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Briefing Paper

What Happened to Argentina?

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INTRODUCTION

On December 20, President Fernando de la Rua of Argentina resigned, after weeks of rioting and looting that had left 27 people dead. Within 14 days the government was officially in default on its international debt, the largest default of a national government in recent memory.

As reported in the United States and the international press, the story was one of a profligate government that could not contain its spending, and make the necessary "hard choices" to build confidence among investors and lenders, including official creditors led by the International Monetary Fund. Indeed, the Fund precipitated the final crisis by refusing to disburse a scheduled $1.3 billion loan on December 5, 2001, because of "Argentina's inability to meet the targets under the zero deficit law."[2]

As millions understand it, Argentina's credit card was cut off because it ran up too big of a tab and couldn't pay its bills. But the official numbers tell a very different story. It is the story of debt, inherited from the past, that was perhaps manageable until—through no fault of the debtor—interest rates on the country's borrowing increased. Higher interest payments, not increased spending, led to higher deficits. Growing deficits in turn created doubts about the overvalued exchange rate, which pushed interest rates still higher, creating larger deficits, in a hopeless spiral that ended in default and devaluation.

As will be seen below, policy failures played a role in Argentina's economic collapse. The most important mistake was the fixed exchange rate, which tied the Argentine peso to the US dollar. But the immediate cause of Argentina's crisis was a series of external shocks that were beyond its control, beginning with the US Federal Reserve Board's decision to raise interest rates in February of 1994. The effect of each of these shocks was much worse than it otherwise would have been, because of the fixed exchange rate. But the commonly believed story that the government could not accept a sufficient dose of the painful medicine of austerity, or spent its way into a hole, is not supported by the data.

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[2] IMF spokesman Thomas Dawson, December 20, 2001, press briefing (at www.imf.org).

FISCAL POLICY

Table 1 shows the Argentine government's revenues, spending, and interest payments for the years 1993-2000. If one looks only at the total budget balance, the numbers generally reported in the press, it looks as though there is a significant loosening of fiscal policy during this period. The budget goes from a surplus of $2.7 billion pesos[3] (1.2 percent of GDP) in 1993 to a deficit of $6.8 billion (2.4 percent of GDP) in 2000. This is a significant change in the government's fiscal position, although it is worth emphasizing that a deficit of 2.4 percent of GDP, the largest in this period[4], is still relatively modest for a nation in a deep recession, with more than 16 percent unemployment. For comparison, the United States ran a budget deficit amounting to 4.7 percent of our economy (or GDP) coming out of the last recession; 1983, at the end of a more serious downturn, the deficit was 6 percent of GDP.[5]

Nonetheless, even this modest deficit, and the shift from surplus at the beginning of the period, does not accurately represent the government's fiscal policy. To see this we must look at the primary balance—that is, the government's spending other than interest payments, subtracted from revenues. This appears in Table 1. The primary balance moves from a surplus of $5.6 billion (2.4 percent of GDP) in 1993 to $2.9 billion (about 1.0 percent of GDP) in 2000, a very modest deterioration.

Furthermore, none of this deterioration occurred on the spending side. Government spending, excluding interest, was essentially flat over the period. It was 19.1 percent of GDP in 1993, and 18.9 percent of GDP in 2000, despite the severe recession of the later years, as shown in figure 1. All of the deterioration occurred on the revenue side, as tax collections fell off during the recession, a normal and economically desirable development.

In light of this path of spending, it is difficult to argue that Argentina's government contributed to the economic crisis through overspending. Nor it is likely that, even if it were politically possible, the government could have averted the default and devaluation through further fiscal tightening throughout the recession.

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[3] All numbers in the text are in current pesos unless otherwise noted; during this period, the peso also exchanged at the rate of one peso = one US dollar.

[4] The deficit of $4.7 billion in 1999 would have been $7.3 billion without income from privatization that year. However, there was still a primary surplus ($876 million) for that year. Revenues from privatization do not grossly alter the primary account balance (see below) for other years.

[5] The IMF noted that Argentina's austerity measures in fiscal 2000 were equal to 2 percent of GDP, the equivalent of a $200 billion reduction in the deficit in the United States ("Article IV Consultation and First Review," December, 2000, p 17)

INTEREST PAYMENTS

As can be seen from Table 1, it was increasing interest payments on the debt that drove the government's budget from surplus to deficit. Interest payments rose from $2.5 billion in 1991 to $9.5 billion in 2000, or from 1.2 to 3.4 percent of GDP (see Figure 2). This by itself is a significant drain on the economy, since almost all of these payments are in foreign currency, and most of the money goes out of the country. But in the context of Argentina's fixed (and then overvalued) exchange rate, the effect of these rising interest rates is much more damaging to the economy. The budget deficit caused by these increasing interest payments increased uncertainty in financial markets about the viability of the exchange rate. Such uncertainty drives interest rates even higher. The government's attempts to eliminate the deficit, by cutting primary spending during a recession, worsens the economic situation: first by directly reducing demand, and also by causing political instability and uncertainty, which fed fears of devaluation and/or default.

It must be emphasized that the whole downward spiral that led to Argentina's economic collapse occurred without any new borrowing by the government to finance primary (non-interest-payment) spending. In other words, the increased interest rates, and consequent increasing interest payments and debt, resulted from a combination of external shocks, and the dynamics of the fixed exchange rate system itself.

The long slide began when the US Federal Reserve Board began a series of interest rate hikes in February of 1994, which would double US short-term rates (from 3 to 6 percent) over the next year. Argentina was hit immediately with the first rate increase, because of the uncertainty it created in emerging financial markets. Thus the cost of the government's borrowing, simply to roll over past debt, increased by both the Fed's 3 percentage points, as well as the increasing spread between Argentine government bonds and US Treasuries of the same maturity.

The situation worsened drastically with the devaluation of the Mexican peso in December of 1994.[6] Within weeks, the Argentine banking system lost 18 percent of its deposits. The economy, which had grown at an average annual rate of 8 percent from the second half of 1990 to the second half of 1994, fell into a steep recession. Gross Domestic Product contracted by 7.6 percent from the last quarter of 1994 to the first quarter of 1996. As can be seen in Table 1, the government's interest burden increased by more than 50% from 1994 to 1996. There was a massive capital outflow and shrinkage of foreign exchange reserves.

Recovery began in the second half of 1996, and capital inflows, both public and private, resumed. But it was not long before the economy was hit with the Asian financial crisis, which began with the slide of the Thai baht in August of 1997. This sent Argentina's risk premium and cost of borrowing up again. Throughout this whole period, at least since the Fed's interest rate hikes of 1994, the Argentine peso also became increasingly overvalued—since it was tied to the

[6] This was also at least partly triggered by the Fed's interest rate hikes, which attracted tens of billions of dollars away from Mexican bonds to the US.

US dollar, which also became overvalued (leading to rapidly expanding US current account deficits).

The overvalued peso damaged the economy by further undermining confidence in the exchange rate regime, and also by worsening the current account, especially in services. It is worth noting that Argentina's increased interest payments from 1993-2000 also showed up in the current account, leading to deficits there as well. For example, in 1998, the current account deficit peaked at $14.6 billion, or 4.9 percent of GDP; over half of this deficit was due to interest payments. The Asian economic crisis spread first to Russia and then to Brazil, where it led to the collapse of the Brazilian *real* in January of 1998. By this time the collapse of Argentina's fixed exchange rate was inevitable, and it was only a matter of how long it would take, and how much more the economy would be sacrificed in order to avoid devaluation and/or default. The economy lapsed into recession in the second half of 1998 and never recovered. Repeated attempts to restore confidence in the overvalued peso through spending cuts, and loans arranged through the IMF—including a $40 billion dollar loan package in December of 2000—could not reverse the downward spiral. In 2001 there were accelerating withdrawals from the banking system, leading to riots, political crisis, the collapse of the government, default, and devaluation.

CONCLUSION

This paper has focused narrowly on certain macroeconomic aspects of Argentina's economic collapse, in order to correct a widespread misunderstanding of its causes. There are other structural and economic changes in the 1980s and 1990s that critics have cited as contributing to Argentina's problems.[7] But even within this narrow focus of this paper, there are certain conclusions that may be drawn.

Many will undoubtedly infer that the main problem was the fixed exchange rate, and that fixed exchange rates are inherently flawed. Argentina's experience certainly makes a strong case for this argument. The Argentine economy's extreme vulnerability to the Fed's interest rate hikes in 1994 is a classic reason for not choosing a fixed exchange rate, and leaving so much of the economy in the hands of a foreign central bank.

It is also worth noting that the other shocks to Argentina's economy during this period came from the global financial system, and were not directly connected to any real factors in Argentina's economy. This is true of the "tequila effect" of the Mexican peso crisis, and perhaps even more strikingly, the transmission of the Asian financial crisis to Russia, and then Brazil and Argentina. In these instances investors responded to a particular crisis by fleeing emerging markets generally, often simply because they assumed other investors would do the same.

[7] Among those often mentioned are: the rapid acceleration of trade liberalization and undermining of domestic industry, high unemployment even during the (1990-94) period of rapid growth, the wholesale privatization of state enterprises (sometimes involving corruption or other problems), and capital flight (which was mentioned briefly in this paper).

Argentina's fixed exchange rate made all of these shocks much worse, because it made adjustment difficult or impossible, and attempts to maintain the exchange rate ended up sacrificing the economy. But Argentina's experience—including the considerable amount of capital flight during this period—does raise questions about the functioning of international capital markets without controls at the national level. It raises the question of how much any country would want to put itself at the mercy of such volatile international markets.

The role of the IMF and international lending agencies is also important here. The Fund supported the fixed exchange rate policy[8] all the way into the abyss, absorbing, together with other official creditors, an increasing share of Argentina's burgeoning debt. From December of 1995 to September 2001, these institutions' Argentine debt more than doubled, from $15 billion to $33 billion dollars. Throughout the period, the Fund insisted that more fiscal tightening was the key to restoring confidence and economic recovery. But it is clear that no amount of budget cutting, or tax increases, could have saved Argentina from the inevitable default and devaluation. And as noted above, the austerity policies almost certainly hurt the economy.

This should be kept in mind as new agreements are negotiated amid renewed calls for budget austerity. Although the fixed exchange rate is gone, austerity is no more likely to help Argentina's economic recovery now than it did in the past. And the government will need to cancel enough debt so that it never falls into the situation that it faced in recent years, in which rising interest rates and payments produce a debilitating debt spiral from which there is no escape.

[8] Fund officials now claim that they were against the fixed exchange rate policy in Argentina from the beginning, but supported it at the behest of the Argentine government. It is worth noting that the IMF supported, with massive loan packages as well as monetary and fiscal tightening, overvalued exchange rates in both Russia and Brazil in 1998. In both cases the Fund's argument was that a devaluation would lead to uncontrolled inflation. But both currencies collapsed, the inflationary effect was controlled and temporary, and both economies responded positively to the devaluation—with Russia registering its highest growth (8.3 percent [real] in 2000) in 20 years.

Table 1

Argentina, National Government Spending and Revenues (1993-2000)

In millions of current pesos

	YEAR 1993	1994	1995	1996	1997	1998	1999	2000
Total Revenue	**50,726.5**	**51,078.2**	**50,293.6**	**47,668.9**	**55,376.7**	**56,726.1**	**58,455.4**	**56,570.5**
Total Spending	**47,996.0**	**51,364.3**	**51,666.9**	**52,933.3**	**59,653.3**	**60,799.6**	**63,223.8**	**63,362.1**
- Total Spending as % of GDP	20.29%	19.95%	20.07%	19.45%	20.37%	20.34%	22.30%	22.29%
- Interest Payments (included in Total Spending)	2,914.0	3,150.3	4,083.5	4,607.9	5,745.0	6,660.3	8,223.6	9,656.0
- Interest Payments as % of GDP	1.23%	1.22%	1.58%	1.69%	1.96%	2.23%	2.90%	3.40%
Deficit or Surplus (Revenue-Spending)	**2,730.5**	**-285.9**	**-1,373.3**	**-5,264.4**	**-4,276.6**	**-4,073.5**	**-4,768.4**	**-6,791.6**
Primary Spending (excluding interest)	**45,082.0**	**48,214.0**	**47,583.4**	**48,325.4**	**53,908.3**	**54,139.3**	**55,000.2**	**53,706.1**
Primary Surplus or Deficit	**5,644.5**	**2,864.2**	**2,710.2**	**-656.5**	**1,468.4**	**2,586.8**	**3,455.2**	**2,864.4**
Primary Spending as % of GDP	**19.06%**	**20.29%**	**18.44%**	**17.76%**	**18.41%**	**18.11%**	**19.40%**	**18.90%**

Source: *Secretaría de Hacienda. Ministerio de Economía, Argentina*

GDP at Current Prices

In millions of current pesos

	1993	1994	1995	1996	1997	1998	1999 (*)	2000 (*)
GDP Market Prices	**236,504.98**	**257,439.96**	**258,031.89**	**272,149.76**	**292,858.88**	**298,948.36**	**283,523.02**	**284,203.74**

(*) Estimates

Source: *Dirección Nacional de Cuentas Nacionales, Argentina*

Figure 1

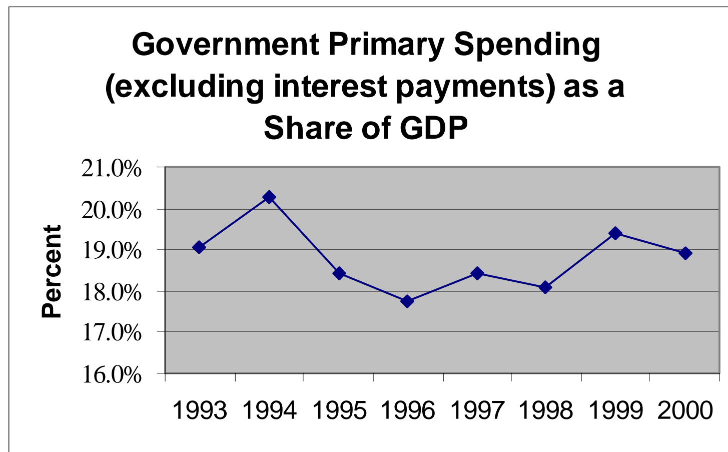

Figure 2