

THE ARGENTINE ECONOMIC CRISIS

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The Argentine economy suffered a deep crisis during 2001 and 2002. Poverty stretched to one in every three homesteads in the suburbs of Buenos Aires, and the traumatic departure from convertibility, together with financial crisis and default (public debt default), undermined investor confidence, both local and foreign.

Causes of the Crisis

We believe the crisis owed its existence to four main causes: (1) inappropriate fiscal policy, (2) wage and price rigidities inconsistent with a fixed exchange regime, (3) a considerable, adverse external shock, and (4) political turmoil.

Two-Tiered Fiscal Inconsistency

On one side, public expenditure growth measured in U.S. dollars outpaced GDP growth, corrected by tradable-goods prices. On the other, the federal and provincial primary fiscal surplus did not rise at an equal pace with the hike in the financial burden linked to growing debt and the gradual phasing out of preferential-rate bonds (Brady bonds and others issued to cancel government liabilities with pensioners and state contractors) replaced in turn by market-rate notes.

The impact and stress on convertibility caused by real shocks has led many analysts to challenge the fiscal nature of the crisis.¹ In our

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¹ Pointing to convertibility or dollarization as basic explanations of the crisis, in order to downplay structural problems in fiscal institutions, overlooks the fact that they were precisely chosen after decades of fiscal mismanagement. From an empirical point of view and despite the many attempted explanations to disregard the fiscal dimension, the only econometric evidence

opinion, that doubt stems from an incomplete observation of Argentine data and to a misinterpretation of causality between public expenditure and real exchange rates.

A first dimension of the issue bears on the fact that public expenditure relies heavily on nontradable goods and services. An uncontrolled expansion of the nontradables sector leads to real exchange-rate overvaluation in small, open economies because the pressure exerted on domestic prices cannot be offset by tradable-good prices limited by a fixed exchange rate and foreign prices. Throughout the 1991–2001 period, the three levels of government expenditure rose 77 percent in dollar terms, while the Argentine GDP rose 57 percent and dollar-denominated tradable prices fell (Table 1).

Even worse, government data do not adequately gauge state outlays because deficit registers systematically underestimate public debt variation—that is, the official data do not consider as “expenditure” the issue of new government debt to cancel claims on the government. If expenditure is “corrected” yearly to account for the difference between consolidated deficits and debt variation, public expenditure in the 1991–2001 period grew about 97 percent; in dollar terms that figure is more than 40 percentage points above tradable-price-adjusted GDP growth. A clearly expansive public spending policy, financed largely by borrowing abroad, contributed to real exchange-rate overvaluation. Actually, government spending in Argentina behaved as if the exceptionally favorable export prices of the 1996–97 interval could have held throughout the whole period. Their subsequent collapse exposed the fragility of the Argentine fiscal policy.

A second dimension of the fiscal problem can be seen when analyzing the evolution of the primary fiscal balance. During the 1991–2001 period, the federal primary balance averaged a surplus of 1 percent of GDP, while interest payments measured 2.8 percent of GDP. However, if properly measured, the real primary balance for the entire 11-year period was in deficit, equal to 0.7 percent of GDP. Toward the end of that period, the *consolidated* fiscal balance was in deficit, equal to nearly 6 percent of GDP. The largely dollar-denominated public debt aggravated the problem for 2002 after the peso devaluation.

Another misinterpretation underlies the comparison of sovereign debt for Argentina to the European Union’s public debt ceiling of 60 percent of GDP under Maastricht standards. The problem with this

available on the transmissions channels of the crisis point to fiscal imbalances as a central explanation of the crisis (Powell 2002).

TABLE 1
 ARGENTINE PUBLIC EXPENDITURE
 (Cumulative Percentage Change)

	Public Expenditures (U.S.\$)		"Corrected" Expenditures		GDP (U.S.\$)	Export Prices	Tradable Prices
	Primary	Total	Total	Total			
1991-2001	59.4	77.0	97.4	56.8	-0.8	-7.9	
1991-1994	54.6	53.0	87.1	50.6	7.0	1.5	
1995-2001	3.1	15.7	5.5	4.1	-7.3	-9.3	
1991-1997	61.7	66.3	82.2	71.3	16.6	7.0	
1997-2001	-1.5	6.4	8.4	-8.5	-14.9	-13.9	

approach was that European Community rules were designed for countries that face no difficulties rolling over principal. This is not always the case with developing countries, where domestic capital markets are limited and external capital flows may wane for reasons beyond their control.

During most of the 1990s, Argentina complied with most of the Maastricht standards, except the one that is central to public debt sustainability—namely, the spread over public bonds issued in domestic currency compared with the lowest European country interest rates. Spreads over Argentine bonds denominated in pesos tripled the 150 basic points admitted by Maastricht. Together with failure to converge toward investment grade qualifications, this suggested that Argentine debt would, sooner or later, be judged unmanageable.

For these reasons, borrowing rules for emerging countries must be tighter, further disclosing the vulnerability of Argentine fiscal accounts (Artana, López Murphy, and Navajas 2003). It is not random that countries with economies considered healthy, such as Chile, have debt ratios considerably lower than those of Argentina, both in terms of the size of the economy and the amount of revenues collected.

The Lack of Flexibility

The problem of economic rigidity has to be dealt with, bearing in mind that the strict observance of convertibility—under the currency board system—requires other economic variables to be flexible enough to accommodate negative external shocks, relying more on nominal rather than on quantitative adjustment. Response of the economy to a sudden drop in dollar inflows (either due to capital outflows or to a fall in exports) may reallocate resources toward tradable activities, or cut imports through a slump in aggregate demand. A flexible economy performs the first kind of correction; a rigid economy will muddle through the second kind, which is obviously more expensive and traumatic.

A first dimension of the rigidity problem is an insufficient exposure of the Argentine economy to foreign trade. Notwithstanding gains made in the direction of regional economic integration, judging by the ratio of imports to GDP, Argentina is one of the least exposed to international trade. The Mercosur average common tariff is 13 percent, compared with 7 percent in Chile and less than 5 percent in developed countries. This anti-export bias limited exports to a mere 10 percent of GDP, despite strong economic growth during the 1990s. The low ratio of exports to GDP means that an external shock that reduces capital inflows by 1 percent of GDP will require an offsetting

expansion of exports of 10 percent above trend to avoid economic contraction.

A second issue is labor regulations and, here, Argentina did not make enough progress to secure the much-needed flexibility. In particular, reallocation of resources toward the tradables sector faced an additional restriction: this sector is essentially formal, while an important part of the nontradables activity is informal. Reassigning the labor force is increasingly difficult given the tax differential that burdens formal activities, in particular, when taxes have an impact directly on hiring labor.

Regarding business flexibility, Argentine bankruptcy legislation is inappropriate. Debtors already enjoy more protection than they do in the United States.

Finally, the most notorious inflexibility occurred in public spending. A successful devaluation should reduce both labor costs and the burden of the state on tradable activities. In the absence of exchange rate flexibility, the situation called for downward flexibility in government spending or a strict limit on the growth of government. Yet spending rigidities extended well into the crisis, revealing the magnitude of the problem.

The External Shock

Argentina suffered an external blow of an unusual nature. Our country traded intensively within the region, exported agricultural and industrial commodities, and relied heavily on capital inflows. From 1997 onward all of these factors fell behind. Export prices dropped around 15 percent between 1996–97 and 1999–2000. In addition, the country's situation worsened because its main trading partners (Europe, Brazil, Chile) depreciated their currencies. With the peso pegged rigidly to the U.S. dollar, there was no way to offset competitive depreciations. What the government should have done was to save in times of bonanza, building reserves to accommodate lower taxes later, thus supporting a private sector handcuffed by the strong peso.

Foreign credit gradually waned and capital markets began to believe that the Argentine crisis was not transitory in nature. Capital inflows, which had averaged 6 percent of GDP in 1997–98, halved by the year 2000, and reversed completely during 2001. The problem of external financing was partially cushioned during 2000 and 2001 by borrowing from multilateral institutions, revealing that the turnaround in private flows was even worse. So long as multilateral institutions cannot increase their net Argentine exposure, the contractive effects may linger on because a country in default, where the

government has interfered with private contracts, may expect a very slow return of private capital.

Political Problems

The coalition, sworn in by year-end 1999, responded to the crisis with hesitation and delay. In 2001, the banking system was further weakened by a government that borrowed compulsorily from bank reserves; the exchange rate regime was reformed by pegging the peso to a basket of currencies that included the euro, in an attempt to introduce some degree of flexibility; budget constraints were ignored as both federal and provincial governments issued quasi-moneys; and pension and retirement funds were interfered with. Those misconducts aggravated the credibility gap and fueled a run on bank deposits that led to a compulsory freeze, default, and devaluation.

Conclusion

The Argentine crisis combined all evils put together. Social drama was excruciating, the state was in default, financial paralysis lingered on, and the fiscal situation was unresolved, waiting for inflation to do the job Congress failed to achieve. Even worse, the rout ended monetary credibility, disavowed the fiscal responsibility legislation passed in 1999, and interfered with private contracts, notwithstanding a law that purportedly protected bank deposits.

Reconstructing Argentina will not be an easy task in spite of the recent recovery in economic activity. Key institutions have to be reconstructed and made credible again, requiring significant political reform. Our vision is that robust fiscal institutions underlie macroeconomic stability and precede exchange-rate decisions, given that fiscal mismanagement is absolutely inconsistent, sooner or later, with any sustainable monetary regime. In truth, the core of the solutions must include a harsh, permanent halt to the Argentine mania of running fiscal deficits, concealing them, and later enduring the consequences of a government that disavows its commitments.

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