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The Argentine Crisis as Coup De Grace?

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For most of the past decade Argentina had been the poster child of the IMF and Wall Street. No developing country in the 1990s had opened its financial markets more avidly, or privatized its state assets more fervidly. These structural reforms were supported by monetary reforms in 1991 that legally froze the peso/dollar exchange rate and tightly tied the money supply to the changing stock of hard currency reserves. To further gain Wall Street confidence, the Argentine government in 1991 announced a major foreign policy shift from nonalignment to an all-out pro-U.S. position—"in carnal embrace," Foreign Minister Guido Di Tella sardonically put it.

Argentina was thus graded A+ by Wall Street and the IMF. U.S. and European capital flowed in, giving the depressed economy a strong initial boost. And although direct investment inflows slackened by the mid-1990s as the assets still to be privatized diminished, portfolio capital inflows kept rising, notably for the purchase of Argentine dollar bonds. Pleased with the strategy, the IMF was quick to protect it with emergency credits against the flightiness of portfolio capital. The defense worked during the 1995-96 *tequila* crisis, but repeated injections of emergency credits failed to revive private capital inflows, or the economy, following the 1998 Brazilian crisis. The strategy had reached a dead end.

Essentially, the capstone of the strategy, the frozen peso/dollar exchange rate and the lifting of capital controls, had transmuted from a magnet for foreign capital into a millstone depressing the economy and a repellent to foreign capital. As the dollar rose relative to the currencies of Argentina's chief trading partners—Europe and its Latino neighbors, notably Brazil—the peso became severely overvalued. Badly squeezed, industrial exporting has declined, while cheapened Asian consumer goods imports have displaced domestic production.

Since 1998 GDP has been falling, while unemployment has risen precipitously, as have bankruptcies among small- and medium-size industrial firms. Concurrently, the stratagem of floating more dollar bonds to finance the currently rising account deficit and service the expanding dollar debt has fallen into a "debt trap," in which the increasingly onerous terms on which bonds have to be sold each period worsens the next period's debt service requirements. By 2000, the international financial markets, sobered by the recent Russian and Ecuadorian defaults, and aware that the likely denouement of debt traps is default, became virtually closed to new Argentine flotations.

Neither a 1999 IMF bailout package nor a much larger one in December 2000, was able to open the foreign bond market to new Argentine placements on viable terms. In desperation the Argentine government has been high-pressuring local banks and pension funds to buy its dollar bonds, thus obtaining dollars at the cost of further weakening the ability of these institutions to survive the adverse impact on their balance sheets of a default or devaluation. Cognizant of this, Argentines began a run on dollar bank deposits in June of this year, which by mid-August had reduced central bank dollar reserves by a fourth.

The dilemma for Argentina is that, while essential to revive the economy, a devaluation and debt reduction would, because of the excessive overhang of public and private dollar debt, be very difficult to pull off without some combination of capital controls and outside financial and big power support to minimize transitional financial turmoil. Lacking the latter, the policy stance remains status quo. Avoid devaluation and debt default at all cost while further cutting

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wages and social expenditures, and productivity will improve and investor confidence revive.

But in the real economy status is not quo. The more skilled and educated are emigrating in growing numbers, taking their human and financial capital with them; the less mobile demonstrate against the austerity with increasing numbers and violence, while foreign investors now believe with virtual unanimity that default is inevitable, and the safe position is to reduce rather than increase exposure in Argentina, at least until the dust has settled and the economy revives.

The dilemma for the IMF and the U.S. is that while generous transitional liquidity from the IMF, a Chapter 11 type payment standstill and negotiated workout with bondholders engineered by the U.S., and Argentine capital controls could substantially reduce the transitional turmoil, the package would be a complete reversal of the IMF's mission, and a bad precedent for other hard-pressed debtor countries. The IMF and the U.S., following the failure of the January 2001 bailout, have instead acceded with great reluctance to Argentine pleas with $8 billion additional credits, while offering Brazil a $15 billion precautionary line of IMF credit against contagion from an Argentine default. The disproportionate allocations indicate that the IMF and U.S. also believe default is inevitable. Wall Street analysts see the credits to Argentina as a foreign policy gesture that merely delays default a bit longer. "Some people are calling this the slowest train wreck in history," is the way one analyst put it. But coming on top of the Russian and Ecuadorian defaults, the much larger Argentine default is likely to accelerate the withdrawal of private financial institutions of the industrialized countries from third world portfolio investment, rendering the IMF's mission futile.

As for the U.S., it needs to resume its original Bretton Woods perspective—that international financial markets cut free from capital controls act to undermine rather than advance the objectives of free trade and stable, high employment growth—and revise its foreign economic policy accordingly, or have political reactions to recurring financial disasters force the policy change on it.

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