London.

——— (ed.) (2001), *Financial Crises in 'Successful' Emerging Economies*, ECLAC/Brookings Institution, Washington D.C.

——— and J.A. Ocampo (2001), "The Globalization of Financial Volatility", In: R. Ffrench-Davis (ed.), *Financial Crises in 'Successful' Emerging Economies*, ECLAC/Brookings Institution, Washington D.C.

Fornari, F. and A. Levy (1999), "Global Liquidity in the 1990s: Geographical and Long-Run Determinants", BIS Conference Papers No. 8, 25-26 October.

Kregel, J. (2002), "The Argentine crisis", mimeo.

Obstfeld, Maurice (1986), "Floating Exchange Rates: Experience and Prospects", NBER Working Paper No. 792, Cambridge M.A.

Soros, G. (1998), *The Crisis of Global Capitalism: Open Society Endangered*, Public Affairs, New York.

Stallings, B. and R. Studart (2002), "Financial Regulation and Supervision in Emerging Markets: The Experience of Latin America since the Tequila Crisis", WIDER Discussion Paper No. 2002/45, UNU/WIDER, Helsinki.

Studart, R. (2002), "Integration among Uneven Partners: Financial Opening in Latin America in the 1990s", In: R. Fendt and M.A.T. Lins (eds.), *Asymmetric Architecture: Emerging Markets and the International Financial System*, Konrad-Adenauer Foundation, Sao Paulo.

Weller, J. (2001), *Economic Reforms*, *Growth and Unemployment: Labour Markets in Latin America and the Caribbean*, ECLAC, Santiago de Chile.

Williamson, J. (2002), "Is Brazil Next?", Policy Brief No. 02-7, Institute of International Economics, Washington D.C., May.