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Argentina's Bankruptcy Foretold

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It is tempting to see finance as a morality play: those who get into trouble must have done wrong, and bankruptcy is the proper punishment for the wayward. When it comes to Argentina, a country that is muddling through its fourth financial crisis in two decades, that temptation is particularly strong. If today nobody will lend to Argentina, pushing its government to the political and economic brink, it must be --Wall Street sages will tell you-- because irresponsible Argentine politicians spent too much and borrowed lavishly. But that assessment is wrong.

Argentina is on the verge of default because investors expect it to be. Paradoxical, but true. The country is in its third year of recession, with unemployment at 15 percent. Despite the temptation to spend its way out of the slump, last year Argentina ran a budget surplus of one percent of domestic output, which became a total deficit of 2.4 percent once interest payments were added in. Public debt stood at a moderate 45 percent of output. Such figures would make the average European finance minister green with envy. In 2001 the Argentine fiscal situation has deteriorated, but not because the government went on a spending binge. The recession reduced tax receipts, driving up the deficit, which then spooked investors who demanded even higher interest rates, enlarging the deficit even further. Most governments forced to pay 15% a year or more on dollar loans would eventually run out of money and stop paying. This is precisely what has almost happened to Argentina.

Fixated on the alleged ill of overspending, Wall Street thinks budget cuts are the only medicine. With his ability to borrow all but cut off, Economy Minister Domingo Cavallo has been forced into an austerity plan which slashes wages and pensions and promises to reduce the government deficit to zero indefinitely. Running a pay-as-you-go government may just possibly allow Argentina to avoid default. And the political pressure may have provided a welcome opportunity to cut some bloated government salaries and pensions. But the future remains uncertain, because fiscal belt tightening will almost surely deepen the recession while failing to treat the underlying disease.

Argentina's problem is lack of growth. As long as the economy stagnates the budget will remain vulnerable and social discontent will continue to build up. Sooner or later, the Cavallo team hopes, investors will see that Argentina is serious about paying its debts, interest rates will fall, and the economy will turn around. Perhaps. Yet even if the spreads being charged Argentina were to drop to a fraction of what they are today, it is unlikely that strong growth would resume. The economy contracted in 1999 and 2000, when interest rates were lower and the U.S. was in a boom. Today the world economy is in recession, commodity prices are mostly weak and neighbors Brazil and Chile are slowing down. Why should Argentina buck the trend?

Argentina has not grown because investment is weak and exports are, for a country of over 30 million people blessed with high human capital and plentiful natural resources, laughably small. Businesses are not rushing to invest and export more because doing so is not profitable.

Excessive regulation, red tape and cumbersome taxation are a problem. Also troublesome is that issue that nobody wants to mention but will simply not go away: the exchange rate.

Pegging the peso to the US dollar and preventing irresponsible monetary expansion through the so-called currency board was a great idea: it ended decades of high inflation, restored a measure of sanity to Argentine finance, and made Cavallo an overnight hero. Ten years on, the policy is looking a little tired. Part of it is simply bad luck-- a surging greenback has sharply appreciated against most of the world's currencies. But the consequences are nasty just the same: Argentine firms find it very difficult to compete abroad.

Cavallo has already taken a half-step back from the currency board by introducing a system that will eventually tie the peso to the euro as well as the dollar. He has also created an alternative currency price for importers and exporters. For both measures he was crucified by Wall Street. True, implementation details are messy and multiple exchange rates are an invitation to corruption. But the basic policy orientation of the Argentine government is right: better to begin addressing the problem than to bury one's head in the sand.

The same holds true for the debt. It is not large, but at current interest rates and with the economy still depressed, servicing it will not prove easy. Perhaps a miracle will cause a surge in confidence, a collapse in interest rates and a turnaround in the economy. If not, creditors may soon need to sit down and discuss the terms of repayment. Better a coordinated and orderly rescheduling of debts earlier on than a messy default later on. In such a rescheduling creditors might have to take part of the hit. Morality is not, after all, unambiguously on their side.