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Lessons from the Crisis in Argentina

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I Overview

In 2001–02, Argentina experienced one of the worst economic crises in its history. Output fell by about 20 percent over three years, inflation reignited, the government defaulted on its debt, the banking system was largely paralyzed, and the Argentine peso, which used to be pegged at par with the U.S. dollar, reached lows of 3.90 pesos per U.S. dollar (in June 2002). In the early months of 2003, the economy began to recover, but there remained a long road back to sustained growth and stability.

The events of the crisis, which imposed major hardships on the people of Argentina, are all the more troubling in light of the country's strong past performance. Less than five years earlier, Argentina had been widely hailed as a model of successful economic reform: inflation, which had reached hyperinflationary levels during the 1980s, was in the low single digits, output growth was impressive, and the economy had successfully weathered the Tequila crisis of the mid-1990s. Then, in the late 1990s, the country slipped into a depression from which it was unable to extricate itself. To be sure, there was widespread recognition of underlying vulnerabilities of the economy—which, in hindsight, played a crucial role in the subsequent events—as well as important slippages in policy implementation and, later on, missteps in handling the crisis. But Argentina was widely considered a model reformer and was engaged in a succession of IMF-supported programs (some of which were precautionary) through much of the 1990s, when many of the vulnerabilities were building up.[1]

The severity of the crisis, and the fact that it occurred despite Argentina's reasonable performance in a succession of IMF-supported programs, make it a particularly important case study for other countries and for the IMF. The Argentine experience holds lessons for crisis prevention, crisis management, and the design of IMF-supported programs.[2] This paper examines the origins of the Argentine crisis and its evolution up until early 2002, with a view to drawing out such lessons, some of which have already been reflected in the IMF's work. It focuses on the economic forces leading up to the crisis and the general policy lessons, both for countries' efforts to prevent crises and for the IMF's surveillance and use of its resources.

Like other financial crises in emerging markets during the past decade, the Argentine crisis stemmed from a combination of fragility in balance sheets and the inability to mount an effective policy response.[3] In Argentina, the critical fragility was in public sector debt dynamics, which were made explosive by the effects of a prolonged economic slump and the difficulties in rolling over debt. The inability to mount a policy response stemmed from a combination of economic constraints and political factors—notably, as in many previous crises, insufficient political support and resolve.

Argentina's latest crisis nevertheless differs in several respects from previous ones, as highlighted in a large and rapidly growing academic literature (Box 1).[4] Unlike many traditional balance-of-payments crises—including those suffered by Argentina in the past—this crisis was not driven by large money-financed deficits and high inflation. On the contrary, the currency board regime precluded direct money financing of fiscal deficits, and in the run-up to the crisis there was significant price deflation. Although the small size of Argentina's financial sector contributed to excessive reliance on foreign financing, the banking system appeared sound and well capital-

[1]During the 1990s, there were four IMF arrangements: an arrangement under the Extended Fund Facility approved on 3/31/92; a Stand-By Arrangement approved on 4/12/96; another Extended Arrangement, approved on 2/4/98; and another Stand-By Arrangement, approved on 3/10/00. Stand-By Arrangements are short-term arrangements designed to address temporary balance of payments difficulties, while Extended Arrangements focus on balance of payments difficulties arising from longer-term structural problems.

[2]Lessons for crisis management, in particular, based on the experience in a number of countries during the past 10 years, are drawn in a more comprehensive fashion in Collyns and Kincaid (2003).

[3]Previous crises and their origins are reviewed in Ghosh and others (2002).

[4]While individual commentators differ in their emphasis on various factors, the view presented in the paper overlaps with many of the features stressed by Calvo (2002) and Mussa (2002).

Box 1. The Argentine Crisis: A Brief Review of the Academic Literature

The economic literature on Argentina's crisis has mushroomed over the past few years with opinion fairly evenly divided on the roots of the crisis. Mussa (2002) emphasizes that the crisis was rooted in insufficient fiscal tightening in the middle of the decade when the economy was growing at over 7 percent a year, partly related to the overestimation of potential output growth in Argentina during the 1990s. Hausmann and Velasco (2002) argue that the origins of the crisis lie in the sharp downturn of 1998. At that time, expectations of future export growth declined sharply, leading to higher risk premia and smaller capital inflows. This development led to lower domestic investment, which in turn depressed output and further curtailed creditworthiness and the ability to borrow.

Other authors place much greater emphasis on the exchange rate regime in explaining the crisis. Feldstein (2002) argues that the fixed exchange rate made it impossible to achieve competitiveness by a traditional currency devaluation (in contrast to a variety of countries during the 1990s, including Brazil, Korea, and the United Kingdom). Moreover, 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. Consistent with this view, Roubini (2001) and De la Torre, Yeyati, and Schmukler (2002) have argued that convertibility does not immunize a country from the balance-sheet effects of a real exchange rate adjustment; it only generates the adjustment through deflation and unemployment, which erodes the repayment capacity of debtors whose earnings come from the nontradable sector. Perry and Serven (2002) also emphasize the existence of a hard peg as a crucial factor in the deteriorating situation. They compare the output adjustment to a terms of trade shock in countries with floating exchange rates and in countries with hard pegs and find that the output adjustment is much greater in the latter, since deflation has to play a large part in the adjustment.

Calvo (2002) emphasizes the sudden reversal of capital flows to Latin America in late 1998 and distinguishes the ability of various Latin American countries to cope with the reversal depending on the degree of openness of the country and the extent of liability dollarization. He argues that since Argentina was a closed economy with an extremely high level of liability dollarization, the change in the real exchange rate required to eliminate the current account deficit was very large.

ized (that is, in terms of traditional measures) until the default on government bonds and the asymmetric *pesoization* and *indexation* of bank balance sheets. As with the collapse of Brazil's exchange rate peg in 1999, the public debt dynamics and doubts about the exchange rate peg were central, although the nature of the peg, the timing of exit, and other aspects of the situation led to very different results in the two cases.

In a nutshell, even though the interaction between fiscal policy and the currency board arrangement played the central role in Argentina's transformation from an apparent star performer to a crisis country, a combination of other factors, including unfavorable external developments, was also at play. The currency board, although it initially played an essential role in achieving disinflation, was an inherently risky enterprise; it changed over time from a confidence-enhancer to a confidence-damager, as the policy orientation shifted from a "money-dominant" to a "fiscal-dominant" regime. Once inflation had stabilized at low levels, the rationale for maintaining a fixed exchange rate was weak, given the economy's structural characteristics. Finally, when the economy slid into recession, the currency board became a liability in the context of a buildup of sizable foreign-currency-denominated public debt—signifying the effective fiscal dominance of the policy regime. Not only was the government constrained to carry out a contractionary monetary policy in the midst of a slump, balance-sheet vulnerabilities had dramatically raised the cost of exiting the fixed exchange-rate regime. The result was a policy dilemma that ultimately undermined the confidence needed to prevent the ensuing crisis.

The paper reviews the four main phases of economic developments and policy responses that led to Argentina's recent crisis. Section II discusses the major vulnerabilities underlying the crisis that emerged during the boom years of the 1990s—in particular, the buildup of public debt and the failure to tackle serious structural weaknesses in fiscal institutions, labor markets, and external trade. Section III describes how these vulnerabilities came into play with the onset of a prolonged depression beginning in mid-1998. Several factors contributed to the downturn, which began as a cyclical correction: domestic political uncertainties, financial contagion from the 1998 Russian crisis, and Brazil's 1999 crisis and the subsequent devaluation of its currency. Once the downturn had started, the currency board arrangement limited the Argentine authorities' ability to prevent a tightening of monetary policy, and the public debt dynamics, which were exacerbated by the protracted slump, ruled out loosening fiscal policy. As a result, the authorities' ability to support economic activity was limited. Section IV takes up events during 2001, as the crisis unfolded in slow

motion with a series of increasingly desperate, and in many cases counterproductive, steps to arrest the debt dynamics. Section V discusses the steps taken by the authorities in 2002, following the default on government debt and collapse of the currency board, many of which made the crisis even more difficult to resolve. Section VI examines the IMF's involvement in the unfolding of Argentina's crisis, and Section VII draws out the lessons from Argentina's experience and presents concluding remarks.