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ARGENTINA

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A Social Contract Abrogated: Argentina's Economic Crisis

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ARGENTINA 1990S: DEVELOPMENT, DOLLARS AND DEFICITS

In the 1990s, Argentina had given up an independent monetary policy in favor of a currency board that would only allow the issuance of another peso if it was backed by a dollar. amd thereby stopped run away inflation, raised investor confidence and attracted considerable foreign investment. The combination made much of the 1990s a period of rapid economic growth. Rapid growth did not eliminate the government's or the provinces' fiscal deficits. Instead, the national government used asset sales to cover some expenses and turned to foreign capital to cover others. Some of the 1990s inflow of foreign capital was used to purchase government assets under a privatization drive or to create a large foreign presence in the Argentine banking system. But much of the capital went to purchase relatively short-term government bonds. The powerful and independent provinces created a particularly Argentine problem for fiscal policy. Under the Argentine system, the provinces could issue international bonds that created added debt for the federal government.

The peso-dollar link that had been such a boon in stabilizing prices, creating confidence and attracting investment became a liability in the late 1990s. The 1997 Asian financial crisis drove many investors to seek the safety of dollars and dollar denominated investments. The resulting appreciation of the dollar (and the Argentine peso linked to it) left Argentina with a significantly overvalued currency. A decline in global commodity prices further reduced Argentina's export earnings. By the late 1990s, Argentina was struggling with a recession, mounting fiscal and external debts, and a significantly overvalued currency.

In 2001, Argentina ran out of time. The foreign investors that had helped mask Argentina's fiscal deficits shifted their investments elsewhere. Neither the International Monetary Fund (IMF) nor the U.S. Treasury was willing to extend added credit to Argentina until the fiscal deficits were brought under control. Most foreign observers also called for an end to the peso-dollar link so that the peso could fall in value and allow Argentine exports to become more price competitive on global markets.

Finally Argentina acted. The peso-dollar link was ended; the peso was devalued and then allowed to float freely. The government defaulted on much of its $141 billion in external debt. Over the past several months, the banking system has suffered a slow-motion run on the banks.

BREAKING A SOCIAL CONTRACT: DEVALUATION AND DEFAULT

Dr. Mario I. Blejer opened his remarks by stressing that there is no textbook solution for the mix of economic and financial challenges facing Argentina. Instead, he was challenged by a mix of default, depreciation and deposit runs when he assumed the governorship of the Central Bank.

Blejer stressed three other realities that condition the government's current thinking. In ending convertibility (the peso-dollar link), the government had broken an important social contract. It was, he noted, a contract that Argentines carried in their pocket – the peso bills were themselves marked as convertible. So many deposits and contracts were written in dollars that breaking the link ended up breaking many individual contracts as well.

Four years of recession had already left Argentina with a high and rising unemployment rate. Several times in recent months the Argentine public has taken to the streets to express their anger over economic policies of earlier governments. In an attempt to maintain services and employment, individual provinces were paying their workers in limited-term bonds that began to circulate as a form of cash. The protests are starting again. The Monday, April 22, 2002 edition of the Financial Times, reported that, "unpaid state workers from Argentina's bankrupt provinces are occupying public buildings around the country and going on strike."

Last week, the government finally closed Scotiabank Quilmes, SA after its parent Canadian company, Bank of Nova Scotia, refused to provide added cash to its affiliate. On Friday (April 19), the government closed all banks and suspended trading in foreign exchange markets.

Blejer, however, was very much looking forward. As he put it, "the past is always changing but the future is clear" in terms of what Argentina must do. First, the government must exercise fiscal and monetary restraint. The government expects to move from a large budget deficit in 2001 to a primary surplus (fiscal balance before interest payments) of one to one and half percent of GDP. With government bonds in default, the Central Bank cannot regulate the money supply through buying and selling bonds. Instead, they must set a quantitative target for money growth that will be achieved through supporting the banking sector and funding the remaining fiscal deficit.

The Argentine courts have overruled several attempts of earlier governments to freeze deposits or limit withdrawals from the banks. The government's decision to close the banks is linked to a legislative proposal to convert sixty percent of bank deposits into bonds. Individuals could chose between five-year pesodenominated bonds or a ten-year dollar denominated variety. By adopting a new law, Blejer was hopeful the bonds for deposits proposal would withstand legal challenge.

Blejer reminded the audience that after his inauguration, Franklin Roosevelt, on March 4, 1933, declared an indefinite bank holiday until Congress passed needed legislation. Congress acted quickly and Roosevelt allowed sound banks to reopen while failing banks were closed. Argentina's plan, so far, does not contemplate closing any banks.

LOOKING FOR A CONFIDENCE SHOCK

What Argentina needs, he concluded, is the kind of "confidence shock" that will come with an IMF

For the last twenty-five years, the Wilson Center's Latin American Program has been creating a dialogue bridge between Latin America and the United States for the exchange of ideas, information and activities. The Program provides a non-partisan platform for discussion of issues related to Latin America and the Caribbean in Washington D.C., with the objective of drawing the attention of opinion leaders and policy makers in the Hemisphere to these issues.
The Latin American Program develops and implements projects that deal with an individual country, such as Argentina, Brazil and Mexico, or a broad theme, such as hemispheric security, Latin American-U.S. relations, the alleviation of poverty, economic development, and democratic governance.

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agreement. An IMF agreement will provide added resources but even more importantly, will also act as a seal of approval from the international financial community. To get that "confidence shock," Argentina must develop a workable plan and provide convincing safeguards to assure the international community that this new plan will become stable and effective policy. Neither Argentina nor the IMF could afford another failure.

Paul Blustein, staff writer for The Washington Post, provided the first commentary. A former Rhodes scholar, Blustein had worked at Forbes and The Wall Street Journal before joining The Washington Post. A five-year stint in Asia (1990-1995) gave him a first hand look at the Asian miracle before the financial crisis hit in 1997. Blustein is also the author of the much praised The Chastening: Inside the Crisis that Rocked the Global Financial System and Humbled the IMF, a detailed look at the Asian financial crisis and its aftermath.

Blustein reminded the audience that Argentina is only the most recent of the financial disasters that started in Thailand and eventually spread to Russia and then Brazil. He was critical of the IMF performance over much of this period but also argued that the IMF faced an almost impossible task given the size of short-term capital flows and the speed with which they can shift from one destination to another.

The breach of social promise, Tulchin stressed, fit into an historical legacy that stretched back over at least fifty years. Military governments often shifted financial policy with virtually no warning and no consultation. The pattern of violating the social contract will make restoring confidence and trust all the more difficult. It is a case of many times burned and ever more shy.

THE DANGERS OF SHORT-TERM BORROWING

Blustein did not agree with the view that the IMF imposed austerity on Argentina through the creation of a currency board and the peso-dollar link. The real story, he said, was quite different. He quoted a leading development specialist who referred to Argentina as the "spoiled child" of the international financial system. A stream of foreign capital had allowed Argentina to ignore its persistent deficits and its growing external debt. On a recent trip to Argentina, Blustein found Argentines saying that the IMF should have been tougher with them in the past.

Blustein wondered, however, if the IMF was now being overly strict with Argentina to make up for past mistakes that it had made in Argentina and elsewhere. He also noted that former Economy Minister Domingo Cavallo too often let the Fund know of major policy shifts only just before he put them into practice. Blustein wondered if the IMF strictures were sending a message that Cavallo-like behavior would not be tolerated.

In the end, Blustein emphasized the complexities that the IMF frequently faced. To make the point, Blustein referred to his interview with former IMF chief economist, Michael Mussa. At the time of the interview, Mussa was taking the active ingredient in rat poison as a way to limit the risk of blood cots. Too little poison and he ran the risk of clots and a serious stroke; too much and the "cure" could prove worse than the disease. Talking to Blustein, Mussa suggested that the IMF often faced a similar dilemma in prescribing just the right amount of macroeconomic discipline.

Dr. Joseph S. Tulchin, current director of the Wilson Center's Latin American Program, provided the second commentary.

ARGENTINA: MISTAKES, BAD LUCK, AND THE BURDEN OF HISTORY

Tulchin made three complementary points: Argentina needed to work with the IMF, private creditors and its own polity to restore international confidence; Argentina had made mistakes but was also quite unlucky; and Argentina has a fifty-year history of breaching its social compacts that make restoring domestic confidence an added challenge.

With IMF negotiations well underway, Tulchin was pleased to learn that Blejer and the Argentine government were thinking seriously of when and how to begin talks over rescheduling Argentina's external debts with international creditors.

The current situation is not just a product of Argentine mistakes. As Argentina entered the 21st century, it was hit by a U.S. recession that slowed global demand and the drying up of short-term capital flows. In Tulchin's view, the IMF probably was being tougher on Argentina to offset its past leniency. The new American Secretary of the Treasury, Paul O'Neill, was very much oriented to a tough love approach and had been critical of past IMF programs, which he viewed as too often safeguarding foreign investors who had already been rewarded with high interest rates. In a considerable change from Clinton-era policies, O'Neill provided a "parental spanking" rather than a "fraternal gesture."

In his concluding remarks, Tulchin returned to Blejer's initial emphasis on the breaking of the social contract. The breach of social promise, Tulchin stressed, fit into an historical legacy that stretched back over at least fifty years. Military governments often shifted financial policy with virtually no warning and no consultation. The pattern of violating the social contract will make restoring confidence and trust all the more difficult. It is a case of many times burned and ever more shy.

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