Lessons from Argentina

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The economic crisis in Argentina will not only cause serous hardship for Argentina's 35 million people but may also bring radical changes in economic policies and in political relations within Latin America and between Latin America and the United States. It is already clear that Argentina will reverse at least some of the favorable economic reforms introduced by President Carlos Menem in the early 1990s. Although the Menem reforms are not responsible for Argentina's current problems, they are a politically convenient scapegoat. Blaming them provides a rationale for renationalizing Argentine firms, erecting barriers to imports and foreign investment, and increasing government spending.

The crisis will weaken the prospects for the Mercosur trading arrangement among Argentina and its neighbors and may kill any chance of a general Free Trade Area of the Americas. Many Argentinians are already blaming their troubles on the United States, claiming that U.S. policies got them into their problem and that the United States then abandoned Argentina because, unlike Turkey, it is not of geopolitical significance.

If other emerging market governments misinterpret Argentina's experience, they too might move away from the pro-market policies that can most effectively raise future living standards. A better understanding of the real reasons for the Argentine crisis might prevent bad policy choices now in Argentina and other emerging countries and might reduce the risk of future financial crises.

An overvalued fixed exchange rate (locked since 1991 at one peso per dollar) and an excessive amount of foreign debt were the two proximate causes of the Argentine crisis. Because the exchange rate was fixed at too high a level, Argentina exported too little and imported too much. This trade imbalance made it impossible for Argentina to earn the foreign exchange needed to pay the interest on its foreign debt. Instead, Argentina had to borrow to meet those interest payments, causing the debt to grow ever larger. The country's foreign debt, most of which was owed by the central and provincial governments, eventually reached 50 percent of GDP and included $30 billion of debts due in the coming year. When it was clear that Argentina

could no longer borrow to roll over those debts and pay the interest, it was forced to default on its
debt and to devalue the peso.

Although the devalued peso will eventually raise Argentine exports, in the near term the currency devaluation will cause widespread bankruptcies because most Argentine businesses have been borrowing in dollars. A company that borrowed $1 million dollars had expected to repay that debt by converting one million pesos into dollars. But if the peso were to be devalued by 50 percent, the firm would have to find 1.5 million pesos to repay its million dollar obligation.
Companies with substantial debt would be likely to go bankrupt because they could not afford such an increase in the peso value of their debt. Corporate bankruptcies will weigh heavily on the Argentine banks and may cause widespread bank failures. The result will be increases in the already high unemployment rates.

The adverse impact of an overvalued exchange rate and excessive foreign debt are certainly not unique to Argentina. These two conditions, either singly or together, have been the cause of every currency crisis during at least the past 25 years. Similarly, the painful effect of
dollar denominated debt when a sharp devaluation occurs was dramatically demonstrated in several of the southeast Asian countries during the late 1990s. All of this was well known to the economists and economic officials in Argentina. Why then did they allow the crisis to develop? Why did Argentina not end the fixed link to the dollar several years ago, allowing the peso to float down to a more competitive level that could improve the trade balance and start to shrink its
foreign debts? If that had been done, the current crisis would probably have been avoided.

Argentina retained the fixed exchange rate to the dollar too long because that policy had cured the hyperinflation at the end of the 1980s and brought a decade of price stability that provided the framework for a period of strong economic growth. Policy officials feared that breaking the link to the dollar would send Argentina back to high rates of inflation and all of the
accompanying economic problems of the 1970s and 1980s.

At the beginning of the 1990s, consumer prices in Argentina were rising at a rate of 200 percent per month, more than 5000 percent per year. Markets ceased to function and productivity

declined. Street riots led to the resignation of the president and the election of Carlos Menem. With his economic minister, Domingo Cavallo, president Menem adopted the policies to move Argentina from an internationally isolated and state dominated economy to one that encouraged foreign trade and investments and that privatized the previously state-owned industries.

In doing so, Argentina was following the lead of Chile and Mexico as well as the southeast Asian nations that had all shown that such liberalization would lead to strong economic growth. Argentina's performance was no exception. The new economic policies caused Argentina to grow at a real rate of more than 7 percent a year from 1991 to 1994, one of the highest growth rates anywhere during those years.

An important and novel feature of the Cavallo economic plan was the "convertibility law" that pegged the peso to the dollar at a one-to-one exchange rate and stipulated that everyone had the right to convert as many pesos to dollars as they wanted at that exchange rate. To give credibility to that promise, the government provided that each peso in circulation would have to be backed by a dollar (or similar hard currency) at the central bank, the so-called "currency board" system.

If the Menem-Cavallo plan had succeeded, Argentina today would be enjoying strong growth, low inflation, and financial stability. The fixed exchange rate could only succeed however if the peso could become competitive enough to generate more exports than imports so that the net foreign exchange earnings could be used to pay interest on the outstanding international debt. Although the one-to-one exchange rate made Argentine products uncompetitively expensive, this could have been remedied if productivity could rise faster than wages, permitting Argentine prices to decline relative to those abroad. Cavallo correctly foresaw that the combination of low inflation and market liberalization would lead to a rapid growth of productivity. Although this was sufficient at first to lead to both rising real wages and increased
international competitiveness, eventually strong union pressures prevented the further reduction in production costs that Argentina needed to be internationally competitive.

The pegged exchange rate prevented the adjustment necessary to shrink the current account deficit but the combination of the currency peg and the rule against creating pesos without foreign exchange backing did achieve the price stability that was its original purpose.

To

the average Argentinian, the convertibility law made the peso "as good as a dollar," since pesos and dollars were fully interchangeable in everyday transactions.

Not everyone was convinced that the peso would never be devalued against the dollar. Some of us worried about what would happen if investors who saw Argentina's rising current account deficit and its increasing foreign debt became nervous and wanted to convert their pesos to dollars. Although the government had enough dollars at the central bank to back the currency in circulation, that was far less than the total amount in checking accounts and saving accounts that individuals might want to convert. In principle , the currency board rules meant that as individuals began to convert their pesos into dollars the central bank would shrink the money supply and cause interest rates to rise sharply. Long before the central bank ran out of dollars, the interest rates on peso deposits would be so high that everyone would be encouraged to keep their funds in pesos. In that way, the central bank would never exhaust its supply of dollars. Moreover, the high interest rates would weaken domestic demand, causing wages and prices to fall until the peso became competitive, eliminating the reason that caused the original investor nervousness.

While the logic of this was impeccable, I and others worried that in practice the government would not be willing to push interest rates high enough to prevent speculation because of the damage that those high rates would do to the economy. If wages did not fall sufficiently in response to economic weakness, the current account deficit would remain and investors would lack confidence in the long-term viability of the exchange rate.

Cavallo hoped that the currency board mechanism would never be put to this test. The productivity gains that he foresaw would make Argentine goods competitive internationally. Once confidence in the peso became established, sound monetary policy would prevent inflation even if the peso were allowed to float. Ideally, the shift from the pegged rate system to a floating

rate would occur when the peso was undervalued, causing the peso to rise when the peg was ended, thereby giving a further boost to price stability.

Unfortunately, these conditions never occurred. Wage increases kept the cost of production in Argentina high, depressing exports and encouraging imports. Argentina's

competitiveness worsened as the dollar strengthened relative to most other currencies, pulling the peso up with it . The dollar rose sharply relative to the Japanese yen after 1995, relative to
the currencies of southeast Asia after their crises of 1997 and 1998, and relative to the European currencies in 1999 and 2000. But the biggest blow to Argentine competitiveness came when the Brazilian real fell sharply in 1999.

In order to keep the peso's peg to the dollar as it lost overall competitiveness, the Argentine government tightened macroeconomic policy, pushing the economy into recession. Despite unemployment rates of close to 15 percent, wages did not decline and competitiveness was not achieved. The fixed exchange rate made it impossible to achieve competitiveness by a traditional currency devaluation (as a variety of countries ranging from England in 1992 to Korea in 1998 and Brazil in 1999 did) and the resistance of unions to lower wages prevented the fall in production costs that could have achieved the same real devaluation without a change in the exchange rate.

The inevitable result was increasing current account deficits and mounting foreign debt. The growth of the foreign debt also reflected the combination of low private saving rates and substantial deficits in the budgets of the central and provincial government. These budget deficits were due to widespread tax evasion and to an inability to control government spending, particularly at the provincial level. A constitutional revenue sharing rule turned any increase in
central government tax revenue into an extra source of finance for provincial government spending. But even with these funds, the provinces ran large budget deficits that were financed by substantial capital inflows from abroad.

As the debt grew, the interest rate that Argentina had to pay foreign creditors rose, further increasing the annual imbalance and accelerating the growth of the foreign debt. An eventual debt default became unavoidable. When Argentina finally defaulted on $155 billion of central and provincial government debt in December 2001, it was the largest ever sovereign debt default.

Sophisticated Argentinians and foreign investors knew that the peso had to be devalued if future current account deficits were to be reduced without a continued massive recession. The convertibility law allowed them to shift pesos into dollars and then to take the dollars our of the

country. The result was a loss of dollar reserves at the Argentine central bank, making it all the more likely that a devaluation would be necessary. Although an IMF loan in 2001 gave a temporary boost to confidence that stemmed the run on the central bank, this lasted only a few months and the currency was devalued sharply in January 2002.

Why then did Argentina not devalue sooner   in 1997, 1998 or even 1999   so that the debt default could be avoided, the devaluation could be smaller, and the adverse effects of devaluation on domestic firms and banks could be reduced? There were three reasons.

First, there was a fear that breaking the peg and devaluing the peso would bring back the high rates of inflation that had plagued the economy before the peso was tied to the dollar. Brazil's experience in 1999 showed that a country with a long history of high inflation could abandon a fixed exchange rate and avoid inflation by an explicit "inflation targeting" approach to monetary policy. But Argentina's history and the centrality of the convertibility law understandably made officials nervous that its inflation was more sensitive to any departure from the fixed peg.

Second, because Argentine households and businesses had so much dollar denominated debt, a devaluation would bring widespread bankruptcies and personal defaults by raising the peso size of outstanding debts. This would also affect the central and provincial governments, whose large dollar denominated debts to foreign creditors would become more of a burden since their tax revenue was collected in pesos.

Finally, there was always the hope that the situation would improve with time by itself. The large U.S. trade deficit suggested that the dollar might experience a sharp decline relative to the yen and the European currencies. If that happened, Argentine products would also become much more competitive internationally. But that did not happen. The dollar and therefore the peso continued to strengthen in 2000 and 2001.

What was the role of the International Monetary Fund in all of this? Critics of the IMF charge three things: the Fund staff did not adequately warn Argentina of the error of its policies; it encouraged bad policies by providing a series of large loans; and it forced Argentina to adopt

contractionary policies that led to three years of recession before the crisis hit.

In reality, the Argentines understood the risk that they were taking at least as well as the IMF staff. It was a calculated risk that might have produced good results even though in the end it did not. It is true, however, that the IMF staff did encourage Argentina to continue with their fixed exchange rate and currency board. Although the IMF and virtually all outside economists believe that a floating exchange rate is preferable to a "fixed but adjustable" system in which the government recognizes that it will have to devalue occasionally, the IMF (as well as some outside economists) came to believe that the currency board system of a firmly fixed exchange rate (a "hard peg" in the jargon of international finance) is a viable long-term policy for an economy. Argentina's experience showed that was wrong.

The contractionary policies that Argentina pursued during the past few years were exactly what the currency board system required. They may have been bad and painful policies, but they were inherent in the currency board approach. The real problem with the IMF conditions is that they did not achieve the changes that were really needed, especially the changes in such things as the constitutional revenue sharing rule and the level of provincial spending that continued to contribute to the budget deficit.

The multi-billion dollar loans that the IMF gave to Argentina permitted it to postpone dealing with its fundamental problems and abandoning the currency board. The IMF held on too long to the belief that the currency board system of a "hard" peg was potentially viable. It also wanted to show support for Argentina because of its previous shift to favorable market-oriented policies. But in the end it poured tens of billions of dollars into a losing battle. It should be possible for the IMF to show support for a country that adopts a variety of pro-market policies while still spending substantially less.

What then are the lessons that can be learned from the Argentine experience? First, a fixed exchange rate system, even one that is based on a currency board or other "hard" fix, is a bad idea that is likely to lead to an overvalued exchange rate, a currency crisis, and widespread defaults. A market determined floating exchange rate is the only way to avoid these problems.

Second, substantial foreign borrowing in dollars is a very risky strategy. This is

particularly true of short-term debt but is also a problem with longer-term debt. It is a problem regardless of whether the borrower is the government or the private sector. Other forms of capital inflow, in particular portfolio equity investments and direct investments in plant and equipment, do not raise the problems associated with debt.

Third, the opening of the economy to trade and foreign direct investment, as well as the privatizing of state-owned firms, remain desirable policies. Those policies did not cause or contribute to Argentina's crisis. It would be a serious mistake if they were now reversed in Argentina or other emerging market conditions.