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Pegged for Failure? Argentina's Crisis

JAMES E. MAHON, JR. AND JAVIER CORRALES

Many observers anticipated Argentina's current financial crisis, but few expected to see the country's worst political crisis since the 1970s, with five presidents in two weeks, looted supermarkets, and urban riots. A year ago analysts marveled at Argentina's political stability. Today no one knows if the new government, created in Congress in the first week of 2002, will survive. And the United States has responded with indifference. While Argentina's malady does not seem as contagious as was Mexico's or Russia's (Brazil may yet sicken independently), it still raises important questions about Latin America's commitment to free-market economics, and about globalization.

What was a mild recession has become one of the country's sharpest economic downturns ever. As Eduardo Duhalde, the hastily appointed president, noted in his acceptance speech before Congress, unemployment is at record levels, approaching 20 percent, while some 40 percent of Argentines now live below the poverty line. In 2001, GDP per capita fell an estimated 12 percent; at the same time, central bank reserves fell by $18 billion (from $35 billion), 24 percent of bank deposits fled, and the fiscal deficit rose to $9 billion (over 4 percent of a severely contracted GDP).

The main problem is some $141 billion in foreign debt that the Argentine government and private sector owe (giving Argentina the highest ratio of debt to annual exports among major debtor countries). This debt has to be paid from government revenues, but the crisis has cut these—most grievously in December, as Duhalde noted, when they fell almost a third. On January 3, the government missed a payment on the foreign debt, placing it into default; the next day it announced plans to devalue the peso, which was pegged to the value of the United States dollar. Since most domestic loans are now in dollars, devaluation compounds the misery of millions of Argentine households and firms, creating debts that are suddenly much harder to pay.

How did Argentina come to this pass? Nearly alone among the larger "emerging markets," Argentina tied its currency tightly to the United States dollar in 1991, renouncing monetary independence in the pursuit of low inflation and economic stability. As a result, in the early 1990s it enjoyed strong economic growth and the praise of Wall Street and Washington. But the system weakened with the accumulation of more foreign debt and after financial shocks from Mexico, East Asia, Russia (these transmitted by nervous global investors), and Brazil. The public and private sectors borrowed more, moderating and postponing the adjustment to these shocks. But once the country fell into recession in late 1998, the debt burden blocked its recovery, largely by robbing the government of the credibility it needed when it promised to pay its debts and hold fast to the currency peg.

Many held up the Argentine government, which privatized even the post office, as a model free-market reformer, so it is understandable that others (including Duhalde's wing of the Peronists) blame free markets for the crisis. But the "free-market model" includes a variety of approaches. The crisis was the fault of a particular financially driven version of this model, persistent fiscal deficits (not excessive but significant nonetheless), especially in the provinces, disappointing export performance, and world financial volatility that has become an enduring feature of globalization. Argentina was also the first casualty of a new United States reluctance to offer rescue packages to countries—or

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rather, to countries far from the war on terrorism—in financial distress.

The ecstasy and the agony of the convertibility plan

Seeds of the current crisis were sown with the measures taken to solve the last one, the hyperinflation and depression of 1989–1990. President Carlos Saúl Menem fixed the currency in a one-to-one embrace of the United States dollar; he also balanced the budget with new taxes, spending cuts, and massive privatizations, and opened the economy to international trade. Under Economy Minister Domingo Cavallo, the exchange policy became law in April 1991 as the "convertibility plan": devaluation required an act of Congress and the central bank could not issue money in excess of its liquid hard-currency reserves. The dollar and the peso would be fully convertible, equally acceptable both as legal tender and as units of account for banking.

Was the convertibility plan doomed from the start? Maybe not. But its creators staked the economy on the easy availability of foreign financing and hence on the government's credibility with financial markets.

Due in part to the circumstances of its birth, the plan reflected a priority on financial stabilization over competitiveness. It linked the Argentine peso to the United States dollar not because Argentina carried out considerable trade with the United States—it did not—but primarily because the government sought to accommodate the status quo after the inflationary 1980s, with dollars circulating everywhere as a parallel currency. Its creators also sought to impress financial markets and the United States Treasury Department. (They succeeded: convertibility was loudly and repeatedly praised by investment bankers and the financial press.)

The move was part of a dramatic reorientation of Argentine foreign policy toward the United States. At times, the new posture might have seemed extreme—Foreign Minister Guido Di Tella liked to joke of his government's "carnal embrace" of the United States. But the policy was popular among the beleaguered urban middle class. And it offered the promise of future benefits from the world's only remaining superpower. It can be compared to NAFTA, but since the United States did not offer trade links to Argentina, a dollar-based currency board had to suffice.

Argentines liked the plan not only because it killed inflation, but also for what it represented politically: a wall between politicians and the currency. It represented a pledge not to return to the bad old days of surprise savings-robbing devaluations and printing money to finance the deficits of patronage-mad governments. For the Peronist government in power in 1991, headed by a former free-spending governor of a minor province, with an economic policy strongman—Domingo Cavallo—then best known for imposing an inflationary shock as central bank president in 1982, such a pledge was absolutely necessary. But keeping it would demand fiscal rectitude and continued reform efforts from Argentine politicians.

Economists generally agree that countries face a "trilemma" when setting currency and monetary policies. Only two of the three things they might want to do—set an independent monetary policy, enjoy free capital movements, or fix their exchange rate to anchor prices—are possible at once. Argentina chose the fixed rate and the free capital, giving up monetary independence. Most Latin American governments—indeed, the majority of governments throughout the world—have embraced a greater degree of independence by letting their currencies "float" (though rarely freely) in value against others. Argentina's choice resembled the gold standard.

Reviewing the world's monetary experience from the 1870s to the 1990s, economic historian Barry Eichengreen has concluded that gold-standard rules have not been widely revived today because they are difficult to maintain under a well-organized and democratic polity. Why? Under gold-standard rules, the government, in response to an external shock that throws the current-account balance into deficit, lets the monetary base shrink until recession (immediately), rising productivity (if policymakers are lucky or clever), and falling domestic prices (more slowly) put the account back in balance. Interest rates rise, attracting capital from abroad. The system corrects itself. But it is politically hazardous. It assumes that those bearing the costs of adjustment—bankrupt firms, workers facing wage cuts or unemployment—are politically insignificant. Realistically, the government has to persuade the financial markets that it can resist political opposition to tight money, perhaps for a few years. Some insist that a government can still use fiscal stimulus in this situation—but this depends on the market's belief that fiscal deficits are temporary.

Yet, if the government incurs too much debt, it risks losing the fiscal tool. Once credibility is in doubt, the market demands higher interest rates and shorter maturities, raising borrowing costs and negating the stimulus. Unless external conditions turn suddenly favorable, this can lead to an unsustainable escalation of rates and fears—a financially caused economic slump.

Thus the convertibility plan, although spectacularly successful for a while, died at the hands of debt and recession. During its initial boom years (1991–1994), debt remained moderate. But when emerging markets felt the "tequila shock" from the Mexican financial crisis of 1994–1995, Argentina paid a huge price in foreign debt, including a multibillion-dollar rescue package organized by the IMF, to maintain its currency peg—even as unemployment topped 18 percent. In the three subsequent years (1996–1998), as Menem abandoned structural reform and pursued growth despite turbulence in world financial markets, more debt accumulated. Then, as the country fell into recession (late 1998 to the present), the government tried to spur recovery while persuading creditors of its commitment to fiscal rectitude and convertibility. This involved, by turns, tax cuts, fiscal austerity pacts, a new deal with the IMF, expensive bond swaps, and coercive debt renegotiations. They did not work.

BAD POLITICIANS, BAD GLOBALIZATION, OR BAD LUCK?

The press is full of diagnoses of the Argentine collapse. Most blame the Argentine political class. There is surely truth in this, and it is an opinion shared by millions of Argentines. But this drama has a larger, less easily personalized setting: tax evasion, the stubborn problem of Argentine exports, and global financial volatility.

The "bad politicians" argument has several important foundations. One is the impression of general venality that comes from press and tell-all book accounts of political life, often confirmed in Argentines' everyday interactions with government. The second relates to policy reversals, mistakes, and personality flaws (for example, Menem's excesses, de la Rúa's aloofness, and Cavallo's gratuitous insults). The third pillar of this argument can be understood by comparing figures for GDP and foreign debt for the years 1996 to 1998. Here rapid growth corresponded to continued accumulation of foreign debt. That is, rather than use the good years to pay down debt (and pass reforms to make the economy more competitive), the government reverted to Peronist habits. The provinces were a particular problem. Home of Peronist strength, they were also the source of critical fiscal excess at an inopportune time. Their combined budget deficit rose after 1995, with the lion's share due to Buenos Aires province—then governed by Eduardo Duhalde. Worst of all was the wild patronage Menem employed in his campaign between 1997 and 1999 for constitutional changes permitting him to run for a third term. All in all (and consistent with scandals reported in the press), the Peronists needlessly saddled Argentina with an unbearable burden. Hence, the "bad politicians" explanation does have a great deal of truth. But let us complicate this picture.

First, why focus on spending rather than tax revenues? Argentines evade taxes at much higher rates than do Chileans or Uruguayans. International Monetary Fund figures from the mid-1990s show compliance with value-added taxes at a rate of around 75 percent in Chile and 50 percent in Argentina. Assuming a similar disparity across all tax types, if the Argentine authorities had been able to reduce evasion by only half of this margin—a gain of 12.5 percent in compliance, and thus of 25 percent in revenues—their fiscal deficit would have turned into an impressive surplus.

The second point concerns the identity of Argentine borrowers. During the critical period between December 1995 and December 1998, the private sector actually took on more debt than the public, doubling its foreign obligations from $18.2 billion to $36.5 billion; the nonfinancial public sector borrowed just under $16 billion. The ratio of public to private foreign debt fell from 3.7 to 2.3. This suggests that something other than fiscal profligacy was at work, encouraging all Argentines to take on foreign debt.

What was it? The convertibility plan saw persistent current account deficits that had to be financed. Its effect on trade was, to many foreign and Argentine observers, a familiar result of curbing inflation by suddenly fixing the exchange rate. Since the peso was tied to the dollar while inflation still raged, inertial inflation thereafter made Argentina expensive—and imports cheap to Argentines. Moreover, from early 1996 onward, the dollar appreciated significantly relative to the ecu (and later, the euro), making Argentine costs even higher relative to the country's main trading partners beyond Mercosur (the Southern Cone Common Market). Argentina thus failed to match the export performance of Chile or Mexico. Brazil's January 1999 devaluation also hurt. Because the real depreciated significantly against the peso/dollar, Argentina's Mercosur trade balance, and its attractiveness as a site for production and investment within the trade area, deteriorated.

But there is another complication. The government did recognize its exchange-rate constraint, and it sought to reduce costs for exporters and improve productivity among producers of tradable goods generally. It cut taxes, offered rebates, and promoted measures to reduce labor costs. And export volumes did rise tremendously—including a significant increase in industrial goods. However, export values rose more slowly, in part because the sectors best prepared to respond to the new incentives produced primary commodities whose prices were generally falling. A key part of Argentina's problem, then, came from an old bugaboo of its nationalist-oriented economists: falling prices of key exports. While a weaker peso arguably would have permitted Argentina to export more of the goods for which global demand was more dynamic, an old structural weakness, if not bad luck, seems to have been at work here.

This is a major point of contention in postmortems on Argentina. While advocates of convertibility assert that export problems would have been surmountable with a more energetic campaign to reduce the "Argentine cost" of labor restrictions and corruption, the idea that real currency appreciation is a good way to force productivity gains seems especially perverse in an economy with massive unemployment. In any case, to the extent the peso was overvalued, this made foreign borrowing necessary for a longer time, and the accumulated debt hobbled the government in its response to economic shocks coming from abroad.

A final set of issues concerns the international financial system. First, it is important to note the strong connection between global (especially United States) liquidity conditions and the fortunes of emerging markets. When United States interest rates were falling or relatively low, the Argentine economy boomed; their rapid rise corresponded to the Mexican crisis (and its propagation to Argentina) in 1994–1995, and their upturn in 2000 corresponded to the deepening of the Argentine crisis. Argentina was an innocent bystander as rich-country liquidity changes and financial shocks from Mexico (1994–1995), East Asia (1997), and Russia (1998), propagated by global investors treating all emerging markets alike, drove up borrowing costs for government and businesses.

More important, many of the same Wall Street firms that now blame Argentine politicians are those that happily lent to them a few years ago—or arranged bond issues, for tidy fees, so that others could hold the paper. This most egregious example came in June 2001, when prominent investment banks, led by a former high-level United States Treasury official, arranged an expensive "mega-swap" for Argentina, publicly uttering only encouraging words about the country's future.

The IMF and the United States Treasury can be faulted for inconstancy. The fund tries to achieve several goals at once: promote adjustment, reward good reformers, and avoid moral hazard. But after making nice with Menem for too long, it suddenly started to worry about moral hazard after de la Rúa came to power, and especially after the change in United States administrations from Clinton to Bush. As for the Treasury Department, much of the world will probably blame it—in part because it is led by a man who made ignorant and pejorative comments about Argentina as the crisis deepened ("They've been off and on in trouble for 70 years or more. . . . They don't have any export industry to speak of at all. And they like it that way. Nobody forced them to be what they are.") and because its actions reflected the Bush administration's doubts about multilateralism in principle.[1] Still, as has been argued, there is plenty of blame to go around.

Lessons

Several points can be made in conclusion. First, it was not a lack of transparency, weak banks, or inadequate intelligence or effort that brought Argentina down. Nor was it free markets. Yes, politicians made mistakes and behaved badly. But Argentina collapsed mainly because of financially biased integration into a volatile world financial market, which surged ahead of the country's progress in remedying old problems with exports, productivity, corruption, and tax evasion.

The answer for Argentina is not a return to the exclusionary liberalism of the nineteenth century, or to the corporatist cocoons of Perón. Since World War II, countries that opened their economies more to trade and capital flows have tended to erect large "shock absorbers" for those bankrupted or unemployed by world market trends. This social edifice has been crucial to maintaining public support for letting markets rule the sphere of production. In addition, as a vulnerable developing country, Argentina will need policies to cushion financial shocks: ample international reserves, countercyclical fiscal policy, and a more diversified export base. The Peronists are politically well positioned to build a market-friendly social edifice, if they can unite behind the president (ignoring the carping of Menem), and if Duhalde recognizes that exchange controls and multiple rates cannot work for long. The goal is clear, but the road to it is difficult. ■

[1]The quotations from Treasury Secretary Paul O'Neill are from *The Economist*, July 21, 2001.