Order Code RS21072
Updated June 5, 2003

The Financial Crisis in Argentina

nae redacted
Specialist in International Trade and Finance
Foreign Affairs, Defense, and Trade Division

Summary

After nearly four years of recession, Argentina plunged into a severe political and financial crisis that ended the presidency of Fernando de la Rua on December 20, 2001. On January 1, 2002, the Argentine Congress selected Peronist Party leader Eduardo Duhalde to complete his term of office. For over a year, President Duhalde struggled with Congress to define an economic strategy that would unify the country and solidify support for a new round of international financial assistance. Unable to come to terms with the IMF over a medium-term package, on January 24, 2003 the Fund approved, with some reservations, a new transitional $6.8 billion arrangement that provided enough financial resources to "roll over" Argentina's current IMF commitments only through August 2003. This helped provide stability during the presidential election cycle, which resulted in Governor Néstor Kirchner's victory. Although Argentina's economy has stabilized, it remains fragile, the country is deeply in debt, and the new administration faces difficult political choices if it is to define a long-term economic recovery strategy. This report concludes with the May 25, 2003 inauguration of President Kirchner and will not be updated.

Background to the Crisis

The seeds of Argentina's financial and political crisis were planted with adoption of its currency board in 1991, a strategy conceived to fight hyperinflation by constraining long-term undisciplined monetary and fiscal governance. Prior to 1991, economic and political turmoil defined Argentine history, punctuated at times by attempts at stabilization. It was widely hoped that the election of Peronist candidate Carlos Menem to President in 1990 (and his selection of Domingo Cavallo as Minister of Economy) would inaugurate a period of lasting change. They began a major structural adjustment program that included tax reform, privatization, trade liberalization, deregulation, and the currency board.[1] Congress approved the currency board with passage of the Convertibility Law, which legally guaranteed the convertibility of peso currency to dollars at a one-to-

[1] More on the reforms of this time can be found in Wise, Carol. Argentina's Currency Board: The Ties That Bind? In: Wise, Carol and Riordan Roett, eds. *Exchange Rate Politics in Latin America*. Washington, D.C. The Brookings Institution. 2000. pp. 96-99.

one fixed rate, and which limited the printing of additional currency only to an amount necessary to purchase dollars in the foreign exchange market. Effectively, each peso in circulation was backed by a U.S. dollar and monetary policy was forcibly constrained to uphold that promise. By tying its currency and monetary policy to the United States, Argentina was able to achieve its goal of a similarly low inflation rate.

The currency board's monetary restriction, however, effectively required a fiscal constraint as well because a government deficit had to be covered by debt rather than by printing money (monetized).[2] Therefore, the currency board raised hopes for a credible economic stabilization based on a compulsory monetary restraint and implied fiscal discipline, both long absent in Argentina. The economy performed well in the early 1990s. Stabilization brought low inflation and interest rates, attracted new investment, and spurred economic growth. But its success hinged on continuing economic growth and disciplined macroeconomic policies, particularly if it were to weather the inevitable external shock. Three major "areas of vulnerability" were clear from the outset: the fiscal deficit, which would threaten the financial stability of the currency board; the high level of external debt, which would compound budgetary pressures and leave Argentina vulnerable to the vagaries of external capital; and a real (inflation-adjusted) appreciation of the peso, which would cause international competitiveness (current account) problems.[3]

Economic Challenges

Despite these concerns being well known, Argentina failed to heed them. First, and foremost, Argentina's convertibility regime required fiscal control. This was no small task given weak tax compliance, recession-induced revenue shortfalls, and overspending by provincial and national governments. As fiscal deficits continued, debt rose to become the key vulnerability. As may be seen in **Table 1**, since 1995, the consolidated *primary* fiscal balance, which excludes interest payments, was slightly negative or positive, but the *overall* balance, with interest, grew to become a serious deficit by 1999. The difference between the two deficit measures shows how between 1995 and 2001 the portion of the budget spent on servicing public debt (interest payments) grew from less than 2% to over 5% of GDP. The debt service ratio, a measure of the foreign component of public debt, was equally dismal, more than doubling from 29.5% in 1995 to 65.7% in 2001.

Importantly, budget deficits and debt plagued both provincial and national governments, eventually undermining credibility in the country's overall fiscal policy (and by extension the convertibility regime).[4] Fiscal sharing guaranteed federal payments to provincial governments that served as a significant portion of their revenue, an arrangement that discouraged discipline at the local level and proved difficult to alter. Neither was there sufficient external pressure on Argentina to change fiscal course given continuing lending by the International Monetary Fund (IMF) and private creditors who

---

[2] See CRS Report RL31169, *Argentina: Economic Problems and Solutions*, by Gail Makinen.

[3] Dornbusch, Rudiger. Progress Report on Argentina. In: Dornbusch, Rudiger and Sebastian Edwards. *Reform, Recovery, and Growth: Latin America and the Middle East*. Chicago, University of Chicago Press. 1995. pp. 224-29.

[4] See Wise, Carol and Manuel Pastor. From Poster Child to Basket Case. *Foreign Affairs*, November/December 2001, p. 6.

did so relying on promises of future policy changes and assumptions of strong economic growth. These assumptions proved to be excessively optimistic, which should have become increasingly clear as Argentina's recession dragged on.

Table 1. Argentina: Selected Economic and Financial Indicators

	1995	1996	1997	1998	1999	2000	2001	2002
GDP Growth (%)	-2.8	5.5	8.1	3.8	-3.4	-0.8	-4.4	-11.0
Inflation - CPI (%)	3.4	0.2	0.5	0.9	-1.2	-0.9	-1.1	25.9
Unemployment (%)	18.4	17.1	16.1	13.2	14.5	15.4	16.4	21.5
Consolidated *Overall* Fiscal Balance (% of GDP)[a]	-2.3	-3.2	-2.1	-2.0	-4.1	-3.6	-6.8	-9.9
Consolidated *Primary* Fiscal Balance (% of GDP)[b]	-0.4	-1.1	0.3	0.6	-0.7	0.4	-1.4	0.0
Current Acct. Bal.(% of GDP)	-1.9	-2.4	-4.1	-4.8	-4.2	-3.1	-1.7	8.2
Debt Service [c]	29.5	33.8	40.1	38.1	49.6	54.8	65.7	47.4
Terms of Trade	0.3	7.8	-1.2	-5.5	-5.9	10.2	-0.6	-1.1

Source: IMF.
a. Includes federal and provincial government budgets, trust funds, and capitalization of interest.
b. Primary balance excludes interest payments.
c. Public sector debt as a percent of exports of goods and nonfactor services.

External factors also threatened the currency board, beginning with a real appreciation of the peso. It started in 1991 with Argentina's higher inflation rate relative to the United States, but became a serious issue when the U.S. dollar appreciated from 1995 to 1999, meaning that the dollar-linked peso also appreciated relative to the currencies of Argentina's trading partners. Argentine exports became less competitive, and imports a bargain, as seen in the deteriorating current account deficit. Argentina's competitiveness was further eroded by the Brazilian devaluation in January 1999, diminished terms of trade due to falling commodity prices, and rising interest rates. By the late 1990s, these inhospitable external factors, along with the global downturn in 2001, compounded the effects of poor domestic policy decisions to compromise Argentina's current account, budget deficit, and debt position (see **Table 1**).

By 2000, Argentina faced a major adjustment problem, creating a policy conundrum that was centered on the inherent constraints of the currency board. In countries with flexible exchange rates, a persistent current account deficit that is not financed by capital inflows would force the exchange rate lower, correcting the currency overvaluation, improving competitiveness, and in time, restoring balance. Given weak productivity growth and Argentina's inability to devalue its nominal exchange rate, the only way to become more competitive was to allow dollars to leave the country, thereby reducing the money supply, and causing domestic prices to fall (a de facto policy of deflation).[5] This process could take years to restore competitiveness and find a new growth equilibrium, and at a severe social cost; Argentina's deepening recession and growing unemployment.

---

[5] Makinen, *Argentina: Economic Problems and Solutions*, p. 3

The constraints of the currency board also kept Argentina from fighting its lingering recession with either a strong fiscal stimulus or expansionary monetary policy, as the United States did in 2001. In fact, the consensus policy recommendation was to do just the opposite and tighten the budget to address concerns over mounting debt and overall fiscal credibility. *In short, Argentina had no way to address both problems of debt and economic growth simultaneously and still maintain its currency board.*

Unable to address basic economic imbalances, President de la Rua, again guided by Minister of Economy Domingo Cavallo, opted for increasingly novel and desperate measures to meet pressing short-term financial needs. In June 2001, $29.5 billion of short-term debt was exchanged for new debt with longer maturities and higher interest rates. It was assumed that the return of strong economic growth would allow Argentina to cover the higher debt service. Argentina then engineered an effective 7% devaluation of the peso for foreign trading, expecting to improve its competitiveness, but which also further compromised confidence in the currency board. As perceptions of risk rose, interest rates followed, so liquidity became tighter and both the federal and provincial governments issued bonds in the form of scrip to pay public salaries. This quasi-money was allowed to circulate as currency, further undermining the monetary system.

Argentina's last hope for financial recovery rested on the debt swap announced in November 2001. The federal government had $132 billion dollars in debt ($95 billion in bonds). Some $60 billion of bonds were refinanced as a tax-receipt guaranteed loan, lowering the average interest rate from between 11-12% to 7% and extending the maturity of the notes by three years. The November debt swap strained credibility with private lenders, who labeled it a "distressed exchange" and treated it effectively as a default. In addition, the interest savings proved to be much smaller than anticipated and Argentina failed again to meet the fiscal targets promised in its IMF program. This led to the IMF's refusal to extend a $1.3 billion draw scheduled for December 2001. By then, Argentina found itself cut off from international financial markets, both public (official) and private. As confidence in the peso waned, the flight to dollars accelerated and international reserves fell by over $4 billion in November. President de la Rua responded with a decree limiting individual cash withdrawals to $1,000 per month, setting off the violent protests that culminated in a full blown crisis, and soon thereafter, his resignation.

The Role of the International Monetary Fund

Argentina's attempts to deal with its financial difficulties included an ongoing relationship with the IMF. As **Table 2** suggests, Argentina is no stranger to the IMF; since the Latin American debt crisis in the 1980s, it has tapped the IMF repeatedly, and in general, for increasingly large amounts of money. Argentina's current $6.8 billion "transitional" (eight-month) IMF stand-by arrangement was approved on January 24, 2003. It replaced the March 20, 2000 arrangement requested by President de la Rua, which in turn had replaced the extended arrangement of February 4, 1998. Argentina's growing indebtedness to the Fund has been conditioned on repeated promises of fiscal adjustment, including reducing transfers to provincial governments and obtaining their commitments to cut local budgets as part of a broader revenue-sharing reform effort. Previous arrangements also assumed that Argentina's economy would grow by 3.5% in 2000, and 4.0% in later years, which clearly did not happen. The Argentine government projects the economy to grow by 3% in 2003.

Table 2. Argentina: History of IMF Lending
(in millions of SDRs[a])

Date of Arrangement	Date of Expiration	Facility	Amount Agreed	Amount Drawn	Amount[b] Outstanding
Dec. 28, 1984	June 30, 1986	Stand-by	1,182.5	1,182.5	0
July 23, 1987	Sept. 30, 1988	Stand-by	947.5	616.5	0
Nov. 10, 1989	March 31, 1991	Stand-by	736.0	506.0	0
July 29, 1991	March 30, 1992	Extended	780.0	438.8	0
March 31, 1992	March 30, 1996	Stand-by	4,020.3	4,020.3	731.4
April 12, 1996	Jan. 11, 1998	Stand-by	720.0	613.0	0
Feb. 4, 1998	March 10, 2000	Extended	2,080.0	0	0
March 10, 2000 Jan. 12, 2001	March 9, 2003 Jan. 11, 2002	Stand-by (of which SRF#)	16,936.8 6,086.6	9,756.3 5,875.0	9,015.3 5,134.0
Jan. 24, 2003	Aug. 31, 2003	Stand-by	2,174.5	747.0	747.0
Total			29,577.6	17,880.4	10,493.7

Source: IMF Web site at [http://www.imf.org].

a. The Special Drawing Right (SDR) is the unit of account at the IMF, its value is based on a basket of currencies and fluctuates over time. On March 18, 2003 it was equal to approximately $1.36.

b. Amount still owed to the IMF as of February 28, 2003. # Supplemental Reserve Facility provides funds at higher rates and shorter maturities to countries that have experienced a sudden loss of market confidence, but have corrective reform measures in place.

Argentina's continued weak economic performance during the crisis prompted the IMF on January 12, 2001 to augment the original agreement by $7.0 billion (SDR 5.2 billion). This was part of a larger package that included $5.0 billion in loan commitments from the Inter-American Development Bank (IDB) and the World Bank, $1.0 billion from Spain, and voluntary refinancing from the private sector of $20 billion. The IMF advanced these funds with an expectation that the Argentine economy would grow by 2.5% in 2001, which also proved unattainable, leading to a third augmentation of $7.4 billion (SDR 5.6 billion) on September 7, 2001. This increase was also based on promises of strong fiscal reform, as defined by the "Zero Deficit Law" passed on July 29, 2001, and revenue sharing reform with the provinces. Despite IMF funding, it became increasingly clear that the high cost of debt combined with recession and doubt over Argentina's ability to make needed adjustments led the country to default.

Outlook

President Duhalde was given broad emergency powers by the congress to keep Argentina's financial crisis from mushrooming into economic and social collapse. He initially attempted to restore Argentina to financial competitiveness and credibility by abandoning the currency board and the peso's 1-to-1 peg with the dollar in favor of a dual exchange rate system based on an official rate for foreign trade transactions of 1.4 pesos to the dollar and a floating rate for domestic transactions. Dollar denominated bank loans up to $100,000 were converted to pesos at the 1-to-1 rate, passing on the cost of devaluation disproportionally to creditors (mostly banks). Duhalde also "guaranteed" dollar deposits, but to avoid bank runs, retained the policy of limiting monthly withdrawals begun under President de la Rua.

From the beginning, this plan faced opposition from both international creditors and domestic interest groups. To complicate matters further, on February 1, 2002, the Argentine Supreme Court ruled that the freeze on bank deposits was unconstitutional. To avoid a run on the banking system, Duhalde responded by easing limitations on withdrawals, but decreed a moratorium on enforcement of the Supreme Court order. On February 3, 2002, Duhalde announced a new economic plan, adopting a single floating exchange rate system and a changing array of capital controls. The foreign exchange market was unstable for months before the peso settled, losing over 70% of its value. Duhalde also gave up on his earlier promise to guarantee dollar deposits, which were converted to pesos at the previous official rate of 1.4 to the dollar. The mismatch in the conversion rate between bank loans (assets) and deposits (liabilities) left banks undercapitalized and relying on government assurances for financial assistance. Argentina was also unable to move quickly to resolve a host of other structural problems that impeded development of a credible plan to rebuild the financial system and work out a new IMF assistance package.

The Argentine economy resumed growth in late 2002, much sooner than many had predicted. Resolving severe economic and social problems, including high rates of unemployment and poverty, will require more time. In addition, Argentina remains in default of its private debt and is subsisting on a short-term transitional $6.8 billion arrangement put in place on January 16, 2003, which was supported by the United states and other G-7 countries as necessary for Argentina to avoid defaulting on the IMF. The Fund provided sufficient financial resources only to "roll over" Argentina's IMF repayments through August 2003 under the assumption that a medium-term arrangement could be put in place by September 9, 2003, when a $2.7 billion payment comes due. The interim agreement helped provide the stability Argentina needed to complete the presidential election cycle that resulted in Governor Néstor Kirchner's victory in what was widely reported as a fair election with near record voter turnout (80%).

As the Kirchner administration takes over, Argentina has already begun a reform process that will have to continue if it is to achieve long-term economic growth and stability. The freeze on bank deposits has been lifted, following a Supreme Court ruling, various scrips are being replaced with pesos, and fiscal control is being re-exerted. Although Argentina's economy has stabilized, it remains fragile and deeper structural reforms await action. These will make for difficult political decisions on such issues as the sovereign debt workout, banking sector reform, public utility contract negotiations, and tax reform, just to name a few in addition to dealing with the IMF. Therefore, although this chapter of Argentina's financial crisis appears to be over, returning to a path of growth and prosperity presents a long-term challenge to the country.