

# **The Argentine Crisis: Issues for Discussion**

Mario I. Blejer, Alejandro Henke, and Eduardo Levy-Yeyati

November 2002

While the Argentine crisis could be comprehensively studied as the consequence of massive macroeconomic imbalances, it seems more tractable to distinguish, at the analytical level, between the *currency* collapse and the *banking* crisis. Both are, of course, inter-related but they can be seen as caused by a number and a combination of different factors.

## I. The Currency Crisis

The currency crisis that reached its peak with the January 2002 devaluation is usually analyzed in the context of the Argentine convertibility regime, or the Argentine currency board system. The main question in this context is: *What were the weaknesses and the main causes for the demise of the convertibility regime?*

Among the many interpretations advanced for assessing this question, there are four basic lines of arguments. Although they overlap in some aspects and may complement each other, the focus the attention of each particular approach is on a specific issue:

- a) **The loss of competitiveness of the Argentine economy**, reflected in increasing unemployment and the long recession that started in 1998. The main exhibits associated with this hypothesis (and the issues for discussion) are the development (and measurement) of the real exchange rate, the evolution of exports and, particularly, of investment, as well as the path of exchange rate expectations, especially in the context of the events in key commercial partners, particularly the devaluation of the Brazilian real which many analysts view as the final trigger of the crisis.

- b) The inconsistencies of macroeconomic policies.** The fixed exchange regime and the lack of nominal flexibility embodied in the convertibility system impose restrictions on the fiscal accounts, given the expected rate of growth of the economy. In this view, the Argentine currency crisis is the consequence of the inconsistencies between the currency board and the fiscal stance, given the savings-investment balance. Moreover, the economic contraction that preceded the crisis was to a large extent the result of anticipated fiscal voracity. The main issues to consider in line with this hypothesis are the evolution of the fiscal accounts over the cycle, the evolution of the stock of sovereign debt with their associated (average and marginal) financing costs, and their impact on the real economy.
- c)** In some ways related to the above argument, there is a view that emphasizes the “*sudden stop*”, i.e. the (largely exogenous) drying up of capital inflows into emerging markets. Given the lack of fiscal adjustment, and the fact that convertibility precludes monetary financing, the *sudden stop* raised real interest rates because of the increased country risk arising from the perceived unsustainability of public debt. High and rising real interest rates led to recession, rendering the system unworkable. The main issues to address in line with the *sudden stop* argument are: i) the exogeneity of the capital account reversal; ii) if indeed the reversal was indeed largely exogenous, what are the reasons that may explain why they affected Argentina differently from other comparable countries.
- d) Institutional and political weakness** that (i) made the system vulnerable to political and sectoral pressures that diffculted the needed fiscal adjustments; and (ii) prevented the design and the implementation of the structural reforms that would have provided the system with the flexibility that was needed in order to cope better with the strictures of the currency board, and with the

changes brought about by convertibility (e.g., price and exchange stability, more openness, and better arbitrage). This hypothesis, possibly the most Argentine-specific, brings about a number of questions, particularly regarding the exogeneity of institutions (or of the institutional response to changes in the environment), the performance of countries with comparable institutions, and the ways and extent to which economic policies should be tailored to the institutional context.

In addition, to gain a clear understanding of the Argentine process and to draw lessons for the future, it is essential to distinguish between what was idiosyncratic to the country and what was common to other comparable emerging economies, to avoid attributing the outcome entirely to domestic factors. Correspondingly, any attempt to address the causes of the currency crisis should carefully consider the following related questions: i) in addition to its monetary regime, was Argentina different from other countries, and in which way?; ii) was the ex-ante probability of a currency crisis higher in Argentina, or was the crisis the result of adverse shocks that would have triggered the same outcome in equally vulnerable emerging economies?

## II. The Banking Crisis

In March 2001 a long-lasting deposit run started to rock the Argentine banking system and led, in November, to the imposition of very restrictive withdrawals restrictions. The run lasted more than 16 months and reduced the level of private sector deposits in the banking sector to about one sixth of their original dollar value. What explains the depth and resilience of the financial crisis? Here again there are a number of views that put the emphasis in specific aspects:

- a) There is a view that the financial crisis was a **necessary corollary of the convertibility crisis**. The perceived lack of sustainability of the exchange rate, combined with the currency imbalance derived from the widespread **financial dollarization of the economy** (with the consequent potentially devastating balance sheet effect of a devaluation), reflected negatively in the perceived capacity of local debtors (public and private) to repay the banks. This, of course, caused widespread losses of confidence in the banking system. Similarly, the early dollarization of local deposits *pari passu* with the increasing currency risk led, ultimately, to a run on deposits and accelerated capital outflow out of fear that a sudden devaluation would be followed by some sort of confiscation or forced conversion of dollar deposits. This hypothesis, which highlights the endogenous nature of the *sudden stop* that triggered the crisis, and its link with financial dollarization as a shock amplifier and a source of capital market procyclicality, raises the following aspects for discussion: i) the evolution of deposit dollarization *vis à vis* exchange rate risk; ii) the anatomy of the banking crisis and the relative role of currency risk, country risk and bank fundamentals; iii) the endogenous component of the capital account reversal (compare with I.c); and iv) the capacity of the banking sector to cope with the real exchange rate adjustment (via price deflation) if the deposit run had been prevented.
- b) A number of **problems specific to a limited number of banks** (particularly public sector banks and one large domestic bank) induced a continued *flight to quality*, towards foreign-owned banks. The resistance of the system to allow the closing of public banks or an increase in the share of foreign banks led to the adoption of system-wide withdrawal restrictions (the *corralito*) that ended up generalizing the sense of insecurity to the whole system.
- c) The perception of **increasing insolvency of the banking system** that would result in widespread bank closings and the freezing and/or confiscation of

deposits by the government. This perception was fed by two developments: (i) the view that the prolonged recession is bound to increase the share of non-performing private sector loans, and (ii) the rapid increase, initially voluntary and then forced, in the percentage of banking sector assets composed of public sector liabilities. The *sudden stop* plus the inability of the government to adjust its financing needs gave rise to this balance-sheet crowding out that, coupled with the growing awareness of increasing sovereign default risk, led to accelerated deposit withdrawals.

### III. Leaving Convertibility

In a retrospective view of the crisis, there are two questions that would inspire many future enquires. Was indeed inevitable to abandon the convertibility regime in January 2002 or there were still alternatives less traumatic to deal with the situation? And if there were no alternatives, could this have been done in a much better way (as opposed to the combination of sovereign default, asymmetrical pesification, imposition of exchange restrictions and tightening of the *corralito* through a deposit freeze)?

Issues that have been discussed under this umbrella include, among others, whether convertibility should have been abandoned earlier, whether an early default (with or without *de jure* dollarization) could have avoided the run and ensuing pesification; whether pesification was indeed inevitable after the abandonment of the one-to-one exchange rate, whether there was indeed room for a stabilizing fiscal contraction in the second semester of 2001, and whether a more forthcoming support from the international community could have prevented (or postponed) the collapse.

#### IV. The Monetary Strategy for the Crisis

Following the default cum devaluation and pesification, and given the persistence of the deposit and currency runs, the Central Bank needed to adopt a strategy to attempt to stabilize the monetary situation. The Central Bank faced the following dilemma. Having regained its lender of last resort function, it could provide the liquidity needed to finance the bank run, but this can be done only at the risk of fueling devaluation and possibly hyperinflation, given the lack of money market or debt instruments necessary to sterilize this injection of liquidity. Alternatively, the Central Bank could limit the rediscount facility and let banks deal with the deposit run on their own, at the risk of widespread bank failures and, through the expected contagion and domino effects, of a total collapse of the banking sector.

The intermediate solution actually implemented consisted in a three-sponged strategy to (i) stabilize devaluation expectations, **intervening in the forex market** to fight the belief (widespread at the beginning of 2002) that the dollar was bound to spiral up; (ii) stretch the limits of **liquidity assistance** in order to slow down the pace of the bank run by preventing massive bank closures that might have further fueled the panic while (iii) **developing sterilization instruments** to absorb, at least partially, the liquidity issued, by sustaining high real interest rate to compete with the US dollar (development that was facilitated by the stabilization of exchange rate expectations due to intervention). In this context, it was crucial to stress the difference, increasingly perceived by the market, between an autonomous Central Bank and a defaulted sovereign.

This strategy was based on the central bank view that, given the lack of reference as to the correct level of the exchange rate, the stabilization of exchange rate expectations was a precondition for a successful sterilization policy, despite the pressure to cease intervention exerted by the IMF during the negotiations. According to this view, **an interest rate defense and an active foreign exchange market intervention were *complementary rather than substitute* policies.**

While the current situation (discussed below) appears to support the hypothesis defended by the Central Bank at the time, several questions related to this crisis management strategy deserve to be explored: i) Was foreign exchange intervention (at the cost of depleting reserves) really needed?; ii) Was the decision to avoid bank runs ex-post efficient, as compared with the alternative of letting the bad apples fall?; iii) What was the role of the IMF in this process, and what were the consequences of the protracted negotiations on the chances and the cost of regaining stability, given the continuous drain of reserves to service multilateral debt?; iv) to what extent the cost and length of the stabilization process hindered on the unprecedented decision by the Supreme Court not to recognize the pesification of deposits?

#### V. Current situation and outlook

The fears of hyperinflation and of a total desintegration of the banking system have been averted, and there are currently signs that the crisis (while it possibly took more than necessary) has bottomed up. The deposit run has stopped for the moment: banks are gaining deposits based on high real interest rates (as intended in the central bank strategy outlined above) and, after devaluation expectations were stabilized, the speculative demand for the dollar dwindled, which, given the favorable trade balance, allowed the central bank to regain reserves without generating exchange rate pressures. Moreover, due to the unprecedented recession and the absence of indexation practices that were common in the 1980s, the pass-through has been very low, and inflation did not respond to the devaluation as most analysts expected.

However, the magnitude of the crisis contributed to leave some pending problems temporarily aside: real wages have declined by 50% (more if the more relevant consumption basket is considered), utility prices have yet to adjust (with a significant impact on low income families), and pressures for increased spending have been

surprisingly weak due to the scarcity of funds. All this suggests that any economic recovery will likely reignite inflation pressures that have been in check due to the economic contraction and the financial constraints.

Moreover, there have been no advance in the sovereign debt front. Here, as before with exchange rate and inflation forecasts, the consensus view tends to be extremely negative, pointing at a required primary surplus that is all but politically feasible. In addition, the political front is still clouded by partisan disputes, and the international community, led by the IMF, has not sent so far a clear signal as to the extent of the support to be expected either directly through an agreement and indirectly through its position in a debt renegotiation process.

In this context, the current positive developments open a number of crucial questions:

- a. Is this incipient macroeconomic balance sustainable?
- b. Given the institutional and political weaknesses, is it feasible to generate the fiscal results needed for a reasonable solution to the (defaulted) debt problem, and what would such a solution entail?
- c. A large part of reprogrammed pesified deposits were eventually redollarized through the various versions of the deposit bond swap. As a result, a large fraction of bank deposits still remains in dollars. Should the government go through with an explicit dedollarization strategy (as suggested at the beginning of 2002) or move back to a bi-currency strategy (as recommended by some former officials)?
- d. Given the presumption that real exchange rate will remain high, and therefore real wages will remain depressed, low rates of capital investment could be



expected, given the current comparative advantage in labor intensive activities. Should this lead to persistently low rates of growth?

- e. What should the federal government do with local “quasi-moneys”, buy them back (possibly against some commitment from the issuing province), reduce its use (e.g., cease to accept them for tax-payments), do nothing? How could this local money issuance be avoided in the future?

## VI. The role of the IMF

The unravelling of the Argentine crisis raised a number of issues related to the role of multilateral financial organizations, particularly the International Monetary Fund, at different stages of the process. In addition to the issues mentioned above in connection to the IMF, some of the many relevant questions that appear recurrently in the debate on the involvement of the Fund are the following:

- a. To what extent the Fund played a procyclical role in the development of the crisis, by endorsing the country’s currency board in good times and withdrawing support in the midst of the crisis?;
- b. Related to the previous question, what is the optimal timing of IMF warning and withdrawal, once one factor in the negative impact that this can have in international markets?
- c. Was the position of the IMF excessively biased, as claimed by some analysts, towards procyclical fiscal adjustment and, if so, to what extent did this play a role in the development of the crisis (did this advice inform domestic policies and to what extent were these policies liable for the crisis)?
- d. Did the IMF change its general stance towards emerging markets crisis due to the a change in the stance of the US government? If so, to what degree was this change had an implication in the context of the Argentinian crisis?

- e. Related with the previous point, was the evolution of the position of the IMF regarding the Argentine crisis consistent with its position regarding other distressed emerging economies in the past and at the time?
- f. What is the rationale of IMF (and other multilaterals') preferred debtor status (seniority) in a context in which no program financing is forthcoming?

Clearly, many of these questions can be addressed in the more general context of emerging market crisis and the international financial architecture. Indeed, we believe that an approach that balances the focus on Argentina with a more general perspective of the evolution of IMF policies, by filtering the exogenous (IMF-specific) factors, shall provide a more accurate picture of what was specific to the management of the Argentine case relative to what was due to swings in the IMF stance.