

Argentinean Tragedy

By Domingo Cavallo

The seminar organized by the NBER deals with the currency crisis in Argentina. I must say that nowadays my country is suffering much more than a currency crisis. Argentina is suffering a true tragedy. The people feel that the Law does not rule anymore. The first step towards a solution must necessarily be to restore the Rule of Law, both in the political and economic arenas.

The brake of the Rule of Law started with the institutional coup that developed between the 19th and the 30th of December 2001. It provoked the resignation of two Presidents and opened the door to a "Parliamentarian Government" lead by Eduardo Duhalde and supported by Raul Alfonsin

Both of them had been advocating for a suspension of payments of the public debt and for devaluation of the peso, but they had never succeeded in convincing people with these proposals at election times. On the contrary, most political analysts argue that Eduardo Duhalde lost the 1999 Presidential Election against Fernando De la Rúa, precisely because he made those proposals and scared the voters. Finally he became President through a coup without the Military but using an army of rioters.

The brake of the Rule of Law was completed with three decisions adopted during the course of the institutional coup and immediately after Duhalde sworn in as President:

- 1) The formal announcement of the suspension of payments on the public debt, including that which had been recently restructured and was guaranteed with tax revenue,
- 2) The freeze imposed on bank deposits, and
- 3) The so-called "pesification", that is the forced conversion of all dollar contracts into peso contracts.

None of the three decisions was a natural outcome of the crisis that had been developing during four consecutive years. None of them helped in any sense to start solving the crisis. On the contrary, these three decisions turned the crisis into a tragedy.

One could still discuss if the exit from the peg and the floating of the peso were necessary outcomes of the crisis. But I want to make the point that this only change would not have created the sense of chaos and lawlessness that those three decisions undoubtedly created.

The crisis

The crisis started in 1988 with a recession of economic activity that could not be reversed during the next four years. The long recession had originated in excessive expending by

the provinces financed by the banks at high interest rates. This had the effect of crowding out credit for the private sector. These excessive expending and borrowing continued at a time of large devaluations and continuous depreciation of the currencies of the country's main commercial partners (the real and the euro), which Argentina could not avoid because the peso was pegged to the dollar.

As the risk of a crisis of the Argentinean debt started to be discussed in the markets and some Argentinean politicians started to advocate for a formal suspension of payments, the long economic recession developed into a financial crisis because bank depositors started to fear that banks assets were deteriorating and, at some stage, they could go bankrupt. The financial crisis was reflected in withdrawals of deposits by significant amounts that resumed after two or three months of tranquility following each one of the various negotiations that the Government conducted with the International Financial Institutions.

The Zero Deficit Bill and the Debt Restructuring Plan.

By July 2001 it became very clear that the provinces would not get new financing from the banks and the Federal Government had lost its access to the bond markets. At that time we decided to look for a complete restructuring of the public debt, both that of the provinces and that of the Federal Government. The targets of the Debt Restructuring Plan were to cut by a half annual interest costs over time and to postpone amortization payments for three or more years.

Once we adopted this decision we had no alternative but to immediately balance the Federal Budget because it was going to be impossible to get any financing while we were restructuring the existing debt. So, in a sense, the Zero Deficit Bill was just one ingredient of our strategy to restructure the debt. Of course, once the interest bill had been reduced from 14 billions dollars in 2001 down to 7 billions in 2002, as we were planning, it would be much easier to sustain a balanced budget.

Provinces agreed to balance the budgets in 2002 and to finance the residual deficits of 2001 by issuing provincial treasury bills of low denominations that people would use as substitutes for pesos. Once they got the benefits of the debt restructuring was not going to be difficult for them to balance their budgets because the reduction of the interest bill of the provinces was 3 to 1.

Between July and October we made all the imaginable efforts to find ways to enhance the debt so as to be able to offer a swap of the old bonds by new enhanced bonds with much lower interest rates and longer terms. We got a commitment by the IMF to lend 3 billion dollars to support the debt restructuring and we finally got the decision of the President to sign a decree authorizing the use of tax revenue as collateral for the restructured debt.

In November we officially launched the Debt Restructuring Plan, which included two stages. First we offered to all creditors to swap their old bonds by loans to the Federal Government collateralized by tax revenue. The loans would pay interest rates up to 7 %

per year and never above 300 basic points over the US treasury bonds. The amortization of these loans would start in 2005. Second, we were going to offer an alternative swap of old bonds by new bonds without any collateral but accepting foreign jurisdiction, in contrast with the local jurisdiction of the collateralized loans. Interest rates would be 200 basic points lower than those of the loans, taking into account the higher liquidity of the bonds of foreign jurisdiction as compared with the local loans.

By the 15 of December the first offering had been extremely successful and 55 billions dollars had been exchanged, including most of the provincial debt, generating an annual reduction in interest cost of 4 billion dollars. More than 75 % of the important bonds had been exchanged for loans and that meant that we could use the voting power of the exchanged bonds to reassure the approval of the exit consent clauses to be included in the second offering. There were still 40 billions dollars of old bonds placed in the international markets and to get all of them involved, it was very important to discourage free riders. That was the purpose of the exit consent clauses that required more than 75 % of the voting power of the bondholders.

We were planning to launch the second offering by mid January to be closed by mid February. So by mid December we were only 2 months away from the complete restructuring of our public debt, which would have generated 7 billion dollars reduction in interest cost and a complete clean up of amortization payments during the next 3 years.

The “corralito”

But we were facing many problems in our financial system. When the public heard about debt restructuring, many depositors started again to withdraw their money from the banks, particularly from those banks that had lent large amounts to the provinces and were supposed to become illiquid after the completion of the first swap. As the banks were running out of liquidity the 1st of December we had no alternative but to restrict the withdrawal of cash from the banks and the financial transfers abroad. Depositors would still keep their deposits in the currency they wanted and they could make payments in Argentina using checks, debit cards or inter account bank transfers, but they would face limitation to transform them into peso or dollar paper notes and to make transfers abroad.

These measures, which become known as the “corralito”, affected many people, particularly those operating in the informal economy that had always used cash to hide their transactions. The organizers of the institutional coup used the suffering of the people as a consequence of the “corralito” to feed the riots of the 19th and 20th of December.

From crisis to chaos

What transformed the crisis into a chaotic situation were those three measures described in the introduction, because they aggravated the nervousness of the depositors and made the financial crisis more difficult to tackle.

The transformation of dollar contracts into peso contracts, aimed to eliminate the effect of the devaluation on the indebted private sector, had the effect of suddenly transforming more than 70 billion dollars in the portfolio of Argentines into 100 billions pesos. Of course Argentines had always wanted to keep their savings in dollars and that is why the convertibility system had allowed the use of the dollar and not only the peso as legal currencies. So they saw the "pesification" much more than the flotation of the peso as the violation of their property rights. Their reaction was to attempt transforming all those not desired pesos into dollars. But as dollar accounts had evaporated they only accepted dollar notes or dollars deposited abroad. That attempt, which tried to be prevented by the deposits freeze, explains the large depreciation of the peso, much larger than anyone had imagined.

The deposits freeze did not only prevent purchases of dollars, but provoked the collapse of most of the asset markets, including real state, sales of automobiles and the like. This, of course, had a terrible effect on the level of economic activity.

The beginning of a solution

Any solution has to start by completely reversing the so-called "pesification", otherwise there will be no savings kept in Argentina. It is useless to do anything else until Argentines recover the right to choose the currency they desire to use in order to preserve the value of their savings. This was, after all, the main objective of the convertibility system. The peg of the peso to the dollar was just a way to make the peso more widely accepted and used. Now that the peg has gone, Argentines will probably use a lower proportion of floating pesos but they could live with it. But what Argentines for sure will never accept is a ban on the use of dollars.

I want to emphasize this point because it makes the Argentinean crisis different from others. In most countries residents always kept their money in the domestic currency and the foreign currencies showed up only in international transactions. Argentines got used to using dollar during the hyperinflations and the acceptance of the convertibility system arose from the recognition of this fact. To force Argentines to save in pesos will be as difficult as to have them speak Chinese rather than Spanish. That is why the so called "pesification" is nowadays the symbol of violation of property rights in Argentina.

To reverse the feeling that there is no "Rule of Law" in my country will require many other actions. But reversing "pesification" will be a necessary component of any successful political and economic program for the future.