

Chapter 2

Argentina's Debt Crisis

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2.1 Introduction

The story of Argentina's external debt can be summarized as follows. At the end of 1975, Argentina's external debt was \$4 billion; at the end of 1982, \$40 billion; and at the end of 2001, \$140 billion. On December 2001, Argentina announced the default of its external debt. It was one of the largest defaults in present value terms since the Russian repudiation of 1918.

How was it that Argentina came to that shocking result? In August 1982, Mexico declared that it would no longer be able to service its debt. In the wake of Mexico's default, most commercial banks reduced significantly or halted new lending to Latin America. As much of Latin America's loans were short term, a crisis ensued when their refinancing was refused. Thereafter, Mexico, Brazil, and Argentina followed suit. Argentina's default lasted until 1992, when it reached an agreement with the creditor banks within the framework of the Brady Plan.

With this antecedent, nobody thought, in the early 1990s, that Argentina's public sector could easily recover access to capital markets. However, while at the end of 1991 Argentina's public debt amounted to \$61 billion, by the end of 1999 it had soared to \$145 billion (Fig. 2.1). How was it possible that such a serial defaulter¹ could more than double its external debt in such a short time? This seems to contradict the explanation given by Reinhart and Rogoff (2004, 13) related to the "paradox" of why so little capital flows to poor countries; they argue that countries that do not repay their debts have a relatively difficult time borrowing from the rest

¹ Although Argentina is known as a serial defaulter, its record is surpassed by many countries in the New World and by almost as many in the Old World including France and Germany (Reinhart and Rogoff 2004, 3).

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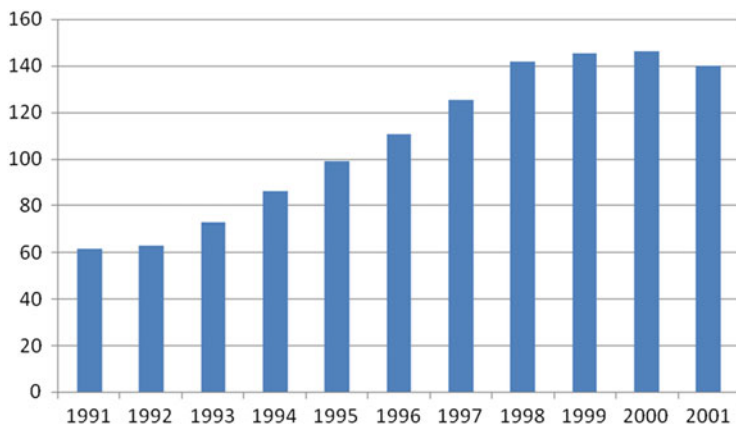


Fig. 2.1 Public indebtedness—national government—1991–2001 (billions of dollars at the end of each year) (*Source:* Ministry of Economy)

of the world. However, this does not seem to have been the case for Argentina, whose external debt largely increased in the 1990s despite just coming out from default.

Of course, lenders could argue that they lent money to a country that was at that time blessed by the IMF. The IMF's point of view was clearly reflected in its former First Deputy Managing Director Anne Krueger's words during the conference on "the Argentine crisis" in July 2002: "Between 1990 and 1997 its economy outperformed that of most other countries in Latin America, growing by more than 6 % a year. Contagion from the Tequila crisis in 1995 was severe, but short-lived with growth soon resuming. Argentina's performance was recognized internationally with President Menem's appearance alongside President Clinton at the 1999 annual meetings of the Fund and Bank" (Krueger 2002).

Of course, as Mrs. Krueger recognized on that occasion, there was mounting fiscal deficit but it was not then considered to be a problem; on the contrary, it was seen as an opportunity to lend money to the Argentine state, the same state that had been in default during most of the previous 10 years.

Figure 2.1 reflects the evolution of the national government public debt—external and domestic—from 1991 until 2001, when Argentina defaulted again. By that time, Argentina's total foreign currency debt was around five times the size of its annual foreign currency receipts from the exports of goods and services.

Mrs. Krueger prefers to play down the role of the IMF and to put the blame on investors and lenders for "providing an apparent vote of confidence by pouring capital in" (Krueger 2002). The fact is that in the 1990s, Argentina was the best pupil of the IMF, the World Bank, and the US government, as not only Mrs. Krueger but also the then Minister of Economy Domingo F. Cavallo recalls (Cavallo 2004, 1). For international organizations, it was a "star" country that had followed most of the policies recommended by the so-called Washington Consensus.

The IMF played a key role in restoring confidence in Argentina by capital markets. During the decade preceding the 2001 crisis, there were successive IMF financing arrangements for Argentina²; the IMF also provided extensive technical assistance during that period, dispatching some 50 missions between 1991 and 2002, mainly in the fiscal, monetary, and banking areas. It widely praised Argentina for its achievements in stabilization, economic growth, and market-oriented reforms under IMF-supported programs.

The misjudgment by the IMF of the sustainability of the Convertibility regime played a key role in reopening Argentina's access to capital markets. The successive bond issues that took place during the 1990s were carried out by a government whose economic policies were under the close scrutiny of the IMF, who had strongly praised them. Without its seal of approval to Argentina's economic policies, would investors and lenders have rushed to buy them? Therefore, in the case of Argentina, it seems to be clear that a primary responsibility in its 2001 public sector debt crisis was played by the IMF endorsement of an economic scheme that had been doomed to fail at least since 1995.³

The rest of the chapter is organized as follows. Section 2.2 is devoted to an analysis of Argentina's economic performance in the 1990s. Section 2.3 reviews the criteria for assessing the country's solvency and applies them to assess the Argentine case. Section 2.4 explains the reasons for Argentina's growing public sector debt. Section 2.5 is devoted to analyzing the role of the IMF in the Argentine debt crisis. Section 2.6 summarizes.

2.2 Argentina's Economic Performance in the 1990s

The economic performance of Latin American countries in the 1980s was unsatisfactory. In what has been called the "lost decade", the region's economy was disrupted by the debt crisis and raging inflation. This experience shocked the region; as a result, Latin America embraced structural economic reforms during the 1990s. All countries liberalized international trade and external capital flows and privatized public utilities. Argentina was no exception. Actually, it was one of the countries where more aggressive economic reforms were implemented.

After the hyperinflationary processes of 1989 and 1990, drastic economic reforms took place in Argentina. The key measures that shaped this economic program were the Convertibility Law, the liberalization of external trade and financial flows, and the privatization of public enterprises.

² During the 1990s, there were four IMF arrangements: that under the Extended Fund Facility (EFF) approved on March 31, 1992; the Stand-By Arrangement (SBA) approved on April 12, 1996; the arrangement under the EFF, approved on February 4, 1998; and the SBA approved on March 10, 2000.

³ See Beker and Escudé (2008, 23–24).

The Convertibility Law established a fixed exchange rate of one peso to one dollar. The Central Bank was obliged to sell foreign currency at that rate as required by the market. In order to fulfill this obligation, it had to keep international reserves equivalent to at least 100 % of the monetary base (except for up to 10 % of the monetary base which could be backed by dollar-denominated government bonds). This meant, virtually, the transformation of the Central Bank into a Currency Board. As a result of this package, inflation was drastically abated from a level of 5 % per year in 1989 to just 0.16 % in 1996. Moreover, GDP grew by 40 % between 1990 and 1994.

Trade liberalization was reflected in a huge increase in foreign trade. Imports soared, from \$4.1 billion to \$21.6 billion in 1994, while exports rose from \$3.7 billion to \$20.1 billion in the same period. The participation of imports in aggregate supply expanded from 5.6 % in 1990 to 14.6 % in 1994. This increase in international trade was accompanied by substantial expansion in the deficit in the current account.

Convertibility together with trade liberalization assured the stability of tradable goods prices. Their domestic prices would not increase if international prices did not because imports could easily replace local production. However, this did not mean the stability of prices for non-tradable goods. The result was a change in relative prices in favor of non-tradables.

Excess demand—fueled by foreign capital inflow—resulted, on one hand, in an increase in the volume of imports and, on the other hand, in the price of non-tradable goods. This price behavior resulted in the continuous erosion of the competitiveness of tradable sectors. The current account deficit thus increased from \$5.5 billion in 1992 to \$12.1 billion in 1997—more than one-third of that year's exports.

Therefore, the current account deficit kept growing during the 1990s and more and more capital inflows were needed to make up for it. As can be seen in Table 2.1, Argentina needed a surplus of more than \$10 billion per year in its capital and financial account not to lose foreign exchange reserves. When there was a sharp reduction in global capital flows to emerging market economies, as happened in 1995 due to the Tequila effect, real GDP fell 4.6 % and unemployment soared, reaching 17 %.

Contrary to the conclusion by the IMF and mainstream analysts that Argentina's economic behavior in the presence of the Tequila effect proved to be the strength of its economy, it showed its Achilles' heel: its high sensitivity to external flows. As later events proved, 1995 was a general rehearsal for the 2001 crisis. The lack of access to funds on international capital markets would strangle the Argentine economy under the Convertibility regime.

In the late 1990s, the Argentine economy suffered a series of external shocks: the East Asian crisis in 1997; the Russian one in 1998; the 1999 devaluation of the Brazilian real, which had a negative impact on the competitiveness of Argentina's significant exports to this country; and the appreciation of the US dollar against most other currencies, which increased Argentina's real effective exchange rate.

Table 2.1 Balance of payments—Argentina 1992–2002 (US dollars, millions)

Year	Current account	Capital and financial account	Net errors and omissions	Variation in international reserves
1992	–5548	9169	–347	3274
1993	–8206	14,196	–1740	4,250
1994	–10,979	13,781	–2120	682
1995	–5118	7701	–2685	–102
1996	–6769	12,249	–1598	3882
1997	–12,137	17,709	–2299	3273
1998	–14,482	18,354	–434	3438
1999	–11,944	13,772	–628	1201
2000	–8981	8737	–196	–439
2001	–3780	–5439	–3354	–12,083
2002	8668	–11,404	–1780	–4516

Source: Ministry of Economy

In the presence of all these adverse shocks, the Convertibility regime prevented a flexible domestic policy response.

The twin deficits required continuous access to external financing. However, far from being considered a drawback or a weakness of the economic program, they were considered by the government to be just a minor detail, assuming that foreign capital markets would always be available to finance both disequilibria. An increasing stock of external debt, rising country risk premiums, and sluggish growth caused the ratio of debt to GDP to rise uncontrollably until the default came in 2001.

Sovereign debt has usually been assumed to be almost risk-free because it is supposed that governments can always resort to an increase in taxes to service it. However, in the real world there is always a political limit for that.

2.3 Country's Solvency and the Argentine Case

Although no simple rule can help determine when foreign debt accumulation is sustainable or not, a number of criteria can be used in assessing the sustainability of the foreign debt of a country. The issue is summarized in Roubini (2001, 3–4).

The analytical literature on current account and foreign debt sustainability provides a theoretical criterion that is not particularly stringent. As long as the discounted value of trade balances is at least equal to its initial foreign debt, the country is solvent; this means only that the country cannot increase its foreign debt faster than the real interest rate on this debt.

Therefore, any path of the current account such that the infinite sum of all current accounts is equal to the initial foreign debt of the country is consistent with solvency. This means, for instance, that if the real interest rate is greater than the

rate of the growth of an economy, solvency is consistent even with a foreign debt-to-GDP ratio that grows continuously over time.

A similar criterion applies in determining whether the public debt of a government is sustainable or not. Specifically, as long as the discounted value of primary balances is at least equal to the initial public debt, the public sector is solvent. However, the dynamics of the current account that lead to an increase without bounds of the foreign debt-to-GDP ratio can be seen as effectively unsustainable: financial markets will eventually become concerned about the country's ability and willingness to repay its debt and will limit its borrowing, leading to a foreign debt crisis. The same things apply for the case of domestic debt.

That is why a nonincreasing foreign debt-to-GDP ratio has been seen as a practical sufficient condition for sustainability: a country is likely to remain solvent as long as the ratio is not growing. Similarly, public debt can be viewed as sustainable as long as the public debt-to-GDP ratio is nonincreasing. The "resource balance gap" is thus the difference between the current trade balance and the trade surplus required to stabilize the debt-to-GDP ratio.

In the same way, the fiscal "primary gap" is the difference between the fiscal primary balance and the primary balance required to stabilize the debt-to-GDP ratio. This criterion provides a normative rule: how much a trade surplus or primary surplus is required to close the resource or primary gap. However, it does not directly provide a tool to assess whether a certain stock of debt is sustainable or not.

Several alternative indicators of fiscal and external debt sustainability can be used to assess insolvency. Three of the most commonly used are the debt-to-GDP ratio, the debt-to-export ratio, and the debt-to-government revenue ratio. The relevant denominator depends on the constraints that are most binding in an individual country, with GDP capturing overall resource constraints, exports those on foreign exchange, and revenues those on the government's ability to generate fiscal resources. In general, it is useful to monitor external debt in relation to GDP and export earnings and public debt in relation to GDP and fiscal revenues.

In this respect, the analysis by IMF staff for low-income countries yields a threshold value for the external debt-to-GDP ratio of around 43 %, for the external debt-to-export ratio of around 192 %, and 288 % for the debt-to-revenue ratio (IMF and IDA 2004, 57).

Based on the criterion of the external debt-to-GDP ratio, Argentina crossed the threshold in 1998 (Table 2.2). However, the GDP calculation was biased upward by the overvaluation of the peso, so entrance into the "danger area" might have happened a couple of years before.

Concerning the external debt-to-export ratio, Argentina had in 2001 a ratio of 561 %, well above the threshold value, although the same happened with all the values of this series in the 1990s (Table 2.3). Finally, the debt-to-government revenue ratio was 220 % in 2001, below the threshold value for this coefficient.

Therefore, the coefficients themselves do not explain why Argentina defaulted in 2001. If the relevant coefficient was the debt-to-export ratio, Argentina was already a potential defaulter in 1991. However, it managed to borrow almost \$80 billion during the following 10 years, more than doubling its external debt.

Table 2.2 External debt-to-GDP ratio

Year	%
1991	32.35
1992	27.36
1993	30.53
1994	33.28
1995	38.20
1996	40.32
1997	42.61
1998	47.11
1999	51.54
2000	51.91
2001	51.95

Source: Ministry of Economy and IMF

Table 2.3 External debt-to-export ratio

Year	%
1991	503.54
1992	512.06
1993	511.53
1994	550.47
1995	540.78
1996	470.10
1997	460.95
1998	472.30
1999	532.97
2000	627.32
2001	560.60

Source: Ministry of Economy and IMF

Perhaps the most important issue at the time of default was the high share of short-term external debt. In fact, for both 2002 and 2003, the repayment of principal exceeded 80 % of the exports. Adding interest payments of about \$12 billion, total debt servicing largely exceeded annual exports. Argentina depended on creditors' willingness to roll over its external debt. This became increasingly difficult since capital flows to Argentina quickly decelerated after the 1998 Russian crisis.

By mid-2001, the economic authorities initiated a process to improve the maturities by extending them. A \$30 billion government debt swap took place in June. The government thought this transaction would offer financial relief in terms of the repayment of principal and interest payments of around \$4.5 billion annually.

However, this was carried out at the price of accepting an implicit interest rate of 15 %, ⁴ which was interpreted by creditors as announcing a high probability of

⁴ At that time, the one-year US Treasury interest rate fluctuated around 3.6 %.

default. After that, the failure of a Treasury bill auction confirmed that the Argentine government had lost access to credit. Default was then inevitable.

Argentina had been continuously issuing new bonds to cancel most of the principal and interests of the debt that were becoming due. Only when default was imminent did creditors refuse to go on playing this game. Even then—in September 2001—the IMF approved one last significant tranche of financing for Argentina.

In the analysis of its role in the Argentine crisis, the IMF (2003, 72) poses the dilemma its authorities faced at that time: even after realizing the high probabilities of failure, it went on supporting the Argentine economic program in light of the high and immediate costs of withdrawing support. This reflects the path dependency existing in decision-making: once you make a considerable wrong bet, you are doomed to increase it in order to try to save your initial investment.

In the context of political instability—the governing coalition was undergoing a political crisis since the resignation by the vice-president in October 2000—Argentina finally defaulted at the end of 2001 after the then president resigned from his job.

2.4 The Reasons for Argentina's Growing Public Sector Debt

When the Convertibility plan started in 1991, a restriction was placed on the Central Bank. It could not make loans to the government (except for short-term limited amounts). Given the reluctance by foreign lenders at that time to become involved in Argentina, it was taken for granted that the constraint was practically equivalent to excluding the possibility of running a fiscal deficit. During the transition, the government would resort to the proceedings from privatizations while leveling expenses with revenues.

In fact, in 1993—for the first time in decades—the nonfinancial public sector had no deficit. However, exactly at that time it was decided to reform the social security system. The main effect of this reform was to transfer most of the system revenues to the private sector while keeping most of the expenses within the public sector.

This meant that since 1994 the federal budget was again continuously in deficit, even in years of good economic growth. New debt was added to old debt year after year, and debt plus interest grew much faster than the economy.

At the end of 1994, the federal government's gross debt was \$75 billion, while GDP in 1994 was \$257 billion. By the end of 2001, debt was almost twice as large, \$140 billion, while GDP was only \$271 billion, just 5 % higher than in 1994.

Thus, what in 1991 was unthinkable did happen: since 1994, Argentina had recovered access to international capital markets. Therefore, the constraint placed on the Central Bank became nonbinding. Capital markets were willingly available to finance Argentina's public sector debt. How did this Copernican change happen?

First, since 1992 Argentina was under the umbrella of an IMF-supported program; second, it enthusiastically adhered to the Washington Consensus and its principles; third, the Currency Board was a guarantee of no devaluation; finally, high interest rates were a significant attraction. From 1994 on, what has been called a “bond festival” took place until the 2001 default put an abrupt end to it.⁵

How can we explain the increase in the nominal and real interest rates? Damill and Frenkel (2003, 8) give a clear explanation: the interest rate in local currency can be expressed as the sum of the international rate in dollars paid by the country plus the devaluation rate established in the exchange policy rules (zero in the case of fixed exchange rates), plus a residual that responds to the exchange risk and the local financial risk.

The sum of the exchange risk premium and the country risk premium—the aggregate price of the risk of devaluation and the risk of default—is the main variable whose increase causes the local interest rate to rise. A steady increase in the current account deficit and—after a certain point—the trend toward shrinking reserves undermines the credibility of the exchange regime on the one hand and, on the other, increases the probability that the debt will not be served in due time and form. Consequently, the risk premiums tend to rise.

The continuous support by the IMF to the Argentine program, even after the Tequila crisis showed its high sensitivity to external flows, allowed the government to pile up a huge debt, long after it was evident that the Currency Board was unsustainable. Therefore, it is worthwhile analyzing the role of the IMF in the Argentine crisis.

2.5 The Role of the IMF

After the 2001 crisis, the IMF produced two documents. One was aimed at examining the origins of the Argentine crisis and its evolution until early 2002 (IMF 2003). The second one was produced by the IMF's Independent Evaluation Office (IEO); this evaluated the role of the IMF in Argentina during 1991–2001 (IMF 2004).

In its report, the IEO recognizes that “the catastrophic collapse of the Argentine economy in 2001–2002 represents the failure of Argentine policymakers to take necessary corrective measures at a sufficiently early stage. The IMF on its part, supported by its major shareholders, also erred in failing to call an earlier halt to support for a strategy that, as implemented, was not sustainable” (IMF 2004, 64).

The IEO argues that favorable factors allowed the exchange rate regime to survive for a number of years without being severely tested but the situation changed in 1998–1999 when Argentina was hit by a series of adverse shocks.

⁵ Those interested in Argentina's development after the 2001 devaluation and default may have a look at Frenkel (2012).

Table 2.4 Unemployment rates—May and October 1991–1995

Year	May	October
1991	6.9	6.0
1992	6.9	7.0
1993	9.9	9.3
1994	10.7	12.2
1995	18.4	16.6

Source: INDEC

However, it admits that “these shocks would have been difficult enough to handle at any time, given the rigidity of the fixed exchange rate and the lack of downward flexibility in domestic wages and prices” (Ibid.).

Therefore, it recognizes that the Convertibility regime, because of its rigidity, was incapable of dealing with any adverse shock of a certain volume. In fact, it did not pass the Tequila test: in order to keep a fixed exchange rate, the country’s economy experienced a jump in its unemployment rate from 10.7 to 18.4 % between May 1994 and May 1995 (Table 2.4).

Therefore, if a test was needed, the Mexican crisis provided it. However, the IMF interpretation even in 2003 was that “the economy had successfully weathered the Tequila crisis of the mid-1990s” (IMF 2003, 3).

Calling a success the management of a crisis that meant an 80 % increase in the unemployment rate is evidence that the IMF underweights unemployment in its assessment scheme.

The IEO report goes onto admit that the IMF’s “support gave credibility to Argentina’s stabilization and structural reform efforts” (IMF 2004, 65), although the IMF was initially skeptical as to whether the Convertibility plan would work. This suggests that political considerations prevailed over the technical opinions of IMF staff.⁶

Although the report underlines that the IMF correctly identified the potential vulnerabilities inherent in the Convertibility regime, the fact is that in spite of that the IMF went on supporting that regime even after it was clear that this support allowed Argentine authorities to swiftly increase Argentine public debt to unsustainable levels. “Moreover, the IMF . . . began to endorse the exchange rate regime itself. Indeed, the IMF publicly lauded convertibility as an example of a Currency Board, the only type of fixed exchange rate regime that is fundamentally sustainable in a world of high capital mobility” (IMF 2004, 65).

In summary, the IMF’s support was a necessary element without which it would have been difficult to increase Argentina’s indebtedness as occurred during the 1990s.

⁶ “. . . dissenting views were overruled by such considerations as the need to maintain influence with a member country or a desire to preserve the catalytic effect of the IMF’s seal of approval” (IMF 2004, 66). Also see IMF and International Development Association (2004).

2.6 Summary

After the hyperinflationary processes of 1989 and 1990, drastic economic reforms took place in Argentina. The central piece of this program was the Convertibility Law, which established a fixed exchange rate of one peso to one dollar.

The Central Bank could issue domestic currency only against foreign currency and could not make loans to the government except for a very tiny sum. It was taken for granted that this constraint was practically equivalent to excluding the possibility of running a fiscal deficit.

However, soon this proved not to be true: from 1994, Argentina recovered access to international capital markets and since then increased its public debt at a very fast rate. How were lenders convinced to lend huge amounts of money to a serial defaulter such as Argentina? There is no explanation but endorsement by the IMF of Argentina's economic program. It is hard to believe that lenders would have rushed to buy Argentine bonds without the IMF's seal of approval.

The misjudgment by the IMF about the sustainability of the Convertibility regime played a key role in reopening Argentina's access to capital markets. Continuous support by the IMF to the Argentine program, even after the Tequila crisis showed its economy's high sensitivity to external flows, allowed the government to pile up a huge debt, long after it was evident that the Currency Board regime was unsustainable.

The IMF played in the Argentine case the same role as credit rating agencies played in the 2008 American crisis: to induce lenders to put their money into buying securities of doubtful collectability.

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