

ARGENTINA 2002: A CASE OF GOVERNMENT FAILURE

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In the aftermath of the Argentine default and devaluation, the Argentine government did little or nothing to alleviate its deep crisis and much to make it worse. The unemployment rate exceeded 20 percent, more than a million people emigrated—a sure sign that they had given up hope of a return to stability—and 40 percent of those who remain are impoverished. Inflation soared following devaluation and rapid money creation. Although 40 percent of daily consumer purchases are cash transactions, the government restricted access to money, sharply limiting these transactions.

Joseph Stiglitz speculated that the International Monetary Fund punished Argentina because it defaulted. This is nonsense. The government did not make any of the reforms needed for recovery. The previous government wrecked the banking system. Devaluation strengthened the export sector, so the government increased export taxes reducing exports. The courts gave people who sued the right to withdraw their bank deposits, so the government threatened to replace the judges to prevent withdrawals. It wasted scarce foreign exchange managing its exchange rate instead of letting it fall to a market level.

The IMF showed remarkable calm compared with its past behavior. Aside from extending the term of some loans that Argentina could not pay, it did not offer any new money. The IMF sent a mission to negotiate a new loan agreement, and separately it sent four former central bankers (the wise men) to appraise conditions and to recommend a monetary framework for noninflationary growth. The wise men made an intriguing statement at the end of their report. They said that if Argentina had credible policies, it would not be in crisis. How true! The Duhalde government made negotiation unpromising.

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Political and Economic Reform: The Need for Credibility

Argentina's main problem for decades has been a political system that cannot maintain credible, pro-growth, noninflationary policies. It has not kept promises to the IMF and other international lenders. Without political reform, there is little prospect that new promises will be kept.

Instead of negotiating another loan in exchange for promises, the IMF should withdraw from Argentine domestic policy. Political reform would come faster, if it comes at all, once Argentines know that they cannot expect any assistance until reforms are implemented, not just promised. These reforms should be part of an Argentine plan to establish a political system that is responsive, transparent, open, honest, and capable of solving economic and social problems, as responsible governments elsewhere do.

Then come economic reforms. The government broke private contracts unilaterally. It forced the public and banks to accept pesos in place of dollars, a move that the Argentine courts declared unconstitutional. It revalued liabilities and assets at different exchange rates, driving an enormous hole in the banks' net worth. Unilaterally, it changed contracts with utility companies. These contracts had proved to be excessively generous. Renegotiation, not unilateral dictate, would have been the appropriate response.

In these and other ways the Argentine government emphasized sovereignty and ignored the rule of law and the sanctity of contracts. This is likely to have a long-term effect on capital investment. The IMF cannot solve Argentina's problems. Success requires political support within the country. Argentina has shown that reform lacks support.

Banking reform is an example. The government offered to exchange blocked deposits for bonds payable in 5 or 10 years. Few accepted this voluntary exchange. The IMF at one time proposed to convert the rejected voluntary exchange plan into a mandatory plan. Is this the way to teach the virtues of the marketplace and the rule of law? Does the IMF encourage democratic government by forcing changes that the public rejected overwhelmingly?

Argentines have shown what they prefer. They went to the trouble of getting court orders to get their deposits out of the banks. They immediately exchanged their pesos for dollars, not the promises of a discredited government.

A Market-Supporting Role for the IMF

The IMF can help Argentina by supporting an Argentine effort to settle its outstanding debt to foreigners, about \$45 billion dollars at

face value and worth about \$9 billion dollars at current prices. As Adam Lerrick and I proposed, Argentina should offer to negotiate an exchange into new debt. Its initial offer would be about 20 cents on the dollar, the illiquid market price, supported by its increased export earnings. This would allow bondholders to liquidate their holdings and rebalance their portfolios (Lerrick and Meltzer 2001).

The IMF can assist by offering to buy the debt for cash at 15 cents while the exchange offer remains outstanding. The total cost to the IMF in the worst possible case would be \$6.8 billion if everyone took cash. This is far less than the amount of the loans the IMF will make if it returns to supporting Argentina. By offering a floor of support, the IMF would make the now illiquid bonds tradable and give an incentive for the market to find a solution.

The IMF will have contributed to a solution of the international part of the problem. It should leave the rest to Argentina. Freed of its default, and with a much smaller debt, Argentina could borrow again, at least at short term. When it has a political system that is transparent and rests on the rule of law, it can begin to resolve its banking, financial, and fiscal problems.

A concern is that the IMF wants a quota increase, more taxpayer money to spend on its command-and-control system. This is an error. What is needed is not more money for the Turkeys, Pakistans, and Argentinas. Far more important is recognition that domestic reforms, anchored in domestic politics and policies, bring loans and direct investment to countries that choose reform. IMF command and control cannot duplicate, or even approach, the benefits for growth or the amounts of money that come following the rule of law, prudent fiscal policy, sound banking systems, and viable exchange rate regimes.

Conclusion

Argentina was on its way, but it did not get there. No amount of IMF funding or exhortation can get it where the public would like to go. The fact that more than 2 percent of the population has left, or has applied for visas, dramatically illustrates what Argentineans anticipate. Until Argentina undertakes fundamental political and economic reform, it will not prosper.

Reference

- Lerrick, A., and Meltzer, A. (2001) "Beyond IMF Bailouts: Default without Disruption." *Quarterly International Economics Report*, Carnegie Mellon Gailliot Center for Public Policy (May).