PRB 02-44E

Library of Parliament
Bibliothèque du Parlement

UNDERSTANDING ARGENTINA'S ECONOMIC COLLAPSE

Marc-André Pigeon
Economics Division

5 December 2002

PARLIAMENTARY RESEARCH BRANCH
DIRECTION DE LA RECHERCHE PARLEMENTAIRE

The Parliamentary Research Branch of the Library of Parliament works exclusively for Parliament, conducting research and providing information for Committees and Members of the Senate and the House of Commons. This service is extended without partisan bias in such forms as Reports, Background Papers and Issue Reviews. Analysts in the Branch are also available for personal consultation in their respective fields of expertise.

CE DOCUMENT EST AUSSI PUBLIÉ EN FRANÇAIS

TABLE OF CONTENTS

Page

HIGHLIGHTS

- Two days before Christmas 2001, the Argentinean government announced the suspension of debt payments, worsening what was already a dire economic situation. Inflation-adjusted per capita income in Argentina had fallen by about 20% since the recession began in late 1998; the unemployment rate exceeded 20%; at least one-half of the population lived in poverty; federal and provincial budget deficits were soaring; interest rate costs were escalating; and the currency board that since 1991 had guaranteed an exchange rate of 1 peso = 1 U.S. dollar was in trouble.

- The crisis followed a decade of experimentation with structural reforms built on the pillars (also known as the "Washington Consensus") of smaller government, trade and capital account liberalization through tariff reductions, and price stability via a currency board.

- The currency board proved to be the linchpin of structural reform. It seemed to be an early success, with inflation falling from quadruple digits in the late 1980s to less than 2% by 1995. Consequently, real incomes rose and income inequality narrowed.

- The currency board, however, mimicked the gold standard of the early 20th century and left Argentina's economy vulnerable to major international financial crises, of which there were four in the 1990s (Mexico in 1994-1995, Southeast Asia in 1997-1998, Russia in 1998 and Brazil in 1999).

- Argentina's only policy "option" was to create the impression that it was pursuing fiscal credibility by trying to generate budgetary surpluses.

- Credibility, however, could be obtained only by pursuing policies that would ultimately prove destructive to the domestic economy, namely fiscal austerity and debt rollovers at higher interest rates.

- Argentina found itself, in the end, unable to sustain the illusion of credibility, and the economy collapsed.

CANADA

LIBRARY OF PARLIAMENT

BIBLIOTHÈQUE DU PARLEMENT

UNDERSTANDING ARGENTINA'S ECONOMIC COLLAPSE

Two days before Christmas 2001, the Argentinean government announced the suspension of its debt payments, worsening what was already a dire economic situation. Inflation-adjusted per capita income in Argentina had fallen by about 20% since the recession began in late 1998; the unemployment rate exceeded 20%; at least one-half of the population lived in poverty; federal and provincial budget deficits were soaring; interest rate costs were escalating; and the currency board that since 1991 had guaranteed an exchange rate of 1 peso = 1 U.S. dollar was in trouble. The suspension of debt payments signalled the end of the currency board, which was the last pillar of the government's 1991 plan to revitalize Argentina's economy through a combination of fiscal credibility, monetary stability and liberalized trade. Argentina reverted to a floating exchange rate in January 2002.

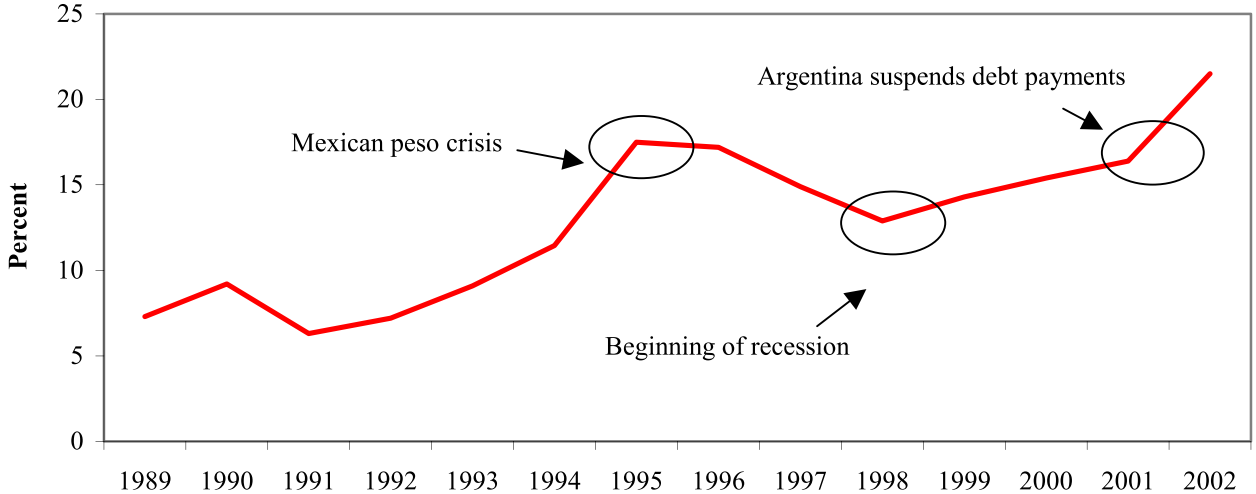
In a span of months, Argentina went from *the* model of economic development based on liberalization, fiscal credibility, and monetary stability(1) to finding itself unworthy of International Monetary Fund (IMF) assistance, and a possible catalyst to a Latin American financial crisis that could rival the 1997-1998 Southeast Asia crisis.(2) The ups and downs of the Argentinean economy are well captured by the evolution of its unemployment rate, as shown in Figure 1.

---

(1) In a 1996 address to the Academy of Economic Science in Buenos Aires, for example, International Monetary Fund (IMF) Managing Director Michel Camdessus said Argentina was "in many respects a blueprint for success"; see *Facing the globalized world economy: the IMF experience: four addresses by Michel Candessus*, IMF, 1996. Subsequent IMF press releases consistently praised Argentina for holding the course on its economic growth strategy. Structural reform indexes constructed by United Nations researchers also put Argentina at the top (in Latin America and the Caribbean) in terms of its willingness to adopt the liberalization policies advocated by the IMF.

(2) As has been widely noted, Brazil's debt situation is considered precarious enough to warrant an IMF loan guarantee of $30 billion, to be disbursed over a number of years. There is considerable speculation in the media and amongst academics that "Brazil could be next."

Figure 1: Argentina's Rising Unemployment Rate



Source: CEPAL Economic Survey of Latin America and the Caribbean and IMF *World Economic Outlook*, September 2002.

For Canadians, Argentina's economic collapse may seem like someone else's problem. After all, Canada exported only $132 million worth of goods to Argentina in 2001, about 5% of what it exported to Mexico that same year and a much smaller fraction of what it exports to the United States. Still, Canadians would be unwise to ignore events in Argentina. It is the second-largest economy in Latin America after Brazil. Moreover, its economy is tightly linked to that of Brazil through the Mercosur customs union and deep historical and economic ties. This is all the more relevant because Brazil faces serious debt problems of its own, problems so severe that it recently secured a $30-billion loan from the IMF. A Brazilian debt default could have serious repercussions for developing and developed countries alike.

It is also worth remembering that Canada has been caught in the downdraft of previous, seemingly distant, financial crises such as the 1994 Mexican peso crisis and the Southeast Asia financial (and economic)(3) crises, both of which compelled the Bank of Canada to increase interest rates in order to shore up demand for the Canadian dollar. In both cases, these interest rate increases affected the Canadian economy.

(3) A purely "financial" crisis would affect only monetary values and prices, while an economic crisis is one where "real" effects such as increased unemployment and lower output are felt. In practice, most – if not all – financial crises have "real" economic effects.

Moreover, Canada is involved in ongoing negotiations with Argentina and other Latin American countries for a Free Trade Area of the Americas (FTAA). Parties to the negotiations hope to have an agreement by 2005. A deeper understanding of Argentina's economy (and, by association, those of many other Latin American countries) provides an important contextual backdrop to understanding how these negotiations might unfold. Some have even suggested that Argentina's economic difficulties – and its response to its economic problems – may make it impossible to obtain an agreement.(4)

This paper looks at the factors that contributed to Argentina's economic collapse, and suggests that the structural reforms put in place early in the 1990s severely limited the country's scope for independent fiscal and monetary policy, leaving the pursuit of "fiscal credibility" as Argentina's only policy tool. In the context of a global economy beset by four major financial crises (Mexico in 1994-1995, Southeast Asia in 1997-1998, Russia in 1998 and Brazil in 1999), a high real exchange rate(5) that hurt exports, high real interest rates(6) that limited domestic investment, and high unemployment that limited domestic consumption (especially in the latter half of the 1990s), Argentina's "fiscal credibility" strategy was doomed to failure. Particular emphasis will be placed on the role played by the currency board in Argentina's eventual economic collapse.

A BRIEF FORAY INTO ARGENTINA'S ECONOMIC HISTORY

It is difficult to understand how Argentina found itself in its current economic difficulties without some cursory understanding of its history. In the first third of the 20th century, Argentina was considered one of the most prosperous countries in the world, experiencing a "golden age of growth."(7) Real annual economic growth averaged 6.6% between 1900 and 1913, and 4% between 1900 and 1929. Operating in the institutional context of the

---

(4) Martin Feldstein, "Argentina's Fall: Lessons from the Latest Financial Crisis," *Foreign Affairs*, April 2002, p. 8: "The current crisis will weaken the prospects for the Mercosur trading arrangement among Argentina and its neighbours and may kill any chance of a general Free Trade Area of the Americas."

(5) The "real exchange rate" is the exchange rate adjusted for price-level differences.

(6) The "real interest rate" is the nominal or market interest rate minus the inflation rate.

(7) Marie-Ange Véganzonès and Carlos Winograd, *Argentina in the 20th Century: An Account of Long-Awaited Growth*, OECD Development Centre Studies, Paris, 1997.

gold standard,(8) the growth was driven by waves of European immigration, large capital inflows and exports.

The grounds for this growth, however, proved fragile. While other developing countries, such as Japan, kept their economies largely closed and focused on exports of textiles and other light manufacturing, Argentina's exports consisted almost solely of agricultural commodities from its fertile pampas around Buenos Aires, a vast agricultural plain of 55 million hectares equal in area to France. Argentina was very dependent on its exports to the United Kingdom: up to one-third of all exports were sold in the United Kingdom in the 1930s. Argentina had an extremely open economy – the ratio of exports plus imports to GDP exceeded 50%, compared with 22% in 2000(9) – and was very dependent on a continuous inflow of foreign capital (both financial and real) for its growth, a strategy that worked well in an era of expanding trade and overall global economic growth.

Until the mid-1930s, Argentina's per capita income was on par with that of Canada, Germany and France, and exceeded by a wide margin per capita income in Japan and Korea. This period of strong growth, however, started to unravel during the Great Depression,(10) as the world economy collapsed and many of Argentina's largest trading partners reverted to the 19th-century strategy of high trade and financial barriers.(11) Argentina became the victim of its dependence on international trade, finance and capital. The Great Depression exposed the weaknesses of an export-oriented strategy built on the gold-standard monetary mechanism, a lesson the Menem government in the early 1990s would have done well to heed.

> The crisis [of the Great Depression] revealed the asymmetry of the automatic adjustment mechanism of the gold standard. The dynamic of adjustment worked properly during phases of expansion, when the

---

(8) In this respect, Argentina was hardly unique. Most other countries, including the United Kingdom, Canada and the United States, operated under the gold standard (except during part of World War I) until the onset of the Great Depression.

(9) Véganzonès and Winograd (1997), p. 26.

(10) While growth slowed markedly, Argentina actually fared relatively well during the 1930s. Growth averaged between 3% and 3.2% per annum for the period 1930 to 1943, even though the economy contracted at an annual rate of 5.3% between 1930 and 1932.

(11) Ha-Joon Chang points out that with the very notable exception of England, virtually all developing countries (including Canada) in the 19th century employed some combination of tariffs, duties and other protective measures to promote the growth of domestic industry. Until the mid-20th century, the United States was among the more enthusiastic employers of this strategy. See "Tariffs and Economic Development," *Challenge*, September-October 2002.

> balance of payments was a source of liquid assets. The increase in deposits and in credit, strengthened by greater development of financial infrastructure, contributed to economic growth. … However, when the external sector contributed to the absorption of the monetary base, the drop in deposits precipitated the financial system's liquidity crisis.(12)

In other words, the gold standard worked well so long as Argentina was either a net exporter of goods and services or a net importer of capital flows: in both cases, the country's gold reserves would be increasing, allowing banks to extend credit to firms. When the mechanism went into reverse, however, and exports and capital inflows shrank, the domestic economy would be constrained: just as firms were most in need of funds (to meet debt commitments, for example), banks were least able or willing to help. The gold standard provided a very unstable monetary regime for any economy susceptible to large swings in exports or capital inflows.

Partly in response to the Great Depression, Argentina helped pioneer what became known as an "import-substitution" strategy whereby high tariffs were used to develop a domestic industrial sector that until that point had been virtually non-existent, save for some agricultural linkages. This strategy was based, in some measure, on the research of Raul Prebisch, an Argentinean economist who found that a commodity-based export strategy did not work in the long run because of declining terms of trade: with each passing year, each unit of commodity exports – be it wheat, barley or other commodities – was worth less in terms of manufactured goods and especially capital equipment, goods that were produced mostly in the developed industrial countries.

To improve its terms of trade, Prebisch recommended that Argentina – and other developing countries – move away from their reliance on commodity exports and produce more value-added goods, where technological advances allowed firms to set prices, at least for a while, rather than act as price takers, which is often the case in the commodities sector. This is a difficult strategy to pursue in a global economy dominated by powerful firms headquartered in

---

(12) Véganzonès and Winograd (1997), p. 210. Véganzonès comes back to this theme repeatedly in her review of Argentinean economic history, noting later (p. 225) for example that the currency board essentially "reproduced the conditions of gold standard financial crises. While the financial system works 'smoothly' during expansion, strong monetary contraction leads to an imbalance in the banks' balance sheets that can degenerate into a major financial crisis. This system is all the more fragile because … the strongly procyclical trends of public finance accentuate the monetary imbalance during phases of monetary expansion." This is what happened in the last third of the 1990s.

the industrial countries: at the slightest threat of a competitor, they could flood the Argentinean market with cheaper, often higher-quality, goods and drive out domestic firms. Hence the perceived need for tariff walls behind which domestic manufacturing could prosper. This is a variant of the "infant-industry" argument used to justify high degrees of protection for U.S. and Canadian manufacturers beginning in the late 19th century through to the middle of the 20th century.

In the post-World War II period, Argentina fell into a pattern of "stop-go" growth where, "after an expansionary period ('go'), came a balance-of-payment crisis and an acceleration of inflation, requiring a stabilization period ('stop'). Healthy again, the economy moved into a new cycle of expansion … ."(13) At the same time, there was considerable political upheaval, with military dictatorships followed by general elections followed by dictatorships. Nevertheless, between 1944 and 1975, the economy grew on average between 3.5% and 4% per annum. In 1975, however, hyper-inflation set in, with inflation exceeding 100% per year for the next 16 years and economic growth grinding to a halt. The government's debt load reached 15% of GDP – considered relatively high at the time – and, along with inflation, "would not be brought under control for any length of time until 1991."(14) Between 1976 and 1989, the economy grew, on average, 0.1 to 0.3% annually.

To summarize: Argentina's economic growth in the first one-third of the 20th century was built on a high degree of openness that ultimately proved its undoing in the Great Depression era. In the post-World War II period, the country adopted an import-substitution strategy and, by the standards of the first half of the century, became virtually a closed economy – the ratio of exports plus imports to GDP fell to 10% from 50% at the beginning of the century. From 1975 to 1990, the economy limped along, plagued by hyper-inflation. In the 1990s, Argentina reverted to its early 20th-century model, liberalizing its economy and moving to a "dollar standard" possessed of the same strengths and weaknesses as the gold standard.(15)

---

(13) *Ibid.*, p. 198.

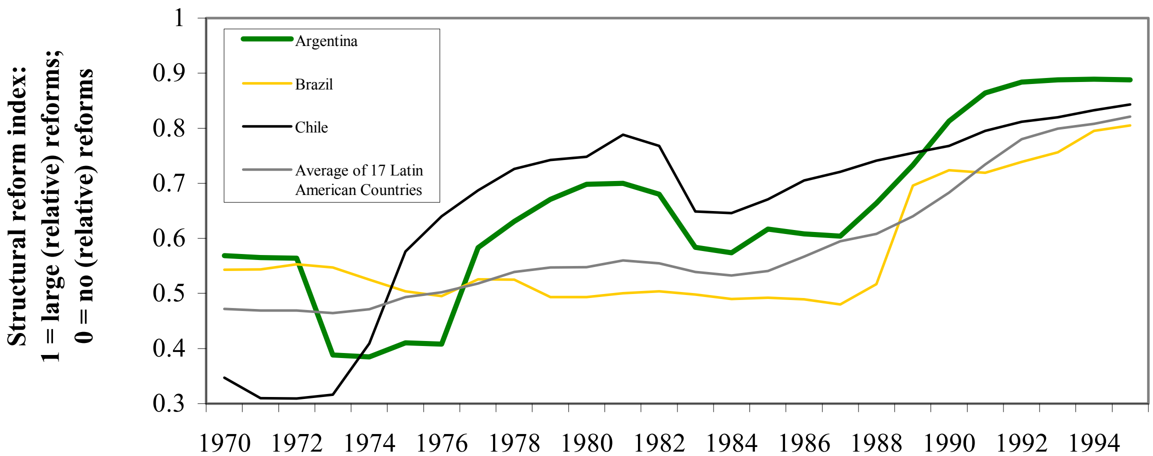
(14) *Ibid.*, p. 38.

(15) As U.S. economist Paul Davidson of the University of Tennessee at Knoxville has noted, dollarization and currency boards are very much like adhering to the gold standard, except the gold mines are located entirely in the United States. (See "Dollarization, the Function of a Central Bank and the Ecuadorian Economy," paper presented at the 75th anniversary of the Central Bank of Ecuador, 2002.) Argentina's history bears that out. In both the early and late 20th century, the country was at the mercy of unpredictable foreign capital. In both cases, the system "worked" only so long as the capital continued to flow inward, a point also emphasized by Véganzonès and Winograd.

THE STRUCTURAL REFORM PACKAGE

By 1989, Argentineans were tired of anaemic growth and hyper-inflation.(16) The newly elected Peronist government of Carlos Menem embarked on a three-pronged strategy of liberalization (i.e., dismantling of tariffs), restoring fiscal credibility (i.e., balancing the books by reducing government's role in the economy through spending reductions and privatization of state-owned enterprises) and targeting monetary stability through a currency board backed by legislation (i.e., the *Convertibility Law*).(17) Argentina wholeheartedly embraced this strategy, as shown in Figure 2, which depicts a structural reform index constructed by the Economic Commission for Latin America and the Caribbean (ECLAC). A reading of '1' would indicate "perfect" reforms relative to others in Latin America, while a reading of '0' would indicate no reforms at all. By the early 1990s, Argentina had pulled ahead of most of its major Latin American competitors in terms of its zealous application of its reforms.

Figure 2: Structural Reforms in Latin American Countries, 1970-1994



Source: Samuel A. Morley et al., "Indexes of Structural Reform in Latin America," 1999.

(16) According to Véganzonès, there was a consensus that the *tentative* liberalization policies of the Radical Party, which was elected for the first time in the 1980s, were an abject failure and that a more radical course needed to be pursued.

(17) This combination of reforms is widely known as reflecting the "Washington Consensus" policies espoused by the IMF, the World Bank and the United States.

A. Trade and Capital Account Liberalization

On the liberalization front, by the early 1990s, Argentina had become a member of the General Agreement on Tariffs and Trade (GATT), now called the World Trade Organization (WTO). Tariffs that in 1989 averaged more than 30% were reduced to 0% for primary materials and machinery, 11% for intermediate inputs, and 22% for other manufactured goods and consumer goods.(18) The Mercosur agreement signed by Argentina, Brazil, Paraguay and Uruguay in March 1991 had, by 1994, "advanced to the stage where there [were] almost no customs tariffs on trade in commodities originating in member countries."(19) Externally, the customs union – which came into being only in 1995 – imposed a 10.2% tariff.

B. Fiscal Credibility

In an effort to achieve fiscal credibility, the Menem government privatized almost all public enterprises and cut spending. It also reduced employment in the public enterprise sector from 295,000 in 1990 to about 50,000 by the end of 1992. Of this 245,000 reduction, one-third was done through layoffs and the rest through privatization. Meanwhile, federal government employment fell from 670,000 in 1990 to less than 285,000 by the end of 1992. While the bulk of these employees were transferred to provincial governments, some 105,000 were permanently dismissed. The Organisation for Economic Co-operation and Development (OECD) described Argentina's privatization efforts as "one of the widest-ranging privatization processes ever initiated by any country."(20) Figure 3 shows how much of the federal government's fiscal gains were achieved by offloading to the provinces, especially in the 1990-1993 period.

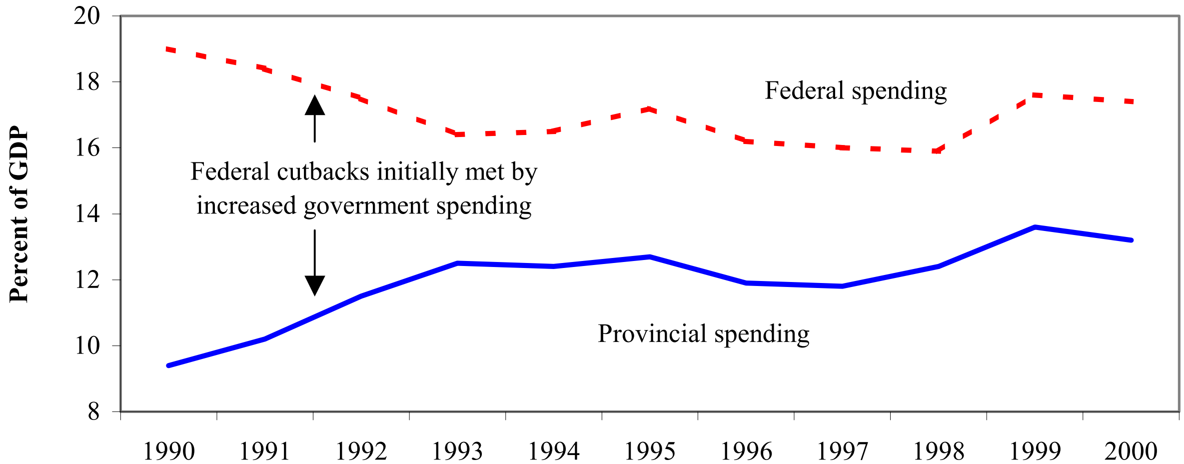
---

(18) Jan Kregel, "Argentina," unpublished paper presented at the Seventh Annual Post Keynesian Summer School, University of Missouri, Kansas City, June 2002, p. 5.

(19) Véganzonès and Winograd (1997), p. 41.

(20) Organisation for Economic Co-operation and Development (OECD), "OECD Reviews of Foreign Direct Investment: Argentina," Washington, 1997, p. 27.

Figure 3: Federal and Provincial Spending, Argentina, 1990-2000



Source: CEPAL Economic Survey of Latin America and the Caribbean.

C. The Currency Board

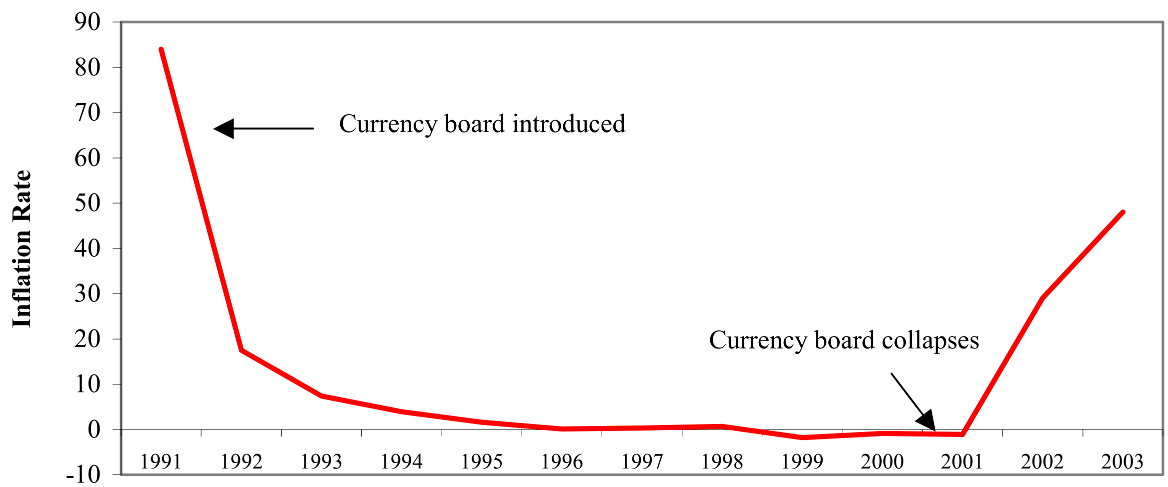
One of the key elements of the Argentinean government's structural reform package – and, as we will see, a linchpin in the most recent crisis – was the *Convertibility Law*, passed in 1991. It created what is known as a "currency board" that stipulated that pesos and dollars would trade at par, i.e., one peso would buy one U.S. dollar. To ensure convertibility, each peso was backed by holdings of U.S. dollar reserves, much as under the gold standard where each peso was backed by a certain amount of gold.[21] Either currency could be used to pay debts, settle transactions and pay taxes. The *Convertibility Law* was seen primarily as a way of controlling inflation by removing the central bank's ability to "print money." Since the government – through the central bank – guaranteed the exchange of one peso for one U.S. dollar, the money supply was given by how many U.S. dollars Argentina could earn through exports, imports of financial capital or asset sales through privatization.

(21) At least two-thirds of these U.S. dollar reserves had to be in cash form; up to one-third could be backed by U.S. dollar-denominated government bonds.

EARLY SUCCESS

Initially, the reforms seemed to work. Argentina's economy expanded at an average annual rate of 6% from 1990 through to the end of 1994, driven largely by increases in capital flows. The *Convertibility Law*, combined with the virtual elimination of tariffs, was successful in reducing inflation. By 1995, inflation had fallen to 1.6%, as shown in Figure 4, after exceeding 5,386% in 1989 and 1,343.9% in 1990.(22)

Figure 4: Inflation Rate, Argentina, 1991-2003



Source: CEPAL Economic Survey of Latin America and the Caribbean and IMF *World Economic Outlook*, September 2002.

Poverty rates fell from 40% in 1990 to a low of 22% in 1994.(23) Low-income households also played an important role in fuelling increased domestic demand during this period. The government's policy of liberalization, fiscal credibility and monetary stability seemed to be working. Meanwhile, pressures that would ultimately undermine this rosy economic picture were building. The currency board would prove to be at the heart of the problem.

---

(22) Véganzonès and Winograd (1997), p. 225. The data for the period before 1994 vary from source to source owing to difficulties in data collection during that period. The IMF data suggest inflation in 1990 was 230% rather than 1,343.9%.

(23) World Bank, *Argentina – Social Protection VI*, Report No. PID10834, 9 November 2001.

FIVE PROBLEMS WITH THE CURRENCY BOARD

Argentina's currency board had what would prove to be five serious problems.(24) First, the currency board approach essentially converted all of the country's peso-denominated debt into U.S. dollar debt. Prior to the *Convertibility Law*, the government, as a sovereign nation, always had the option – however unpalatable – of paying its peso-denominated debts by printing money. By passing the *Convertibility Law*, it relinquished this right. Henceforth, Argentina could expand the money supply only by:

1. Exporting more goods than are imported;
2. Importing more financial capital than is exported;
3. Selling off state assets; and/or
4. Borrowing more abroad.

The second major problem with the *Convertibility Law* was that it led to an increase in the real exchange rate. In 1992 and 1993, the real exchange rate appreciated by more than 10%, putting Argentinean exporters at a disadvantage relative to their foreign competitors.(25) Figure 5 shows that the real exchange rate did not begin to depreciate until 1995.(26)

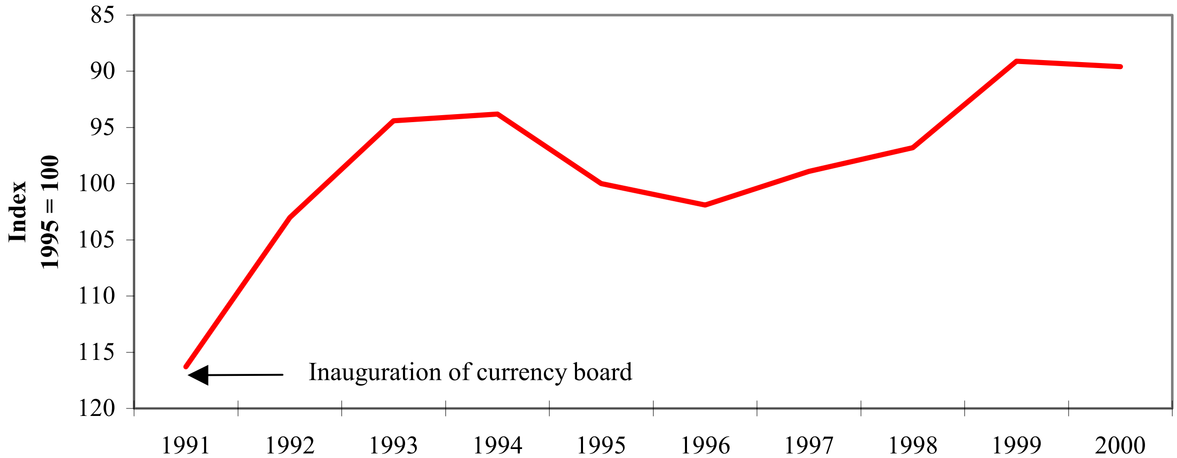
---

(24) There is a sixth potential drawback with moving to a currency board, namely, the loss of seigniorage revenue, i.e., the printing of money to finance expenditures. The loss of this seigniorage revenue does not appear to have played an important role in the collapse of the currency board and is scarcely mentioned in most economic analyses of Argentina.

(25) Kregel (2002), p. 6. The Economist Intelligence Unit (*Country Profile 2000: Argentina*, p. 51) makes a similar point, noting that from 1991 through to 1994, "the fixed nominal exchange rate led to a sizeable real appreciation of the domestic currency."

(26) The Economist Intelligence Unit (*ibid.*) attributes the depreciation to Argentina's success in bringing inflation rates in line with OECD rates starting in 1994.

Figure 5: Real Effective Exchange Rate, Argentina, 1991-2000



Source: CEPAL Economic Survey of Latin America and the Caribbean. The data depicted here represent the real exchange rate adjusted for the relative importance of Argentina's major trading partners. This is sometimes called the real effective exchange rate.

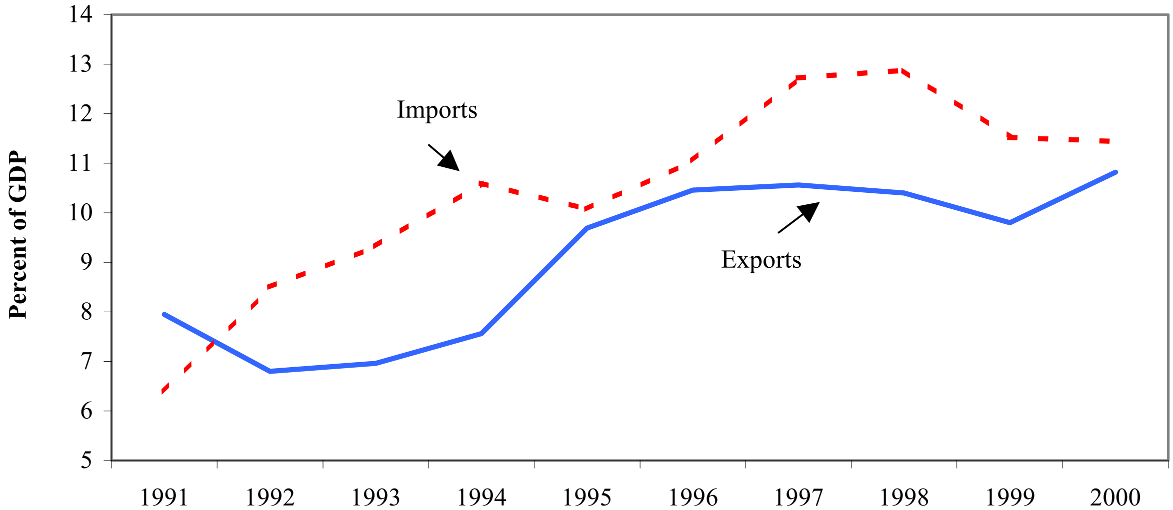
Between 1990 and 1997, the share of imports doubled to about 12% of GDP, as low-income Argentineans, previously hurt by hyper-inflation and high tariffs, found their income could buy more imported goods.(27) The share of exports, however, was stuck at about 10% of GDP, at least in part because throughout this period the U.S. dollar (and hence the peso) was gaining ground against most other major currencies.(28) Fuelled by this growing gap between exports and imports as well as debt service costs (from Argentina's growing debt load) and profit payments (from foreign-owned domestic firms) to foreigners, Argentina's current account deficit grew to more than 4% of GDP in 1994, mirroring the long-standing U.S. current account deficit. Figure 6 shows how Argentina's merchandise trade account evolved during the 1990s.

---

(27) This is a normal by-product of efforts to stabilize currencies. See Stanley Fischer, Ratna Sahay and Carlos A. Végh, "Modern Hyper- and High Inflations," *Journal of Economic Literature*, Vol. XL, No. 3, September 2002, p. 877.

(28) Kregel (2002), p. 4. U.S. exporters had (and have) suffered a similar fate, complaining that the strong U.S. dollar hurts their exports.

Figure 6: Imports and Exports as a Percent of GDP, Argentina, 1991-2000

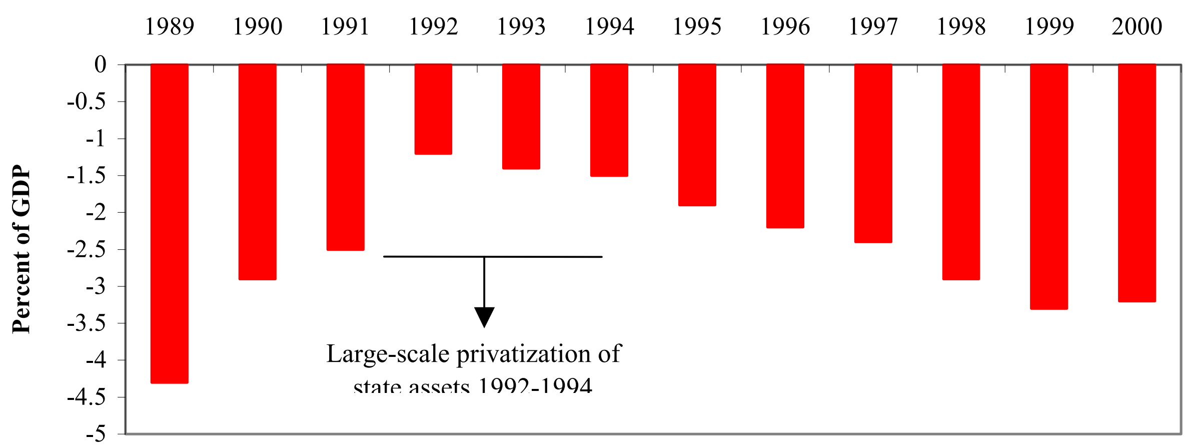


Source: CEPAL Economic Survey of Latin America and the Caribbean.

The third major problem was that the currency board did not inspire the confidence predicted by its promoters, resulting in higher-than-expected real interest rates. Proponents of the *Convertibility Law* had argued that under a currency board, a loan to an Argentinean borrower would be no different than a loan to a U.S. borrower (i.e., they would each have similar interest rates), since each would be paid in dollars. The appeal of this argument was heightened by falling U.S. interest rates. The 1994-1995 Mexican peso crisis (which was preceded by a sudden increase in U.S. interest rates), however, undermined this hope. Fearing the collapse of the currency board, Argentinean residents removed some 40% of their cash from the banking system in 1995, effectively reducing the supply of money available for loans. Risk premiums on Argentinean bonds rose markedly and remained high throughout the last half of the 1990s and into the new millennium. Investment over the decade stagnated at about 18% of GDP, while interest rates on Argentinean debt were not much different from those of other developing countries because of persistent fear that the convertibility regime would not hold. In short, the promise of low real interest rates comparable with those of the United States failed to materialize, and that translated into ever-increasing interest payments. Meanwhile, dividend payments to foreigners were also growing because of increased foreign ownership of the economy, stemming in part from the government's aggressive privatization agenda. In the end, these outflows of interest and dividend payments would have serious consequences for

Argentina's balance of payments, a problem discussed later in the paper. Figure 7 shows the evolution of interest and dividend payments to foreigners.

Figure 7: Interest and Dividend Flows to Foreigners as a Percent of GDP, Argentina, 1989-2000



Source: CEPAL Economic Survey of Latin America and the Caribbean.

Fourth, the *Convertibility Law* and currency board or fixed exchange rates in general eliminated the central bank's ability to conduct independent interest rate policy appropriate for the domestic economy. Interest rates were effectively set in Washington (plus a country-specific risk premium imposed by investors) with little or no regard for their impact on countries such as Argentina.(29)

Finally, the *Convertibility Law* prevented the central bank from playing the "lender-of-last-resort" role that is one of the main functions of a modern-day central bank. By law, Argentina's central bank could not flood the market with liquidity during or after a major financial crisis unless it had sufficient U.S. dollar reserves to back up its actions. Almost by definition, this is not possible in a serious financial crisis where investors and average citizens

(29) On 21 April 1999, the United States Secretary of the Treasury, Robert Rubin, warned that dollarization is "a highly consequential step that would limit the ability of a nation to constrain a banking crisis. But it would not, in our judgment, be appropriate for United States authorities to extend the net of bank supervision, to provide access to the Federal Reserve discount window, or to adjust bank supervisory responsibilities or the procedures or orientation of U.S. monetary policy in light of another country's decision to dollarize its monetary system." See Davidson (2002), p. 17.

are desperately trying to *remove* U.S. dollars from the banking system (and the country).(30) The lender-of-last-resort role is an important part of modern-day market economies, as the events of 11 September 2001 show:(31) without forceful intervention by the Bank of Canada and the U.S. Federal Reserve, falling stock market prices and a general unwillingness on the part of the private banks to extend credit could have led to a full-blown financial and economic crisis.

EXPECTATIONS NOT REALIZED

In theory, the sudden increase in the real value of the exchange rate brought about by the convertibility regime should not have posed a problem for Argentinean exporters. As Véganzonès and Winograd argue, the *Convertibility Law* was supposed to work much like the gold standard of the early 20th century: the loss of currency, in this case U.S. dollars, from the current account deficit should have led to a fall in wages and prices that would have eventually restored competitiveness in the international context. This view is based on what is known in economics as the "quantity theory of money" and is the theoretical underpinning for the law of comparative advantage.(32) The quantity theory of money says that, assuming a given level of output and a given level of velocity (a term used to describe the number of times the currency circulates in the economy over some defined period of time), a change in the money supply should be compensated by changes in prices: the money supply, in other words, determines the price level. If money supply is falling, prices should be too. If it is rising, so should prices. The mechanism did not work quite as expected.

---

(30) The Argentinean central bank did arrange for lines of credit from large U.S. commercial banks. These, however, proved inadequate in the face of the subsequent crisis. At best, this kind of arrangement could be described as a "quasi-lender-of-last-resort" policy.

(31) An economist at the Kansas City Federal Reserve bank described the policy response in the following terms: "Monetary policy responded quickly to the crisis by supplying an unprecedented amount of liquidity to the financial system. Discount window borrowing on 5 September [2001], the Wednesday before the attack, totalled $195 million. On the day after the attack, 12 September, it peaked at a record $45.6 billion, and a week later it had receded to $2.7 billion. On the day after the attack, the Open Market Desk at the Federal Reserve Bank of New York injected $38 billion in liquidity through overnight repurchase agreements. … In addition, the Federal Reserve established or expanded swap lines, totaling $90 billion, with the European Central Bank, the Bank of Canada, and the Bank of England to facilitate the provision of dollar liquidity to European, Canadian, and British banks. Importantly and more basically, the Federal Reserve remained open and operating in the aftermath of the attacks to ensure the continuation of 8 vital payment services, including electronic transfers, check processing and currency distribution. On a longer-term basis, the Federal Open Market Committee, the Fed's principal policymaking body, further eased the stance of monetary policy" (George Kahn, "The Economic Outlook and Monetary Policy Before and After September 11, 2001," paper presented to the Oklahoma Economics Forum, October 2001).

(32) The "law" of comparative advantage and the quantity theory of money were both pioneered by the 19th-century economist David Ricardo.

First, employees were reluctant to accept wage cuts.(33) More importantly from a developing country perspective, the mechanism could not have worked because of the surge of capital coming into the country. The money supply, in other words, was not falling (as had been expected) but increasing. Two sources of income drove the money supply increases: repatriated savings from Argentineans who had regained some measure of faith in their country and, more importantly, money from investors who were taking over newly privatized government businesses.(34) The current account deficit was thus more than offset by capital inflows. As Kregel notes, "[t]he automatic adjustment mechanism could not provide relief since capital flows much more rapidly than the time required for falling domestic wages and prices and lower incomes to produce a commercial account surplus large enough to meet the debt services."(35) The mechanism that in theory was supposed to restore Argentina's competitiveness did not and could not work, at least not quickly enough to avert the crisis that followed. By the time wages and prices did start to fall in the mid- to late 1990s, the country's debt burden had grown significantly. Argentina found itself in much the same position it had been under the gold standard in the early part of the 20th century: large capital inflows not only overwhelmed the mechanism that was presumed would work, but proved insufficient in the event of a sharp and severe international financial crisis, of which there were four in the 1990s. Each crisis led to sales of the domestic currency (and bonds) at the international level and withdrawals of U.S. dollars domestically, thus limiting the government's ability to support the economy through increased expenditures as well as the corporate sector's ability to finance its own operations (especially in terms of debt payments).

The World Bank was apparently aware of the inherent dangers of a currency board. In 1993, the World Bank warned that inflexible wages or sudden and large capital inflows could undermine the adjustment mechanisms on which Argentina, and its lenders, were depending.

---

(33) Feldstein (2002), an economics professor at Harvard University and president of the National Bureau of Economic Research, makes this point repeatedly in his analysis of the economic crisis.

(34) The OECD, in a review of foreign direct investment in Argentina (OECD [1997], pp. 11-12), notes that "[t]he significant role played by privatization in attracting foreign investment in the 1990s is undeniable." By the late 1990s, however, this strategy was unsustainable because there were few, if any, state assets left to sell: "Except for increasing foreign shares in existing firms, there is little scope for further acquisitions of state assets for the simple reason that there is relatively little left to privatize at the Federal level."

(35) Kregel (2002), p. 11.

> An "overshooting" of capital inflows may drive up imports and domestic asset prices to unsustainably high levels, and then, as the correction ensued, private capital flows would tamper off or even reverse, pushing up domestic interest rates. Resulting higher domestic interest rates would dampen or even extinguish growth. At the same time, domestic prices may prove to be sticky downwards and converge to competitive international levels only slowly.[36]

In both scenarios, a recession would be likely, creating:

> added fiscal pressure with unpredictable consequences. As revenues fell and the domestic interest bill rose, the speed of central government adjustment in reducing expenditures would determine the size of any increase in the Government's net borrowing requirement. Any increase in the borrowing requirement would make it more difficult for the government to achieve the partial rollover of its domestic debt with bondholders in its projections."[37]

Later still, the World Bank acknowledged that "[a] worsening macroeconomic panorama – or even random political or international events – could trigger a speculative attack on the peso" that even a build-up of reserves would prove insufficient to stem.[38]

IN THE NAME OF FISCAL CREDIBILITY

Given its commitment to the free flow of capital and trade, and given the ineffectiveness of monetary policy, the government's only "policy tool" was to emphasize its fiscal credibility. If this strategy proved successful, Argentina would continue to attract foreign capital and qualify for its increasingly necessary IMF loans. For international investors, the IMF and the World Bank, fiscal credibility meant the government had to run sufficiently large budget surpluses to cover future debt commitments. Early into its reform mandate, the government projected an average annual primary surplus (i.e., before interest payments on the debt) of $1.8 billion between 1996 and 2000. In this respect, the government was largely successful, running consistent primary surpluses for most of the 1990s through to 2001.[39] In the mid-

---

(36) World Bank, *Argentina: From Insolvency to Growth*, Washington, 1993, p. 198.

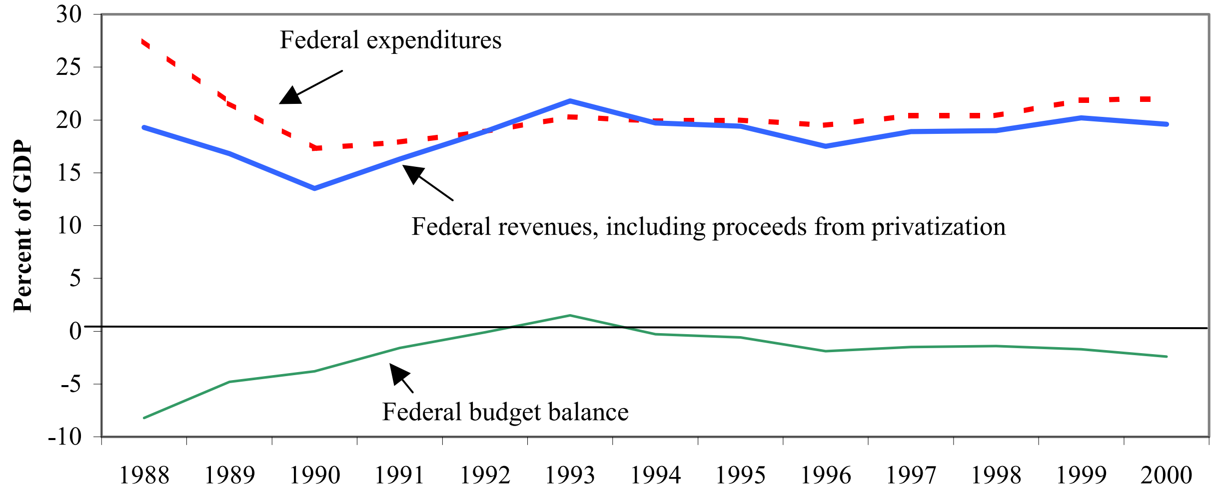
(37) *Ibid.*, pp. 198-199.

(38) *Ibid.*, p. 199.

(39) Dean Baker and Mark Weisbrot argue that the government's fiscal position would have been even stronger had it not partially privatized its social security system. See "The Role of Social Security Privatization in Argentina's Economic Crisis," April 2002, available on-line at: http://www.cepr.net/argentina_and_ss_privatization.htm.

1990s, the government even posted an overall surplus (i.e., after interest payments) and came very close to balancing its books in at least two other years, as shown in Figure 8.

Figure 8: Federal Expenditures, Revenues and Budget Balance as a Percent of GDP, Argentina, 1988-2000



Source: CEPAL Economic Survey of Latin America and the Caribbean.

These results were achieved with the help of privatization proceeds and by reducing transfer payments to the provincial governments, which are constitutionally responsible for the delivery of key social services (health care, education, poverty programs and housing).[40]

In the second half of the 1990s, the federal government covered deficits with public-sector borrowing. As the 1990s drew to a close, and the economy was beset by one international financial crisis after another, the government could no longer count on either strategy. Another consequence of the currency board was that the central bank could no longer, in any way, finance government spending – a practice that, to this day, happens in most developed countries, including Canada.[41] Deficits had to be financed entirely through some

(40) While in theory both the federal and provincial governments share similar tax bases, in practice the federal government collects the bulk of tax revenue and redistributes it to the provinces through various tax-sharing agreements and transfer payments.

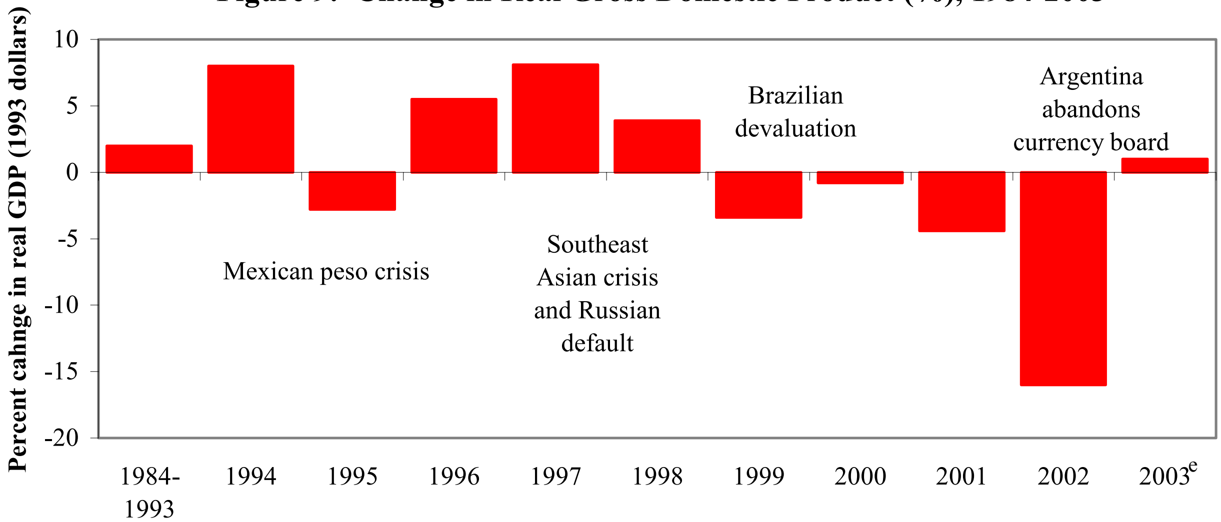
(41) In addition to open market operations where the Bank of Canada purchases existing debt to inject base money into the economy, the Bank also purchases a 15% stake in all new Government of Canada bond issues, including treasury bills. These purchases are part of the Bank of Canada's effort to retain a balanced portfolio of government debt and often replace debt that has matured. In 2000, about 7.8% of the government's market debt was held by all levels of government, including the federal government, which by definition includes the Bank of Canada. Data are from the Department of Finance publication *Debt Management Report 2001-2002*.

combination of tax increases, spending cuts, asset sales and debt sales. With a growing portion of its budget devoted to servicing its debt, and with its commitment to "fiscal credibility," Argentina was put in the position of having to cut expenditures and raise taxes as the economy was slowing – the same scenario that, as Véganzonès and Winograd warned in their 1997 book, played itself out under the gold standard in the 1930s. This budget policy only exacerbated an already weak economy, which in turn further weakened taxation revenue. The negative cycle continues to this day. In sum, much as capital inflows overwhelmed the adjustment mechanism on the trade front, debt servicing costs overwhelmed efforts to balance the books.

THE LIMITS OF CREDIBILITY

The limits of pursuing "credible" fiscal policy (and of adopting the recommended structural reforms) should have become clear in late 1994 and early 1995, when the Mexican peso (or Tequila) crisis shook the confidence of global financial markets. Developing countries, Argentina included, were caught up in a "credit strike" by major international lenders. The crisis revealed the serious problems with Argentina's convertibility plan. The banking sector came under pressure as citizens questioned the sustainability of the convertibility plan and withdrew their U.S. dollar savings. Meanwhile, the government was forced to sell bonds domestically to meet its financing needs as external funds and privatization proceeds declined. At the same time, the combination of higher U.S. interest rates plus higher risk premiums on emerging market debt signalled potential trouble for Argentina's future ability to repay its debts. The economy shrank by 2.8% in 1995, following a 1994 rise in the unemployment rate from 11.5% to 17.5%. Figure 9 shows how the economy contracted after the Mexican peso and subsequent crises.

Figure 9: Change in Real Gross Domestic Product (%), 1984-2003[e]



Source: CEPAL Economic Survey of Latin America and the Caribbean and IMF *World Economic Outlook*, September 2002. e = estimate

The Argentinean government's only recourse was to reassert its commitment to fiscal credibility.(42) It appeared to work. In March 1995, the IMF said it was considering a $2-billion increase in its loans to Argentina because it was encouraged by "the strong actions taken by Argentina. In the context of unsettled international financial markets, they demonstrate the firm commitment of the authorities to raise domestic savings, and to maintain fiscal and financial equilibrium and price stability."(43) The loan was eventually granted. As the financial storm around Mexico abated, the Argentinean economy recovered quickly and the rapid pace of capital inflows resumed. The Argentinean economy had survived its first major brush with financial crisis under the convertibility regime, apparently none the worse for wear. The fiscal credibility strategy had succeeded, at least temporarily.

In 1997, Argentina was again swept up in a problem not of its making, as the Southeast Asian financial crisis rolled over economies near and far. The full extent of the "contagion" would be truly evident only a year later when, in 1998, the Russians defaulted on their debt. This was followed in 1999 by a steep devaluation of the Brazilian currency, the *real*. This last development was especially dangerous for Argentina because Brazil, until that point and because of its overvalued fixed exchange rate, had been one of the few places where

---

(42) The IMF expected Argentina to post an overall surplus equal to 1.5% of GDP in 1995 (the fiscal year coincides with the calendar year in Argentina). See "IMF Praises Argentine Measures, Sees US$2b Loan Increase," IMF News Brief 95/9, 13 March 1995.

(43) *Ibid.*

Argentina's exports were competitive. The crises fuelled speculation that Argentina could be next, and that its currency board this time would not withstand sustained withdrawal of U.S. dollars from its banking system. As a result, Argentina was again virtually shut out of international lending markets. Domestic interest rates rose. The capital inflows from privatization that had once propped up the Argentinean economy ceased because there were few, if any, state assets left to sell. Meanwhile, previous capital inflows were beginning to exact a steep cost in the form of repatriated profits, dividends and debt servicing payments. The only way to meet these payments was through increased borrowing.

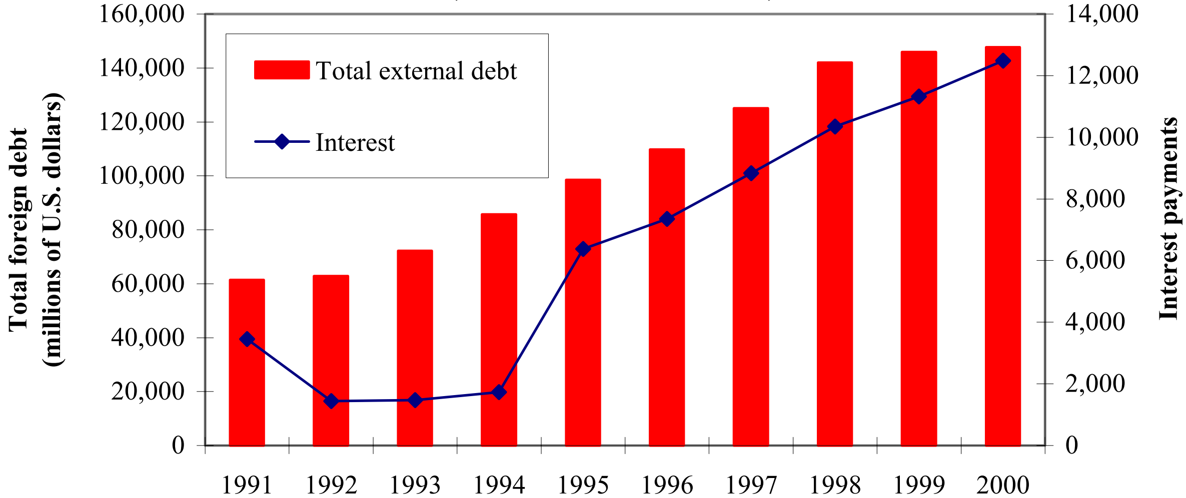
In a bid to bolster international confidence, the Argentinean government pursued the same strategy that had seemed to work in the previous financial crisis. It reasserted its commitment to the three principles that had ushered in the 1990s (liberalization, fiscal credibility and monetary stability), built a "war chest" of foreign currency to meet future debt repayment needs by selling new debt whenever it felt conditions were right, swapping short-term low-interest-rate debt for more costly long-term debt, and, most importantly, seeking additional funding from the IMF. As it had in the past, the IMF imposed strict budgetary conditions on Argentina in the form of surplus targets, all in a bid to reassure creditors of the soundness of the Argentinean economy. None of the IMF budgetary targets was ever met. "Thus from 1999, the economy entered a vicious circle in which the government continually cut expenditures in order to preserve IMF funding, but failed to meet the primary deficit targets as growth rates fell, and continued to borrow in international markets in order to supplement reserves, but at increasingly onerous interest rates which increased the interest burden of the debt" – a burden that manifested itself as rising interest costs in the budget.(44) In short, Argentina's policy seemed to be one of reassuring creditors that its debt burden was not excessive by increasing borrowing, while "reassuring them of the soundness of the economy by pledging to meet deficit conditions that could only debilitate domestic production."(45) It was, in essence, a pyramid scheme writ large. Figure 10 shows the evolution of Argentina's debt and interest cost burden, which under the currency board were all denominated in U.S. dollars.

---

(44) Kregel (2002), p. 17.

(45) *Ibid.*

Figure 10: Debt Burden and Interest Payments, Argentina, 1991-2000 (millions of U.S. dollars)



Source: CEPAL Economic Survey of Latin America and the Caribbean.

THE CURRENCY BOARD COLLAPSES

Until late 2001, the World Bank and the IMF appeared to believe Argentina could push through its difficulties, with each new crisis trumpeting Argentina's commitment to its structural reforms and, in particular, fiscal credibility.(46) In August 2001, less than six months before the country's economy collapsed, IMF Managing Director Horst Köhler said the IMF wanted to accelerate a $1.2-billion loan to Argentina based on the country's "strong commitment to the convertibility regime and to decisive implementation of the package of measures designed to achieve a zero fiscal deficit that will help greatly to stabilize the macroeconomic situation and to strengthen confidence. In view of these resolute efforts, the IMF stands ready to support Argentina."(47)

---

(46) In November 1998, as the Southeast Asian financial crisis was winding down, the World Bank noted (Report No. PIF7126) that "Argentina's record in satisfying the conditions of Bank adjustment loans has been excellent." In October 1999, the World Bank (Report No. PID8332) said that "Argentina is in the latter stages of a successful economic transformation" and that "the government has remained committed to fiscal prudence." In August 2001, the World Bank (Report No. PID8332) approved a $400-million loan based on the government's strategy – negotiated with the World Bank and the IMF – to pull the economy out of its downward spiral.

(47) "Köhler Says IMF Management to Recommend Accelerated Disbursement of US$1.2 Billion for Argentina," IMF News Brief No. 71/01, 3 August 2001.

Notwithstanding the rhetoric, the government continued to miss its deficit targets as Argentina's economy floundered. In January 2001, the Argentinean government had successfully rescheduled some of its debt into the future. The short-term picture was secured, however, at the expense of the long-term: the new debt carried substantially higher interest rates, which in turn meant that growth in the future had to be that much higher if the government was to meet its debt obligations. The government's strategy started to unravel in the summer of 2001, when several provinces found themselves on the verge of default because the federal government had not made its legally binding payments under the *Co-participation Law*, a law that allowed the federal government to collect taxes on behalf of the provinces.

Even as late as September 2001, however, it appeared the government might have achieved its budget targets as the IMF disbursed $6 billion in loans and another $3 billion for an unspecified restructuring of the external debt. This was not to be: with a growing run on the banks, and a shortage of U.S. dollars at the central bank, the government closed the banks temporarily and imposed a limit on withdrawals of $250 a week per person. This was greeted by a middle-class uprising, with citizens beating on casseroles as they marched through the streets. By Christmas 2001, the government had given up, saying it could not meet its financial commitments.

In the context of its structural reform policies, the government's credibility strategy could not work: each new crisis increased social pressure to at least maintain constant spending on the one hand (and hence diminish social instability), while the credibility strategy demanded reduced spending on the other (heightening social instability). Meanwhile, the debt payments and profits/dividend flows out of the country were reducing the nation's money supply.

The *Convertibility Law*/currency board was one of the key reasons why the credibility strategy could not work. While it initially appeared to serve Argentina well, it was a policy that, like the gold standard, could work only in an era of strong capital inflows and broad-based global economic growth. The drawbacks of a currency board become manifest in the face of the global financial crises of the 1990s.

CONCLUSION

In the late 1980s and early 1990s, Argentina found itself in a difficult position: inflation was rampant, poverty rates were high and the economy was generally in a shambles after more than 15 years of anaemic growth. Given this context, and given its history of a golden age of growth under a very open economy, Argentineans were ready for a radical change in economic policy. The Menem government delivered, offering a combination of liberalized trade and capital flows, fiscal credibility and monetary stability.

The policy seemed to work, initially. Inflation and poverty rates fell, the economy grew, surpluses were achieved and the currency board seemed to hold up well, even during one of the worst financial crises of the decade (the Mexican peso crisis). Meanwhile, the underlying difficulties – a rapid rise in real exchange rates, high real interest rates and stubbornly high unemployment rates – were masked by inflows of financial capital seeking to purchase newly privatized government assets and by Argentineans newly confident in their domestic economy.

The success of the structural reforms, however, depended on conditions and expectations that were unlikely to be maintained or to be realized. Wages did not fall, at least not quickly enough to restore competitiveness. Capital inflows overwhelmed the mechanism that was supposed to pull all the pieces of its growth strategy together. And the international economy was far from stable, with four major financial crises creating great uncertainty in the minds of investors about the financial, economic and social stability of developing countries such as Argentina.

Meanwhile, because of the dramatic nature of its structural reforms, Argentina had effectively surrendered the three major macroeconomic policy tools available to sovereign governments, namely, control over the capital account and trade, monetary policy and fiscal policy. All that was left was the government's promise of fiscal credibility, something that proved impossible to achieve in the context of a large debt burden (made more intractable by the currency board) and a global economy beset by periodic crises significant enough to prompt quick action by monetary and fiscal authorities in the more developed countries.

The *Convertibility Law*/currency board played a key role in all of this. Most obviously, it eliminated Argentina's ability to pursue independent monetary policy. More subtly, however, it also bound the three components of the government's structural reforms (liberalization, fiscal credibility and monetary stability) together in a dangerous way. First, pegging the exchange rate to the U.S. dollar combined with a sharp fall in inflation (brought about by the peg) led to a dramatic increase in real exchange rates, which undermined the country's trade balance, one of the expected engines for growth in the new structural reform era. Second, the *Convertibility Law* immediately turned all of the government's debt into foreign debt, which would ultimately undermine the government's attempts to maintain fiscal credibility. Third, it did not bring about sufficiently low real interest rates to stimulate domestic investment growth. Fourth and finally, it eliminated the central bank's ability to play a lender-of-last-resort role during the four crises that beset the Argentinean economy during the 1990s.

SELECTED REFERENCES

Camdessus, Michel. *Facing the globalized world economy: the IMF experience: four addresses by Michel Camdessus*. International Monetary Fund, 1996.

Chang, Ha-Joon. "Tariffs and Economic Development." *Challenge*, September-October 2002.

Davidson, Paul. "Dollarization, the Functions of a Central Bank and the Ecuadorean Economy." Paper presented at the 75th anniversary of the Central Bank of Ecuador, 2002. Available on-line at: http://econ.bus.utk.edu/davidsonextra/Davidson.html.

Economist Intelligence Unit (EIU). *Country Profile 2000: Argentina*.

Edwards, Sebastian. "The Argentine Debt Crisis of 2001-2002: A Chronology and Some Key Policy Issues." University of California, Los Angeles, and National Bureau of Economic Research, 2002. Available on-line at: www.nber.org/~confer/2002/argentina02/edwards.pdf.

Feldstein, Martin. "Argentina's Fall: Lessons from the Latest Financial Crisis." *Foreign Affairs*, April 2002.

Frenkel, Roberto. "Argentina: A Decade of the Convertibility Regime." *Challenge*, Vol. 45, No. 4, July-August 2002.

International Monetary Fund. "IMF Praises Argentine Measures, Sees US$2b Loan Increase." IMF News Brief No. 95/9, 13 March 1995.

———. "Köhler Says IMF Management to Recommend Accelerated Disbursement of US$1.2 Billion for Argentina." IMF News Brief No. 01/71, 3 August 2001.

Kahn, George A. "The Economic Outlook and Monetary Policy Before and After September 11, 2001." Paper presented to the Oklahoma Economics Forum, October 2001. Available on-line at: www.kc.frb.org/spch&bio/oklahoma2001/ok2001doc.pdf.

Kregel, Jan. "Argentina." Unpublished paper presented at the Seventh Annual Post Keynesian Summer School, University of Missouri, Kansas City, 2002. Copies available upon request.

Morley, S.A. "The Income Distribution Problem in Latin America and the Caribbean." 2001. Available on-line at: http://www.eclac.cl/analisis/TIN5.htm.

Morley, S.A., Roberto Machado and Stefano Pettinato. "Indexes of Structural Reform in Latin America." ECLAC Economic Division, January 1999. Available on-line at: http://www.eclac.cl/analisis/TIN31.htm#9.

Murray, John, and James Powell. "Dollarization in Canada: The Buck Stops There." *Bank of Canada Technical Report*, No. 90, August 2002. Available on-line at: http://www.bankofcanada.ca/en/res/tr90-e.htm.

Paraje, Guillermo. "Inequality, Welfare and Polarization in the Greater Buenos Aires 1986-1999." 2002. Available on-line at: http://smye2002.univ-paris1.fr/program/paper/d3_par.pdf.

Scoffield, Heather. "Crow sees no easy economic fix for beleaguered Argentina." *The Globe and Mail*, 26 August 2002, p. B1.

Tommasi, Mariano. "Federalism in Argentina and the Reforms of the 1990s." Centre for Research on Economic Development and Policy Reform, Stanford, Connecticut, May 2002. Available on-line at: http://credpr.stanford.edu/publications/Fiscal_PubsList.html.

Véganzonès, Marie-Ange, and Carlos Winograd. *Argentina in the 20th Century: An Account of Long-Awaited Growth*. Organisation for Economic Co-operation and Development, Paris, 1997.

World Bank. *Argentina: From Insolvency to Growth*. World Bank, Washington, 1993.