Policy Report

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After the Fall: The Argentine Crisis and Repercussions

By David Felix

The inevitable happened. Beginning in 2000, the government of Fernando de la Rúa set out to revive Argentina's sinking economy with new IMF credits and foreign capital. To appease the IMF and Wall Street, it chose to retain a policy triad that had ceased to make sense: to defend at all costs a severely overvalued peso exchange rate; keep up full servicing of the oppressively large dollar debt; and balance the fiscal budget in the face of skyrocketing unemployment and falling production.

The frantic effort of de la Rúa's economic policy czar, Domingo Cavallo, to implement the triad was an abject failure on all fronts. The result was debt default, a run from the peso that rapidly diminished its value in the exchange market, an expanding fiscal deficit, and a resounding *no* from the IMF and Wall Street to requests for more credit or help in rolling over the existing foreign debt on more viable terms. A violent popular uprising drove Cavallo and de la Rúa from office, leaving the economy in shambles and the polity in crisis.

The failure was foretold not merely by academic critics, but more importantly by bond investors who by 1999 had come to see Argentina as over-indebted and the peso as overvalued. They began to reduce lending to Argentina and to raise the risk premium for holding Argentine paper. More difficult to foretell is what the future may bring. A brief review of Argentina's decline from poster child of the IMF and Wall Street during most of the 1990s to pariah today may help lay out alternatives.

1. Argentina's Road to Disaster

More avidly than any other developing country, Argentina opened its financial markets and privatized its public assets in the 1990s. New monetary laws in 1991 strengthened these structural reforms. The cornerstone of the new policy was the Convertibility Law, which froze the peso/dollar exchange rate and tied the peso money supply tightly to the stock of hard currency reserves. To bolster Wall Street confidence, the Argentine government in 1991 also announced a major foreign policy shift from nonalignment to an all-out pro-U.S. position—"in carnal embrace," as Foreign Minister Guido Di Tella sardonically put it.

Argentina was graded A+ by Wall Street and the IMF. European and U.S. direct investment poured in to exploit privatization opportunities, giving the depressed economy a strong initial boost. Although such inflows slackened by the mid-1990s as the stock of assets to be privatized shrank, portfolio capital inflows kept rising, notably to purchase 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 1995-1996 "tequila" crisis, but repeated injections of credits failed to revive private capital inflows or the economy, following the 1998 Brazilian crisis. The strategy had reached a dead end.

Essentially, the Convertibility Law had transmuted from magnet for foreign capital to millstone depressing the economy, and had become a repellent to foreign capital. As the dollar rose after 1995 relative to the currencies of Argentina's chief trading partners—Europe and its Latin American neighbors, notably Brazil—the peso became severely overvalued. Badly squeezed, industrial exports declined, and cheapened consumer imports displaced domestic production. Industrial production stagnated and unemployment reached double digits. Keeping the economy afloat by incurring additional dollar debt, albeit with rising

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risk premiums, worked for a while to cover the widening trade deficits and rising debt service. But with the overvalued exchange rate holding down exports, it became evident that Argentina was headed into a debt trap. Each year's debt service augmented the next year's in an expanding series that was becoming unsustainable. The bond markets hastened the denouement by raising the risk premium on Argentine bonds to levels that effectively closed the international markets to Argentine placements. Neither a 1999 IMF rescue package nor a much larger one in December 2000 was able to reopen these bond markets on viable terms.

The dilemma for Argentina was that while devaluing and reducing the dollar debt service were essential for reviving the economy, capital decontrol had encouraged a major domestic buildup of private dollar debts, whose servicing costs would be substantially increased by a devaluation. Without capital controls and financial support via the IMF or other channels to minimize transitional turmoil, devaluation would be economically and politically difficult to implement. But Washington, and hence the IMF, would not offer more aid.

De la Rúa had a political opening for changing policy direction. His predecessor, Carlos Menem, left office in 1999 pursued by corruption charges and accusations of having brought on the recession and debt crisis by overissuing dollar bonds to finance fiscal deficits. De la Rúa's center-left coalition, which campaigned on an anti-corruption and economic recovery platform, won a decisive victory in the elections. Could he have used this political momentum to revise the Convertibility Law and bargain successfully with Washington and the IMF for transitional help in scrapping the senseless policy triad? We will never know. After some initial dithering, de la Rúa chose to break with his coalition and pursue the triad to its bitter end.

2. Policy options

The popular uprising dramatically altered the political parameters shaping economic policy. Three policy changes became certain: default on the dollar debt, an easing of monetary-fiscal austerity, and exchange rate depreciation. Formal dollarization, favored by conservative Argentine economists and politicians as an alternative to devaluation, was no longer a viable option.

The Peronist party, which still controlled the Congress, and the Peronist interim president, Adolfo Rodríguez Sáa, pledged to suspend service on the dollar debt immediately while negotiating a "haircut" with bondholders—a permanent write-down of at least 30% of the debt. Complete suspension of the $155 billion in federal and provincial dollar debts would have released around $28 billion for emergency jobs and other social programs in the coming year. But complete suspension was unlikely, since at least $64 billion of the dollar debt was held by local banks and privatized pension funds formed to replace the national pension system.

Among Cavallo's last acts was to force these institutions to accept a replacement of their federal bond portfolio with lower interest rate issues, which weakened their cash flow. Suspending payments on these bond holdings would risk driving many into insolvency, deepening the domestic financial crisis and probably setting off another popular explosion. Initially at least, payment suspension would release only a fraction of the $28 billion debt service for 2002 to fund fiscal outlays on proposed emergency programs.As for devaluation, Rodríguez Sáa's confusing pronouncements increased the likelihood that it would be disorderly. He opposed repeal of the Convertibility Law, because devaluation of the peso would lower real wages, and proposed instead to issue enough of an inconvertible new currency, the argentino, to near-

ly double the domestic money supply. Some financially strapped provinces had already issued similar currencies, lecops, to make wage payments. These circulated at substantial discounts from face value, so that workers paid in lecops were already taking a real wage cut, and responding with mass protests. Lecops also had a "Paul paying Peter to rob him" effect on fiscal revenues. Firms accepted them at substantial discounts primarily to cut their tax bills, since they could be used at face value for payments to provincial and federal governments. Issuing argentinos in massive amounts would have further cut real fiscal revenue as well as real wages. Rodríguez Sáa's confusing monetary pronouncements seemed to reflect demagoguery more than economic illiteracy.

The Convertibility Law still had backers, notably among businesses and households with heavy dollar-denominated liabilities, whom the Peronists were fearful of antagonizing. They were also reported to be exploring ways of imposing haircuts on private dollar debts, to ease the pain to dollar debtors of a devaluation. The demagoguery increased the likelihood that bringing the exchange rate to a lower, but stable level would be a disorderly, drawn-out process.

De facto, however, the Convertibility Law was well on its way to desuetude. The flight to the dollar by Argentines reduced the dollar reserves of the central bank below its stock of peso emissions, putting it in violation of the law, while in the foreign exchange market, the forward rate on dollars was rising rapidly. To enforce convertibility, the Peronist government would have had to reduce drastically the peso money supply. The The pledges to preserve convertibility merely implied that it would die by neglect rather than by formal repeal.

The Peronists also ruled out formal dollarization as an alternative to devaluation. The central bank lacked sufficient dollar reserves to buy up its peso emissions. Augmenting central bank reserves with new IMF and/or G-7 dollar loans could have ruled in dollarization. But Washington, and thus the IMF, remained firmly opposed to more lending unless Argentina first imposed more austerity measures to reduce the fiscal deficit. Dollarization proponents suggested devaluation first, followed by dollarization. But that fallback had no appeal to the Peronists in control, since dollarization would curb the financing of their expansionary fiscal programs. It might yet become an active option were repercussions from failed economic revival efforts to produce an explosive inflation and financial chaos sufficient to bring a rightist regime to power, by ballot or bullet.

3. The global context

Convinced that the immediate global repercussions from Argentina's default would be minimal, the Bush administration and the IMF were comfortable with their tough love response to Argentina's carnal embrace. The reasoning was that, in contrast to the Asian crisis, the default was long in coming, giving creditors ample time to take protective measures. Moreover, in summer 2001, the IMF granted Brazil an additional $15 billion standby credit as anti-contagion insurance. This optimism, however, badly underestimated repercussions via slower channels of contagion.

A sovereign bond default in each of the past three years (with the latest, Argentina's, by far the largest), plus the hardening of IMF's bailout terms, has been a red flag to international financial markets. The IMF reports that net bond flows to developing countries, which had fallen to zero after 1998, turned negative after mid-2001. Syndicated bank loans, which are mainly directed to large private firms of developing countries, have taken a similar downward path.

Latin American and Asian countries burdened with large hard currency debts have been facing stiffening terms for rolling over or adding to their debts. And compared to the 1997 Asian crisis, promoting exports to offset the higher debt service is encountering tougher going. The industrial countries are in recession, and the U.S., erstwhile global importer of last resort, is now turning again to selective protectionism. The terms of trade of exporters of primary materials and low-tech industrial commodities have been deteriorating, and intensifying export promotion would intensify the deterioration. Unless the industrial countries recover soon and strongly from their recessions, export-led growth efforts would be immiserating for many developing countries.

The direct trade effect of the large Argentine peso devaluation and deepening depression has not been important globally, but is having a significant regional impact. Argentina is a large enough trading partner for Brazil, Chile and other neighboring countries for its troubles to have hurt their economies. Had Eduardo Duhalde, who took over as provisional president in January, been able to carry out his intent to build up regional import substitution as a partial substitute for export-led growth by strengthening MERCOSUR, the repercussions might have been positive for the Southern Cone countries, though contentious for the U.S., since it would have undercut its Free Trade Area of the Americas (FTAA) initiative.

Moreover, were Duhalde's attempted recovery strategy of prolonged debt payment suspension, expanded public expenditure and more protectionist, inward-oriented growth to bring about a sustainable economic recovery, it would gain popular appeal in other debt-ridden developing countries as a viable alternative to troubled free-market, export-led systems, with their heavy dependence on volatile foreign capital.

Such possibilities presented the Bush administration with a Hobson's choice. It could block emergency loans to Argentina and take a hard line on debt renegotiation to ensure the failure of any breakaway from neoliberalism. But that would also increase the risk that the resulting economic chaos would produce political chaos and a return of the jackboots. It would also increase the discontent within the IMF directorate over U.S. dominance of IMF policy toward developing countries, which could further erode the Fund's usefulness as a key U.S. instrument for globalizing neoliberalism. The alternative for the Bush administration would be to resort to softer Clintonism; i.e., help Argentina financially in hopes that would modify policy breakaways, protect Argentine democracy and ease tensions within the IMF.

4. Current prospects

In the event, the hard-line alternative won out initially. Instead of providing liquidity to smooth the downward adjustment of the badly overvalued peso, the IMF embarked on a cynical strategy of moving the conditionality goal posts; that is denying Argentina credits by imposing new prerequisites each time the government agreed to existing ones.

The cynical strategy succeeded in thwarting Duhalde's attempted breakaway from the IMF policy line. Duhalde had begun his term with congressional backing from the Radicals as well as the center-left wing of the Peronists. His proposed recovery effort deviated from neoliberal orthodoxy by prioritizing the revival of domestic industry over the early restoration of debt servicing. Instead of more fiscal austerity, it would focus on reinvigorating MERCOSUR and overcoming the domestic credit crunch by restricting capital flight and pressuring the home offices of the multinational banks to recapitalize their Argentine subsidiaries. Price controls on wage goods were to dampen inflationary repercussions from devaluation, etc.

Without new IMF credits, capital flight intensified. So did the credit crunch, as multinational banks chose to cut their losses rather than bring in new capital, which forced the government to tighten restrictions on dollar and peso deposit withdrawals. The dollar/peso exchange rate continued sinking while inflation mounted. Argentine GDP plummeted 15% in the first quarter of 2002, open unemployment rose to nearly 25%, and the number of Argentine households consuming below the poverty line soared above 50%.

Duhalde soon ended his effort to get U.S. and IMF support for his program, and instead abandoned the program in a desperate effort to win IMF credits. Under IMF pressure he cut back fiscal outlays and repealed legislation that had subjected banks violating currency regulations to judicial prosecution. But as of early August, 2002 the policy reversal had not brought new IMF credits, merely renewed anti-presidential demonstrations and riots, which Duhalde has sought to pacify by advancing the fall 2003 presidential elections by six months.

As is its wont, the IMF justifies its hard line on Argentina by placing full responsibility for the disaster on government mismanagement and corruption. It insists that Argentina must balance its fiscal budget, claiming that chronic deficits have been at the root of the excessive run-up of hard currency debt that produced the defaults. Indeed, to resume servicing that debt so as to regain access to the global financial markets, primary fiscal surpluses were essential. Without the fiscal turnaround, the IMF argues, additional credits would be throwing good money after bad.

This new IMF prescription for Argentina makes little economic sense for three reasons. First, it misreads the fiscal trajectory. From 1993 on, Argentina ran a primary surplus every year but 1996, with primary spending—all fiscal expenditure except on interest payments—representing a slightly declining percent of GDP. Rising interest payments that overtook the primary surpluses are what caused overall fiscal deficits to surge after 1996. During most of Menem's last three years in office, increased borrowing was mainly responsible for the rising interest bill. But the IMF made no overt effort then to discourage the borrowing. Instead, the alacrity with which it came through with new credits during tight spots partly reassured the increasingly nervous financial markets that payments would be protected. It was during the latter half of the de la Rúa/Cavallo era that the IMF became reluctant to lend. The timing coincided with near universal consensus in the financial markets that Cavallo's effort to overcome peso overvaluation with tighter monetary-fiscal measures was tanking the economy to a politically explosive degree. It also coincided with the Bush administration signaling the IMF to cut back because it was convinced that IMF bailouts merely encouraged overborrowing and overlending. Risk premiums on Argentine paper ballooned, making default inevitable.

The tanking and default might have been averted had the IMF supported de la Rúa's initial intent to loosen fiscal-monetary policy to revive the economy, on the condition that it be accompanied by a peso devaluation and debt workout. Instead the IMF helped deepen the disaster by backing the policy triad long after it had become counterproductive. It bears partial responsibility for the consequences.

Second, elementary macroeconomics tells us that imposing still more fiscal austerity on an already deeply depressed economy, as the IMF persisted in doing to Argentina, can push unemployment and bankruptcies to politically explosive

levels. For IMF Executive Director Horst Koehler to throw up his hands at the Argentines' loss of faith in their political system, declaring it to be "the most difficult problem" impeding IMF assistance, is disingenuous. The IMF had pressured the leaders of each of the two major political parties, the Radicals and the Peronists, to replace the recovery programs they had promised the voters with harsher austerity soon after gaining office. The lost faith and political chaos that ensued should hardly surprise.

Third, it insults the intelligence of foreign investors to assume they would plunge back in en masse were further austerity to succeed in squeezing a budget surplus from the deeply depressed and politically demoralized country. Indeed, it may insult the intelligence of the IMF operatives to assume they really believe the economic rationalization they offer for the Fund's harshness toward Argentina. It seems more reasonable to assume that the chief motive has been to punish Argentina, as a warning to others not to default. This may be morally reprehensible and in violation of the IMF's fiduciary responsibility under Article 1 of its charter, the Breton Woods Articles of Agreement, to assist members in balance of payments distress on economically viable terms. But at least it gives a rational gloss to the harsh treatment.

5. The contagion effect

Washington and the IMF badly underestimated the regional contagion from the Argentine disaster. It is now spreading along both financial and political channels, threatening more defaults and challenges to U.S. regional hegemony. Financial markets view Uruguay and Brazil as headed for default. Uruguay's foreign reserves have fallen this year by more than half. Despite a hurried $3 billion IMF loan in June, risk premium on Uruguayan government bonds still hovered around 13%, with Moody downgrading the sovereign bonds and the foreign currency liabilities of the country's banks to near junk levels. After Brazil in June drew $10 billion of its $15 billion IMF standby to stanch capital flight, accompanied by messages of full confidence from Koehler and U.S. Treasury Secretary O'Neill, Brazilian dollar bonds still carried a 15% risk premium and a Standard & Poor B+ rating—on a par with Senegal and Jamaica.

Brazil is of course South America's largest economy, more than twice the size of the Argentine economy before its collapse. But its government debt, about half of it in dollar liabilities, has risen to ratio to GDP that's nearly 20% higher than Argentina's on the eve of its default. The Brazilian government has been relying on IMF-approved medicine—raising interest rates and cutting primary spending—but has nevertheless fallen into a debt trap dynamic comparable to Argentina's.

Exchange rate depreciation and rising risk premiums keep increasing both the government's and the corporate sector's dollar-denominated debt loads, while higher interest rates for real-denominated bonds add to their domestic currency payment burdens. High interest rates and a credit crunch are depressing industrial output and real wages, with unemployment approaching double digits. The political fallout in Brazil includes a strong likelihood that the runoff in the fall 2002 presidential election will be between two left-wing candidates, each pledged to renegotiate the foreign debt. Analysts disagree on whether even an unexpected victory for the centrist candidate will suffice to avert default.

The political fallout extends to Bolivia and Peru, where left-nationalistic populism is on the rise and neoliberalism has become a political kiss of death. But populism can also evoke responses reminiscent of the "national security state" era. Currently, the affluent Venezuelan classes, furious at the redistributive reforms of the Chávez government, are foregoing the electoral process and openly urging the military to drive out that democratically elected government.

Latin American governments are also retreating from broad trade liberalization to bilateral and sub-regional trade compacts, and are trying to lessen their dependence on the U.S. by strengthening trade ties with the European Union. Here the main motive is resentment and distrust of the Bush administration for its protectionist moves in steel and agriculture, and its retreat from the Clintonian financial bailout stance, as illustrated by the harsh treatment of Argentina. Even Mexico, upset at the Bush administration, is negotiating bilateral trade agreements with Brazil and MERCOSUR.

All this now has the Bush administration and the IMF rushing to shore up defenses against new defaults with an abrupt return to the despised Clinton bailout strategy. On August 4, the U.S. Treasury gave Uruguay a $1.5 billion bridge loan, pending the award of additional IMF credits, which was announced 3 days later. On August 7 the IMF also announced agreement with Brazilian negotiators on a $30 billion standby arrangement of 15 months duration, to begin in September.

Eighty percent of the funds for Brazil are earmarked for quarterly disbursement in 2003, and each disbursement is contingent on the government maintaining a primary fiscal surplus in that quarter of at least 3.75% of GDP to cover debt servicing, which works out to maintaining primary budget surpluses of about 18%. Surpluses of this size would put the newly elected government, left-wing or not, in a strait jacket, virtually denying it financial resources to carry out populist reforms. The announcement, however, also puts the two left-wing candidates in a pre-election bind. Fearful of being denounced as spoilers, they have given tepid approval to the new standby, without fully committing themselves to meeting its conditions if elected.

Wall Street banks are clearly skeptical. For the past few months they have been reducing their Brazilian exposure by refusing to roll over maturing short-term loans, even export credits, to Brazilian entities. Although they had pushed behind the scenes for the IMF bailout, they have since announced they will wait until after the October elections before deciding whether to resume Brazilian lending.

In the interim Brazilian dollar reserves will keep shrinking as firms payoff their maturing dollar debts. All this will put the next president in a still tighter bind. If it's one of the left-wing candidates, he will be quickly confronted with a Hobson's choice. Suspend dollar debt servicing and renegotiate the payment terms in order to gain some financial space for funding the reforms he promised the electorate, or become a Brazilian De la Rua or Duhalde, and acquiesce to the IMF austerity conditions.

It is too early to predict what the choice in Brazil will be and how it would play out politically and financially. What is clear is that despite the IMF's reformist rhetoric about "bailing in" foreign investors and distributing adjustment costs more equitably, there is nothing novel about the new IMF standby credit. It is once again about bailing out banks and bondholders.

At the same time, Argentina has not yet benefited from the Bush administration's reprise of the Clintonian bailout strategy. Having already defaulted, Argentina is still left swinging in the wind without IMF financial support.

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