

## 12. The Recent Crisis – and Recovery – of the Argentine Economy: Some Elements and Background

**Arturo O’Connell**

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### INTRODUCTION

The Argentine crisis could be examined as one more crisis of the developing countries – admittedly a star pupil that had received praise from many sides – hit by the vagaries of the international financial markets and/or its own policy mistakes. To a great extent that is a line of argument that could provide some illumination. However, it could be even more interesting to examine the peculiarities of the Argentine experience – always in that general context – that have made it such an intractable case for normal medication. Not only would it be best to pin down those peculiarities and their consequences, but also it is necessary to understand that they were not just a result of the eccentricities of some people in some far-off Southern end of the world.

Finance, both external and domestic, is one essential part of the story. Argentina became one of the most highly liberalized financial systems in the world. Capital could freely flow in and out without even clear registration demands; big firms profited from such a system by being able to finance themselves – at cheaper financial costs – in the international market at the same time that wealthy families chose to hold a significant proportion of their liquid assets abroad. The domestic banking system was opened to foreign entry to the point of not requiring the habitual reciprocity with third countries and a large and increasing proportion of the operations became denominated in foreign currency. To build up confidence in the local currency a hard peg to the US dollar was instituted by law rather than by Executive Order and the Central Bank became a mere currency board issuing currency at the legally determined rate only against foreign exchange. But in spite of wholesale trade liberalization the economy remained very closed and the relatively reduced genuine foreign exchange revenues were derived from exports to South America and Europe, the currencies of which were undergoing wild oscillations *vis-à-vis* the US dollar. Those financial pecu-

liarities of the Argentine economy – and other aspects – have their roots in a previous experience of instability and high inflation but explain to a great extent what went wrong in the 1990s and the crisis of 2001–2002.

This chapter is organized in the following way. In the first section, an attempt is made at a thorough examination of the performance of the Argentine economy in the 1990s – and its background in the previous decades – and the development of some severe imbalances eventually leading to an unsustainable situation. In the next section, an explanation is provided of the interaction among those various imbalances also as intensified by the peculiarities of the Argentine economic-institutional setup. The final section, is a brief description of the major events since the crisis and the present-day recovery.

## THE PREVIOUS PERFORMANCE OF THE ARGENTINE ECONOMY AND THE RUN-UP TO THE EARLY 21ST CENTURY CRISIS

As it is well known Argentina had been a case of extremely successful development beginning at some time in the third quarter of the 19th century. But that happened not only in the pre-1930s period. Argentina continued to grow at quite a satisfactory rate up to the mid-1970s, admittedly at a lower pace than some similar countries so that it started losing its position in the world income per head leagues.<sup>2</sup>

The contrast with the last quarter-century could not be more striking; while income per head increased by about two-thirds in the previous 1950–1974 quarter, in 1975–1999 the increase was practically nil. That this period coincided with the first and second attempts at the ‘opening-up’ of the economy – the first one under military rule in the late 1970s and the second one in the 1990s – should not make us rush to conclusions about the relative successes of the previous import substitution strategy *vis-à-vis* ‘economic liberalization’, but at least it helps to set the record straight.

This last quarter of a century was not only characterized by stagnation but it was also a period of instability. As to instability in real terms, the period 1980–2002 witnessed five major crises, three in the 1980s, of which the worst one was the 1987–1990 one (GDP dropped 16.7 percent between the third quarter of 1987 and the first quarter of 1990), then the mid-1990s one – associated with the ‘tequila’ Mexican crisis – and finally the one starting in the second quarter of 1998 and bottoming in the first quarter of 2002 (an accumulated fall of 27.9 percent in GDP).

As to ‘non-real’ instability, it is enough to say that the rate of inflation went up from an average of 24 percent per year in 1950–1974 to 95 percent in the 1975–2000 period with a significant increase in variability. Of course,

the most dramatic years were those at the end of the 1980s and the beginning of the 1990s: three episodes of hyperinflation, two of which were under the Menem government and the other under the previous Alfonsín administration.<sup>3</sup>

Additionally, Argentina, starting in the mid-1970s, acquired a sizeable external debt while back in the early 1950s it had cleared almost all debt inherited from the pre-Second World War period on top of nationalizing all public utilities, so that there were no charges against the current account from this side. In contrast, over the 1974–2000 period total external debt increased more than 19 times and ended up being more than half of Gross National Income (GNI) instead of only 10 percent back in the mid-1970s.<sup>4</sup>

Another force that became permanent in that last quarter of the 20th century was a regressive income redistribution – the relation between the top and bottom deciles in the income pyramid shot up from 12.1 times in 1975 to 23.7 times in 1999. In addition, high unemployment of the labor force – both open and disguised – became a permanent feature of Argentine society (for a long time under the much-maligned ISI – import substituting industrialization – unemployment hovered around 6 percent), but it had reached 12.4 percent at the highest point of the cycle in the 1990s and it went up to 21.5 percent at the bottom of the early 21st century crisis in addition to a rate of underemployment of little less than that.<sup>5</sup>

Such was the long to medium-run background to the present-day Argentine crisis. The revolt of large sections of the population that exploded at the end of 2001 may be easily explained if one remembers that they had been used to a long period of growth, equality of incomes and full employment and were now experiencing stagnation, instability, unemployment and rising inequality in the last quarter of a century.

With those developments in the long run and the hyperinflation episodes as the immediate background, the last decade started in earnest with the implementation of a set of policy measures which Argentina carried further than almost any other country in the application of ‘market-friendly’ reforms. There was trade and financial opening-up, privatization of almost anything that used to belong to the State, all around deregulation and so on.

It might have been on account of those reforms that Argentina of the 1990s had widely been predicated as the success story of the decade among the so-called ‘emerging markets’. The country had become a showcase of the application of the internationally sanctioned policies. Transnational firms and investors rushed to place their funds, shops and factories in Argentina soothed by the advice coming from widely respected economists and more generally from people in high places. And the IMF continued to provide increasing financial support to Argentina until only a few months before the last crisis.

But besides those that were applied in many other countries, in Argentina some specific and peculiar reforms were introduced that went to a great extent to explain recent troubles. The crisis of the Argentine economy – spilling over into the socio-political system – has quite a few common elements with the crises that other ‘emerging market’ countries went through in the last decade, the 21st century crises as Mr Camdessus somewhat prematurely labeled them. But it owes also quite a great deal to some specific elements included in the Argentine package.

### **The Economic Reforms**

By the late 1980s, the public seemed to have had enough of the frustrations of run-down public utilities, chronic inflation turning into near hyperinflation and the bad quality and obsolescence of many consumer goods, all of which were ascribed to protectionism and, more generally, to excessive government intervention in economic life.<sup>6</sup>

The main elements that set Argentina somewhat apart from other emerging countries’ efforts to pursue a liberalization process were: i) the Currency Board system – starting in March 1991 and only rejected at the end of 2001 – under which the exchange rate with the US dollar was fixed by Congress and the local currency – pesos – could be issued almost only against the exchange of foreign currencies, meaning that the Central Bank could not possibly finance government deficits nor could it provide support to commercial banks confronting a liquidity squeeze; ii) a full bi-monetary system, placing on an equal status pesos and foreign currency (mainly the US dollar), the public being absolutely free to choose the currency of denomination of their transactions; iii) a fractional reserve banking system even for foreign currency denominated deposits with fully liberalized interest rates and income tax exemptions for interest on deposits; iv) the adoption – particularly after the ‘tequila’ crisis – of so-called Basel-plus regulations (with high liquidity requirements and capital ratios higher than those prescribed by the Basel I agreements) and full liberalization of the banking system, including the privatization of almost all the provincial government banks and the sale of a few of the medium to large institutions to foreign owners; v) total liberalization of capital movements – both financial and direct investment – without even registration requirements; vi) thorough privatization of state-owned firms including almost all public utilities – from the airline company to hydroelectricity generation to the Post Office – under extremely weak or almost non-existent regulatory systems with tariffs in some key services dollarized and indexed to the US cost of living index (in fact most sales – particularly the early ones – were inspired more by pressures to repay debt than guided by the idea of enhancing the efficiency of the economy); vii) elimination of almost any non-tariff barrier – but for the

case of the motor vehicle regime and sugar imports – and reduction of tariffs from an average of 45 percent at the beginning of the 1990s to something around 11 percent by 2000 as well as almost full liberalization of exchanges with Brazil and the rest of MERCOSUR countries; viii) adoption in 1994 of a mixed privatized pension system under which workers could choose to divert their contributions to private funds while all existing and immediately prospective pensioners remained dependent on the State system; ix) unresolved conflict with the provinces as to the distribution of revenues that are not the exclusive domain of the Federal government (only foreign trade taxes are the exclusive privilege of the Federal government under the constitution) as well as sharing the costs of ‘social expenditure’, the bulk of education and health expenses having been transferred to the provinces; x) a weak regulatory regime for competition that allowed an extraordinary concentration of market power and control of mass media; xi) a highly urbanized country almost devoid of an unemployment insurance system.

As we shall see, many of these factors that were unique to Argentina did have a great deal of influence on the performance of the Argentine economy, on unleashing the various crises – including the recent one – and the difficulties of sorting out the consequences of the ‘tango’ crisis of 2001–2002 (collapse in output, employment and incomes, widespread hunger, extreme devaluation, freeze on bank deposits, collapse of public finances, default on public and private debt and so on).

### **The Performance of the Argentine Economy in the Last Decade and the ‘Tango’ Crisis**

The following paragraphs review the performance of various aspects of the Argentine economy in the 1990s.

#### **Lagging and unstable performance of output and investment**

The rate of growth between 1987 and 1998 – from peak to peak of the cycle – was on average 3.2 percent. The overall performance of the economy over this period – associated with the imposition of ‘Washington Consensus’ reforms – was far from being exceptional even in the post-Second World War period.<sup>7</sup>

In fact the decade can be neatly divided between two phases of expansion interrupted briefly and mildly by the ‘tequila’ crisis. It ended in a recession, starting in 1998 – first protracted and touching only the real sphere – and then developing into true crisis proportions by the year 2001.<sup>8</sup> Under such a situation, resources were severely underutilized. For instance, unused capacity in the manufacturing industry rose to 41 percent of full capacity.<sup>9</sup> Simultaneously, investment collapsed dramatically, falling to only 10 percent of GDP.

**The decline of employment and the surge in unemployment**

By May 2002, open unemployment and underemployment of the labor force, as already mentioned, stood, respectively at 21.5 and 18.6 percent. It should be remembered that even under the hyperinflationary crisis of the late 1980s and early 1990s, open unemployment had been comfortably in the single-digit range (at its highest point, in May 1990, it had reached 8.6 percent).

An important fact to keep in mind is that the employment-unemployment situation had been deteriorating for quite some time. While in the 1980s the total employment rate had been stable, the beginning of the 1990s marked the start of a downward trend in employment levels. The gradual decline in the full employment rate of the previous years accelerated and went through two lows, the first one in 1996–1997 as a consequence of the ‘tequila’ crisis and the second, during the ‘tango’ early 21st century crisis.

What is striking is that even during the first expansion of the decade – 1990 to 1994 – total employment rates were declining. Part of this decline was due to an expansion in the activity rate, with a larger section of the population entering the labor force. But this increase in the labor force does not fully explain the behavior of employment rates (out of an increase of 2.5 percentage points in the unemployment rate, only 1.8 percentage points could be explained by the increase in activity rates). A better explanation hinges on both increases in productivity and the rising share of imports in total demand. In its turn, this surge in import desubstitution was a consequence of the lowering of trade barriers and the progressive overvaluation of the peso; this last factor will be discussed later in the chapter. The increase in productivity was also a consequence of the same factors that made capital goods cheaper relative to labor. A detailed sectoral examination of employment performance shows that the manufacturing sector was the laggard in the boom years and the sector that shed more jobs in the recession ones.<sup>10</sup>

**Price behavior; inflation inertia, stability and deflation**

Under the influence of such an accumulation of idle resources and a fall in output and sales, a true deflation started to dominate the goods markets by 1999.<sup>11</sup> If the influence of a fixed exchange rate had been decisive in the first few years of the 1990s in dominating inflation, by the year 2001 price stability – or better yet, decline – was a consequence of recession rather than of anything else.<sup>12</sup>

If in the 1990s an element of inflation remained in the system, it originated in the services sectors and most specifically in the public utilities. An index of tariffs of public utilities shows an increase in the life of ‘convertibility’ – from April 1991 to December 2001, of a full 57 percent more than goods prices. Privatization and ‘foreignization’ of public utilities had been easily accepted by public opinion at the beginning of the 1990s, but

had become a very contentious issue by the beginning of the present decade and one that impinged on the attitudes towards the readjustment of tariffs under devaluation and inflation after January 2002.

### **The overvaluation of the peso**

As already mentioned, at the end of March 1991, the Argentine government decided to fix the exchange rate to the US dollar at a 1:1 ratio under a law passed by Congress, making it more difficult to devalue than if it had only been fixed by the monetary authorities. It was part of the ‘Convertibility Program’, which additionally instituted a quasi-Currency Board, that is, the authority granted to the Central Bank to issue domestic currency only against foreign exchange.<sup>13</sup> No doubt it became a powerful instrument to bring down price increases from almost hyperinflationary rates.

The problem with the fixed exchange rate was, first, that at the moment of the enactment of the ‘convertibility law’, the real exchange rate was already overvalued for what had been the experience of Argentina in the second half of the 1980s.<sup>14</sup> Second, as the rate of inflation took some time to come down, the overvaluation was even greater in the following two years, the real exchange rate reaching its highest point early in 1993. From then on, as a consequence of inflation being lower in Argentina than in the United States or as already mentioned actually turning into deflation, the peso started to gradually devalue against the US dollar. This process however came to a stop in early 1997. After that a major customer for Argentine exports – Brazil – was forced to undergo a drastic devaluation of its new currency – the real – early in 1999. And many other developing countries – including China – as a consequence of the various financial crises had also devalued their currencies beginning with Mexico in 1995. Argentina and Hong Kong therefore remained almost the only two countries that maintained their exchange rates. In addition, the US dollar – to which the Argentine peso was ‘hard pegged’ – underwent a sizeable overvaluation against the other major currencies, which was most important for Argentina against the European currencies. It has been estimated that over the whole decade the real effective exchange rate of Argentina appreciated by around 40 percent.

The above estimates of the real exchange rate are based on historical comparisons. Many observers – mostly local – had argued that the overvaluation of the peso at the beginning of the 1990s was justified on the grounds of the boost in productivity and efficiency as a consequence of the victory against inflation and the ‘opening-up’ to foreign trade and investment. In fact, as our figures for employment and output have shown, there was a significant increase in productivity in those early years of ‘convertibility’. But if such a consideration is to be taken into account, it is for relative changes in productivity – *vis-à-vis* other competing countries – that the correction has to be introduced. In addition, the sustainability of the

current account, increasingly burdened by debt service, has to be factored in. Such a calculation would easily lead to an estimate of around 50 percent overvaluation of the peso relative to its equilibrium value as shown in a paper for the World Bank by Guillermo Perry and Luis Servén.<sup>15</sup>

The result of all this was to place an enormous burden of adjustment on the Argentine economy which had to be sorted out through a combination of deflation and recession, cushioned by renewed access to international finance in the 1996–1998 period. It would have to give way under the growing difficulties of obtaining finance in later years.

### **Declining real wages, exploding poverty and worsening income distribution**

As to real wages there was a mild recovery after the hyperinflation episodes at the turn of the decade in the early 1990s which lasted up to the third quarter of 1992 (+8.1 percent relative to the 1989 figure). It was followed by a gradual decline in the ‘formal’ economy and some spurts of recovery in the later years. It obviously was largely influenced by the behavior of unemployment and underemployment that we have mentioned. For the whole decade of the 1990s, however, the average real wage was 15 percent below that of the 1980s.<sup>16</sup>

The initial recovery in real wages plus the progressive overvaluation of the peso, caused manufacturing labor costs – measured in US dollars – to increase rapidly in the initial years of the decade. But under the influence of further increases in productivity, costs eventually did fall, mitigating the fall in the competitiveness of the industrial sector in spite of the fixed exchange rate. The increase in real wages – even if unemployment rates kept increasing – led to a decrease in poverty levels in the first few years of the 1990s.<sup>17</sup>

The odd question is that even in those more favorable years of the early 1990s, the proportion of the population below the food poverty line – whose income was not enough to buy a basket of basic foodstuffs – was already increasing. Moreover, after a mild decline during the post-‘tequila’ crisis recovery, it began to increase again.

To summarize, the performance of the Argentine economy in the 1990s, on the real side, led to an accumulation of idle resources resulting in a persistent deflation that had become a feature of the Argentine economy by the late 1990s. It was accompanied by overvaluation of the peso, a decline in real wages, a regressive income redistribution and a rapid increase in the number of people living below the poverty and food poverty lines.



### **Some Major Imbalances**

Besides the imbalances in the real sector of the economy – unused capacity and labor force unemployment – some serious disequilibria developed in other sectors of the economy. In the following sections the issues of external, fiscal and banking imbalances are taken up.

#### **The external imbalances**

The external imbalance became more than apparent much earlier in the 1990s. The current account deficit, already negative in 1992, had accumulated to US\$ 84.9 billion by 2000. At cyclical peaks in economic activity – in 1994 and 1998 – it reached 4 percent and 6 percent of GDP respectively. Additionally, those deficits can hardly be attributed to the public sector. The private sector was always in deficit, more precisely in the boom years of 1993–1994 and in 1998.<sup>18</sup>

In the 1992–2000 period the public nonfinancial sector and the central bank financed more than 50 percent of the deficit in the current account and more than 60 percent of the deficit in the current account plus the accumulation of international reserves. In fact, by acquiring debt and selling state property to foreign investors, the government financed a huge private sector deficit. But on top of financing the current account deficit and accumulation of foreign reserves, there was a significant private sector capital outflow. In fact, gross private capital outflows amounted to 40 percent of external financing requirements to which – net – the nonfinancial public sector provided 43 percent of the needs. Foreign direct investment was the other compensating item. A great deal of it was not greenfield investment but merely a change of ownership and fully a quarter of the total was the outcome of government privatization.

The external current account deficit was associated with extremely imbalanced foreign trade. As it happened all around Latin America, ‘opening up’ to foreign trade resulted in a faster increase in exports than that achieved in previous decades.<sup>19</sup> But the other side of the coin was an even faster increase in imports.<sup>20</sup> Perhaps it is true that at some distant date in the future, ‘opening up’ might lead to improvements in efficiency and leading to a surge in exports. The trouble is that financial markets do not look so far into the future; instead, they start getting nervous when year after year the country produces enormous trade deficits that are only redressed at the cost of recession.

In addition, Argentine exports continue to be dominated by those based on natural resource exploitation (up to two-thirds of the total) and most specifically – although oil and fisheries do matter now – on grains and meat. Geographically, Argentina’s exports destinations are quite diversified, the

European Union rather than the US being the second largest market after Brazil.<sup>21</sup>

It has to be kept in mind, however, that, in spite of the 'reform' efforts to lower trade barriers, Argentina continued to be an extremely closed economy, imports remaining well below 10 percent of GDP. Consequently, reduction of the current account deficit through import cuts would demand a highly amplified shrinkage of GDP. But, on the other hand, trade-wise, Argentina was and is quite immune to the world business cycle, specializing as it does in foodstuffs with low income elasticity and therefore able to remain insulated from the ups and downs of the world economy.<sup>22</sup>

However, Argentina had become much more vulnerable to capital flows. In fact, the whole 'model' became a 'debt-led' model rather than one following the concept of 'export-led' development, that is, opening up and other 'market-friendly' policies intended to establish the pattern successfully followed in other countries. As mentioned before, even in spite of sizeable direct investments in the country, the accumulation of current account deficits and gross private financial outflows led to a significant increase in foreign debt.<sup>23</sup> A much larger proportion of external debt than at the beginning of the 1990s was private – private debt increased from 14 to 37 percent of total foreign debt – and external debt became mainly bond debt rather than bank loans as had been the case in the 1980s. Both factors have made external debt much more intractable to renegotiate than in the early 1980s. The phenomenon of private external debt accumulation was similar to that experienced in the late 1970s; that is, under a liberalized system of capital movements and due to the asymmetries of the financial system, it was much cheaper for firms having access to international financial markets, to fund themselves abroad rather than in the domestic market which offered only short-run finance at extremely high interest rates (above 10 percent in real terms and going all the way up to 50 percent). Thus, foreign or large domestically owned firms were able to gain a competitive advantage over the rest.

The hidden side of the coin comes to the surface when devaluation of the local currency occurs and the local debtor is working in a non-tradable sector. With income denominated in pesos and debts denominated in what suddenly becomes expensive dollars, most firms become technically insolvent, as the increase in debt translated into local currency wipes away their entire net worth. But besides such balance sheet effects, honoring debt service obligations becomes an almost impossible task.

Nonfinancial sector external private debt was mainly concentrated in a handful of companies (three-quarters was owed by 59 companies); foreign-owned firms were responsible for 75 percent of the total and most specifically, the privatized public utilities held 39 percent of all external private debt.<sup>24</sup> The recent difficulties of honoring debt service obligations by

the private sector, therefore, is a highly concentrated phenomenon in terms of the number of firms and their position in the economy<sup>25</sup> and this time private debtors have had to bargain a restructuring of their foreign obligations on their own.<sup>26</sup>

As to the total external debt, the usual ratios to gauge its burden show a more than highly indebted country. External debt was almost four times goods exports and – at the 1:1 rate of exchange to the US dollar – more than 50 percent of GDP (after the devaluation the ratio between external debt and GDP may have jumped to almost 150 percent).<sup>27</sup>

And of course, in what used to be a totally liberalized – domestically and externally – financial market there is always the possibility of a run against the banks' holdings – deposits of about US\$ 83.9 billion at the end of year 2000 – 62 percent of which were denominated in foreign currencies.

Conditions for multiple equilibria and self-fulfilled runs against debt, the peso and the banks were by the end of the decade already well established and the country had become extremely vulnerable to the deteriorating conditions in international financial markets and most specifically in the 'emerging markets' section of it.

### **The fiscal imbalances**

A large section of analysts and commentators both inside and outside Argentina have pointed to fiscal imbalances as the reason for all the misfortunes of the country. It is important therefore to examine some data on the subject. First, the total Federal fiscal deficit was very small: on average, in the 1993–2001 period, it was only 1.3 percent of GDP. Second, there is a clear deterioration after 1998, when the size of the deficit rose under the impact of the joint action of recession on revenues and of higher interest rates on total expenditure. As to the last factor one may recollect that but for the year 1996 – still under the effects of the 'tequila' crisis – the country was in primary surplus throughout. Incidentally, the primary surplus net of the social security deficit would have reached well above three points of GDP in the last few years. The effect of pension 'reform' on fiscal deficits is discussed further below.<sup>28</sup>

Third, over the last 20 years, total public expenditure as a percentage of GDP in Argentina has increased only slightly; it was 29 percent of GDP in 1980 and it was 30 percent in 1997, the last year before the current recession. Beginning in 1998, consolidated public expenditure rose to 35 percent of GDP but out of this increase of five points almost three points went to pay for an augmented public debt service. So it is pretty difficult to argue that there has been fiscal profligacy and that this is 'the' reason behind the various crises.

Fourth, the deficit of the pension system – partially privatized – jumped from around 0.5 points of GDP in 1993–1994 to 5.6 points of GDP in 2000.

That was principally the consequence of the already mentioned fact that while the public pension system continued to be in charge of almost all pensioners, workers' contributions were to a large extent diverted to the private system.<sup>29</sup> In fact, in every year except 2001, the public pension system deficit was much larger than the Public Sector Borrowing Requirement (PSBR) and larger than the Public Sector Deficit.<sup>30</sup> Surely as advised by the IMF in 1994 – leading to a break-up with Minister Cavallo at that time – ‘pension reform’ would have demanded further fiscal adjustments and also funding the resulting net imbalance in the very long term. Of course many commentators and perhaps the Minister himself thought that they had a nice source of funding at hand although one much more expensive to resort to than just collecting pension contributions. But bearing in mind the incompleteness of markets for ‘emerging-market’ debts, most specifically for long-term paper, then bringing forward what was an implicit contract with future pensioners no doubt resulted in a larger debt burden.

Whatever its origin, the public deficit cumulated into a ballooning public debt.<sup>31</sup> By the end of 2000 it had reached 45 percent of GDP at current prices, admittedly not a large figure by European Union standards, for example.<sup>32</sup> But in spite of those low ratios, service on public debt – estimated for 2002 with no change in interest payments relative to 2001 – would have taken up more than half the gross revenue of the federal government and more than twice that revenue net of transfers to the pensions system, to subnational levels of government, autarchic agencies and the private sector: a true razor's edge.<sup>33</sup>

Additionally, as is true of external debt in general, the relation between public debt and GDP is very much dependent on the exchange rate. Under anything close to an equilibrium exchange rate – and as discussed previously, by 2001 this was quite far away from the 1:1 ratio – the innocuous-looking public debt to GDP ratio would increase to a much more threatening level, let alone under a devaluation like the one that the peso underwent in 2002.<sup>34</sup> Of course with a much larger debt ratio there is no conceivable primary surplus – even under optimistic assumptions about growth and interest rates – that would result in a situation of public debt sustainability.

On the other hand, it has to be kept in mind that having persisted with the Currency Board *cum* 1:1 exchange rate system, the deflationary adjustment that would have been necessary to achieve equilibrium in the external accounts would also have made it extremely difficult for public debt to be sustainable. Either way, with or without devaluation, debt had become unsustainable.

### **The banking imbalances**

In the 1990s decade, a strong process of financial development took place. With inflation and hyperinflation left behind and under renewed expansion,

liquidity in relation to GDP increased sharply. The degree of monetization was multiplied, although the level reached was still below the usual standards.<sup>35</sup>

The Argentine banking system, particularly after renewed efforts to strengthen it in the second half of the 1990s, was supposed to be among the best in the (developing) world.<sup>36</sup> Regulations were tightened after the ‘tequila’ crisis resulted in a bank run that – devoid of a full lender of last resort – demanded some external support, most specifically, from the international financial institutions. Capital requirements became much more stringent than those recommended under Basel standards. Liquidity demand was also very high and a privately managed limited deposit insurance company (SEDESA) was set up. At the same time, a contingent repo facility was established with a consortium of international banks which, later, was reinforced by World Bank support.<sup>37</sup>

In addition, a process of concentration and increased foreign bank participation – in a way an almost expected consequence of the 1995 crisis – received some active support from the authorities. The number of banks was drastically cut and the number of provincial and local authority-owned banks was reduced, mainly through privatization, by more than half. Moreover, some of the locally incorporated or cooperative banks were taken over by foreign banks so that out of 53 locally incorporated banks, 21 became foreign-owned.<sup>38</sup> In the aggregate, therefore, 39 banks, representing 73 percent of total bank assets, had become foreign-owned by the end of 2000.<sup>39</sup>

Foreign bank entry was supposed to help in the event of foreign shocks having an impact on the country. The experience of the most recent crisis – the ‘tango’ one – does not confirm such a hypothesis. Only to an extremely minor extent, and at a much later stage, have foreign-owned banks been ready to bring in additional capital or even to roll over debts with their main offices to compensate for a run on their deposits.

At first sight, therefore, the standing achieved by the Argentine banking system in the world league tables seemed to be justified. But, in addition to averages not applying to each and every institution, two worrying elements stand out under further examination. First, bank profitability was low and becoming negative for many sections of the industry. Second, the proportion of non-performing loans (NPLs) – in spite of many efforts to cover up the phenomenon – was shooting up.<sup>40</sup> An additional risk factor was the increasing proportion of bank assets being taken up by the public sector. That way, the banking system was becoming increasingly vulnerable to the growing fiscal difficulties of Argentina.<sup>41</sup>

Throughout this process, as mentioned above, the increase in liquidity was huge. Bank deposits doubled between 1994 and early 2001. There was a sudden and precipitated fall at the time of the ‘tequila’ crisis in early 1995 when total deposits fell 18 percent during a period of only five months (from

November 1994 to April 1995). After that brief, although serious episode, it was only in February 2001 that deposits, on the whole, started declining with the beginning of the first bank run of the early 21st century crisis. However, a gradually increasing proportion of deposits came to be dominated in foreign currency. In fact, peso-denominated deposits started falling – in absolute terms – at the time of the Russian crisis (July-August 1998).

On the other side of the balance sheets, loans peaked later in 1998; these were even more dollarized than deposits.<sup>42</sup> Dollarization of loans was another of the crucial imbalances in the banking system, that is, the hidden risk in bank portfolios arising from a potential devaluation of the peso in real terms. In such circumstances the ability of bank debtors – mainly those in non-tradable sectors – to honor their foreign currency-denominated debts would be at stake.

Again, on the other hand, resisting devaluation would hardly be of any help. Starting in 1999, under the deflationary and recessionary adjustments to which Argentina was subject in order to weather the various external shocks – mainly the increasing difficulty and costs of obtaining foreign finance – without abandoning the 1:1 exchange rate, the growing proportion of non-performing loans was a sign that a problem was already developing.

It is also important to emphasize that over the whole of the 1990s' decade interest rates remained high even under almost total exchange rate and price stability, in fact, as we have seen, beginning in 1999, under actual deflation.

## THE INTERPLAY OF THE IMBALANCES AND THE RECESSION; A GENERAL PATTERN AND THE ARGENTINE IDIOSYNCRACIES

Having identified the elements of the developing Argentine crisis, we can now begin to put the pieces together. In fact, the Argentinian case is not very different from what has happened in other 'emerging markets', although it might have been specifically influenced by some of the peculiarities of the situation.

### **A General Pattern of Boom and Bust Cycles**

In an environment of liberalized and significant international capital flows, the pattern followed in the 1990s by more than one country may be simplistically depicted as follows. There are two phases: the first one, that of the virtuous cycle and the second one, that of the vicious cycle, separated by some event or events that lifts the veil over the vulnerabilities building up during the first phase.<sup>43</sup>

During the first phase, driven mainly by events in international markets – although also influenced by a shift to ‘market-friendly’ policies in the developing countries – private capital starts flowing to these faraway lands. Those inflows simultaneously add to demand and provide the wherewithal – in terms of foreign currency – to finance the ensuing economic expansion. In an environment of growth, government revenues increase and price stability is achieved with more ease, most specifically as the increased availability of foreign finance tends to depress – viewed from the pesos per foreign currency ratio – the exchange rate, a crucial element of price pressures in those economies. The virtuous cycle is instituted.

But at the same time, some fragilities begin to build up. The abundant foreign exchange and overvalued exchange rate – associated with a more programmatic attitude in favor of trade liberalization – leads to cheaper and surging imports. Foreign obligations rise as lagging exports and soaring imports create a current account deficit. International interest rates, low relative to domestic rates, encourage firms to fund themselves in the international market. Additionally, local investors profit from the liberalization of capital movements and the cheap foreign exchange to diversify their portfolios and place a significant portion of it in foreign markets (the so-called ‘capital flight’). Employment tends to lag behind output as substitution of capital goods for labor takes place; imported machinery becoming cheaper in terms of local wages and easy to finance. After some time, the country in question finds itself running a large current account deficit and having accumulated a sizeable external debt the service of which requires a growing proportion of its normal foreign exchange earnings. Still, the international market keeps refinancing maturities so that not even interest has to be fully repaid. A typical situation of ‘multiple equilibria’ develops under which a self-fulfilling run against a country might take place.

As the build-up of these fragilities proceeds, at some point in time some event in international markets – ‘news’ – or their sheer accumulation lead both international and local agents to start losing trust in the sustainability of the process. For some authors like Calvo or Sachs, international markets, unrelated to the ‘fundamentals’ of any of the ‘emerging markets’, go through a ‘sudden stop’ (Calvo’s term). Alternatively, there might be some ‘contagion’ from crises in third countries hitting one that was up until the last minute accumulating some vulnerabilities but still rated ‘investment grade’ or at least acceptable by the markets.

Thus, we see the beginning of the vicious cycle begins. The ‘rationing’ of capital flows and/or the increase in ‘country risk’ spreads results in less growth and declining government revenues. Higher interest rates and lower growth rates determine a reduced debt sustainability requiring – at high levels of indebtedness – larger and larger primary and/or trade surpluses, to

avoid an explosive increase in, respectively, public or external debt ratios to GDP. Reduced debt sustainability calculations lead to further rationing and higher interest rates. The country is forced to undergo a drastic macroeconomic adjustment. The crisis has set in.

This pattern is intimately connected with some specific characteristics of international markets and the insertion of developing countries in them. But it is also associated with the highly liberalized environment within which capital movements have been operating, again in the last decade. The issues are well known and part of a cyclical debate about the international financial architecture, although elements of the asymmetries dominating the relations between ‘center’ and ‘periphery’ hardly get enough attention.

A pattern of boom and bust in international financial flows has been a feature of those markets for at least two centuries. Minimal adjustments in portfolios in industrialized countries result in differences in net flows that, relative to the size of the ‘emerging market’ economies, are decisive. Additionally, since the breakdown of the Bretton Woods arrangements, the major currencies have been fluctuating wildly, forcing adjustments, again of substantial weight, on developing countries totally unrelated to their own behavior.

Financial markets also tend to be myopic in their attitude to long-term finance so that firms in developing countries have serious difficulty in funding their expansion. Local markets, with transactions denominated in local currencies, only fund very short-run liabilities. A double mismatch, therefore, tends to develop, that is, a maturity mismatch between the need for long-term funding and the lack of such finance in local currency and/or a currency mismatch – particularly serious for the non-tradable sector firms – between revenues in local currency and indebtedness in foreign currency.

### **The Specifics of the Argentine Case**

Following this general pattern, Argentina added some specific elements of its own. First, the ‘hard-peg’ of the peso required all the adjustment effort to be placed on deflation, which, in its turn, under normal contemporary market circumstances, would have resulted in a recession even if markets had shown some downward price-wage flexibility. As we have just analyzed, recession only compounds the problems that lead to the crisis. A more flexible exchange rate system might have allowed a milder adjustment with an earlier real exchange rate devaluation and a lesser need for a cut in domestic absorption. The fact that the ‘hard-peg’ was implemented *vis-à-vis* the US dollar imposed additional problems. First, the US does not have the same trade shocks as Argentina does, nor is it an important customer for Argentina’s exports. Second, the significant overvaluation of the dollar *vis-*



*à-vis* other major currencies in the last few years contributed to make the difficulties arising out of the rigid exchange rate system even more serious.

The second specifically Argentinian element was the bi-monetary system under which a high proportion of assets and liabilities, even those held by local residents, were dollarized. Such a circumstance, although explainable in terms of the monetary and banking history of Argentina, stood in the way of a shift to a more flexible exchange rate system.

Third, banks were allowed to function under a fractional reserve system even for the dollarized section of their business. The country that, as a consequence of the Currency Board, already lacked a lender of last resort in pesos had only partial – although admittedly pretty high – resources to stand a run against dollar-denominated deposits. The idea that foreign banks would provide such a safety net did not, as we have seen, reflect the realities of the situation. This was not to speak of the widely accepted official line that the Currency Board provided full backing for pesos in circulation and that the public, if willing, would be provided with US dollars on demand, something that was only true for the monetary base leaving the fractional reserve banking system caught in the middle. This misleading information had been responsible for a high degree of deposit stability despite minor crises.

Those are the more basic Argentine ingredients of the contradictions, in fact, revolving around a conflict between an exchange rate arrangement that would have been reasonable from a trade-real-side-of-the-economy point of view – surely one with some degree of flexibility and geared to other countries' currencies – and another one that could square with financial transactions habits – a preference for US dollars – that had been fed by years of inflation, currency crises and bank problems sorted out by shifting the burden of adjustment unto deposits held in local institutions and denominated in local currency.

To those elements, one could add factors like the pension reform and other measures in this area or the fire-sale prices at which public utilities were privatized that left the public sector without sizeable amounts of badly needed finance and the practice of entering into contracts involving tariff dollarization and even adjustment for the US cost of living. Unresolved conflicts between the Federal and Provincial jurisdictions about sharing taxes added their own complications.

## THE CRISIS AND THE RECOVERY

The crisis that had begun in 1998 and that was at first restricted to the real sphere was full-blown by year 2001. Bank deposits fell 28 percent between February and November that year. International reserves that had been grow-

until the end of 2000, dropped to US\$ 10.4 billion or 42 percent over the 11-month period to November 2001. Country risk – as measured by the EMBI+ – that still stood at 534 points in March 2000 and had reached only 766 points by the end of 2000 began to shoot up and by the end of November 2001 had reached 3.340 points.

Several important attempts had been made before to avert the crisis by operating on the fiscal and foreign exchange imbalances as well as on the accumulation of public debt. The results were disappointing. Recession only became deeper, capital flight worsened and debt restructuring plus massive finance from international financial institutions merely partially postponed the need for a significant ‘haircut’.<sup>44</sup> In the end, in November 2001, domestic investors – mainly banks and pension funds – had to accept an exchange of government bonds for ‘guaranteed loans’ carrying a lower interest rate.<sup>45</sup> Eventually, faced with the run against both banks and the currency, the government on the first working day in December 2001 chose to introduce a partial bank deposit freeze – the so-called ‘corralito’ – and exchange controls. It was followed by the downfall of the President, a succession of provisional governments and, early in 2002, default on public debt and the devaluation of the peso.

The consequences were as expected but would defeat the prophets of doom, the IMF and the establishment economists among them. The end of the ‘hard peg’ and an IMF-imposed floating of the exchange rate led to a typical overshooting under which devaluation at some point reached 300 percent, only to fall later to about 190 percent.<sup>46</sup> Recession, a near-freeze of wages and of public utility tariffs and some social discipline acquired in a decade of no inflation allowed prices to increase only slightly. Most of the increase in prices took place in the first half of 2003, after which the rate of inflation dropped to about 3 percent per annum over 2003.<sup>47</sup>

The impact of devaluation – and the run on deposits – on the financial sector was at first nothing less than catastrophic. With the high degree of ‘dollarization’ the only sensible course of action would have been to convert into pesos all assets and liabilities at the previous 1:1 rate. On the contrary, in his inaugural speech the President – who would remain in office till May 2003 – announced that deposits denominated in foreign currency would be returned in the original denomination. But a few days afterwards after some hesitation all bank credits – including the ‘guaranteed loans’ – were converted into pesos at the 1:1 rate, although indexed by the CPI. These two decisions resulted in huge losses to banks that had to be compensated by the government, which resorted to the issue of new debt, in addition to that already in default, although service on this new debt has been punctually honored.<sup>48</sup>

Even under the partial freeze, banks continued to lose deposits up to mid-2002. A reformed Central Bank, having regained the legal authority to issue

currency and therefore able to act as lender of last resort, provided rediscounting up to an amount close to the entire net worth of the banking system, although individual bank situations differed. But bank deposits – in spite of all the dire predictions that the public would never again trust the system – resumed and continued to increase beginning in August 2002. In fact, liquidity of the banking system attained an all-time high in the same month and interest rates reached low levels by the beginning of 2004.<sup>49</sup> Net lending started to increase in mid-2003 and an arrangement was struck by which banks, having received funds through rediscounting from the Central Bank would return them *pari passu* with service on their loans to government (a transaction known as ‘matching’).

Capital flight continued to be severe in 2002 but started to subside in 2003, resulting in an initial significant reduction in international reserves, later compensated by surpluses in the balance of trade. Payments to IFIs have also had a substantial impact on reserves as the Argentine government has tried to avoid defaulting on these obligations.<sup>50</sup>

Private sector external debt is also in default to a great extent, as most firms, even those in tradable sectors, have found it impossible to honor their service. But the government – as mentioned before – refused to provide any scheme to support the firms involved, which were mainly big foreign-owned firms and privatized public utilities. Restructuring negotiations with their creditors, however, are well under way and have already been successful in a few major cases.

The government itself has put forward a proposal to subject its own debt in default – slightly below half of its debt as the rest is being punctually serviced – to a 75 percent ‘haircut’.<sup>51</sup> Another bone of contention is the matter of public utility rates’ adjustment that has been only very partially authorized in the face of massive opposition by the public.<sup>52</sup>

Of course, the impact of devaluation on the balance of payments has been decisive with a positive current account reaching at some point more than 10 percent of GDP, although mainly as a consequence of a drastic fall in imports – that are nevertheless quickly recovering – than an expansion of exports, that anyway is also taking place.

In the meantime, the favorable impact of the devaluation on output and employment has taken hold. From the bottom reached in the first quarter of 2002, GDP – at constant prices – increased by about 25 percent by the first quarter of 2004 and should by now be less than 10 percent below the highest level reached in the second quarter of 1998. Employment is also increasing at a fast pace, at about the same rate as GDP, resulting in a significant lowering of unemployment and poverty levels.

Although there is no dearth of problems inherited from the crisis to be sorted out, mainly through the device of devaluation and the imposition of exchange controls as well as the demand for a significant ‘haircut’ in external

debt, the Argentine economy looks like it has overcome the worst of the crisis and has entered into quite a reasonable growth path.

## NOTES

1. A first version of this paper was presented at the ERC/METU International Conference in Economics at Ankara, Turkey, in September 2002. I remain sincerely grateful for the invitation to that conference and most specifically to Erinç Yeldan and colleagues of the IDEAS group. The author is presently a Member of the Board of Governors of the Central Bank of the Argentine Republic. Under no circumstances should opinions in this paper be construed as representing the official stance of the Central Bank or of the Argentine government.
2. Among 39 selected counties in the world – almost all those with high incomes per head – Argentina stood in 10th place right before the First World War, in 13th place right after the Second World War and still in 20th place in 1974. At that time only Venezuela – an oil exporting country basking in the consequences of the first oil price shock – was ahead of Argentina among the developing countries. Source: Author's calculations on the basis of estimates provided by Maddison, A. 'Monitoring the World Economy, 1880–1992'; Development Center Studies; OECD; Paris, 1995.
3. The monthly rate of growth of prices – as measured by the producer's price index (PPI) – reached 96 percent over the second quarter of 1989 and again 73 percent and 15 percent in the first quarters of 1990 and 1991. Macroeconomic figures, unless explicitly mentioned, are drawn from the website of the Ministry of the Economy or from the Macroeconomic Indicators published by the Buenos Aires office of the United Nations Economic Commission for Latin America and the Caribbean.
4. In 1950, debt and FDI service took up less than 1 percent of exports. See Ministerio de Finanzas de la Nación, BCRA, 'La evolución del balance de pagos de la Rep. Argentina'; Buenos Aires, 1952 (BT:Economía 2718). For more recent figures, see the World Bank 'Global Development Finance,' 2003 CD edition.
5. The figures on income distribution originate in the Household Survey data of the National Institute of Statistics (INDEC).
6. The dark sides of an early attempt at 'liberalization' – under military rule – in the late 1970s and early 1980s were almost forgotten and the public at large wholeheartedly embraced a totally distorted and exaggerated version of a dogma that has gone down in a shorthand expression as the 'Washington Consensus'.
7. Admittedly, it was better than that of the crisis years of the late 1970s and the lost decade of the 1980s, but lower than the 3.3 percent and 4.4 percent per year, respectively, for the 1950s and the 'long' 1960s (up to 1974).
8. The rate of recovery and growth in the period between 1990 Q1 and 1994 Q4 was 9 percent per year out of which 6 points could be explained by recovery from the earlier crisis while the rest was true growth; that from 1995 Q3 to 1998 Q2 was 8.2 percent per year. The end of the decade recession in fact started in the second quarter of 1998 and by early 2002 had accumulated a decline of almost 28 percent of GDP and lasted almost 4 years (compare this crisis both in magnitude and length with the previous ones in the last 20 years; even the 'tequila' crisis of 1995 was a minor event; it lasted only 3 quarters and the accumulated fall in GDP was 7.2 percent).
9. See FIEL Indicadores 'Utilización de la capacidad instalada' as found in Cuadro A1.23 in Rep. Argentina, Ministerio de Economía, Indicadores Económicos, agosto de 2002.
10. For a full treatment of these issues see the seminal paper by Frenkel, R. y M. Gonzalez Rozada 'Liberalización del balance de pagos; Efectos sobre el crecimiento, el empleo y los ingresos en Argentina'; CEDES, Buenos Aires, 1999, from which I have derived inspiration for these paragraphs on the employment-unemployment situation. The trend in labor productivity growth in manufacturing industry – between 1990 and 1996 – could explain an employment contraction of 25 percent; it was less than that due to the expansion in demand. In its turn the expansion in demand for domestic output was less

than the overall expansion in demand – over the same period – as a consequence of the increase in imports; the authors estimate that more than half the increase in demand was eaten up by this factor.

11. Goods prices in the consumer price index had dropped 8.6 percent by December 2001, relative to their peak in September 1998. And producer's prices also declined persistently in about the same proportion beginning in the second half of 1997.
12. Such an argument would be validated again in the year 2002 when a devaluation that peaked at 284 percent – at the end of the first half of the year – but had subsided to an increase of 187 percent by March 2003, resulted in an inflation over those 15 months of 'only' 73 percent and 120 percent, as measured, respectively, by the CPI and the PPI.
13. I use the term quasi-Currency Board because there was some leeway built into the 'Convertibility Law' by which a portion of the currency could be issued against Government debt denominated in foreign currencies.
14. Leaving aside the years of huge devaluations at the end of the 1980s' decade, the real exchange rate against the US dollar stood, at the moment of enactment of 'convertibility', 14 percent above the average for the second half of 1986 year, a moment widely acknowledged to be one of a reasonable real exchange rate (as measured by the JPMorgan real broad effective exchange rate calculations).
15. The paper by G. Perry and L. Servén helps to make an attempt at better gauging the overvaluation of the peso and its components. To begin with, their estimate of the accumulated appreciation of the peso – as measured by an index of the real effective exchange rate – the period 1990–2001 is 75 percent. Introducing corrections for relative changes in productivity and the demands for debt service, their estimate of deviation from equilibrium reaches 55 percent by year 2001. See their 'The Anatomy of a Multiple Crisis; Why was Argentina special and what can we learn from it;' May 10, 2002 version. In a further examination of the question these same authors reach the conclusion that the strong United States dollar could easily account for half the overvaluation of the peso hard-pegged to that currency and that devaluation of the Brazilian real added some 14 points to the 55 percent overvaluation in 2001.
16. With the unleashing of the 'tango' crisis of 2002, real wages in manufacturing had dropped – by March 2002 – 21 percent relative to the December 2001 level. Household survey data show a decline between October 2001 and May 2002 of 22.2 percent, with the 'black economy' earners being 28 percent worse.
17. Later on a strong increasing trend in poverty levels predominated, reaching 40 percent of the population by May 2002.
18. On average – in the 1992–2000 period – the current account deficit was 3.6 percent of GDP while the government deficit was only 1 percent of GDP. Moreover, while in 1994 at the first peak in economic activity of the decade, interest payments and profit remittances were only a third of the current account deficit by 1998, those net outflows had become more than half of that deficit, surely making its correction more intractable. Recession and devaluations would leave that part of the deficit invariant differently to what could have been the case with trade in goods or real services. Most synthetically, the net transfer of resources originated in both the private and public sectors – equal to the deficit on goods and real services – was a net result of a positive transfer by the public sector and a negative transfer by the private sector. In the 1993–2001 period, a positive transfer of resources with the rest of the world – on average – of 1.4 percent of GDP was the result of a +2.8 percent and a –1.4 percent of GDP transfer of resources, respectively, by the public and the private sector.
19. In the case of Argentina, a slight progress in the share of world imports may be detected but always as a consequence of the integration in the MERCOSUR customs union. And unfortunately, the only area where there is no increase in participation in world imports is high-technology manufacturing.
20. In the case of Argentina, an average annual rate of growth of exports of 7.8 percent in the 1990–2000 period was counterbalanced by an average increase of imports of 19.7 percent per year.
21. The composition of Argentina's foreign trade has several important consequences. First, the country is subject to some extreme forms of protectionism against its exports as a result

- of its specialization in temperate-zone food products, so that there is a ceiling in terms of quantities and prices to expansion along such well-established lines. Second, the large concentration of exports in its own region characterized by a more dynamic group of products more than justifies the building-up of a network of preferential agreements, most notably that of the MERCOSUR customs union. Third, the inconsistency between, on the one hand, the slim geographic orientation of its exports toward the United States, making it unadvisable – in a world of floating exchange rates – to peg the peso to the US dollar and, on the other, the preference of the population for this currency as the main one in terms of store of value and denomination of all major transactions (for instance, real estate transactions that for decades have been denominated in US dollars).
22. Additionally, the country, having become a minor oil exporter, is much less vulnerable than, say, Brazil and Chile in the Southern Cone of South America to the instability and periodic surges in world oil prices.
  23. In the 1992–2000 period the accumulated current account deficit and the gross capital outflows were, respectively, US\$ 84.9 billion and 70.5 billion; external debt – over the same period – went up from US\$ 62.2 billion to 146.2 billion.
  24. See Rep. Argentina, Min. Economía ‘External Obligations of the Private Non-Financial Sector; 1991–1998’; Tables 5 and 6.
  25. It should be remembered that a majority of the privatization contracts for public utilities had prescribed ‘dollarized’ tariffs (additionally indexed by the cost of living in the United States). Under a huge devaluation like the one experienced over 2002, such clauses have become impossible to implement because of the impact such an increase of utilities’ rates could have had on the population at large. Risk avoidance leads to the writing of contracts that become unenforceable precisely in the circumstances when the risk materializes.
  26. In the 1980s, in Argentina, the problem of a sudden increase in indebtedness – as a consequence of devaluation – was sorted out through a system of exchange rate insurance that resulted in a large subsidy from the government that placed an enormous burden on the budget. As a consequence of the precarious state of public finances – also under the impact of devaluation on its own debt – and the criticisms that had been leveled against the 1980s’ scheme, no support from the government has come forward this time.
  27. The sum of short-term debt – that entered into at less than 12 months’ maturity – plus amortization of medium to long-term debt and interest on all external debt, in the last few years before the devaluation, used to represent about twice a normal year goods exports. The country therefore was under the need to obtain finance for the current account deficit plus renewal of maturing debt of enormous amounts. Additionally, profit remittances on foreign direct investment were growing fast with a total stock of FDI – by the end of 2000 – of US\$ 72.9 billion. Out of a total of US\$ 71.9 billion of gross inflows of FDI – in the 1992–2000 period – US\$ 42 billion was just change of hands, that is, did not involve new plant and equipment. On the whole what is labeled as the international investment position of Argentina – investments abroad less debts and investment by foreigners in the country – shifted from – US\$ 8.6 million to – US\$ 90 million in the 1991–2001 period (but the private sector accumulated direct, portfolio and other investments abroad for about US\$ 58 million). See Rep. Argentina, Min. Economía, ‘La Posición de Inversión Internacional de Argentina a fines del año 2001’; 31 de julio de 2002.
  28. In the already mentioned paper by Perry and Servén an effort is made to correct the actual fiscal figures for the effect of recession and the rise in interest rates in the last three–to–four years. As to the first factor, their conclusion – and that in a paper by Blanchard that is quoted by them – is that there was a significant impact of recession and that correcting for this factor the period after 1998 looks like one when the structural overall budget balance did not deteriorate; to the contrary some improvement may be detected (but over the boom period of 1996–1998 there certainly was some deterioration criticized as unnecessary laxity). The problem was that the improvement in the structural fiscal balance was not enough to compensate for the increase in interest payments. Interest payments increased from 1.6 to 1.7 percent in 1995–1996 – prior to the Asian crisis – to 3.4 and 3.8 percent of GDP, respectively, in years 2002 and 2001. They ended up being 20 percent of government current revenues. Perry and Servén estimate that out of the close to two

- points of GDP of increase in interest payments – between 1996 and 2000 – 1 full point was just a consequence of the rise in interest rates.
29. From 1994 to 1996 social security contributions to the State system went down from approximately US\$ 11.5 million to US\$ 9.5 million. Additionally, with the purpose of defending the fixed 1:1 exchange rate to the US dollar, in a policy of partially redressing the lost competitiveness, firms' contributions to the pension system that were collected by the public sector system – even those in the non-tradable sector like the public utilities – were cut, resulting in an augmented negative impact on fiscal resources.
  30. It is true that pension reform merely precipitated what would anyway have been a future drain on public finances. But that is precisely the point: a future need for more finance was forced to be tapped immediately in the international and domestic markets and thus, it might have alerted market agents to an imbalance that had been hidden up to that moment, as is still the case in many advanced countries.
  31. Public debt grew from US\$ 97 billion to US\$ 128 billion and US\$ 141 billion pesos, respectively, at the end of 2000 and that of 2001.
  32. Of that total, however, only 4 percent was denominated in local currency. On the other hand, by the end of year 2000, success had been achieved in reducing the proportion of short-term debt to only a few percentage points of the total, contrary, for instance, to the situation in other 'emerging market' economies.
  33. And, also, examination of debt sustainability at those levels of public debt to GDP – the minimum ratio in the primary surplus to GDP necessary for public debt not to grow more than GDP – would result in the need, in the last few years for an almost unimaginable increase in the surplus actually achieved of 2.5 to 3 points of GDP. Such a result can be derived from the habitual equation that multiplies the difference between projected growth and interest rates by the proportion of debt to GDP, the crucial assumption – besides the high rates of interest being paid by the Argentine government – would be the one about the expected growth rate which was actually negative in the three last years before the final crisis.
  34. If an exercise at valuating debt ratios after devaluation – but still at the exchange rate of about 2.90 for each US dollar the average rate by the end of 2003 – is undertaken, public debt could be estimated to have reached 140 percent of GDP and external debt 164 percent of GDP.
  35. The M3 to GDP ratio increased from 5.4 percent in 1990 to 29.9 percent in 2000.
  36. By 1998, following the CAMELOT rating system applied by the World Bank to evaluate banking systems around the world (developing countries only), Argentina stood in second place, right behind Singapore and ahead, for instance, of Chile in the region. The CAMELOT index combines rankings for different elements: (C) for capital requirements; (A) for loan-loss provisioning and definition of non-performing loans; (M) for management as measured by high-quality foreign bank presence; (L) liquidity; (O) for operating environment as measured by definition and enforcement of property and creditor rights and (T) for transparency as measured by banks being rated by international agencies and by an index of corruption. See the World Bank 'Argentina: Financial Sector Review'; Report 17864-AR; September 28, 1998.
  37. A minimum capital requirement of 11.5 percent of risk-weighted private sector assets was introduced. During 2000 it was complemented with positive weights for government loans and an obligation to mark-to-market government bonds. Supervision was organized around an enhanced CAMEL system under the BASIC program. Among other things, banks were forced to issue subordinated debt so as to introduce more market discipline in their behavior and large banks had to get annual ratings from an international agency. As to liquidity, deposits with maturities of less than 90 days had a 20 percent reserve to which the repo international line was added providing an overall liquidity coverage of around 30 percent (the fall in deposits under the 'tequila' crisis, as we shall see, had been less than 20 percent).
  38. At the end of 1994, out of a total of 82 locally incorporated banks, only 13 had been foreign owned.
  39. See Table 1 in De la Torre, A., E. Levy Yeyati and S.L. Schmukler 'Argentina's Financial Crisis: Floating Money, Sinking Banking', June 3, 2002. The impact of concentration and

transfer to foreign ownership has been much debated. One of the elements in the debate – apparently of relevance for the whole of Latin America – is its impact on lending to small and medium-sized firms. The evidence is not fully conclusive but on the whole this sector of firms – of great weight in all our economies especially in terms of employment – seem to have been mostly cut off from access to credit. An additional reason for such a development in the case of Argentina was that excluded – partially or fully – from the international market, big firms resorted to the domestic banking system that received them with open arms. In this way large firms crowded out small firms in the last few years. Concentration of bank lending, however, cut across different forms of ownership. Only cooperatively organized banks show a significant lower degree of concentration of their loan portfolios.

40. Between 1997 and 2001, NPLs increased from 8.2 percent to 12.2 percent of total loans. There were large differences among banks on the two grounds of profitability and NPLs. On the one hand, large private banks were much more profitable and, on the other, government owned banks were showing much larger proportions of NPLs. See, for instance, Dujovne, N. and P. Guidotti 'El sistema financiero argentino y su regulación prudencial'; mayo de 2001.
41. Regulations had some influence on this because only late in the day – as mentioned above only by 2000 – some non-zero risk weight was attached to government loans and government bonds were supposed to be marked-to-market. In an already quoted paper by Dujovne and Guidotti, some stress tests were imagined to examine the impact of a fall in government bond prices. The conclusion was drawn that on the whole the system would resist no more than a fall of 37 percent in those prices but foreign-owned banks would resist a drop of only 27 percent.
42. The credit crunch that started in 1998 may not have been independent of the implementation of the severe regulatory environment. The experience of even the United States but especially of many developing countries trying – for the sake of winning the goodwill of international financial markets – to adopt Basel rules on capital requirements and even exceeding them, is that it results in an all-round credit restriction. For quite a conclusive examination of this case see 'The Macroeconomic Impact of Bank Capital Requirements in Emerging Economies: Past Evidence to Assess the Future' by Maria Concetta Chiuri, Giovanni Ferri and Giovanni Majnoni; the World Bank and University of Bari (Italy), May 2001.
43. Such a pattern was also part of the experience of the Southern Cone economies in the late 1970s; moreover it has been a pattern endlessly repeated over, at least, more than 180 years of independent life of the Southern American republics and other parts of the world (Turkey, for instance). See, for instance, Suter, Christian 'Debt Cycles in the World Economy'; Westview Press, 1992 or Pettis, M. 'The Volatility Machine'; OUP 2001, especially Ch. 4 '180 years of liquidity expansion and international lending'.
44. The last heroic attempt at closing down fiscal deficits was the one labeled as the 'zero deficit' policy adopted in August 2001 which only worsened the recession, expenditure chasing down revenues. At the end of 2000, a financial so-called 'shield' had been provided by the IFIs – and the government of Spain – coupled with rather vague commitments by private investors to refinance obligations reaching maturity; as in the case of quite a few other countries it evaporated in financing capital flight. Additionally, some major exchange of debt instruments aiming to postpone service were made, the last one in May 2001 – the 'megacanje' – that managed to restructure around US\$ 30 billion of debt exchanging it – at high interest rates – for instruments that would mature at later stages. And in August 2001, with country risk already reaching 1.405 points, the IMF provided an extra US\$ 8 billion of support.
45. This so-called 'Phase 1' of debt restructuring – to be followed by a 'Phase 2' involving foreign creditors – resulted in a reduction of interest rates – from an average of about 11 percent to 7 percent per year but with service being guaranteed by a tax on bank depositors transactions and with income on new loans being exempt from income tax.
46. The Argentine government first had chosen a fixed devaluation of 40 percent.
47. Inflation in the first few months accumulated an increase of between 40 percent and 100 percent depending which index – either CPI or PPI – is used to measure it. One dramatic



element of this matter is that as food products are the major exportables, their prices have tended to rise much more in association with the overshooting exchange rate, hitting relatively more the lowest paid sectors of society. Not surprisingly, therefore, as already mentioned, poverty levels shot up and the proportion of people below the food poverty line increased to a socially unacceptable level.

48. Dollarized depositors – not the lowest income group of society – having been granted an increase of 40 percent – on account of the initial devaluation – plus indexation according to the cost of living, ended up receiving a higher amount than that outstanding in December 2001 in terms of domestic purchasing power, a subsidy being paid by all and every inhabitant of the republic.
49. About 2 percent per year for a 60-day deposit and even less than that on paper issued by the Central Bank, the so-called LEBACs and NOBACs.
50. Over the worst year of the crisis – 2002 – Argentina paid net to IFIs some US\$4 billion in net service. Some relief was granted mainly by the IMF as ‘expectations’ of repayment have been postponed to the date of ‘obligations’ of repayment. The IMF, which had let the agreement with Argentina to lapse back in December 2001, continued to negotiate a new agreement in 2002 – dominated by a diagnosis of total collapse of the economy and its financial system; eventually, in January 2003, an agreement was struck covering only six months. A new agreement was then reached in September 2003 for a period of three years but with, for instance, targets for the government’s primary surplus only specified for year 2004. This policy of ‘lending into arrears’ – as Argentina is in default with a large proportion of its public external debt – has led to criticisms of the IMF as having accepted the ‘blackmail’ of the Argentine government that was almost openly threatening to default on service of its obligations to the IMF. It has recently been a matter of contention the interpretation of the ‘good-faith’ clause involved in that policy, as to the negotiations that have to be entertained with foreign creditors. The agreements anyway involve only a refinancing of maturities but not of ‘charges’ – interest – so as to freeze the exposure of the IMF towards Argentina.
51. The specifics are being thrashed out between the government and a committee of advisory banks, both local and international. With government finances much strengthened by a huge increase in revenues – part of it however transitory – and a near-freeze on salaries, pressure is mounting for a better deal to be offered to creditors.
52. That almost all of them are foreign-owned has led to a conflict with governments that are highly influential in the IMF and the governing bodies of other international institutions.