5 What Went Wrong?

Pointing to convertibility or dollarisation as basic explanations of the crisis, in order to downplay structural problems in fiscal institutions, overlooks the fact that they were precisely chosen after decades of fiscal mismanagement.\(^\text{527}\)

5.1 The Main Suspects

After the CBA's collapse at the turn of the year 2001, obituaries mushroomed. A multitude of factors was made responsible for Argentina's latest crisis, factors of external or internal origin, solely or jointly in a variety of combinations. Many of them had been the subjects of ever-repeated warnings since the CBA's inception.

Fiscal imbalances as well as the overvalued real exchange rate, clearly interrelated as they are, figure most prominently among the culprits. These predispositions made the country extremely vulnerable to external shocks. Accordingly, the "sudden stop" hypothesis has gained some prominence; an approach focussing on adverse policy constellations within MERCOSUR sheds further light on the issue. Important co-factors of the crisis are, undoubtedly, various institutional deficiencies, tackled little or not at all during the 1990s, as well as political economy in a country that, for many, seemed improbable to bring forth durably coherent politics, given its track record. Other blames extend beyond the country's sole responsibilities, and point at international financial organisations, in their vanguard the IMF, as having helped bring about the unfortunate outcome. In the same vein, the liberal policy recommendations labelled "Washington Consensus" find themselves made responsible for the disastrous outcome. Finally, the much-repeated argument that the CBA itself contained the conditions of its own inevitable destruction has to be addressed.

5.1.1 Fiscal Imbalance

The foremost explanation for the CBA's fall relates to large and persistent fiscal deficits. As has been shown, Convertibility made fiscal policy extremely important, as it was, due to the reserve backing rule which constrained monetary policy, the only tool of macroeconomic management. This required budgets balanced over the business cycle, but in any case levels of public debt low enough to maintain

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\(^{527}\) López Murphy/Artana/Navajas (2003), p. 23.
borrowing capacities that would be large enough to allow for sufficient deficit financing during downturns and for lender of last resort assistance in case of banking crises. Moreover, credibility of the Dollar parity required the government's unquestioned capacity to borrow in Dollars, itself again dependent on fiscal solvency, in order to guarantee unrestricted convertibility.

As has been shown, fiscal deficits persisted, and were massively financed by borrowing on domestic and, increasingly, international capital markets\(^{528}\). Though Argentina's debt management was quite sophisticated (it avoided excessive dependence on short term or floating interest rate debt and sought to discharge it from the dominance of Dollar denominated debt\(^ {529}\)), the rapid growth in public indebtedness resulted in serious rollover problems when the external shocks of the late 90s pushed the country into recession and encumbered access to capital markets. However, the core of fiscal problems was widely, and for too long, seen as lying in the flow variable, the budget deficit. Only after a lengthening row of failed attempts to redress the fiscal deficit did it become undeniable that the problem was much harder to come by, as it had developed into a stock problem: total debt was far too high to be sustainable under other than very favourable conditions.

Thus, fiscal profligacy seems to stand at the centre of Argentina's crisis, giving perfect credit to traditional, fundamentals oriented, crisis explanations. Both the flow and stock determinants of debt sustainability will be dealt with in what follows.

### 5.1.1.1 Persistent Budget Deficits

The federal primary balance averaged, over the period 1992-2001, 0.73 percent of GDP. It was in deficit once (in 1996) and usually, with the exception of the early 90s, amounted to a surplus of less than one percent. Including the provinces, the record deteriorates, with an average of 0.03 percent, and four years of negative

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\(^{528}\) Despite the growth in domestic financial markets (Argentina started with very small domestic markets in 1991, due partly to Argentina's low savings rate of hardly 15 percent of GDP), domestic sources (mostly banks and pension funds) amounted, in late 2000, to only roughly half of the financing, with the rest stemming from external sources. 90 percent of total public debt was foreign currency denominated. By late 2000, Argentina was the largest emerging-market borrower on international capital markets (accounting for a fifth of the entire asset class). See IMF Independent Evaluation Office (2004), p. 86, and Mussa (2002), p. 15.

\(^{529}\) During much of 1999 and early 2000, Argentina issued Euro bonds, taking advantage from the decline in European interest rates, induced by the advent of the Euro, and serving the preferences of yield seeking investors.
primary balances (1995/96, 1999, and 2001). Interest payments averaged 2.8 percent of GDP during 1991-2001. The resulting overall fiscal balance was negative, both with and without the provinces, throughout the whole period, with the single exception of the year 1993. Argentina entered the recession of the late 1990s with an overall fiscal deficit of 2.1 percent of GDP in 1998 (1.3 percent excluding the provinces), which, taken at face value, does not seem too worrying. However, several facts have to be taken into account to judge these deficits adequately.

First, a simple exercise in summing-up reveals that the accumulated budget deficits do not correspond, as one would reasonably expect, with the rise in public debt. Taking the period between 1993 and 1998 (which largely excludes the initial stabilisation boom, but still incorporates, despite the Tequila interruption, strong average growth with virtual zero inflation), the difference between the two amounts to more or less one percent of GDP. The explanation for this difference is that a substantial portion of public debt incorporated borrowings to finance off-budget-liabilities (such as the court-ordered payments of past obligations to pensioners, to government suppliers, and to provincial governments). Budget deficits therefore never represented a complete measure of fiscal performance. The debt to GDP ratio rose by around 12 percent during six years – six years in which growth would have been strong enough to allow for a constant ratio of indebtedness.

Second, the comparatively favourable official deficit figures included two major sources of non-recurring relief. One was the Brady restructuring of 1993 which incorporated a significant upfront relief in interest payments against a back-loading of payments due in later years. So, the 1993 fiscal surplus was aided by proceeds from the Brady bond restructuring entering the books of that year. The other boost was given by non-recurring privatisation receipts, amounting to around 24 billion Dollars until 1998.

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532 On basis of the data given by the IMF Independent Evaluation Office (2004), the difference amounts to 1.3 percent of GDP. Mussa (2002) uses slightly different numbers and arrives at 0.6 percent. See Mussa (2002), p. 8.
533 Mussa (2002) reckons that, without the off-budget-liabilities, the strong GDP growth (by 26 percent in nominal terms between 1993 and 1998) should have made the debt to GDP ratio result seven percent below the sum of declared yearly deficits. See Mussa (2002), p. 8.
On the other hand, the extraordinary burden on the public budget arising from the social security reform of 1994, i.e. the upfront transfer of funds from the public to the private pension scheme (equalling about one percent of GDP in the years following the reform), although promising long-term relief, worsened the short-term fiscal situation. Yet, it should have been possible to neutralise this effect with the extraordinary receipts and back-loaded obligations sketched above.

Thus, looking behind the mere numbers of seemingly modest fiscal deficits, the fiscal performance of the nineties clearly does not look like the reflection of disciplined fiscal policies. What is more, such record obviously defies the notion of the CBA disciplining fiscal policy, as well as of privatisations helping restore fiscal balance. Tellingly, as soon as 1994, one of the early expansionary years (with 5.8 percent GDP growth), Argentina missed, for the first time in a lengthy row, a fiscal target set by the IMF\textsuperscript{536}.

5.1.1.2 Total Indebtedness

Total public sector debt was less than 30 percent of GDP in 1992, and reached 41 percent in late 1998, to rise faster during the following recession years. The absolute level of indebtedness, however, was not perceived as worrying until well into 2000, when the debt to GDP ratio surpassed 50 percent. From an industrial country's perspective, and to judge from the Maastricht criteria, such ratios might seem not alarming. Yet for Argentina, the case has to be judged differently for several reasons.

First, emerging market economies, with the typically low degree of trade diversification, are in general far more susceptible to real external shocks than industrialised countries, even more so when they have fixed exchange rates and lack the option to devalue. Such susceptibility requires much lower debt levels ex ante, so as to dispose of a broader margin of debt sustainability in the light of a more volatile GDP.

Second, a country which, like Argentina, depends on foreign capital to finance its current account deficit needs to insure not only against a cut-off of market access in case of deteriorating fundamentals, but also against changes in general market sentiment due to contagion\textsuperscript{537}. The only insurance against the latter risk is

\textsuperscript{536} This stayed without consequences only because of Mexico's devaluation a few days later, which necessitated fresh assistance.

creditworthiness to a degree that expectations of default never emerge, and never become self-fulfilling.

Third, Argentina's both public and private sector debt were for the largest part denominated in foreign currency and contracted with creditors abroad. This required, for the public sector, enough fiscal revenues available as well as the maintenance of convertibility (so that one Peso of these revenues was always convertible into one Dollar to service debt), and, for the private sector, enough foreign exchange earned out of exports to service the debt. While industrial countries raise tax revenues of 40 to 50 percent of GDP, Argentina's tax raising capacity rarely exceeded 20 percent of GDP. As, due to Argentina's peculiar federal fiscal relations, most of the tax receipts were sucked into the coparticipation scheme, only a small proportion of these tax revenues was available for debt service. As for the private sector, by 1998, the ratio of total external foreign currency debt to export earnings in foreign currency was 500 percent. Such ratios necessarily imply a high risk of an external financing crisis.\(^{538}\)

Fourth, beyond any static measure of indebtedness, debt dynamics over time should have given enough reason for concern. As already noted, the strongly growing indebtedness over years of generally strong economic growth is clear proof of a deficient fiscal performance.\(^{539}\)

After Argentina's collapse, efforts were made to develop tools to identify benchmarks for sustainable debt-to-GDP ratios for developing countries, both for public debt and for total external debt. The IMF arrived, in 2003, at a 40 percent threshold for Argentina's external debt to GDP with the CBA, at which point the probability for a crisis was estimated at 15-20 percent. Such diagnostics, if in place, would have rung alarm in 1998 the latest (factual external debt surpassed 50 percent of GDP in 1999 and would have required, depending on projections, a

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\(^{538}\) Eichengreen/Hausmann/Panizza (2003) depict currency mismatches as a consequence of two distinguished phenomena responsible for developing countries' financing difficulties: "original sin" and "debt intolerance", the first comprising problems arising externally, through realities on international capital markets (especially the impossibility for a country to place debt in local currency), and the latter describing internal problems such as weak institutions and unreliable policies.

\(^{539}\) An analysis of the dynamics of debt towards unsustainability is undertaken in the paragraph dedicated to the sudden stop thesis below.
turnaround of up to 2.5 percent of GDP in the non-interest current account balance)\textsuperscript{540}.

Reinhart et al. argue that Argentina, with its five defaults since 1820, had developed higher debt intolerance through the accumulation of payment difficulties over time. With this level of debt intolerance, acquired before the 1990s already, they estimate a threshold where markets start ascribing the country a risk of default at a total debt to GDP ratio of only 25 to 30 percent (the 30 percent mark was surpassed since 1993)\textsuperscript{541}. Consistent with that view is Argentina's estimated "revenue-equivalent debt-to-GDP Maastricht target" of 30 percent\textsuperscript{542}. In late 2000, the factual public debt to GDP ratio of 47.6 percent would, according to retrospective IMF estimations, have required a primary surplus of 1.6 percent, while the actual balance was in deficit by 0.5 percent\textsuperscript{543}.

5.1.2 Overvalued Exchange Rate

The second common view of the single most important cause of the CBA's end is the growing real exchange rate misalignment, developing as a result of the Peso appreciating significantly against the Dollar in real terms, first, between 1991 and 1993, and, second, from 1998 onwards. In between, the real exchange rate showed smaller movements, showing both phases of mild depreciation (above all in 1994 and 1995) and of slight appreciation.

5.1.2.1 Real Appreciation before 1998

The Peso's real appreciation of the early 1990s can be explained as the result of several factors. First, as a legacy from the high inflation years during the 1980s, the Argentine currency started, in 1991, with a value significantly below its long-term equilibrium level, so that the post-stabilisation appreciation partly reflected an overdue correction. One estimate is that, while the Peso appreciated in real terms by about 50 percent in the early 90s with respect to its 1980s average (admittedly a doubtful benchmark, but at least giving a clue), half of this appreciation represented a catch-up of the previous undervaluation, so that "only" 25 percent of the Peso's

\textsuperscript{540} The external debt to GDP ratio jumped to over 140 percent in 2002, displaying the Peso's previous degree of overvaluation. See IMF Independent Evaluation Office (2004), p. 88.

\textsuperscript{541} See Reinhart/Rogoff/Savastano (2003).

\textsuperscript{542} See Guidotti (2004), p. 17.

\textsuperscript{543} See IMF Independent Evaluation Office (2004), ibid.
appreciation originated in the 1990s\textsuperscript{544}. Second, in the aftermath of hyperinflation, price movements took time to stabilise. While inflation inertia was, to a limited degree, calculated into the choice of the exchange rate fixed in 1991, it was well known and accepted that disinflation would create additional real appreciation of the currency. It took until 1994 for Argentine inflation to fall to international levels, and much of the rise in the real value of the currency occurred until that time. Third, in addition to the real appreciation of the early 1990s, the US-Dollar started, in 1995, to continuously revalue against the European currencies (and later the Euro) which meant that the Peso likewise revalued against the currencies of Argentina’s trading partners\textsuperscript{545}.

Pastor/Wise undertook, in 1999, an estimation of the Peso’s equilibrium exchange rate, via regression of the real exchange rate since 1960. They found that its equilibrium value rose over time, which justifies the view of the Peso’s real appreciation partly as a long-term and sustainable trend\textsuperscript{546}. Nevertheless, they find that, in 1993, the Peso was already about 25 percent above its estimated equilibrium value, though this gap was narrowing somewhat due to subsequent real depreciation via low (and even negative) inflation towards the end of the decade\textsuperscript{547}.

5.1.2.2 The Real Exchange Rate after 1998

Inescapably, the order of magnitude of a real exchange rate misalignment is a controversial issue, due to the impossibility to exactly detect the equilibrium (or “fair”) value of an exchange rate at any point of time\textsuperscript{548}. Hence, it is disputed

\textsuperscript{544} See Pastor/Wise (1999), pp. 480 and 496, as well as Dominguez/Tesar (2003), p. 12.
\textsuperscript{545} The US-Dollar’s surge lasted from August 1995 to February 2002, during which period the US-Dollar appreciated by 34 percent. See Joint Economic Committee (2005), p. 2.
\textsuperscript{546} See Pastor/Wise (1999), p. 498. It is, however, questionable to conjecture a stable trend in equilibrium values, given the highly volatile economic development in the period considered.
\textsuperscript{547} “If we generously assume that: (a) zero inflation continues, (b) international inflation stays at around 3%, and (c) the equilibrium currency value continues to drift upward, then the actual real exchange rate will arrive within 5% of its equilibrium value by the end of 2001.” Pastor/Wise (1999), p. 498.
\textsuperscript{548} There are three theoretical concepts to gauge the “fair” or equilibrium value of a currency. These are, first, the notion of purchasing power parity (PPP) which holds that, in the long run, exchange rates should equalise the prices of a common basket of tradable goods and services in any two countries, but which itself is reduced in its operability by its inherent long-term perspective. Second, the concept of the fundamental equilibrium exchange rate (FEER) holds that the fair currency value would be consistent with external (current account) and internal balance (full
whether, and to which extent, the Peso was overvalued before the series of external shocks hit Argentina from 1998 onwards.

The most evident operational criteria from which to gauge the approximate position of the equilibrium exchange rate are, on the one hand, the current account balance (a deficit would argue, prima facie, for an overvalued real exchange rate), and on the other, the development of foreign exchange reserves (declining reserves would suggest overvaluation). The current account aspect, especially the strong rise in imports, might support the notion of a real overvaluation of the Peso during the whole of the 1990s, both in relation to the main trading partners and to the US. However, evident counterarguments are, first, the equally (if less than imports) rising exports (which, granted, are difficult to interpret, given the low initial base, the trade liberalisation efforts, and the impact on trade flows of MERCOSUR), second, the notion that trade does not have to be perfectly balanced to be "fair", and, third and probably more important, that the deficits might mainly have reflected differences in national savings and investment rates: given the low domestic savings rate (less than 15 percent of GDP during the 1990s on average\textsuperscript{549}), the investment growth, primarily of the early 1990s, was largely financed out of vigorous capital inflows, themselves validating the exchange rate\textsuperscript{550}. As to the international reserves criterion, these were built up strongly to back the currency and to remonetise the economy, so that they can be referred to as a symptom of overvaluation only from late 2000, when they ended their strong and almost uninterrupted rise during the 1990s.

A further important argument as to why the real appreciation of the Peso might be judged as more of a natural and potentially beneficial process is the rapid productivity growth. This is supported by calculations which find the real Peso-Dollar employment with low inflation), but again, this concept is not an operable guide. Third, the idea of the behavioural equilibrium exchange rate (BEER) examines which economic variables (such as productivity growth or budget balances relative to other countries, or net foreign assets) have determined the exchange rate in the past and compares them with current values of these variables and the current exchange rate, assuming stable relationships. While, e.g., Argentina's strong productivity growth in the early 1990s can be argued to take the edge of much of overvaluation concerns, its overall turbulent past disqualifies any such serious analysis from the start.

\textsuperscript{549} Argentines thus saved nearly 10 percent of GDP less than emerging economies on average. See IMF Independent Evaluation Office (2004), p. 86.

\textsuperscript{550} Both FDI and portfolio investment showed sound term structures, so that the suspicion of a prevalence of short-term, easy-exit, positions of investment which would reflect doubts about exchange rate sustainability does not hold. See Pastor/Wise (1999), p. 481.
exchange rate based on unit labour costs depreciating by almost 50 percent between 1991 and 1998.  

Thus, it is far from clear whether, or to which degree, the Peso's real appreciation up to 1998 was an equilibrium phenomenon, reflecting a necessary and positive course of events, or rather was the result of the fixed exchange rate (i.e. of economic parameters inconsistent with the hard peg). Accordingly, views on the Peso's overvaluation in 1998, when the series of external shocks started to hit the country, vary widely. Estimations ranged, in 1999, from zero (held, understandably, by government officials) to about 25 percent. In early 2000 (the period before economic and financial conditions worsened further, and before the Euro further weakened against the Dollar), the Peso's overvaluation was still gauged highly differently by economic researchers, ranging from a mere seven to over twenty percent.

5.1.3 Sudden Stop

The sudden stop interpretation of the CBA's collapse focuses on the unforeseen standstill of capital inflows, provoked by the Russian crisis in August 1998, and its detrimental effects on an economy with the peculiar characteristics of Argentina. The sudden stop came, in its severity, to most as a surprise, as the speed and extent of contagion was hitherto unseen, and as it also hit countries that had little or no economic relations to Russia – such as Argentina. Thus, the crisis did not fit well with traditional explanations of financial crises, which is why it led to an intensified focussing on capital market behaviour as an autonomous trigger of crisis.

Besides having been unexpected, the sudden stop also failed to meet expectations that it would stay, as the Tequila crisis had been, only short-term, and that markets would recover quickly. Tellingly, the spreads on Argentine government

553 This paragraph draws mainly from Calvo/Izquierdo/Talvi (2003).
554 The most important arguments are derived from the assumption of asymmetric information: given the relatively high fixed costs of obtaining information about a country to invest in, only the largest investors will be able to specialise and to be well informed. The remaining, less informed, investors in the market tend to observe the informed leaders' market transactions to the minute, in order to derive from these a directive for their own behaviour. Seeing a presumably informed investor selling assets, but not being able to deduct his motives with certainty, can lead to supersensitive behaviour of other investors, and a spreading of asset sales through the market on the grounds of reasons possibly not related to the country's fundamentals.
bonds over US treasuries remained lower than average emerging markets' spreads until August 2000, which can be interpreted as capital markets considering Argentina's fiscal situation sustainable until then. The provision of multilateral institutions' (IMF) financing during that time obviously made up for the missing private capital flows and their negative impact on the economy and government finances. Hence the conjecture that, would the shock have been less long-lived, default could have been avoided\textsuperscript{555}. However, the capital stop's persistence and the subsequent adaptation of expectations about Argentina's fiscal solvency worked to render the fiscal situation unsustainable.

The following calculations depict the magnitude of derogation of fiscal sustainability after the sudden stop. While it can be argued that, in the absence of the sudden stop, Argentina's fiscal position was not unsustainable in 1998, there is no doubt that it was highly vulnerable to real exchange rate swings.

\subsection*{5.1.3.1 Leveraged Argentina}

The large and unexpected withdrawal of international capital from the current account and the corresponding rise in interest rates met a country with the three well-known fatal characteristics of relative closedness, high public and private indebtedness, and high liability dollarisation. Being closed meant that the share of exported tradable goods in total output was small in relation to the domestic absorption of tradables (i.e. of imports or exportable goods of domestic origin), and that, consequently, a high proportion of domestic absorption (consumption and investment) had to be financed by capital imports (rather than by export revenues)\textsuperscript{556}. High liability dollarisation, on the other hand, implied large currency mismatches in the public as well as the private non-tradables sector (Dollar debts to be serviced out of Peso incomes). These mismatches in both output and debt composition potentialised the sudden stop's devastating effects.

The sudden stop withdrew the current account deficit's financing. With the exchange rate fixed, the corresponding improvement of the current account had to occur via a fall in the domestic absorption of tradables. This fall required a fall in the prices of non-tradable relative to tradable goods, i.e. domestic deflation, or, put

\textsuperscript{555} See Calvo/lzquierdo/Talvi (2003), p. 35.
\textsuperscript{556} Put differently, the more closed an economy, i.e. the smaller the share of tradables in domestic production in relation to the domestic absorption of tradables, the higher is the country leveraged towards the exterior, i.e. the higher are the domestic adjustment needs following external shocks.
differently, an increase (depreciation) in the real exchange rate. The more closed an economy, the higher the real exchange rate adjustment required to compensate for the withering capital inflows.

Calvo/Izquierdo/Talvi (2003) quantify Argentina’s economic characteristics and the effects of the sudden stop. According to their computation of an “un-leveraged absorption coefficient”, Argentina ranked, in 1998, comparatively low within a group of Latin American economies, signifying that its absorption was higher leveraged, i.e. its economy significantly more closed, than, say, that of its neighbour Chile. From this they derive the required real exchange rate depreciation to bring the current account to balance: it would have been 46 percent. As it turned out, according to their calculations, Argentina’s real exchange rate depreciated by only 14 percent between 1998 and 2001, which accordingly did not suffice to close the current account gap.

5.1.3.2 Debt Sustainability

Taking high liability dollarisation into the picture, it gets clear that Argentina’s debt composition added to its unfavourable output composition to aggravate the consequences of the sudden stop. Thus, besides the immediate recessionary impact of the required rise in the real exchange rate, its effects on debt sustainability were detrimental.

Debt sustainability requires a minimum primary surplus to service a constant debt to GDP ratio. The debt to GDP ratio is determined by debt (Peso debt, and Dollar debt times the real exchange rate) and output (output of non-tradables, and of tradables times the real exchange rate). When, as in the case of Argentina, domestic output is dominated by non-tradables, while total debt is dominated by Dollar debt, the real depreciation necessary to restore external balance has to be comparatively large, and thus breaks through heavily on the debt component: the revaluation effects of the real exchange rate depreciation undermine debt sustainability.

Calvo/Izquierdo/Talvi (2003) quantify Argentina’s “public sector debt mismatch measure” for the year 1998, and find that its value was one of the lowest in Latin America, and very close to zero, i.e. close to the worst case where a real

558 Calvo/Izquierdo/Talvi (2003) calculate Argentina’s “public sector debt mismatch measure” at 0.01, the worst (together with Ecuador) of the sample of Latin American countries, compared with the highest sample measure of 0.45 for Chile. See Calvo/Izquierdo/Talvi (2003), p. 22.
exchange rate depreciation fully hits upon debt sustainability. With this mismatch, under the (unrealistically optimistic) assumption of both constant interest rates and GDP growth, the required 46 percent rise in the real exchange rate would lead to a revaluation of debt such, that Argentina's debt to GDP ratio would jump from 36.5 (the observed value of 1998) to 49.7 percent, increasing the primary surplus required for debt sustainability by 0.7 percent of GDP to 1.6 percent.

Allowing for the more realistic conditions of increased interest rates and slower GDP growth, as well as for the inclusion of those contingent liabilities which reflect the fiscal cost expected to be incurred by the government eventually bailing out the financial sector, the post sudden stop-debt to GDP ratio approaches 59 percent, so that the required primary surplus rises to 3.6 percent of GDP (from an observed primary surplus of 0.9 percent in 1998), itself requiring, e.g., a 13.5 percent cut in total expenditures, or, alternatively, a debt reduction by 75 percent. \(^{559}\)

5.1.3.3 The Sudden Stop in the Region

A comparison of the different outcomes of the sudden stop within Latin America sheds further light on Argentina's unfavourable predispositions.

Figure 27: Capital Flows to Latin America between 1998 and 2001 (% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>II/1998</th>
<th>III/2001</th>
<th>Reversal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Capital Flows</td>
<td>5.6</td>
<td>1.6</td>
<td>-4</td>
</tr>
<tr>
<td>Non-FDI Capital Flows</td>
<td>2.0</td>
<td>-0.9</td>
<td>-2.9</td>
</tr>
<tr>
<td>FDI</td>
<td>3.6</td>
<td>2.5</td>
<td>-1.1</td>
</tr>
</tbody>
</table>

Includes: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela.
Source: Corresponding central banks. \(^{560}\)

Figure 27 reflects the dimension of the reversal in capital flows for the biggest Latin American economies between the 2\(^{nd}\) quarter of 1998 and the 3\(^{rd}\) quarter of 2001. This sample of countries experienced an improvement in their consolidated current account from a deficit of almost five to one percent of their cumulative GDP during the same period.

\(^{559}\) Interest rates were chosen at 200 basis points above the 1998 average, and GDP was assumed to slow down by one percent. Contingent liabilities were estimated at 19 billion US-Dollars. See Calvo/Izquierdo/Talvi (2003), pp. 27 and 31.

\(^{560}\) See Calvo/Izquierdo/Talvi (2003), p. 11.
Argentina and its biggest neighbours, Brazil and Chile, confronted the sudden stop quite differently. Chile had a higher share of tradables in GDP and a lower share of Dollar denominated debt in total debt. Consequently, it required a smaller real exchange rate adjustment (32 percent) to close its current account gap, and the debt revaluation effects were smaller (its public sector debt mismatch measure being much higher – see figure 28). Effectively, between 1998 and 2001, Chile’s currency depreciated by 45 percent in real terms (as opposed to Argentina’s 14 percent), and its debt to GDP ratio remained largely constant.

In fact, Chile closed its current account gap (which amounted to nearly 19 percent of its imports in 1998) completely within one year. Besides import reductions, a production shift towards exports (induced by the real exchange rate depreciation) contributed to closing the current account gap: as figure 28 shows, the change in exports relative to the current account change was positive both until 1999 and for the period until 2001. In contrast, Argentina’s comparatively small increase in the real exchange rate delivered no similar incentive to shift production, and exports collapsed in 1999, helping further deteriorate the current account.

Brazil provides another contrasting example. It started from a worse position in two respects: its economy was even more closed than Argentina’s (its un-leveraged absorption coefficient was 0.56), and its debt to GDP ratio already very high at 51 percent. However, its public debt was to a far smaller degree dollarised than Argentina’s, which compensated for the unfavourably high absorption of tradables. Two other factors contributed to Brazil’s more favourable development. First, the devaluation of the Real in January 1999 made investments in Brazil highly attractive, which obviously managed to quickly overcome international investors’ general caution (FDI flows increased by 80 percent between 1998 and 2001), and second, Brazil undertook a severe fiscal adjustment in 1999, resulting in a strongly increased primary surplus and improved debt sustainability.
Figure 28: The Sudden Stop in Argentina, Brazil, and Chile

<table>
<thead>
<tr>
<th>Current Account</th>
<th>Argentina</th>
<th>Brazil</th>
<th>Chile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Account Balance 1998 (% of GDP)</td>
<td>-4.9</td>
<td>-5.0</td>
<td>-6.0</td>
</tr>
<tr>
<td>Current Account Balance 1999 (% of GDP)</td>
<td>-4.2</td>
<td>-4.7</td>
<td>0</td>
</tr>
<tr>
<td>Current Account Balance 2001 (% of GDP)</td>
<td>-1.7</td>
<td>-4.6</td>
<td>-1.4</td>
</tr>
<tr>
<td>Current Account Change between 1998 and 1999 (% of 1998 imports)</td>
<td>6.1</td>
<td>10.6</td>
<td>18.8</td>
</tr>
<tr>
<td>Exports Change / Current Account Change between 1998 and 1999 (%)</td>
<td>-127.5</td>
<td>-47.6</td>
<td>11.1</td>
</tr>
<tr>
<td>Exports Change / Current Account Change between 1998 and 2001 (%)</td>
<td>-1.8</td>
<td>82.7</td>
<td>79.1</td>
</tr>
<tr>
<td>Exports Change between 1998 and 1999 (%)</td>
<td>-10.6</td>
<td>-6.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Exports Change between 1998 and 2001 (%)</td>
<td>-0.5</td>
<td>14.3</td>
<td>13.4</td>
</tr>
</tbody>
</table>

Public Sector

| Debt to GDP Ratio 1998 (%)                           | 36.5      | 51.0   | 17.3  |
| Primary Surplus 1998 (% of GDP)                     | 0.9       | 0.6    | 0.6   |
| Primary Surplus 1999 (% of GDP)                     | 0.4       | 4.1    | n.a.  |
| Primary Surplus 2001 (% of GDP)                     | 0.1       | n.a.   | n.a.  |

Debt Sustainability Measures

| Un-leveraged Absorption Coefficient                  | 0.66      | 0.56   | 0.81  |
| Required Real Exchange Rate Depreciation (to close the current account gap, in %) | 46.2      | 52.5   | 32.4  |
| Observed Real Exchange Rate Depreciation between 1998 and 2001 | 14        | n.a.   | 45    |
| Public Sector Debt Mismatch Measure                  | 0.01      | 0.14   | 0.45  |

Sources: Calvo/Izquierdo/Talvi (2003); World Economic Outlook (IMF), April 2002; Economist Intelligence Unit.
5.1.4 Shock Exacerbation within MERCOSUR

In the debate of the reasons for Argentina's collapse, the focus on MERCOSUR, and especially on policy interdependencies within the common trade area, is highly relevant.\textsuperscript{561}

It might seem that the exchange rate systems of the most important MERCOSUR members, Argentina and Brazil – at least until Brazil's devaluation in early 1999 – were conducive to the integration of their economies and trade: in July 1994, Brazil, after several less than successful stabilisation attempts, had pegged its new currency, the Real, to the Dollar at a 1:1 exchange rate. Thus, the Argentine Peso and the Brazilian Real were, via the parallel Dollar peg, effectively pegged to each other. Such monetary integration should, as one would expect from the theory of optimal currency areas, and especially the argument of economic integration being endogenous to monetary integration, foster economic integration between the two countries, i.e. within MERCOSUR.\textsuperscript{562}

However, though the fixed exchange rate required that the money supply in both countries be kept in line with Dollar reserves, there was still scope for differences in the monetary policies of both countries, as the Real exchange rate was allowed to move within a target band. This opened the possibility for the Brazilian central bank to sterilise reserve shocks, in order to not let them pass through to the domestic money supply. That this scope for different monetary policies actually mattered can be shown empirically: monetary base and foreign reserves moved nearly completely in parallel in Argentina, mirroring the strict currency board rule, while the Brazilian monetary base was only to a small degree dependent on the development of Dollar reserves.\textsuperscript{563} In other words, Brazil, despite its fixed exchange rate regime, pursued an independent monetary policy within its

\textsuperscript{561} This paragraph draws largely from Andrade/Falcão Silva/Trautwein (2005).

\textsuperscript{562} For the purpose of this analysis, Argentina and Brazil are taken as equivalent with MERCOSUR, while the two other members, Paraguay and Uruguay, are ignored. This is because, together, Argentina and Brazil represent the bulk of MERCOSUR: both their combined GNP and population figures account for more than 96 percent of the respective MERCOSUR totals. The shares in total MERCOSUR GNP are 70.8 and 26.5 percent for Brazil and Argentina, respectively. 79 percent of the total MERCOSUR population are Brazilian nationals, and 17.3 percent are Argentines.

\textsuperscript{563} Andrade/Falcão Silva/Trautwein calculate a cointegration vector, which describes the relationship between monetary base and reserves between 1991 and 2001, of 0.915 for Argentina and of 0.186 for Brazil. See Andrade/Falcão Silva/Trautwein (2005), p. 68.
scope for sterilisation of reserves changes (and continued to do so after its move to floating the Real) while Argentina closely followed the currency board rule.

It can be shown that these differences in monetary policies mattered with respect to the efficacy of economic policies in both countries, on the one hand, and to the transmission of common external shocks, on the other. Since Argentina’s economy is only roughly a third of its neighbour in size, Brazilian policies generally could be expected to have a bigger impact on Argentina than vice versa. As to the particular effects of policies and external shocks, the Mundell-Fleming framework is adequate to highlight the implications for both the period between 1994 and 1998, when both countries had fixed exchange rates, and the period between 1999 and 2001, after Brazil had moved to floating.

5.1.4.1 1994-1998: Fixed Here, Fixed plus Sterilisation There

In the described fixed-fixed-scenario of the years between 1994 and 1998, the Mundell-Fleming analysis yields the following effects of macroeconomic policies and external shocks on Argentina:

First, Argentina is positively affected by expansionary monetary policies in Brazil, insofar as they lower equilibrium interest rates and increase equilibrium income levels in both countries. Second, Argentina is negatively affected by Brazilian expansionary fiscal policies, since, while Brazil’s higher demand for exports from Argentina increases also the income of the latter, this effect is outweighed by interest rate-induced capital flows from Argentina to Brazil, which are sterilised by the latter, so that the Brazilian restrictive monetary antidote again reflects negatively back to Argentina, in the end raising Argentina’s equilibrium interest rate and lowering its equilibrium income. Third, Argentina’s fiscal policies (monetary policies are precluded) experience an amplification through Brazilian sterilisation: an Argentine fiscal expansion leads to higher, income-induced, demand for imports of goods and services from Brazil, as well as to higher, interest rate-induced, capital imports from Brazil. Brazil sterilises its reserve outflows through expansive open-market operations, which in turn reinforce the expansionary effect of Argentina’s fiscal policies, delivering a process that ends when, due to continuing capital imports from Brazil, Argentina’s interest rate reaches its original equilibrium level.

564 See also Mussa et al. (2000), p. 51f.
565 For a concise summary of the Mundell-Fleming model, see e.g. <http://cepa.newschool.edu/het/essays/keynes/international.htm>.
The third of the described policy interactions within MERCOSUR is highly relevant for the understanding Argentina’s fiscal performance during the years 1994 to 1998. According to this analysis, Argentine fiscal expansion did not crowd out private investment, since the equilibrium interest rate level remained unchanged due to the Brazilian sterilisation policy. Fiscal policy, the only remaining macro policy tool for Argentina, was thus, as both theoretical analysis and empirical evidence suggest, highly effective because it was boosted by its neighbour’s monetary policy.

For common external shocks, the analysis yields a mitigating effect of Brazil’s sterilisation policy on both countries. For the case of symmetric negative reserve shocks (like, e.g., the Tequila crisis), Brazilian sterilisation of its reserve outflows to the rest of the world works, first, to lower Brazilian interest rates and induce arbitrage capital movements towards Argentina, and second, to keep up Brazilian income and demand for imports from Argentina. Of course, there are limits to sterilisation, which did materialise in the wake of the Asian and Russian crisis, when reserve outflows in Brazil reached levels which the Brazilian central bank could no longer neutralise. Brazil’s move to floating and inflation targeting changed the described policy interdependencies profoundly.

5.1.4.2 1999-2001: Fixed Here, Floating plus Sterilisation There

For the new constellation (CBA in Argentina and floating exchange rate in Brazil), the analysis yields a drastic exacerbation of the impacts of external shocks on Argentina, as follows:

A common negative reserve shock in both countries now leads to a devaluation of the Brazilian currency. This reduces Brazilian demand for imports from Argentina, and increases Argentine demand for imports from Brazil. Thus, the Argentine economy is hit twice: first by the reserve shock itself (representing, in the Mundell-Fleming framework, a left-shift of the LM curve), and second, by Brazil’s depreciation (which induces a left-shift of the IS curve). Possible sterilisation in Brazil now changes little, as a sterilisation-induced interest rate differential commands arbitrage capital from Brazil to Argentina (thus correcting the LM curve again a bit to the right), but thereby also works to further depreciate the Brazilian currency (and so to command the IS curve further to the left). The degree of the

566 Andrade/Falcão Silva/Trautwein (2005) give empirical evidence, using filter analysis and a structural VAR model.

567 Of course, the same would have been true for the case of fiscal restriction.
negative reaction on goods markets (left-shift of the IS curve) depends on the degree to which Brazil sterilises the reserve shock.

5.1.4.3 Exposed within MERCOSUR

As has been shown, even before 1999, monetary policies of Argentina and Brazil were different enough to be responsible for various asymmetries in the absorption of internal and external shocks. Moreover, while the “fixed / fixed plus sterilisation” constellation before 1999 favoured the effects of monetary expansion in Brazil and fiscal expansion in Argentina, and mitigated the effects of negative external shocks in both countries, this was a double-edged sword: the highly effective expansionary policies undermined the fixed exchange rates and led to increasing devaluation pressures in the wake of the massive external shocks of the late 1990s. So, the lack of monetary policy coordination before 1999 contributed to the vulnerability of the fixed exchange rate regimes and to their ultimate collapses. After Brazil’s move to floating, the disintegrated monetary policies brought the existing asymmetries to their extremes, so that common external shocks hit Argentina twice, while the impact on the Brazilian economy was buffered by the depreciation of the Real.

Andrade/Falcão Silva/Trautwein (2005) substantiate the above analysis with empirical evidence. They find that, as was to be expected, the asymmetries in the transmission of domestic and external shocks were strongest when both countries pursued extremely different exchange rate and monetary policies. In particular, their correlation analysis of Argentine and Brazilian economic indicators yields evidence of increasingly different reactions to exogenous variables: Argentina’s vulnerability to changes in foreign interest rates and Brazilian output doubled after 1999, while Brazil was affected less, after 1999, by changes in foreign interest rates or Argentine output than before.

Thus, the diverging monetary policies of Argentina and Brazil have not only undermined economic integration within MERCOSUR, but also aggravated its member countries’ vulnerabilities and, ultimately, helped evoke their deep crises.

568 They examine the correlation of the output cycles of both countries and find significantly less synchronised cycles after 1999. See Andrade/Falcão Silva/Trautwein (2005), pp. 74-5.

569 A further symptom for disintegrating monetary policies in MERCOSUR can be found in decreasing trade between the countries. As, according to the endogeneity argument of the theory of optimal currency areas, monetary integration is expected to foster economic integration, diverging monetary policies within a currency area are, conversely, expected to result in less,
5.1.5 Institutional Defects

Given the impressive growth and disinflation results of the CBA, but the disturbing employment and distributional developments, it is argued that the failure to co-ordinate macro and micro reforms were also decisive in contributing to the CBA's collapse. In other words, the macroeconomic framework, defined by the rigid monetary regime and accompanied by the simultaneous trade liberalisation and privatisation policies, would have called for deeper institutional changes to help the economy adjust to the new conditions. As the argument goes, the lack or incompleteness of such microeconomic reforms worked to undermine economic performance and social peace, and thus lastly the per se successful macroeconomic reforms.

5.1.5.1 Insufficient Labour Market Reforms

With a fixed exchange rate, the burden of adjustment of an overvalued real exchange rate falls on domestic prices, the flexibility of which can be ensured only by, especially downward, flexible wages. Thus, theory has it that flexible labour markets have to act as the substitute for a flexible exchange rate. No one would sincerely contest the verdict that the labour market reforms Argentina implemented were insufficient and sometimes contradictory, often performed in a stop & go mode, and often paid heed more to political constraints than to fundamental economic necessities.

One flaw was that the main incentive for, and measure of, the realised labour market reforms was always the high unemployment rate. While the combat of unemployment clearly need not run against the objective of more labour market flexibility, there was a neglect and failure in politics to acknowledge, internally and publicly, the need for reforms due to other, more fundamental, economic reasons. From the start, no serious efforts were made to make the public familiar with the thought that higher labour market flexibility was the price to pay for the cherished "Convertibilidad". Hence, a lack of consistency and of political courage to market and promote labour market deregulation with the parallel goals of reducing especially intra-industry, trade. This is confirmed by empirical data: intra-industry trade between Argentina and Brazil increased substantially until 1997, and declined afterwards. This development can be explained econometrically by macroeconomic policy variables. See Andrade/Falcão Silva/Trautwein (2005), pp. 80ff.

570 Other motives for reform were, occasionally, also industrial and sectoral policies, while distributional aspects never featured as goals of labour market policies.
unemployment and “insuring the economy against devaluation” is a serious blame the Menem administration has to bear. Clearly, the main factor behind this neglect were the trade unions, traditionally strong and the Peronists’ fundus, anything but weakened from the inflationary past, and generally more worried about preserving regulatory achievements than about unemployment.

Apart from this basic neglect, the reforms enacted can for the biggest part be labelled as “too little and too late”. What happened during the early 1990s’ reforms has to be judged partly as steps, if small, into the right direction (above all the denting of non-wage labour costs, especially of indemnity payments after dismissals), partly as neutral or potentially beneficial but running into the void because not achieving sufficient coverage (the employment insurance scheme), and partly as complicating and strengthening the regulatory framework while serving neither the employment nor the flexibility goals (such as the changes in working time and vacation regulations, the frequently altered and diluted rebates on social security contributions, or the to and fro manoeuvres with probation period length).

The record of the reforms of the late 90s can be judged only slightly better: some mixed and counterproductive measures (such as the shortening of probation periods) were purely politically motivated, meant to secure trade unions’ support in the elections of 1999. Further gradual reductions in non-wage labour costs and very limited freedom to change regulations through collective bargaining were the most important achievements. But while the need to adopt deeper labour market reforms generally got more acknowledged towards the end of the decade, chronic political opposition stood in the way of realising them.

Potentialising a sufficient adjustment mechanism via labour and goods markets would have required more deregulation, especially a weakening of the dominance of sectoral collective bargaining in favour of an encouragement of wage negotiations on enterprise levels, much further reductions of contractual regulations (instead of introducing new, highly regularised, contracting variants), and, especially, more easing of the very strict hiring and dismissal regulations. Certainly, an agreed and socially acceptable level of labour regulations would have had to be respected, with the safety nets provided by employment insurance and cash transfer programmes for the unemployed, both of which the foundations were laid for. Very importantly,

Likewise, institutions such as “special labour statutes” (giving some workers favoured status over others) and union-run health plans sheltered from competition should have been abolished. See IMF Independent Evaluation Office (2004), p. 32.
qualification measures would have been needed to reduce the mismatches between labour demand and supply, and especially to improve the employability of blue collar workers, who were hit unproportionately by rising unemployment and by the rise of sectors like financial services that favoured workers with higher skills.\textsuperscript{572}

Perhaps the most severe failure is that the labour market policies of the 90s did not succeed in reducing unregistered employment (to the contrary, they seemingly helped drive registered employment into the "black" sphere). The expectation was that dented non-wage labour costs and more short-term labour contracts would bring about a higher propensity to formalise employment (which measures, to be sure, would certainly have helped, but were far from sufficient), but there was no (accompanying) direct targeting of the problem.\textsuperscript{573} While one can cynically comment that more "black" labour means more overall labour market flexibility, the growth of unregistered labour during periods of strong growth is a testimonium paupertatis, and proof of labour market regulations still highly burdensome.

5.1.5.2 Insufficient Diversification of Production

Argentina’s productive structure is also made responsible for standing in the way of smoother adjustment to changes in external conditions. In the tradables sector, limited progress was made in reducing the dominance of low value-added production in favour of the higher value-added export products needed to trigger future development and thus income and employment growth. Though various measures were taken to subsidise exports of higher value-added products (such as tax reimbursements on such exports), the industry’s response was weak. The reason was the strong Peso which increasingly overlay these incentives by discouraging production for foreign and stimulating production for domestic markets.\textsuperscript{574}

Diversification of production and trade was also encumbered by the relative cheapening of capital relative to labour, itself again a consequence of brakeless capital imports and of strong trade unions. It entailed growing capital intensity, declining employment, and an ongoing process of industrial concentration in capital intensive sectors, mirrored by a process of de-industrialisation in labour intensive, import-competing sectors. Small and medium sized companies were squeezed out


\textsuperscript{573} Direct measures would have included, e.g., systematic compliance controls and the enforcement of penalties.

\textsuperscript{574} See Pastor/Wise (1999), p. 486.
of markets by growing industrial conglomerates, which were financed by foreign capital and enjoyed better access to the technologies, skills, and market information necessary to compete on world markets.\textsuperscript{575}

Concentration took place in the financial sector as well, with bank closures and takeovers in the wake of the Tequila crisis. Segmented credit markets reinforced industrial concentration: small enterprises were demanded interest rates for business loans easily double or triple those demanded from large companies.\textsuperscript{576} A further factor in the thinning base of small and medium sized companies was that few traditional links between small and large firms existed, partly a consequence of the economy's capricious and inflationary past where inter-business relations were kept as small as possible in order to minimise cost and delivery risks.

Arguably, MERCOSUR also contributed to spare Argentina from more competitive pressure from the rest of the world: most (about two thirds during the early 90s) of total export growth resulted from intra-industry trade with Brazil. Exports to Brazil consisted overwhelmingly of products from the motor vehicles industry, the sector still most regulated through exemptions from trade liberalisation, and thus least based on competitive advantages. As a result, Argentina's trade got increasingly concentrated on one partner (Brazil) and one sector (motor vehicles).\textsuperscript{577}

A further disappointing trait of Argentina's industrial development is that privatised firms, overall, failed to fulfil the expectations of more dynamic production and investment activities: neither R&D activities nor export orientation increased by much. This was clearly also the failure of the bodies regulating privatised utilities, the work of which partly was influenced by lobbying and corruption rather than by efficiency considerations.\textsuperscript{578}

The sketched problems could have been tackled primarily by improving the business environment much more than actually happened. Though, during the

\textsuperscript{575} Some numbers illustrate the concentration and labour saving process: in 1994, the biggest 30 export firms, belonging to just four sectors, covered 55 percent of total exports; the biggest 500 companies accounted for 30 percent of GDP, but employed only 20% of the workforce; both the number of small enterprises and of workers employed by them had fallen during the previous 10 years by 21 percent. See Pastor/Wise (1999), p. 486.


\textsuperscript{577} While trade with MERCOSUR partners was 20 percent of Argentina's total in 1991, it rose to 45 percent in 1998, with the bulk of exports going to Brazil. See Dominguez/Tesar (2004), p. 12.

\textsuperscript{578} "The picture is more of oligopolistic rent-seeking than of dynamic enterprise [...]." Pastor/Wise (1999), p. 489.
1990s, the physical infrastructure got, via utility privatisation, vastly better, and the legal framework also improved (with, e.g., a world-class bankruptcy law adopted in 1991), judicial as well as political imponderabilities remained (or even increased in the late 1990s). As for the human resource base, this essential part of a forward-looking business environment was vastly neglected. Striving for higher value-added production would have necessitated policies to promote qualification measures and the diffusion of technological and marketing skills, as well as measures to expedite R&D activities, to encourage venture capital and possibly the growth of industrial clusters, in order to facilitate horizontal and vertical integration between smaller and larger firms. Very importantly, these measures should have been designed explicitly to promote industrial development in the provinces. After all, “market reform in and of itself is not a development strategy”.

With these cornerstones of a successful industrial policy missed, the final goal, an increase in Argentina's openness via a higher share of non-traditional exports, was also missed, which helped undermine the macroeconomic framework.

5.1.5.3 Banking Sector Reforms Impaired

As indicated above, the banking sector reforms, especially those carried through after 1995, concerning banking supervision and prudential policies, were considered one of the most successful reform areas within the Convertibility Plan, and praised as a model for emerging economies. Together with the encouraged entry of foreign-owned banks, assumed to diversify risk away towards their owners abroad, the swiftly widening and deepening Argentine financial sector was thought healthy and able to match the requirements of an open market economy.

However, some concerns remained about credit policies. The first concern was the strong segmentation of credit markets, reflected in wide gaps between the interest rates charged small as opposed to large industrial borrowers, and between interest payable on Peso as opposed to Dollar loans. This segmentation

581 Banking assets doubled between 1991 and 1999 (from 20 to 40 percent of GDP), and the percentage of banking system assets held with foreign banks rose from 15 percent in 1994 to 73 percent in 2000. See Dominguez/Tesar (2004), p. 12.
582 Small enterprises were demanded interest rates for business loans easily double or triple those demanded from large companies. See Pastor/Wise (1999), p. 487. Interest rate spreads between Peso and Dollar currency transactions, often exceeding two percent p.a., reflected not
persisted even in times of strong growth, low inflation, and high confidence, such as during 1997, when risk spreads of government bonds over US treasuries reached their minimum. In discriminating against small businesses and low income earners, this partly excessive segmentation fostered industrial concentration and a deteriorating distribution of wealth. Second, in the effort to catch up and gain market shares in the field of consumer credit, financial institutions embarked on aggressive consumer credit policies. Increasingly, credit cards were pushed into a retail banking market that just started to develop and largely consisted of over-confident consumers, with the result of ever more indebted private households. Arguably, these developments mirrored neglects in the otherwise successful implementation of banking regulations. On the whole, though, and to judge from the weak financial constitution the country had started from in 1991, the elaborate prudential standards after 1995 represented a huge progress, and, above all, they largely satisfied the regulatory needs for a banking sector operating under a currency board, i.e. without a lender of last resort.

But any regulatory framework, however fit, is useless if subject to political influence. Several instances of political meddling exposed Argentine banks to additional risks. These were, first, the forced resignation of the supposedly independent central bank manager, Pedro Pou, in April 2001. Second, the politically encouraged, and later openly imposed, massive purchases of government bonds by public and private banks (as well as by private pension funds) loaded the banking sector with assets of dubitable worth. The permission for banks, in April 2001, to include government securities up to 2 billion Dollars to meet liquidity requirements was thus only the first formal political abrogation of prudential standards, in a row of several factual violations before. With the growing weight of government bonds in banks' balance sheets, the financial sector was exposed to a broadened cluster of risks: not only was it vulnerable to economic downturn (non-performing loans) and primarily devaluation risk, but also a lack of competition among banks in a regional context, enabling banks to exert some degree of monopoly power on nontradables producers and households with a lack of access to international capital markets. See Catão (1998), p. 22.

583 Payments via bank accounts were also politically encouraged as a means to reduce tax evasion.

to the risk of devaluation (currency mismatch), but also to default by the public sector (worthless assets).\textsuperscript{585}

The third blow to the financial sector's constitution came, finally, with the "corralito" in early December 2001. The drastic violation of property rights destroyed any reputation the banking sector had enjoyed before.\textsuperscript{586} The financial sector was dealt the fourth and final blow after default and the end of the CBA had been sealed, with asymmetric pesification in February 2002, which entailed a massive redistribution of wealth between depositors, lenders, and financial institutions, as well as a cauda of court injunctions and legal action that should occupy banks and courts for years, and which left the banking system in shatters.

What remains is that banking sector reforms of the early and mid-1990s basically deserved their reputation as having been apt and well implemented, and served the financial sector and the economy well – so long as banks remained free from fiscal desires.\textsuperscript{587} With the central bank, in its supervising and regulating function, captured by politics, and the banking system saddled with worthless assets, the financial sector was directed towards the utmost exposition to devaluation and public default.

\textbf{5.1.5.4 Other Deficient Reforms}

The single most neglected area of reform undoubtedly has been (it still is) the sphere of federal fiscal relations. Though the damaging nature of the existing regulations has always been recognised, political intricacies constantly stood in the way of approaching more rational norms. Even the constitutional commitment of 1994 to redefine the coparticipation scheme until 1996 failed to produce a result: no

\textsuperscript{585} Public sector banks (such as the federally owned Banco de la Nación, the Banco de la Provincia de Buenos Aires, and a few other provincial banks) were particularly vulnerable to reduced confidence in the government, as they were especially exposed to political influence. This perception affected the banking system as a whole. See IMF Independent Evaluation Office (2004), p. 35

\textsuperscript{586} Though meant to dam capital flight, the corralito contained a loophole that facilitated a legal transfer of funds abroad for the financially versed. It worked via so-called "ADRs" (American Depository Receipts), shares of Argentine companies also listed in the US. The corralito allowed depositors to use funds in excess of the monthly 1,000 Dollars withdrawal maximum to buy either government bonds or shares of Argentine companies. Shares of Argentine companies cross-listed in the US could be legally converted into ADRs, sold in the US, and the Dollar proceeds deposited on a US-account. See Dominguez/Tesar (2004), p. 15.

\textsuperscript{587} See Calvo/Mishkin (2003), p. 4.
fundamental reform passed the fierce resistance of the main beneficiaries of the existing regulations, the provincial governors. To the contrary, the few realised modifications, such as the introduction of “precoparticipaciones”, or the guaranteed fixed transfer sums, made the system even more complex and, above all, counterproductive in creating additional moral hazard and procyclical fiscal outcomes. The effects of several sensible fiscal reforms realised in the areas of tax compliance and tax structure effectively got stifled by the increasingly perverse fiscal redistribution process. Besides a rationalisation of federal fiscal relations, the fiscal task would have also been to reduce the reliance on regressive taxes, above all VAT, in favour of higher direct taxes on income, and, generally, to improve tax compliance and tax administration.

The social security reform, while completely necessary and broadly judged as a success, proved to create a massive burden on the government’s borrowing requirements. Its consequences for the public purse should have received greater consideration, as a result of which the financing of reform costs via taxes or expenditure cuts, rather than via borrowings, should have been envisaged.

Generally, social policy is a field massively disregarded during the whole of the 1990s. As Argentina disposed of a highly educated population and comparatively wide welfare coverage, the market reforms of the early 90s were implemented without social compensation schemes. But as the described productive changes, such as increases in low value-added production and industrial concentration, took hold and the employment and distribution situation continued to worsen, it would have been necessary to boost and coordinate industrial and social policies. Better targeting of social expenditures to high risk groups on the one hand and, as indicated above, more active industrial policies (favouring higher value-added production and educational training programmes) on the other would have been needed to tackle the increasing social problems. Again, a shift in taxes towards more taxation of income (which is typically at least mildly progressive), away from regressive VAT, would also have created an element of redistribution.

As for commercial policies, apart from the proposed measures to promote trade diversification, limited capital controls, such as, e.g., reserve requirements on external debt by firms, or minimum stays of FDI, could have been used to encounter...
short term and volatile capital flows. As long as the repatriation of profits from FDI is not restricted, the experience shows that such measures can be implemented without discouraging long-term capital inflows, and without compromising trade liberalisation\textsuperscript{591}. Such limited capital controls could, at the same time, have been tailored to bring up "infant" industries, i.e. to confront the dominance of low value-added primary production by supporting investment in a broader spectrum of higher value-added production for export purposes\textsuperscript{592}.

In parallel, Argentina's trade policies should have been aimed more at diversifying not only the basket of traded goods but also of its trading partners. Negotiations within MERCOSUR, though essentially rational in terms of boosting intra-industrial trade, have always been hampered by lack of bilateral and industrial commitment, and should have been in any case complemented by efforts to deepen trade relations with industrial, but also with other developing countries. With the latter, the development of trade patterns beyond Argentina's traditional patterns would possibly have been easier to stimulate, and possible common exchange rate links to the US-Dollar would have reduced the exposedness of trade to Dollar appreciation.

Finally, several public sector institutions, such as the judiciary, regulatory commissions, social ministries, the civil service, police, and provincial governments, remained prone not only to lobbying interests and corruption, but also to political pressure. They would have needed a thorough remake to comply with the requirements imposed by an efficiency seeking market economy. Instead, state institutions continued to justify the suspicion it was viewed with by the Argentine public, in times when their conduit should have been targeted at fostering greater equality in the benefits of market reform\textsuperscript{593}.

The described failure to co-ordinate macro and microeconomic reforms, with macroeconomic stabilisation highly successful, but micro reforms failing to help the economy adjust to the rigid macro conditions, was, as late as 1999, generally viewed as still curable. Accordingly, a "second generation of reforms" was urgently called for, in order to secure the successes of stabilisation and growth and to shield

\textsuperscript{591} Chile successfully implemented such capital controls in the 1990s. See Rojas-Suárez (2003), p. 151.

\textsuperscript{592} Capital controls are in any case preferable to the more protectionist stance of import tariffs and duties, which make counteractions from trading partners more probable.

\textsuperscript{593} See Pastor/Wise (1999), p. 495.
the economy against external shocks. Such a second generation of reforms should have been designed to confront the described inadequacies of institutional defects, broadly along the proposals made above.

5.1.6 Politics

While thorough political analysis is beyond the scope of this investigation, the field of politics cannot be left out in the search of explanations for the Argentine CBA’s fate. The analysis shall be confined to some conspicuous traits of Argentine politics during the 1990s and their relation to economic outcomes.

Though next to unbelievable with a view to its roots, Peronism has, by its figurehead Carlos Menem, got inseparably linked to Convertibilidad. Among Menem’s merits was, in the late 1980s, the broadening of the Peronist electoral base, to add larger business and middle class segments to the traditional backbone of working classes, and thus turn Peronism into a grantor of majorities. While this was a precondition for the agenda of market-oriented reforms to realise, it also entailed ample potential for intra-party rivalry, which favoured autocratic governing, corruption, and the turning of a blind eye towards the country’s military past. A symptom of this is the massive “governing by decree” the President took recourse to in order to overcome anti-market sentiments within party and government. Topics such as the revision of tax and labour laws, the setting of the trade regime, or the modification of public contracts were settled autocratically, by executive decree, and the core of the reform programme comprised in the Convertibility Plan was realised as decrees of “necessity and urgency”. Circumvention of the parliament, defiance of the constitution, and biased nominations for the Supreme Court were customary traits of the Menem governing style, the legitimacy of which got additionally undermined by personal charges of corruption. While autocratic tendencies may be justified in case of economic emergency, the danger is that they persist and get routine; a country subscribing to market economy needs fundamentally free

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595 According to Pastor/Wise, another tactic to grant majorities was the initial sparing of the provinces from fiscal tightening, and the maintenance of “clientelistic and traditional networks of power and mobilization in the periphery”. Pastor/Wise (1999), p. 492.

596 Between July 1989 and December 1993 alone, over 12,000 executive decrees and 308 decrees of “necessity and urgency” were passed. The number of presidential emergency decrees passed by Menem exceeds the total number issued by all constitutional presidents in the past 130 years. See Pastor/Wise (1999), p. 492f.
“political markets” for successful development. The persisting lack of factual democracy fit badly with the country’s late 1990s’ image of a poster boy among emerging economies, and inevitably turned against the government as soon as luck ran out.\footnote{One popular suspicion runs as follows: when political support from the traditional Peronist voter bases, increasingly hit by unemployment and declining real wages, wore thin in the run-up to the 1999 presidential elections, and the economic and fiscal situation deteriorated, the calculation of the ruling Peronists was to “leave the bomb to the Alianza”. The bomb would be left to “explode” under the Radicals, and to interrupt their constitutional term, so that the Peronists could take over early again (of course never taking responsibility for the existence of the bomb). With hindsight, the course of events can be interpreted to match this assumption, with the cynical aftertaste that it would have been, for political reasons, perfectly consistent with such a strategy to avoid minimising the costs related with the end of Convertibility. Opinion expressed by Fernando Navajas during an interview conducted by the author on November, 18\textsuperscript{th}, 2004, in Buenos Aires.} The constitutional reform of 1994, launched to allow for a second term of President Menem, entailed political deals with the opposition, as well as with provincial leaders and organised labour, which softened fiscal discipline and stalled or even rolled back the structural reform process. To the merits of the Peronist government, much of this languishing was corrected soon after, under the pressure of the Mexican crisis. Equally, Menem’s attempt to get admitted as a candidate seeking a third term caused, as long as the case was not yet settled, the competition for nominations within the Peronist party, which entailed again increased public spending for political reasons.\footnote{See IMF Independent Evaluation Office (2004), p. 16.} A clear political fault of the Peronists in the mid to late 1990s, in terms not only of securing majorities, but also of ensuring sustainability of the per se necessary and successful macroeconomic reforms, was the apparent lack of concern for the employment and distributional consequences of reform. As indicated above, turning a blind eye to the increasing social malaise did not only defy the Peronist stance but also destabilised the country politically and socially, and thus undermined the whole stabilisation success.

As to the Alianza government, the coalition faced extremely difficult tasks while having to cope with widely diverging political positions internally. In sticking to the CBA and setting to increase the primary surplus to regain debt sustainability, it struggled with the fierce redistribution conflict which arose over who was to bear the adjustment costs. Since taxes and spending cuts hit predominantly the non-
corporate sector\textsuperscript{599}, the coalition risked its main constituency, the middle class. Under accusations of leaving external creditors unscathed, the Alianza finally broke into pieces over the redistribution conflict\textsuperscript{600}. Certainly, the chances of succeeding in turning the rudder and installing debt sustainability would doubtlessly have been higher had the government, taking over from the Peronists in 1999, appeared a unified whole.

As to opposition to the Convertibility regime, there has always been some, mainly from the left, which criticised the negative effects of the radical liberalisation and privatisation policies on employment, distribution, and industrial structures\textsuperscript{601}. Such opposition remained marginal until the late 90s' recession exposed more of the CBA's vulnerabilities and led even major candidates in the 1999 elections to call it into question publicly. However, such criticism could not dent the CBA's popularity with the vast majority of the public.

5.1.7 The IMF

Almost continuously involved in Argentina during the whole of the 1990s, the IMF ("the Fund") inescapably played a role in the developments that led to the devastating crisis in 2001\textsuperscript{602}. The IMF's attitude towards the CBA, its engagement during the CBA's existence, as well as the role it played before and during the crisis are the issues addressed in what follows\textsuperscript{603}.

\textsuperscript{599} With the "impuestazo", taxes on income, personal net assets, and some consumer goods were increased in early 2000. The "plan déficit cero" of July 2001 included a cut of salaries and pensions of public sector employees by 13 percent.

\textsuperscript{600} "Coalition governments almost never succeed in implementing long-lasting fiscal adjustments of the sort that are likely to have short-run expansionary effects". Eichengreen (2001a), p. 18.

\textsuperscript{601} See, e.g., Rofman (1997), or, written in 2001 with the claim to offer a plan for the Argentine economy to arise from the ashes of convertibility: Universidad de Buenos Aires, Facultad de Ciencias Económicas (2001): "Hacia el Plan Fénix - Una Alternativa Económica".

\textsuperscript{602} Indeed, Argentina is different from most other cases where the IMF has provided extraordinarily large support in that the IMF was strongly involved in the country for many years before the emergence of the crisis. See Mussa (2002), p. 2.

\textsuperscript{603} The Evaluation Report "The IMF and Argentina, 1991-2001", issued in 2004, is the result of the Independent Evaluation Office's (IEO) investigations into the Fund's role in Argentina. This recently installed office operates under the authority of the IMF's Executive Board, independent of staff and management, so that, though ultimately responsible to the Fund's membership, it is thought to be relatively free of bias. This paragraph draws in many, though not all, aspects from this candid analysis.
5.1.7.1 The IMF and the CBA

The Convertibility Plan of 1991, implemented by the Argentine government without consultation with the IMF, was initially treated with scepticism but, with a view to the broad agenda of market-oriented and efficiency-enhancing reforms, basically welcomed by the latter. The quick and impressive defeat of inflation and the stabilisation boom of the early years did their part to mute occasional concerns about the medium-term viability of the programme within the Fund.\(^{604}\)

During the Tequila crisis, the Fund supported Argentina’s efforts to maintain the CBA. The decisiveness shown by the Argentine government pushing through tax and financial sector reforms in the eve of presidential elections impressed even sceptics within the IMF. The success in mastering the crisis proved very important in that it brought the IMF to unambiguously endorse the fixed exchange rate regime as "both essential for price stability and fundamentally viable".\(^{605}\) After Tequila, the CBA experienced a veritable credibility thrust which encouraged public and private spending and drove critics of the CBA into the background.\(^{606}\)

During the expansionary period after Tequila, Argentina and its Convertibility Plan were even praised by the IMF as a model for developing countries. Remarkably, the IMF continued to provide funds even though there was no longer an immediate balance of payments need, and even when the political preconditions for the implementation of policies needed to sustain the exchange rate regime had broken away. When recession and a loss of access to international capital markets followed the shocks of the late nineties, the IMF stepped in with a new arrangement in early 2000 in support of the newly elected government’s effort to halt the recession and redress public finances, in order to maintain the CBA. Even after repeated instances of non-compliance with fiscal and policy targets agreed with the Argentine government, and with ever smaller chances of avoiding default and collapse of the CBA, did the IMF stick to its support of the CBA, and granted

\(^{604}\) "Little substantive discussion took place with the authorities on whether or not the exchange rate peg was appropriate for Argentina over the medium term, and the issue received scant analysis within the IMF." IMF Independent Evaluation Office (2004), p. 3.


\(^{606}\) Daniel Heymann minted the expression "excess credibility" of the Convertibility Plan, responsible for a collective overestimation of Argentina’s potential and long-term growth expectations. Expressed during an interview conducted by the author on November 16th, 2004, in Buenos Aires.
extraordinarily large sums. Thus, the Fund knowingly pursued a high risk strategy in support of the Argentine CBA until things could not turn to the better any more.

5.1.7.2 Outline of the IMF's Engagement 1991-2001

During the decade between 1991 and 2001, Argentina maintained five successive financing arrangements with the IMF (see figure 29). These included three Stand-by Arrangements, one approved in 1991 after the introduction of the CBA, one in 1996 in the midst of the Tequila crisis, and one in 2000 to replace and continue the previous arrangement. In addition, two Extended Fund Facility arrangements were agreed upon in 1992 and in 1998, the latter of which was treated as precautionary, with no funds actually drawn. Accompanying the financial support, the Fund gave technical assistance, mainly in the fiscal and banking sphere, to support the objectives of the programmes.
Figure 29: IMF Financing Arrangements with Argentina 1991-2001

<table>
<thead>
<tr>
<th>Type of Arrangement</th>
<th>Approved</th>
<th>Expired/ Cancelled</th>
<th>Amount Agreed (million SDR)</th>
<th>Amount Agreed (million USD)</th>
<th>Percent of Quota</th>
<th>Amount Drawn (million USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Stand-by Arrangement</td>
<td>07/1991</td>
<td>03/1992</td>
<td>780</td>
<td>1,065</td>
<td>70.1</td>
<td>600</td>
</tr>
<tr>
<td>2 Extended Arrangement</td>
<td>03/1992</td>
<td>03/1996</td>
<td>4,020</td>
<td>5,661</td>
<td>361.2</td>
<td>5,661</td>
</tr>
<tr>
<td>3 Stand-by Arrangement</td>
<td>04/1996</td>
<td>01/1998</td>
<td>720</td>
<td>1,045</td>
<td>46.8</td>
<td>890</td>
</tr>
<tr>
<td>4 Extended Arrangement</td>
<td>02/1998</td>
<td>03/2000</td>
<td>2,080</td>
<td>2,820</td>
<td>135.3</td>
<td>0</td>
</tr>
<tr>
<td>5 Stand-by Arrangement</td>
<td>03/2000</td>
<td>01/2003</td>
<td>16,937</td>
<td>22,315</td>
<td>800</td>
<td>12,854</td>
</tr>
<tr>
<td>Of which Supplemental Reserve Facility</td>
<td>01/2001</td>
<td>01/2002</td>
<td>6,087</td>
<td>7,961</td>
<td>287.5</td>
<td>7,684</td>
</tr>
</tbody>
</table>

Source: IMF Independent Evaluation Office (2004), p. 77. SDRs converted to US-Dollars at the respective yearly average exchange rates, with exception of the 2001 Supplemental Reserve Facility which is converted to USD at the exchange rate of the day of approval.

The first two arrangements were designed to support the structural reforms undertaken, while the third arrangement (of 1996) supported Argentina in coping with the Mexican crisis. The three-year Stand-by Arrangement of early 2000, originally amounting to SDR 5.4 billion (around USD 7 billion), was designed to address the worsening recession as well as, from early 2001, when it was augmented by an additional SDR 5.2 billion, to help Argentina regain access to international capital markets. Additional financing from official and private sources was arranged at the same time, so that the total package was announced to comprise USD 39 billion ("el blindaje"). IMF assistance was further augmented in late 2001 by an additional SDR 6.4 billion, so that the IMF’s total exposure amounted to around SDR 17 billion (USD 22 billion), with USD 3 billion earmarked for a planned debt restructuring. With the non-completion of the scheduled fifth programme review in December 2001, IMF support was effectively cut off.
5.1.7.3 The Role of the IMF during 1991 to 2000

Criticisms of the Fund’s role for the Argentine CBA concentrates on the areas of exchange rate policy, fiscal policy, and structural reforms.

As to exchange rate policy, the Fund had, following its statutes, to accept any member country’s prerogative to choose an exchange rate regime of its own liking. However, it clearly failed to examine the consistency of the chosen exchange rate regime with other policy choices.\(^{607}\) Explanations for this failure are, first, a reluctance to discuss Convertibility for fear of upsetting financial markets and triggering self-fulfilling speculations (though this was not an argument for refraining from undisclosed discussion with the Argentine authorities), second, a lack of analytical tools to objectively evaluate the sustainability of a chosen exchange rate regime,\(^{608}\) and third, the difficulty to address the topic, in light of repeated public statements by the IMF supportive of the CBA. In any case, this failure “must be read as a weakness of [the Fund’s] surveillance over exchange rate arrangements.”\(^{609}\)

A similarly disappointing assessment has to be made of the IMF’s stance with respect to fiscal policy. First, the IMF focused too much and for too long on flow variables without considering the year-to-year changes in the debt stock. Only in 2000, when the debt to GDP ratio approached fifty percent, did overall indebtedness become an issue.\(^{610}\) A second critique refers to the IMF’s failure to pay sufficient attention to provincial finances. Until 1998, formal fiscal conditionality included only the federal government budget, so that provincial profligacy remained largely unmonitored. Finally, partly due to the absence (or non-application) of diagnostic tools, and partly also due to neglect, the sustainable level of debt was overestimated by the IMF. Thus, the IMF’s fiscal analysis underestimated the vulnerabilities emanating from Argentina’s peculiar set of economic policies in the

\(^{607}\) “Yet, IMF staff devoted only limited resources to determining whether the exchange rate regime adopted in Argentina was consistent with other policies and institutional constraints and, if not, what possible exit strategies Argentina should consider.” IMF Independent Evaluation Office (2004), p. 22.


\(^{610}\) Primarily focussing on annual deficits, unmet fiscal targets remained mostly without consequence, or were loosened when growth fell below forecasts, but not strengthened when growth exceeded forecasts. See IMF Independent Evaluation Office (2004), p. 25.
case of potential external shocks, with the effect that the required degree of fiscal discipline was underestimated.

In the area of monitoring structural reforms, the IMF's credentials are not much better. First, fiscal reforms, i.e. reforms of federal fiscal relations, of the tax structure, and of tax compliance, were only moderately successful in the latter two cases, and a complete failure in the former. Political and cultural (tax evasion!) realities may exonerate the IMF from much of the blame, but "it can be argued that the IMF did not employ all the available tools to bring about reform in some critical areas. Despite the rhetoric about the importance of structural fiscal reforms, there was only one structural performance criterion (on tax reform) included in all of the successive IMF-supported programs in this area." A similar judgement has to be made with respect to labour market reforms, rightly emphasised as crucial by the IMF but not followed up consequently enough, as from 1998, when political obstacles increasingly foiled their implementation. As to social security reform, the IMF erred in the same way as did most other observers, in overestimating the potential benefits of the new system and underestimating its fiscal consequences by far. Finally, while the financial sector reforms, carried out with limited IMF assistance, were supported and recognised to be favourable with respect to prudential regulations and supervision, the IMF failed to address the vulnerabilities emanating from extensive liability dollarisation early enough. Likewise, it did not press the government to tackle the weaknesses of the banks still owned by the state. One general feature of the IMF's programmes with Argentina was their brevity with respect to structural conditionality, and "what little conditionality the programs contained was not rigorously enforced."

612 "However, this forbearance on an issue that was ultimately central to the viability of the convertibility regime had its costs, because policies that a few months earlier were meant to be at the core of the IMF-supported program would be delayed to the point where they would have little impact on the economy's ability to respond to the shocks of 1999-2000." IMF Independent Evaluation Office (2004), p. 33.
613 "The IMF, among others, did not fully grasp early on the conceptual weaknesses of the way the transition to the new system was financed, which together with other accompanying policy changes implied a flawed reform with serious long-term consequences." IMF Independent Evaluation Office (2004), p. 35.
615 IMF Independent Evaluation Office (2004), p. 36. And: "Stronger conditionality would be unlikely to have brought greater change in the absence of domestic ownership, but the IMF did not
The findings about the Fund’s internal decision making process shall not be dealt with here. As to the general mood, “the record suggests that the staff’s generally upbeat public assessments were shared by most of the Executive Board”, and “there was almost universal confidence expressed in the [Argentine] authorities’ ability and willingness to implement the appropriate policies. Voices expressing serious doubt about the overall logic of the actions of the IMF or the authorities became rarer as the decade wore on.”

With hindsight, the rationale for maintaining a programme relationship with Argentina after the Mexican crisis had been overcome does not seem justified, given the country’s access to relatively cheap international capital and the absence of an immediate balance of payments need. Yet, although fiscal adjustment and structural reforms stalled during the second expansionary phase due to political obstacles, and ever more of the targets of IMF-supported programmes were missed, IMF support was continued, and an Extended Fund Facility approved in 1998, while there would have been sufficient reason to end the programme relationship. However, markets’ perception of the sustainability of policies was still favourable, which is why the Fund’s confidence was viewed as justified.

5.1.7.4 The Role of the IMF in the Crisis

IMF support during the years 2000/2001 consisted in a new Stand-by Arrangement, agreed in early 2000 to replace the Extended Arrangement of 1998, which was reviewed four times and augmented twice until late 2001.

Initially, the Fund’s support was based on the assumption that Argentina’s recession and loss of market access were mostly the result of a combination of adequately identify the structural measures that were key to longer-term success and then make adequate progress in those areas a prerequisite for its continued program relationship with the country.”

Yet, the report’s criticisms concerning the decision making process (both the outspoken and the implicit) offer lessons of a more general nature. While some of the tangible findings may lead to improve the working of the institution in the future, other indications point at external political and market pressures that influenced decision making, which are inevitably harder to detect and to tackle. See IMF Independent Evaluation Office (2004), p. 63.


adverse, but temporary shocks, and thus constituted primarily a liquidity crisis. Hence, fiscal adjustment and measures increasing international competitiveness were expected to suffice to restore confidence and restart growth. A need for fundamental changes in the exchange rate regime and/or the debt structure was not recognised, as both external and public debt levels did not seem alarming, and no estimations were made as to the degree of misalignment of the real exchange rate. The provision of large Fund support therefore was viewed as justified "on catalytic grounds", i.e. to help build confidence in order to (re)gain complementary financing from capital markets.

This was the also rationale of the augmentation decision in December 2000 ("el blindaje") which was complemented by financing assurances by the private sector, to amount in total to 39 billion US-Dollars. Programme conditionality was based on a combination of slightly relaxed fiscal deficit and debt targets (meant to limit contractionary effects) and intensified structural reforms aiming at promoting competitiveness and investment (subject to benchmarks, not to targets). Although the risks faced by the programme were acknowledged to be "significant" with a view to possible adverse external developments and the political constraints the government faced, the benefit of doubt was given to the Argentine authorities, referring to the excellent track record of the CBA as well as to the high potential costs of its collapse and/or a debt default, including fears of international contagion.

This stance was basically kept through the following reviews which included a scheduled disbursement (of 1.2 billion USD in May 2001) and a second augmentation (by eight billion USD in September of that year). Despite

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619 An interim improvement in external conditions during 2000 (above all growth in global commodity prices) seemed to justify this stance and nourished expectations of further improvement of external conditions.


621 In an internal briefing paper, possible exit options (move to floating, dollarisation at par, dollarisation at a depreciated rate) were discussed by IMF staff, but without stating the Peso's overvaluation or debt sustainability as fundamental problems, and without seriously pressing for considerations of exit strategies in IMF support. See IMF Independent Evaluation Office (2004), p. 42.

622 "In fact, even within the IMF, there was an increasing recognition that Argentina had an unsustainable debt profile, an unsustainable exchange rate peg, or both. Yet no alternative course of action was presented to the Board, and the decisions were made to continue disbursing funds to Argentina under the existing policy framework, on the basis of largely noneconomic considerations.
continuously missed targets (partly due to political opposition, partly to deteriorating market access), and despite a departure from the agreed policy mix and deteriorating cooperation with the IMF since the advent of Minister Cavallo, the Fund approved continuance of the programme, at the same time recognising its low probability of succeeding in staving off crisis. The need for stop-loss rules for the Fund as well as for alternative approaches to crisis resolution was an issue in internal memoranda, but was not seriously followed up for fear of the catastrophic consequences of an exit from the CBA, and also because the Argentine authorities’ refusal to discuss the topic was accepted.

During 2001, the economic policy agenda was almost entirely set by the Argentine government without prior consultation with the Fund (instead sometimes furnished with premature public statements of allegedly secured IMF support) and consisted largely of increasingly desperate and unorthodox measures which effectively urged the IMF to put a good face to things if it did not want to “shy[ ] away” from its mandate and to “effectively surrender[ ] to the same procyclical influences that are driving market behaviour”.

Without straight assessment of the risks and costs of possible alternatives, there was, in the decision process for the augmentation of September 2001, only the choice between supporting a programme with a low probability of success (estimated internally at 20-30 percent at best) and withdrawing support entirely, with the consequence of triggering a catastrophic collapse, and without any idea of what should follow. The IMF was well aware that the money would, at best, buy a few months, and “would be more likely to disappear in capital flight”.

Even after it had become clear, by late October, that the augmentation of the SBA had been a failure, the IMF continued to defer to the Argentine government’s

623 Among the measures taken are the “competitiveness plans”, the financial transactions tax, the modification of the Convertibility law towards a Dollar-Euro basket peg, the pertinent “convergence factor” installing a dual exchange rate by fiscal means, the “mega swap”, the “zero deficit plan”, the planned debt exchange, and, finally, the “corralito”.
refusal to discuss alternative policy frameworks. The conviction that the fifth review would most likely not be going to be completed spread within the IMF, but stayed without communication to the Argentine authorities. Finally, during the corresponding negotiations, on the background of the accelerating bank run and the single-handed introduction of the corralito, differences in the Fund's and the Argentine authorities' assessments on the prospects of the CBA became overwhelming, and the non-completion of the review was decided. Given the acceleration of social and political turbulence in December, the stance of the IMF was to wait for a new government in order to offer fresh assistance for a comprehensive medium-term solution, including debt restructuring and either floating or devaluation cum dollarisation. The introduction of the dual exchange rate regime to replace Convertibility in early 2002, however, plainly excluded further IMF support.

5.1.7.5 The Fund's Responsibilities

From the above, it becomes apparent that the IMF has to bear some responsibility for Argentina's crisis. This is not to say that the Fund was completely wrong with its support for the CBA, or that it was the main responsible for the outcome (this position is incontestably reserved for the Argentine authorities). But it is important to detect the instances where serious errors have become obvious. Clearly, in retrospect things are easier to put into context than in the middle of an inextricable situation.

Of course, the Argentine authorities' non-compliance as well as unfavourable external developments cannot be laid at the IMF's door. What can be laid there, however, are two fatal failures: first, the failure to press more for policy consistency, i.e. for much more conservative fiscal policies, during the whole of the 1990s (especially during the second expansionary phase), and second, the continuance of

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627 However, IMF staff had finally outlined a strategy to move to an alternative setting. It included further fiscal adjustment, debt restructuring with a reduction in the NPV by 40 percent, dollarisation at par (paying heed to the assumed preferences of the Argentine government), and full disbursement of undrawn balances under the existing SBA. The proposal was overtaken by events, as yet another stance of single-handed action by the Argentine government made it irrelevant. See IMF Independent Evaluation Office (2004), p. 56.


629 All the more so since the Argentine authorities "owned", i.e. stood firmly behind, virtually all of the key policies adopted during the decade.
support after mid-2001, when it had become obvious enough that efforts to maintain
the CBA and avoid default had no reasonable chance of success. The first failure is
nothing less than astonishing, given the Fund’s usual standards, while the second, a
reflex of lacking adequate risk assessment and contingency planning, is more of an
embarrassment.

Citing these two failures implies that the IMF was basically right in all the other
instances of its relationship with Argentina. This includes its support of the CBA in
principle, being a regime sovereignly chosen by an IMF member, with a reasonable
chance of success, as well as its support of the attempts to stick to the CBA through
shocks and recession up to, and including, the financial package of December 2000
(the “blindaje”), which could be ascribed a reasonable chance of success in helping
avert a major crisis.\footnote{See Mussa (2002), p. 3. Also: “Given the probabilistic nature of any such decision, the
chosen strategy may well have proved successful if the assumptions had turned out to be correct
(which they were not) and if the agreed program had been impeccably executed by the authorities
(which it was not). The critical error was not so much with the decision itself as with the failure to
have an exit strategy, including a contingency plan, in place, inasmuch as the strategy was known
be risky. No serious decision of alternative strategies took place, as the authorities refused to
engage in such discussions and the IMF did not insist.” IMF Independent Evaluation Office (2004),
p. 5.}

There are some conspicuous and ill-omened characteristics of the Fund’s
second failure, the protracted support. These are, first, the Fund’s obedience to
increasingly being taken hostage by a perceived “take it or leave it” situation with
assumedly only two options, namely to unambiguously endorse the CBA or to take
responsibility for triggering a crisis (this, often enough, went in parallel with being
taken hostage by a non-complying government).\footnote{“... it may be difficult to understand how great a perversion of [the Fund’s] policies and
principles was perpetrated in this incident.” Mussa (2002), p. 25.} While such a bipolar approach,
clearly to a large extent dictated by the centrality of credibility for the arrangement,
may be viable under fundamentally sustainable conditions (witness the Tequila
experience), it is clearly not in case of a severely misaligned exchange rate and/or
an unsustainable fiscal stance. As indicated, the Fund failed for too long in
recognising this, at the cost of a needed proactive approach to crisis resolution.\footnote{However, “... it is quite possible that a situation in which some groups in Argentina viewed
a devaluation/debt restructuring as having been “forced” by the IMF would have been associated
with even greater political disruptions and short-term policy choices that would have made the
situation worse. In other words, there may well have been no feasible actions by the IMF that would}
Second, as a consequence of the Fund’s failure to correctly judge the situation (namely to detect that the problem had developed into a solvency problem), it overestimated its leverage with respect to market sentiment. The policy of private sector involvement which stood behind the “blindaje”, effectively linking official support to voluntary finance from domestic and international private markets, was based on the assumption that official finance had to be only as large as to create enough confidence to catalyze further private finance which would, in turn, restart economic growth. As it turned out, correspondingly limited further official finance, as delivered with the augmentation decision of September 2001, worked to puzzle markets more than to reassure them, because they rightly judged the situation worse than the IMF implicitly signalled. This is not to say that the Fund’s support for Argentina was not enough; rather, that any sums granted after the failure of the “blindaje” were, in retrospect, doomed to be futile. Indeed, the Fund’s exposure to Argentina had become exceptionally large after the subsequent augmentation, which created serious concerns of the country’s capacity to repay.

The most severe reproach, however, is fed by the circumstances of the augmentation decision of September 2001, when the money, as even admitted by those responsible, was expected to buy a few months at best and to disappear in capital flight. This, together with the ambiguity inherent in the augmentation itself (the provision of funds to mend what was labelled a liquidity crisis, with parts of have enabled the adoption of a meaningful Plan B. But this possibility is not an adequate justification for failing to think about, let alone design and actively promote, such a plan.” IMF Independent Evaluation Office (2004), p. 69.

633 The catalytic approach suffers, above all, from free rider and first mover problems, i.e. from the fact that for individual investors it is rational to wait and see whether the government’s commitment, together with other investors’ new funds, brings about the hoped-for consolidation, before they themselves put in new money. See Eichengreen (2001a), pp. 24ff.

634 At the same time, the 3 billion Dollars as part of the augmentation earmarked for debt restructuring in effect was an unambiguous warning to markets that a restructuring including a loss in creditors’ NPV was unavoidable.

635 Certainly, it belongs to the nature of a crisis lender to assume “beyond-market” credit risks (and, after all, IMF credit enjoys seniority). However, internally there seems to have been a lack of focus on financial risk: “It is still striking how few Directors raised this issue as a concern during Board discussions, especially given the lack of conditionality on net international reserves (in view of what was considered to be a functioning currency board arrangement) and, in September 2001, the absence of standard assurances in the staff report concerning Argentina’s ability to repay the IMF.” IMF Independent Evaluation Office (2004), p. 61.
those funds earmarked to facilitate a debt restructuring), worked to feed the suspicion that external interests, political and economic alike, might have been unduly involved\textsuperscript{636}. The potential motives would not be hard to conjecture, as, in the last weeks of the CBA, what remained of big and sophisticated investors' capital had time to leave the country\textsuperscript{637}.

One positive thing may be derived from the Fund's travails in Argentina, and this is the supposition that contagion remained limited after Argentina's collapse because the crisis was so protracted as to be widely anticipated by market participants in the end. The IMF has rightly emerged deeply damaged from the Argentine crisis. It has since tackled some of the identified shortcomings, and accordingly revised some policies and procedures.

5.1.8 The Washington Consensus

The term "Washington Consensus" was coined by US-economist John Williamson after a conference held in 1989 in Washington, DC, with economists from both the World Bank and the IMF, on policy reforms in Latin America. It was subsequently understood to stand for a set of free-market economic policies meant, after the debt crisis of the 1980s, to chart a path for restoring sustained prosperity in the region, or, in other words, "to refer to the lowest common denominator of policy advice being addressed by the Washington-based institutions to Latin American countries as of 1989"\textsuperscript{638}.

The Washington Consensus comprised a set of ten reforms to create growth on the basis of a commitment to macroeconomic discipline, market economy, and openness to trade. These reforms focused on fiscal discipline, a reordering of public

\textsuperscript{636} "In fact, the practice of certain prominent shareholders [in the IMF] of bypassing the Board raises serious transparency concerns in the decision-making process, not only as to the negative effect on the lack of proper and adequate debate in the Board as the natural "locus" for discussions, but also as to the "agenda" – other than finding the best possible alternative in specific crisis prevention or crisis resolution scenarios – that such shareholders might be advancing." Lavagna (2004), p. 119. And, referring to shortcomings in governance and transparency in the handling of the Argentine crisis: "These shortcomings are indeed compounded by the fact that representation at the Board does not adequately reflect the importance of emerging economies in the global economy." Ibid.

\textsuperscript{637} "Argentina's program was explicitly tailored to take the country out of the capital market through the end of 2001. That is to say, it allowed creditors with maturing claims to exit without losses. It was the opposite of a bail in." Eichengreen (2001a), p. 28.

expenditure (towards more spending on primary health, education, and infrastructure) and revenue (tax reforms that combine a broader tax base with moderate marginal tax rates), financial and interest rate liberalisation, a competitive exchange rate, trade liberalisation (replacement of quantitative restrictions with low and uniform tariffs), liberalisation of inward FDI, privatisation, deregulation (to abolish barriers to entry and exit), and secure property rights. The Washington Consensus has become to be viewed by its critics as a manifesto of neoliberalism and market fundamentalism.

Clearly, the policy set around the Argentine “Convertibilidad” was in line with the recommendations formulated in the Washington Consensus. Although the choice of exchange rate regime did not explicitly form part of them, being claimed by the IMF as a “poster boy for emerging economies” was tantamount to being praised as a “poster child for the Washington Consensus”.

There are (apart from, first, piles of mainly ideologically founded anti-capitalist, anti-US, and anti-globalisation criticisms, and second, claims that the Washington consensus neglected environmental and political issues) basically three areas where the Washington Consensus ideas arguably were too blunt. These are, first, the requirement of financial liberalisation, which seemed to require completely open capital accounts and thus the encouragement of foreign capital to flood in without restraint. Together with fixed exchange rates and/or irresponsible fiscal policies, this inevitably led to overvaluation and/or fiscal unsustainability, and so made countries vulnerable to the vagaries of international capital markets. Second, it can be

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639 “The term 'competitive exchange rate' [...] signifies a rate that is either at, or undervalued relative to, its long-run equilibrium.” Williamson (2000), p. 263.

640 Williamson noted on the recommendation of "competitive exchange rates" in 2002: “I fear I indulged in wishful thinking in asserting that there was a consensus in favor of ensuring that the exchange rate would be competitive, which implies an intermediate regime; in fact Washington was already beginning to subscribe to the two-corner doctrine.” Williamson (2002).


643 “Too many countries encouraged money to flood in and overvalue the currency when the capital markets were throwing money at the region, or used a fixed or crawling exchange rate as a nominal anchor, or pursued a procyclical fiscal policy. They thereby made themselves vulnerable to "sudden stops" in capital inflows, and they left themselves no scope to relax fiscal policy in difficult times. The policy agenda of a decade ago certainly did not warn countries against such foolish acts, and indeed in certain cases countries may even have been encouraged to do some of those things.” Williamson (2003), p. 5.
argued that the Washington Consensus did not emphasise sufficiently the importance of institutional (later called “second-generation”) reforms which are necessary to make any “first-generation” reform (i.e. the original policy set) work\textsuperscript{644}. With incomplete or neglected fiscal and labour reforms, and other, complementary, institutional preconditions lacking (e.g. on fields such as the judiciary, civil service, tax collection, fiscal federalism, education), advantage could not be taken from the per se beneficial “first-generation” reforms\textsuperscript{645}. The third critique is that policies shaped after the Washington Consensus were too narrowly focussed on growth, instead on “growth plus equity”\textsuperscript{646}. There was little concern for income distribution or the social agenda, relegating to the conviction that the proposed reforms were generally pro-poor in being pro-growth. The prevalence of an already relatively unequal income distribution and of different income elasticities with respect to aggregate growth across different layers of income was not taken account of, with the effect that income distribution even worsened during growth phases.

The proponents of the Washington Consensus have largely, and productively, accepted such criticism\textsuperscript{647}. The position claiming that, in Argentina, “the neo-liberal economic model was never implemented or, if it was, it was half-baked”\textsuperscript{648} contains both aspects of the Washington Consensus’ responsibility for Argentina’s experience: on the one hand, the Washington Consensus represented a paradigm that seemed to fit ideally with Argentina’s needs at the beginning 90s, and so (irrespective of the fact that, anyway, the stabilisation need made a very hard external anchor, and thus an economic alignment somewhere along the Washington Consensus proposals, unavoidable) offered a perfect ideological backing for the Convertibility Plan (which also helped in the relationship with the IMF). On the other hand, Argentina proved to comply least with the most important, namely the fiscal,

\textsuperscript{644} See Burky/Perry (1998).

\textsuperscript{645} See Huber/Solt (2004), p. 162.

\textsuperscript{646} “My version quite consciously eschewed redistributive policies, taking the view that Washington had not reached a consensus on their desirability”. Williamson (2000), p. 258.

\textsuperscript{647} They have made a variety of proposals to tackle the post-1990s’ problems of Latin America, paying heed to some lessons they, along with many economists worldwide, have learned from the experience with Latin America during the past 15 years. See Kuczynski, P.-P., and Williamson, J. (eds.): After the Washington Consensus. Restarting Growth and Reform in Latin America, Institute for International Economics, Washington, D.C., March 2003.

\textsuperscript{648} Hanke (2002), p. 2.
policy requirements of the Washington Consensus, and so clearly disqualifies as a case study, and therefore also as a prey, of the Washington Consensus.

5.1.9 The Currency Board Itself

A popular attitude is that the 2001 crisis was a direct and necessary consequence of the chosen monetary constitution, i.e. of the CBA itself. The arguments are obvious: both the straitjacket the CBA imposed on monetary policy and the dollarisation it encouraged left the country without the flexibility to adequately respond to external shocks. The fiscal dimension plays, for the “culprit CBA” advocates, no independent role in causing the crisis.

Prima facie, there is little to oppose. However, such argumentation goes easy in fading out the very origins and the purpose of the CBA, i.e. the historical dependencies any responsible analysis cannot avoid bothering with. It is a fact that the CBA precisely was chosen as a last resort from chaos owed to decades-long macroeconomic mismanagement. There is no doubt that it was initially, and could well have been for a longer term, good at rectifying this. The true mistake was the failure of those responsible to acknowledge that, beneath its immediate effectiveness, the CBA, if it was to be viable in the medium to longer term, needed making the economy compatible with the CBA’s functioning principles and limits, i.e. with restricted policy options, with harder adjustment processes, and with the elementary obligation to balance public budgets\(^{649}\). Beyond a wholesale condemnation of a potentially beneficial monetary constitution (which has been amply tested in history, and not only in pre-globalisation times), therefore, it is imperative to investigate into the defects in the Argentine CBA’s gearing – as has been done above. Such investigation inevitably suggests that Argentine politics did not live up to their own commitment, to the CBA\(^{650}\). Thus, the CBA cannot per se be made responsible for the crisis.

A slightly more acceptable variant of the “culprit CBA” thesis is that the CBA obviously failed to fulfil expectations of its disciplining effect on fiscal policy\(^{651}\). However, such expectations enjoyed very little justification from the start: the

\(^{649}\) “But surely, the ultimate tragic collapse was not preordained from the time that Argentina's stabilization and reform efforts began a decade earlier.” Mussa (2002), p. 30.

\(^{650}\) See e.g. Lavagna (2004), p. 116.

\(^{651}\) Calvo/Mishkin claim that hard pegs may even weaken governments’ incentives for fiscal rectitude, as they make foreign borrowing easier and thus allow them to delay necessary reforms. See Calvo/Mishkin (2003), p. 25.
Convertibility regime hinges on an open economy, and an open capital account, wherefrom deficits were financed, is a necessary precondition for the choice of an external nominal anchor. So, expectations of the CBA disciplining fiscal policy could realistically be based less on some sort of built-in restraints than on hopes that either responsible policies or, if not, rational capital markets would take over the disciplining role, in providing funds to a debtor just as much and as costly as sustainable. However, as long as international capital markets can reasonably expect international financial institutions to eventually bail out the country, the latter hope is ill-founded – moral hazard makes the provision of unserviceable finance a perfectly rational act\textsuperscript{652}. So, there has never been a way around responsible fiscal policies.

5.2 Taking Stock

So far, the different factors that contributed to the collapse of the CBA have been examined. It has become evident that many of these factors have their origins well before the advent of crisis, some of them even before the CBA’s inception. Just as in medical sciences where it is well known that pathogens unfold their worst effects when coming across a weak physical constitution, one has to distinguish here between the factors that created vulnerabilities (invaliding factors) and other factors that evoked crisis when encountering the vulnerable constitution (triggering factors). This implies the notion that, in the absence of triggering factors, the crisis would not (yet) have unfolded, and on the other hand that, in the absence of vulnerabilities, the triggers would have met a much more resistant environment and thus not have been able to do so much harm. Categorising and weighing the individual factors is what remains to be done.

5.2.1 Vulnerability

The uncontested lead in the ranks of the invaliding factors is held, not surprisingly, by fiscal profligacy. The most serious mistake made was that the high growth years, especially the post-Tequila years, were not used to generate fiscal surpluses in order to potentialise anticyclical fiscal policies, and to moderate later

\textsuperscript{652} There are hopes that the hitherto unseen losses investors incurred in the aftermath of Argentina’s sovereign default (the haircut was by 70 cent on the Dollar) will discipline future lending. History, as well as the fact that international capital quickly returned to Argentina, however, suggest otherwise.
liquidity constraints. Mussa (2002) argues that an improvement of the primary fiscal balance by two percent on average since 1991, or, alternatively, a roughly equivalent improvement starting after Tequila (of one, two, and three percent in 1996, 97, and 98 respectively, and the subsequent maintenance of this improvement) would have been sufficient to cumulatively reduce Argentine sovereign debt in 2001 by enough as to reduce concerns about sovereign default. Such fiscal performance would have been imaginable in political as well as economic terms, and would have allowed lower interest rates and better conditions for economic recovery. The chronic fiscal deficits, financed largely by Dollar-denominated government bonds placed on international capital markets, facilitated domestic absorption financed from abroad and persisting current account deficits, and left public accounts heavily currency mismatched. Fiscal irresponsibility is thus the root cause for the triple macroeconomic vulnerability Argentina developed up to the late 1990s, consisting of high indebtedness, high leverage towards the exterior, and vast currency mismatches in public balance sheets. Thus, fiscal profligacy is also co-responsible for the increasing gap between the Peso’s nominal exchange rate and its intrinsic, i.e. fundamentals oriented, value, i.e. for much of its overvaluation. Clearly, not all of the blame is with the public sector: the private sector equally borrowed freely from abroad, and/or incurred Dollar liabilities while its revenues were in Pesos (as in the nontradables sector). However, in doing so, it responded to the framework, policies, and mood set by the authorities.

Correspondingly, among the institutional weaknesses, those were most damaging that were responsible for the vast, especially non-discretionary, portions of federal public spending. As has been shown, the counterproductive rules that govern federal fiscal relations bear significant responsibility for the fiscal outcome. Had the provinces been prompted to balance (or improve) their budgets, the overall

653 See Galiani et al. (2002), p. 22.
654 “Thus, the margin between sustained success of Argentina’s stabilization and reform efforts of the past decade and the tragic collapse at the end of last year was far from insurmountable.” Mussa (2002), p. 31.
655 “The combination of a weak fiscal policy and heavy reliance on external borrowing within the constraint of the Convertibility regime became a recipe for disaster, when the country was hit by the prolonged adverse shocks.” Independent Evaluation Office (2004), p. 15. Thanks to careful management of maturity structure, the impact of the sudden stop on the public sector’s immediate financing needs was not as bad as it could have been with shorter maturities; but this only meant that the crisis took a few years to develop.
fiscal stance would have been easier to keep sustainable (between 1992 and 2001, the combined annual provincial deficits added on average 1.1, and in 2001 alone 2.4, percent of GDP to the federal fiscal deficit\(^{656}\)). Other traits, such as the generally weak tax administration, persisting loopholes, widespread tax evasion, as well as the corrupt judiciary, added to fiscal morbidity. The social security reform cannot be left unmentioned here as the single most fiscally burdensome, because blatantly ill-financed, institutional reform.

Very importantly, economic policy constellations within MERCOSUR were highly adverse in boosting expansionary Argentine fiscal policies before 1999, and in aggravating the effects of external shocks after 1999. MERCOSUR thus acted, for Argentina, as an amplifier of unsound policies and negative shocks, and thus added massively to its vulnerability.

Next come the much-lamented labour market rigidities. Undoubtedly, the labour market reforms stayed insufficient, and the regulatory burden was anything but helpful for the needs of structural change and wage flexibilisation. Nevertheless, the argument of rigid labour markets preventing the "automatic adjustment mechanism" is dented by the observation that the deflationary process significantly reduced nominal wages in the private sector as from 1998. This suggests that market pressures did pass through on wages, but that the degree of deflationary adjustment could not make up for the massive overvaluation\(^{657}\). Thus, maybe labour markets were not as flexible as they could have been, but they would have been in any case vastly overstrained if they had been expected to bring about the whole of the required real exchange rate adjustment\(^{658}\). Hence the reluctance to place labour market rigidities at a more prominent place in the score of culprits.

Other neglects follow, with declining importance as to their contribution to Argentina's crisis (though not necessarily for the country's long-term perspectives). Though the country made big efforts to move away from inward orientation and improve efficiency, and, overall, the realised privatisations brought significant efficiency gains and improved supply, in several cases, unduly monitored privatisation processes and deficient regulatory institutions, as well as generally insufficient industrial policies stood in the way of better meeting the demands of the new economic alignment. The educational system continued to deteriorate

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\(^{658}\) See Williamson (2003), p. 4.
throughout the 1990s, while it would have been crucial to match it with new qualification needs of those set free in privatised state companies. The complete lack of concern for social and distribution policies went largely unpunished during the high growth years but turned into a curse during the protracted recession.

5.2.2 Triggers

It is well known which factors triggered the crisis and exhibited Argentina’s vulnerabilities. However, as will be argued, they are not exclusively of external origin.

First comes, now proceeding chronologically, the Dollar appreciation, which started in 1995 and unexpectedly continued even in the wake of the high-tech bubble burst, to appreciate, in total, by 34 percent between 1995 and early 2002. It contributed to the overvaluation the Peso entered the crisis with (the Dollar had appreciated by roughly 18% between 1995 and early 1999), and helped slow down export growth and attract international capital. However, as Argentina’s trade share remained comparatively low, the appreciated Dollar’s impact on growth stayed limited, which is also why Argentina’s problem was not predominantly one of competitiveness. More important than the Dollar’s rise was that part of the Peso’s overvaluation that developed as a consequence of country risk considerations, i.e., of Argentina’s increasingly unsustainable fiscal situation given its characteristics of relative closedness and of currency mismatched balance sheets. In the absence of other external shocks, the Dollar’s appreciation could plausibly have been compensated via deflationary adjustment (the Dollar’s rise between 1999 and late 2001 was by roughly another 12 percent\(^{659}\)). Given the high credibility of Convertibility, the Dollar’s rise alone would, with sounder fundamentals, probably not have evoked speculative attacks of the CBA, even though the external shocks of the late 90s would have put the economy under strain (as they did with other emerging economies).

Clearly, the sequence of emerging economies’ crises between 1997 and 1999, starting with the Asian crisis, among them most severely the Russian crisis that dried out international capital markets, as well as the Brazilian devaluation that hit Argentina’s trade balance, were the most fatal triggers for Argentina\(^{660}\).

\(^{659}\) See Joint Economic Committee (2005), p. 2.

\(^{660}\) Turkey and Brazil also suffered major crises induced by the sudden stop. Uruguay’s crisis, however, was the reflex of Argentina’s collapse; contagion remained limited to Argentina’s highly dependent neighbour.
It has been said that until some point in 2000, Argentina's fiscal situation seemed not unsustainable. As has been argued, even the "blindaje", disbursed in early 2001, still had a reasonable chance of success, as there were still ample international reserves available in the vaults of the central bank, the banking system was as yet unaffected by confidence losses, and there was the hope that the slowing US economy would weaken the Dollar.661

This implies an additional category of trigger, pulled by the Argentine authorities themselves. Arguably, two events within just four weeks sealed Argentina's fate, the first of them by perforating hopes that politics could bring about the necessary fiscal redressing, and the second by lancinating the exchange rate peg. The refusal of the Argentine government to embark on the fiscal consolidation measures, as proposed by the new economy minister Ricardo López Murphy, and his forced resignation in March 2001, was the first of these fatal triggers662, while the second completed the damage with what has been called above "meddling with the CBA", i.e. with the announcement in April 2001 of a change to a basket peg. This worked to actively undermine the CBA, in demolishing confidence into the peg and thus destroying any hope of avoiding default, and was helped by the violation of central bank independence a few days later when the central bank governor was removed from office663. To be sure, the change to a basket was, in principle, a fundamentally rational goal, and could have been envisaged in a fundamentally stable economic environment, but in the prevailing situation, the softening of support for the Dollar parity that had been firmly held up since ten years could not do other than upset markets as well as the Argentine public, accelerate bank runs and bankruptcies, and ultimately provoke the end of Convertibilidad664. Subsequent measures such as

661 "While skeptical that the chance of success was as great as 50 percent, my view was that in late 2000 there still was a reasonable chance that tragedy could be avoided — if the Argentine government assiduously implemented fiscal measures that reassured private creditors about longer-term debt sustainability." And: "An interest rate spread of 750 basis points indicated concerns in financial markets about debt sustainability, but not yet firm conviction that sovereign default was virtually inevitable." Mussa (2002), p. 19.
662 "In my view, this event marked the effective end to any realistic hope that the Argentine government would address its fiscal difficulties with sufficient resolve to avoid sovereign default and its attendant chaos." Mussa (2002), p. 22.
664 Of course, the "convergence factor", tied to the hypothetical Euro-Dollar basket and, in effect, a devaluation by fiscal means, worked to reduce the real exchange rate misalignment, but
the “mega canje” and the competitiveness and zero deficit plans, therefore, were deprived of any chance of success. Advancing these two events as the ultimate triggers (the second pulled, ironically, by the “father of Convertibility” himself) implies the conviction that until early 2001, and with López Murphy’s fiscal programme, the collapse could have been avoided, the CBA could have stayed in place, and the economy could have adjusted in the required, although painful, manner to the external shocks. With the ensuing recovery of the world economy and the finally falling US-Dollar, Argentina would have been likely to recover as well, with its CBA in place (and possibly preparing for a softer exit at a later stage).

So, well aware of the unabated populist attitudes that still accuse the IMF, the Washington Consensus, or even, for that matter, globalisation as such of being accountable for Argentina’s recent tragedy, any responsible analysis must arrive at Argentine politics as lastly having spoiled its own success. Sure, the Washington consensus was too sweeping in several aspects, and the IMF can be blamed for serious misjudgements long before, as well as during, the crisis. Also, external developments were extremely unfavourable, and it can, by extension, even be argued that, again, the IMF and its ideological alignment had contributed to the occurrence of these external shocks (especially the Asian crisis, from which the other crises spread). But, even when all these findings are acknowledged, Argentine politics cannot be spared from the verdict that they bear the ultimate responsibility for having failed to pursue the policies necessary to sustain its chosen macroeconomic framework, the CBA.

5.3 Missed Opportunities?

Considerations of possible opportunities to exit the CBA hinge upon the prevailing political and economic constellations. In retrospect, there would have been basically two time windows where an exit from the CBA, after having reaped its stabilisation benefits, towards a more flexible exchange rate would have been possible out of a position of strength (“soft exit”). The years immediately before, and those after, the Tequila crisis would have offered such opportunities, with the latter period certainly more apt, given the greater distance from, and thus assumedly lesser fear of a relapse into, high inflation. Though more painful and unavoidably implying a degree of expropriation (with the inevitable consequences for further

not enough by far, and at the cost of undermining credibility and thus the complete macroeconomic framework. See also Calvo/Izquierdo/Talvi (2003), p. 47.
policy credibility), an exit towards a flexible exchange rate would have been conceivable even after the advent of external shocks and recession at the end of the decade ("hard exit"). Fleeing ahead, i.e. taking the exit towards full dollarisation, would have been feasible basically anytime and in several variants. Contrary to an exit towards flexible exchange rates, official dollarisation would not have included a reneging on past commitments, but could have been viewed as a logical sequel of the CBA.

Of course, the assumption that any of these options, if realised, would have been preferable to the factual outcome is derived from hindsight. While it might be thought pointless to engage in hypothetical contemplations of past opportunities, such considerations help not only to assess factual developments but also to draw some important lessons. In what follows, these possible exit opportunities, as well as the facts that stood in the way of seizing them, will be addressed.

5.3.1 Soft Exit during 1993/1994

Once the economy was stabilised, with single-digit and continuously falling inflation rates and strong growth, the period 1993/1994, in retrospect, could have looked like an opportune time to exit the hard peg. The fiscal improvement of 1992/93, the US-Dollar depreciating in 1994 against Argentina's main trading partners and taking off pressure from the Peso, as well as improvements in competitiveness due to deregulation and privatisation, made existing concerns about the large current account deficit look less worrying.

As indicated, neither the Argentine authorities, nor economists (including those of the IMF) seriously considered the issue of an exit at the time. One part of the explanation is that the CBA was still considered mainly as a stabilisation tool, and attention was focused on its immediate success at that. Considerations of its medium or long term viability had not been undertaken at its inception, and only slowly started to enter analysis after the advent of stabilisation.

Moreover, memories of hyperinflation were still fresh. Raising the topic of exiting the peg and risking a relapse, at a time when things went well, was next to unthinkable. Such an exit, "soft" how it might have been (in terms of the economic environment and the distance between real and equilibrium exchange rate), would have implied the nullification of the law that was at the core of Argentina's revival. Thus, even if the Peso were not overvalued at that time, there would probably have been fears that, in the absence of the Convertibility law, the government would, at the first incidence of stress, take control of the central bank, which would soon lead
into new self-reinforcing inflationary dynamics. This is why, despite a fairly favourable economic environment, an exit towards floating or a more flexible peg at such an early stage would almost certainly have been counterproductive in reviving inflation expectations – regardless of whether the replacement of the external anchor by another monetary rule (which would in any case have been necessary to show commitment to further stability) would have accompanied the move.

Perhaps the only advantage of the extremely hard exit actually seen in early 2002 over the discussed hypothetical exit at some time during 1993 or 1994 was its distance from the year 1991: inflation allergy had time enough to subside, and economic agents time enough to get accustomed to the new macroeconomic and institutional framework, so that, even after the traumatic parting from the CBA, fears of a relapse into old inflationary habits, or even of endangered democracy, were not paramount, and the country’s basic economic alignment was not seriously questioned.

5.3.2 Soft Exit during the Second Expansionary Phase

With hindsight, the years 1996, 1997, or even 1998 offered the last, and at the same time best, opportunity for a “soft” exit from the CBA. At that stage, the main benefits of exchange rate-based stabilisation had been reaped, and many preconditions for monetary stability without a fixed exchange rate seemed reliably installed, such as a government professedly devoted to stability, a (still) bearable fiscal stance, an independent central bank, and a robust financial sector. Overall confidence into the economy was high, and growth was expected to stay high. Strong growth, receding unemployment (from 17 to 13 percent between 1996 and 1998), zero inflation, and a favourable external environment stood positively against the only worrying facts that the current account gap was quickly widening (from 2.5 to 4.9 percent between 1996 and 1998), due to strongly rising imports and less strongly rising exports. The real exchange rate appreciated only mildly over the period, and spreads between Dollar and Peso interest rates were small throughout 1996 and 1997 (never surpassing 200 basis points), indicating that the markets did not gauge the nominal exchange rate far from the equilibrium rate.

Although in this phase some economists raised the issue of considering an exit from the CBA, the topic did not seem pressing. There are several reasons why an

665 It has even been claimed, e.g. by Domingo Cavallo, that the Peso would have appreciated against the Dollar if floated in 1997. See interview <http://www.stern.nyu.edu/Sternbusiness/spring_summer_2003/argentina.html>.
exit was not seriously considered during these boom years. First, the fear that giving up the hard peg and moving to a milder peg (e.g., an adjustable peg, or an exchange rate band) or to a floating exchange rate would bring back inflation was still existent. Second, the ever higher degree of debt dollarisation in both public and private balance sheets founded fears of payment difficulties in the case of devaluation, which would probably have had to be expected, as a reflex of the current-account deficit, initially possibly worsened by overshooting. Third, there were hopes that the current-account balance would improve and turn to the positive due to a widely expected depreciation of the US-Dollar relative to the Yen and the European currencies, and that Argentina would continue to grow up to its potential, so that eventually a more comfortable exit opportunity would arise in the future. Finally, again, the very necessity of an eventual exit was far from accepted. Both the Argentine government and the IMF (not to speak of the Argentine public which valued the Peso-Dollar parity and the growth it had brought very high), dazzled by the favourable experience with the Tequila crisis, had come to believe that the CBA was a viable long-term option for Argentina.

This belief obviously stood also behind the favourable market reactions to Domingo Cavallo leaving office in July 1996. The “self-styled guarantor of the famed Convertibility Plan” could leave office and nobody felt the CBA was endangered. “It appeared that the country had made the transition from sole reliance on the credibility of just a handful of officials to a deeper faith in the macroeconomic laws now governing Argentina’s economy.”

5.3.3 Hard Exit after the External Shocks of the Late Nineties

Finally, there would have been the possibility to exit the CBA after the advent of the Asian, the Russian, and the Brazilian crises, when international capital started to shun Argentina. The potential costs of adjustment to external shocks with fixed exchange rates in place were well known; the rising difficulties to finance the fiscal and current account deficits could have given rise to contemplations of opening the

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666 Expectations that Argentina could keep up growing at seven percent per year in the long run, and eventually catch up with the first world, were widespread. With hindsight, these were fed by a collective, and officially nourished, overestimation of the situation. Opinion expressed by Daniel Heymann during an interview conducted by the author on November, 16th, 2004, in Buenos Aires.


door towards flexibilisation and devaluation in 1999/2000, or even until early 2001. However, not even the Brazilian devaluation appeared to prompt the government, or the IMF, to seriously question the viability of the CBA. President De la Rúa, keen on demonstrating a difference to the 1980s, when hyperinflation had brought down the last Radical government, won the late 1999 elections on a pledge to maintain Convertibility.

Sticking to Convertibility seemed not only a laudable pose (the Tequila experience seemed to teach that it pays to stand firm) but, given the widespread currency mismatches in balance sheets, also a necessity if payment difficulties in the public and private sector, which devaluation would bring about, were to be avoided. To the credit of those responsible, an information problem also stood in the way of contemplating an exit: the true order of disequilibrium was not readily recognisable for a long time. The sluggish depreciation of the real exchange rate during the recession concealed the magnitude of necessary fiscal adjustment, and so the true distance from debt sustainability remained a matter of speculation, for policymakers and economists alike.

Yet, assuming the Alianza government had suspected both magnitude and necessity of fiscal adjustment, and chosen the way of, as well as found the backing for, floating the Peso in 2000 or even in early 2001: what would have been different from the float actually experienced later? Very importantly, even in early 2001, there would have still been ample international reserves to smooth the overshoot of the exchange rate, the balance sheets in the financial sector would not yet have been so weakened by forced purchases of government bonds, and there would have been resources available from the IMF to bolster the transition. Above all, the independence of the central bank would not have been violated and policy credibility not so much eroded, which would have been an essential asset in the move towards a new monetary rule which could have aimed at either, again, the exchange rate (via exchange rate targets or some other variety of managed exchange rates) or inflation (via inflation or monetary targeting).


670 It is likely that the government would have exposed “fear of floating”, i.e. would, because of currency mismatches, fear of inflation, and/or concerns about credibility, not have allowed the peso to instantly depreciate all the way down to its equilibrium rate. Incomplete depreciation would have resulted in interest rates rising in expectation of further devaluation, with the concomitant real effects. “Therefore it is unclear that a more flexible exchange rate system would have successfully cleared the air in 2000.” Calvo/Izquierdo/Talvi (2004), p. 38.
After floating the exchange rate, real wages and prices would have been reduced by inflation more rapidly and probably against less social resistance than that experienced after the "plan déficit cero", and inflation would have facilitated fiscal adjustment. The currency mismatches in corporate and financial sector balance sheets as well as on fiscal accounts would have in any case required remedial policies, and the restructuring of public debt would have most likely been unavoidable. However, all of this would have taken place on the background of a still less fragile economic and social environment. If coupled with a forced conversion of Dollar deposits and loans into Pesos, the devaluation would have implied the same abrogation of property rights, but would, to the degree that the realised devaluation would have been smaller than that incurred later, have entailed less factual economic harm and less distributional effects. To the extent that deposit freezes could have been reduced in extent or duration, or avoided altogether, public discontent would have been more limited.

It seems plausible to assume that such policies would have been feasible and in their consequences less hurting than what actually happened afterwards. The biggest appeal of such an "emergency exit" seems indeed that it would have prevented the excesses in political and social development that unfolded during 2001, done less economic harm, and possibly left the government in office. The comparison with solutions that would have avoided devaluation and the concomitant immediate balance sheet effects, however, is not so clear-cut.

5.3.4 Exit towards Full Dollarisation until 1999

Given the pervasive dollarisation of contracts in Argentina during the 1990s, the step from the CBA towards full dollarisation, i.e. the Peso's complete replacement by the Dollar, would have been a small one at virtually every point during the 1990s. Official dollarisation was indeed publicly considered by the Menem administration after the Brazilian devaluation, early in 1999. After the elections of 1999, the new government explicitly rejected the idea. As indicated, the IMF staff team also considered the option to exit towards official dollarisation (combined, of course, with a comprehensive debt restructuring). Would full dollarisation have been desirable before, during, or after the crisis, or at any other point of time, for that matter?

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671 The "pesification" of deposits and loans was widely seen as unavoidable in the case of devaluation. See Schuler/Hanke (2002), p. 10.

672 Talks with the US authorities about technical aspects of dollarisation had already taken place in 1998. See also Hanke (1999), and Schuler (2000).
Clearly, nothing would have changed the fact that Argentina by no means formed an optimal currency area with the US\textsuperscript{673}. Full dollarisation was thus, viewed from the optimal currency criteria, as unsuitable for Argentina as was the CBA (but not more). And, clearly, full dollarisation, to be sustainable, would have required the same set of sustainable fiscal policies and institutional preconditions as required the CBA.

Thus, the only question is whether the gains of dollarisation per se, in terms of even more firmly "tied hands" and higher monetary credibility, would, at any point of time, have exceeded the costs of embarking on a monetary regime even more costly to exit\textsuperscript{674}, and of renouncing seigniorage income. Indeed, this trade-off would probably have ruled in favour of full dollarisation during the early nineties: full dollarisation would have prevented the speculative intermezzo of 1992 as well as the repercussions of the Tequila crisis, during which the Argentine CBA was put to a test. Thereafter, however, credibility of the peg was not the problem any more, so that Argentina, in the minds of its economic agents, was effectively "fully dollarised". So, a move towards official dollarisation would arguably have made not much difference after the successful mastering of Tequila until well into the crisis.

5.3.5 Dollarisation in the Midst of Crisis

Would full dollarisation, at par or at a previously devalued exchange rate, if introduced at some point during the crisis, have been preferable to, first, the factual outcome, and, second, to a conceivable "emergency exit" towards floating in time, as described above? As has been shown, the fiscal situation made sovereign default unavoidable since the failure of the "blindaje" in early 2001 at the very latest. Clearly, full dollarisation, until early 2001, would have avoided any meddling with the peg, and thus the massive credibility losses that translated into extreme rises of currency risk in spreads, the bank runs, and the capital flight evoked by the announcement of the switch to a basket peg. This alone would have been a clear advantage over the factual course of events, in preventing the acceleration down the road to catastrophe, and, as one can conjecture, much of public indignation and

\textsuperscript{673} However: "The flaw with the theory of optimum currency areas is that economists presume to determine costs and benefits for consumers, rather than acknowledging that it is the evaluations of consumers that determine the costs and benefits economists must consider. If Argentines prefer to hold Dollars (and they do), it indicates that for them Argentina is part of an optimum currency area with the United States, no matter what economists may think." Schuler/Hanke (2002), p. 31.

\textsuperscript{674} See Carrera et.al. (2002), p. 19.
probably even the government’s dethronement. What is more, dollarisation at par would have prevented the breach of contracts incurred by devaluation and pesification, as well as the immediate balance sheet effects that led to rows of disorderly bankruptcies in the nontradables sector and to financial sector insolvency. And it would have brought down interest rates and so helped the recovery. Again, as in the scenario of the “CBA rescued”, full dollarisation, whether at par or not, would not have been the optimal long-term constitution for Argentina, all the more so after Brazil’s move to floating. But the avoidance of the extreme economic, social, and political costs incurred with the breach of law could have outweighed much in the way of economic adjustment, plus the higher costs of a future exit from dollarisation.

One important qualification is key in comparing the options of floating versus dollarising. While dollarisation at par would have prevented the balance sheet effects of devaluation in the short run, it would not have done so in the long run, as the (then hypothetical) real exchange rate would nevertheless have needed to approach its equilibrium value, via a continuation of the deflationary process and the concomitant changes in relative prices. With the necessary relative fall in prices of nontradable goods, the increase in the real value of dollar debt would have entailed “creeping” balance sheet effects which, in the long run, necessarily would have equalled those incurred after a “once-and-for-all” devaluation. It is only that portion of balance sheet effects which occurs as a reflex of the exchange rate’s initial overshooting after a float that can be avoided altogether via full dollarisation (such overshooting, again, can be limited with the help of temporary capital controls). Moreover, even after a move towards full dollarisation, capital and exchange controls, including deposit freezes, might well have been unavoidable,


676 Dollarisation at par would have been feasible even after the run on reserves of late 2001: the central bank’s foreign reserves as of late December 2001, complemented by domestic assets sold at market rates against Dollars, would have sufficed to change the monetary base into Dollars, and so would have allowed adhering to the Convertibility law. See Schuler/Hanke (2002), p. 14.

677 Over time, the relative advantage of dollarisation will decrease, as every year of imported stability potentially increases the country’s policy credibility and thus the relative costs of forgone seigniorage. See Alexander/von Furstenberg (2000), p. 219.

678 While it can be argued that giving economic agents time to adjust to the necessary real depreciation occurring over time could smooth its negative effects, the counterargument is that the overall result could well be worsened by individuals’ reactions to the expected fall in the relative prices of their goods, in terms of lower investment and output. See Roubini (2001), p. 13.
especially after the credibility-bashing policies after April 2001, as a run on reserves would have been the reflex of the severely damaged balance sheets of banks (packed with worthless government bonds on the assets side and non-performing loans on the liabilities side) even without the threat of devaluation\textsuperscript{679}. Finally, without a seigniorage sharing agreement with the US, lost seigniorage would amount to an estimated 0.2 percent of GDP annually (with the respective seigniorage gains for the United States). While this opportunity cost is moderate because of low inflation and the low propensity to hold Pesos, it is higher than under the CBA where the bulk of Dollar reserves could be invested in interest-bearing assets\textsuperscript{680}.

The option of dollarising at a devalued exchange rate might seem relatively more appealing in that it would have confronted the economy with the unavoidable balance sheet effects largely once-and-for-all (provided a sufficient rate of devaluation) while avoiding the problems with overshooting. The caveat is that it would have entailed the same credibility losses and abrogation of property rights as those incurred with a move to a float. Being the less appropriate monetary constitution in the long run, dollarisation cum devaluation would thus have been plausibly inferior to the alternative of an "emergency exit" towards a flexible exchange rate, as sketched above\textsuperscript{681}, but possibly still superior to the events as they unfolded. The ranking in the comparison with dollarisation at par is not so clear-cut, and lastly depends on the time preference attributed to economic outcomes. If an immediate relative alleviation of adjustment costs is valued very high against potentially higher long-run costs, and if there is the expectation that the potential long-run costs can, in addition, be moderated in the course of time via an orderly and relatively favourable debt restructuring and subsequent apt fiscal and structural policies, a move towards dollarisation at par might seem superior to the dollarisation cum devaluation option\textsuperscript{682}.

\textsuperscript{680} See Hanke/Schuler (1999). Alexander/von Furstenberg (2000), pp. 216 and 221, give a higher estimate, with 0.3 to 0.35 percent of GDP.
\textsuperscript{681} "Since that credibility will be lost anyway by devaluation, why lock the country into an inappropriate currency regime?" Krugman (2001a).
\textsuperscript{682} An appealing proposal of full dollarisation at par, designed to contain the long-run costs, has been made by Schuler/Hanke. According to this study, an exit towards official dollarisation would have been conceivable even at the turn of the year 2001/02. Among a variety of practical advice to model the move towards full dollarisation in the midst of chaos, a solution is given for the vexing problem of how to smooth further deflation and allow for recovery within the monetary
However, the question remains of whether Argentina would have been served well in the long run if surrendering its monetary autonomy to the US Federal Reserve, and renouncing any formal lender of last resort support. With a view to Argentina's history, there is every reason to expect more responsible monetary policies even from an expansive-minded Fed, than from any conceivable Argentine central bank with a floating or intermediate exchange rate regime. The decisive question is whether, with official dollarisation, the additional hurdles in the way of an exit would have sufficed to provide the decisive push towards inescapably “condemning” the country to responsible fiscal and microeconomic policies, designed to grant sustainability and to smooth adjustment to external shocks. The experience with the CBA makes for anything but an optimistic answer.

Given, first, the fundamental inappropriateness of a monetary union with the US, second, the significant adjustment needs received as a legacy from previous political irresponsibility, and third, doubts of whether Argentina would be able bring forth better future policies, it was probably the better option for Argentina, from a long-run perspective, to take the exit from the CBA towards flexible exchange rates, although the move could have been done vastly better.

straitjacket of dollarisation: with a move towards free banking, i.e. the encouragement of competitive note issue by private banks (paper money denominated in Dollars, which would be, like traveller’s cheques, not forced legal tender), overall liquidity would increase and exchange controls would be largely dispensable as confidence in the banking system could be regained quickly (after all: “Central banking is central planning in money, and central planning works as poorly in money as it does in agriculture and industry.” Schuler/Hanke (1999), p. 411). Though too late to avoid sovereign default, full dollarisation would have “quarantined” the government’s financial problems and so limited their damage to the rest of the economy; coupled with fiscal reform including comprehensive tax reductions these measures could have spurred economic growth. Moreover, as they argue, dollarisation would have encouraged Argentina to extend the liberalisation and reform processes it started in the 1990s. See Schuler/Hanke (2002). See also de la Torre et al. (2002) with their similar proposal of dollarisation to be followed over time by the introduction of greater flexibility, including through “pesification at the margin”.

The independence of the US Federal Reserve to conduct a nationally oriented monetary policy without having to react to liquidity pressures from dollarised countries is part of the very stability promise of dollarisation.

See Eichengreen (2001b). The belief that economic reform remained insufficient because the CBA remained less than credible, and that dollarisation would decisively alter the framework in increasing credibility, fits ill with the overall evidence for high credibility (even claimed “excess credibility”) of Convertibility in Argentina, especially during those years, after 1995, in which the bulk of economic, especially fiscal, policy legacies has its origin.