

The ABCs of the Argentine Crisis

Since the terrorist attacks in the US on September 11, Argentina appears to have drawn closer to the brink of financial crisis. Despite an \$8 billion emergency loan from the IMF in late August, Argentina's risk rating reached 1.924 points on October 6, the worst rating after Nigeria among emerging economies. The country's access to external credit has been virtually cut off due to investors' lack of confidence in its ability to meet its IMF obligations and make its external debt service.

With IMF support, the government of President Fernando de la Rúa and Economics Minister Domingo Cavallo has placed its faith in a zero deficit policy to win back the trust of foreign and domestic investors and stave off extreme measures like default or dollarization. Unfortunately, tax revenues fell by 14% in September, and it is becoming clear that restoring the fiscal balance will be impossible without an economic recovery. Argentina is now in its third year of recession.

What is this zero deficit policy, anyway? It's as if the United States, in an effort to come out of its current recession, raised taxes, reduced public spending and increased interest rates, all at the same time. Of course, this is exactly the opposite of what the US has done and goes against the most basic economic logic. In the last nine months, the Federal Reserve has lowered interest rates from 6.5% to 2.5%, and the Bush administration has cut taxes, issued a tax rebate, and increased emergency public spending. But Argentina seems to have had no other choice. How did this South American giant-which once fed Europe and was the first country in Latin America to industrialize its economy-get to such a point?

In recent years, Argentina's exports have struggled to keep up with annual imports. In the last three years, for example, exports totaled \$76.18 billion, and imports \$82.15 billion. A trade surplus in 2000 was due only to the fact that the recession led to a drop in capital goods imports. Argentina's hefty external debt (\$148 billion, according to CEPAL) has meant increased annual payments: \$28.05 billion in 2000 (of which \$18.40 billion was in capital amortization and \$9.64 billion in interest). The economy was able to sustain this deficit in the external accounts balance through recourse to multilateral external credit in the 1980s, and through foreign investment in the 1990s -mostly via the privatization of federal and provincial government-owned companies.

The problem seems clear: With the public patrimony sold off, the only option left was to increase exports. But the anticipated global recession, which seems clearly to have arrived in the aftermath of September 11, closed off this source of support for the country's economic model as well. Argentina could still try to sell its large privately owned companies, a trend that has been gradually under way, but investors can be expected to look for less risky options or to wait for fire sale prices. The past model has nowhere left to go.

Complicating matters is Argentina's decision in 1991 to peg the peso to the dollar (1:1) as a way to stabilize prices. The measure was in fact successful at controlling the hyperinflation of previous decades. Brazil followed the same course in 1994, but reverted to a free-floating currency in 1997. As a result, Brazil has been able to devalue the real when necessary, but Argentina has adhered to its policy of dollar-peso parity. Now, with other macroeconomic indicators off (unemployment of more than 15% for the past three years, and an increase in the public debt from 33.8% of GDP in 1995 to 46.2% in 2000), and greater global financial insecurity because of the terrorist attacks, Argentina would run a serious risk if it attempted to scrap its previous commitments and call for a devaluation.

On the one hand, a devaluation—a tool to regain export capacity and protect national production—could bankrupt large companies that hold debt in dollars. It would have the same effect on the public debt. But the biggest consequence would be a return to inflation. Many analysts believe that a devaluation would lead eventually to dollarization in an attempt to prevent disastrous hyperinflation. But while dollarization would help stabilize prices, it would in no way solve Argentina's problems with financing its external debt service, boosting the competitiveness of its exports or improving its fiscal deficit.

On the other hand, a default would bankrupt holders of Argentine public debt, of which 60% are domestic companies and individual debt holders. To take just one example, Argentina's pension fund administrators have 50% of their assets in public bonds and securities. Banks would also lose a substantial part of their assets, with ripple effects to accounts and deposits. The international financial system could also be expected to cut off all credits for Argentine imports. Those in the government and academia who oppose a default point to all of these scenarios to support their position.

A compromise of sorts was presented last week by Roberto Frenkel and Mario Damill. Their suggestion is for a limited devaluation, raising the value of the dollar only for imports and exports. This mechanism, they say, would stimulate and protect the productive sectors of the economy without affecting dollar-peso parity in financial operations, thus sparing any impact on holders of debts and loans in dollars. It is not clear what would happen to the services sector (cargo, insurance, remittances, tourism).

Another option is the radical orthodoxy of former Economics Minister Ricardo López Murphy: sticking to the zero deficit policy whatever its short-term consequences, including layoffs of 100,000 workers or more. Others propose a policy of perpetual fiscal adjustment, reducing pensions and increasing labor flexibility.

Yet another policy being pursued mocks the whole idea of fiscal adjustment through the creation of a parallel, nonconvertible currency, the *patacón*, which joins the ranks of nine other parallel currencies in Argentina. The effect of this measure is to pauperize the salaries of public functionaries.

All of these scenarios put their faith in the belief that Argentina's democratic system will overcome this latest, unprecedented social crisis.

http://www.lanacion.com.ar/01/07/22/de_321797.asp

http://www.cepal.org/publicaciones/DesarrolloEconomico/2/LCG2142P/lcg2142e_arg.pdf

Other sources consulted: Alberto Carrasquilla, *El Tiempo*, July 25, 2001; Marcelo Cantón, *El Clarín*, August 23, 2001; various authors, *Página 12*, September 2, 2001.