
The Argentine crisis a year on

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1. INTRODUCTION

In late 2001 the outbreak of a serious economic, social and political crisis in Argentina brought its exchange rate convertibility to an end. This exchange rate regime, based on the parity of the peso with the dollar, was pivotal in eliminating hyperinflation and was the cornerstone of Argentine economic policies during the nineties, the first half of which were marked by a prolonged and sharp economic expansion.

This apparent success meant that, during the nineties, the Argentine experience was seen as a model for other emerging economies. But underlying this process were deep-seated problems that remained masked during the upturn. The constraints imposed by a fixed exchange rate were not accompanied either by sufficient headway in terms of reforms, which would have given the economy the flexibility it needed, or by true fiscal discipline. When a series of adverse external disturbances affected the emerging countries and the fiscal position began visibly to deteriorate, under the weight of insufficiently rigorous policies, the economy's expansionary cycle petered out towards 1998. Difficulties then began to build up and the loss of competitiveness associated with exchange rate parity and with the strength of the dollar made itself felt, particularly following the devaluation of the Brazilian real in 1999. Thereafter, the economy went into recession and the vulnerability of the fiscal position became a cause for alarm. Gradually, a scenario took shape in which a crisis was as inevitable as it was difficult to manage, as is usually the case in highly dollarised economies. The crash was disorderly and accompanied by a grave political and social crisis. This bore on the subsequent management of the crisis, in which a series of measures were taken that involved the abandonment of the legal and economic framework in place: the suspension of payments on sovereign debt; banking, foreign exchange and capital restrictions; the asymmetrical conversion into pesos of bank balance sheets, and price controls.

The first part of this article describes how the crisis unfolded during the course of 2002, taking us to the present time when, after a deep slump and several months of stabilisation, a recovery seems to be under way in the economy. Nonetheless, the economy continues to operate under heavy financial, foreign exchange, price and legal restrictions, and against a backdrop of heightened legal and institutional uncertainty,

which is exacerbated by the fact that elections are due this year. In the near term, Argentina faces the difficult challenge of bringing its economic environment on to a normal footing and of entrenching the precarious stability attained to date so that the incipient economic recovery may be firmly and sustainably underpinned. The main elements of this complex task are reviewed in the second part of the article.

2. ECONOMIC DEVELOPMENTS IN ARGENTINA DURING 2002

The cumulative decline in GDP forecast for 2002 is around 11%. If the four previous years of recession are added, GDP will have fallen by 23% since early 1998 (see Chart 1), meaning it has reverted to 1993 levels. Meantime, poverty indices have reached unprecedented levels. This economic depression is only comparable in recent history to that which the formerly centrally planned economies of Central Europe underwent in the early nineties.

The key factor behind the deepening of the crisis in 2002 was the growing expectation surrounding the unsustainability of the convertibility regime in the closing months of 2001, and its subsequent abandonment in early 2002, which had an immediate impact on monetary and exchange rate developments. The devaluation and subsequent float was accompanied by a serious loss of savers' confidence in their currency, which prompted a flight towards the dollar and a swifter exchange rate depreciation. The peso tumbled from parity with the dollar, at end-2001, to a rate of four pesos per dollar in April 2002 (see Chart 2). Given the deep-seated dollarisation of the economy, there was a risk of entering into a vicious circle in which depreciation would increase inflation expectations, and these, in turn, would ratchet up pressures on the currency. In parallel, the central government and the provinces, beleaguered by the deterioration of their fiscal position, proliferated the issuance of public securities as a means of payment (quasi-currencies). This aroused fears of an inflation-exchange rate spiral being activated and the return of hyperinflation. Monthly inflation rates ran into two digits in April. Since August, however, the stability of the monetary and exchange-rate variables has been notable, as can be seen in Chart 2, thereby averting an uncontrollable inflation spiral and placing the annual inflation rate at the end of 2002 at 41%, a substantially lower rate than forecast some quarters back. The exchange rate held at around 3.60-3.70 pesos against the dollar during the second half of the year and the reaction of the foreign exchange market to adverse shocks - the Brazilian pre-electoral crisis or the Argentine govern-

ment's default vis-à-vis the World Bank - was very limited. With these disturbances behind the peso has moved onto an appreciating path, taking it to around 3.2 pesos per dollar in recent months. That has allowed a partial but swift easing of the restrictions in place on the foreign exchange market, especially those affecting current transactions.

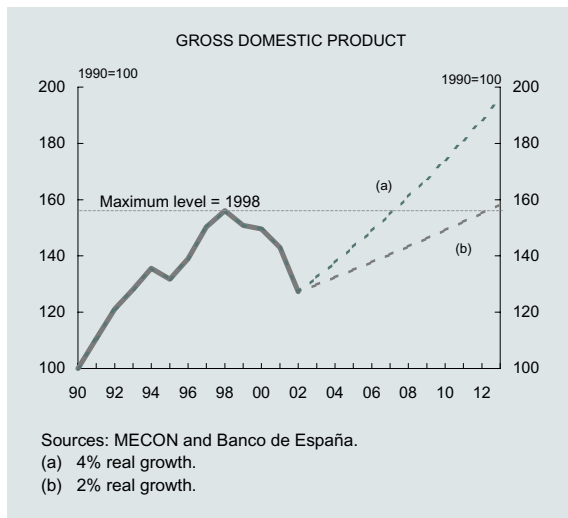
The stabilisation of the exchange rate and of prices has been based on various factors. Firstly, the authorities have established a complex system of restrictions of the monetary and foreign exchange markets. The controls on the purchase, settlement and sale of currency have limited capital flight, and the financial and banking restrictions have brought the money-creation process to a halt; moreover, the drastic external adjustment, along with the suspension of payments, has allowed the stock of foreign reserves to stabilise (see Chart 2). In this way, the central bank has been able to regulate effectively the supply of dollars, to temper the draining off of liquidity from the system and, indeed, to initiate the regulation of the money stock via monetary instruments (this is in its early stages). The counterpoint to these restrictions is that, in all likelihood, the decline in activity has been deepened and the allocation of resources distorted, since financial flows in the economy have been hindered and agents' confidence dented.

There have been other relevant factors in the containment of financial indicators. First, the suspension of payments on foreign sovereign debt (which has subsequently and temporarily eased the financial burden on federal government, until restructuring is resolved) and the favourable effect of inflation on tax revenue and public finances, both of which factors have reduced pressures to monetise budget deficits. Next, the administrative regulation of a wide range of prices (especially government-set rates) and the control of wages (imposed in the case of the public sector and concerted in that of the private sector), which has in many cases enabled indexation processes to be unwound. Finally, the high level of unemployment and depressed domestic demand have exerted a restraining influence on nominal wage rises (which have been virtually zero), prompting a heavy fall in real wages and mitigating the generalised increases in prices, despite the pesoification of the economy.

Amid the confidence crisis besetting the country in late 2001, the Argentine financial system experienced massive withdrawals of funds (see Chart 2). The withdrawal restrictions on deposits, known as the "corralito" (sight deposits) and the "corralón" (term deposits), were

CHART 1

The magnitude of the Argentine crisis



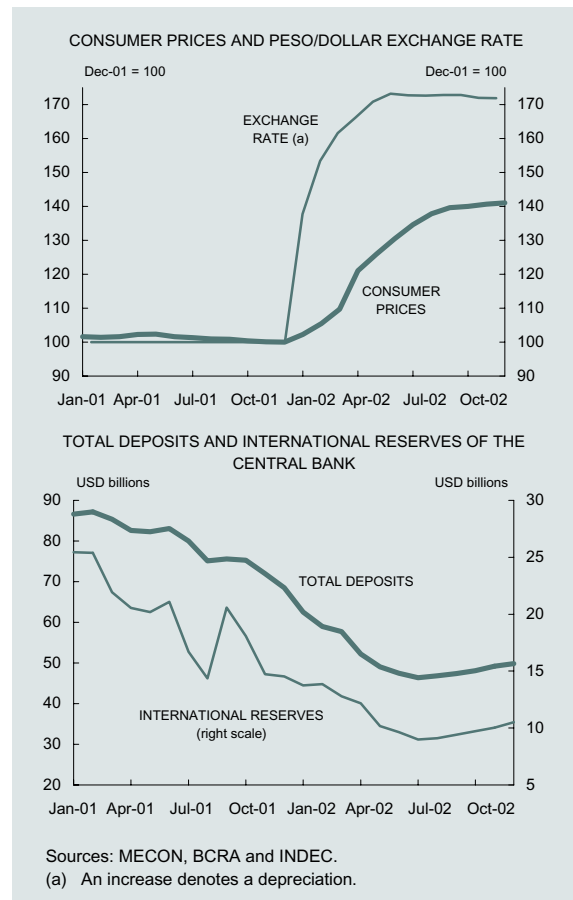
imposed in order to avoid a run on banks. But they have seriously weakened banks' relations with their clients and distorted activity in this sector, since the intermediation of funds between loans and deposits has been seriously hampered. The suspension of payments decreed at Christmas in 2001 generated very high losses at financial institutions, whose exposure to the public sector had increased notably owing to the major role they had played in financing the deficit during the pre-crisis period. Finally, the abandonment of convertibility and the asymmetrical pesoification of deposits and loans unbalanced bank balance sheets (1). Moreover, last year the deposits withheld by the banking system were continuously depleted further by the so-called "amparos" (legal injunctions), which allowed savers to retrieve their funds in the original currency, giving rise to substantial costs for banks and obliging them to resort to rediscounting facilities from the Argentine central bank.

As from the summer the decline in deposits has been checked thanks to the stability of the exchange rate and of inflation. The high interest rates offered by banks, along with the capital flight restrictions, have attracted fresh funds from savers. This return of deposits has made for a certain improvement in banks' liquidity. Against this background, the decision to remove the restrictions on sight deposits and some of those on term deposits has not prompted appreciably adverse affects, and many banks have

(1) To be precise, most of the exposure to the public sector was in the form of guaranteed loans (the outcome of the conversion of debt in 2001). But following their pesoification, the terms of these loans became drastically less favourable for banks.

CHART 2

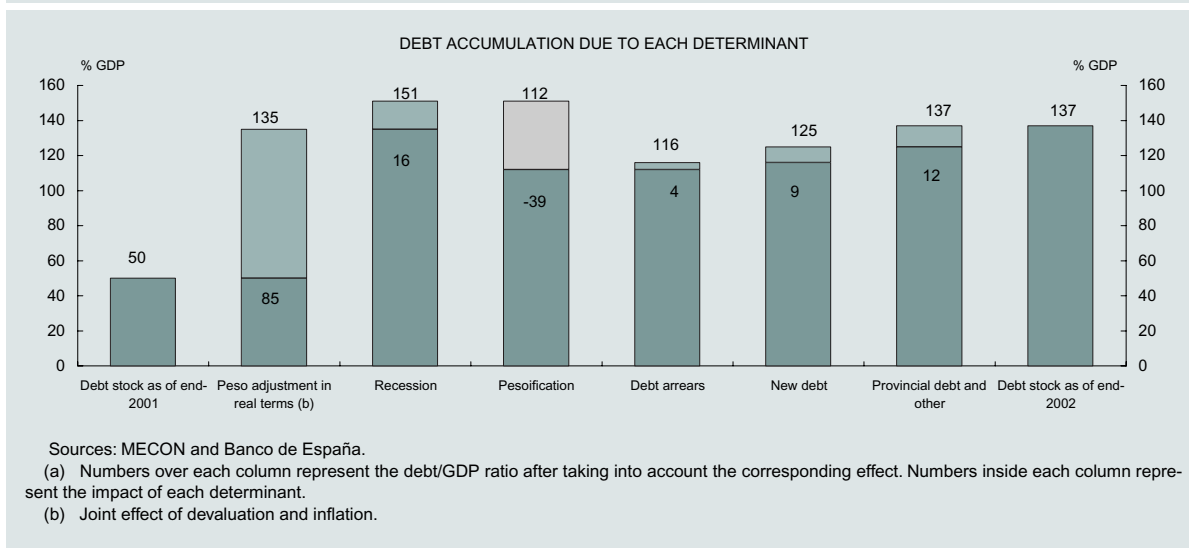
Crisis and stabilisation of monetary and financial variables



even decided to allow fixed-term fund withdrawals for amounts above those regulated. This shows that some headway may be made, with caution, towards financial normalisation, although a high degree of uncertainty remains concerning ongoing legal processes, the impact of the normalisation of banking activity and the future restructuring of the sector.

As indicated in the introduction, the lack of fiscal discipline at both the federal and provincial levels was one of the explanatory factors of the crisis. Since the summer Argentine public finances have trended relatively favourably, but underlying this positive development are two conjunctural factors: the effect of inflation, which has boosted revenues on existing taxes, and the introduction of high withholdings on exports. In combination, these two factors mean that tax revenue has, in nominal terms, exceeded pre-crisis levels, while public spending has held stable. As a result, there was a federal government primary surplus of 0.8% of GDP in 2002. It should be recalled, however, that the suspension of payments on debt has clearly eased the fiscal situation, enabling central government net

Federal debt



borrowing to be reduced from 18% to 6% of GDP.

As Chart 3 shows, however, several factors have almost tripled the federal debt/GDP ratio. First, the drastic exchange rate depreciation (which has raised the value of foreign debt in terms of domestic currency) has been only partly offset by the effect of inflation on nominal GDP, such that the combined impact of this adjustment of relative prices on debt is estimated at 85 points of GDP. In addition, the heavy fall in GDP has added a further 16 points to the ratio. The pesoification of guaranteed loans (at 1.4 pesos per dollar) has not sufficed to counter these effects, despite entailing a reduction of almost 40 points of GDP in the stock of debt. Lastly, the build-up in arrears, the issuance of new securities (including those arising from the conversion of deposits and the compensation to banks for the asymmetrical pesoification), the takeover of provincial debt and other lesser items have added a further 25 points, making for an estimated ratio of 137% at end-2002.

The provinces' borrowing requirements were eased at the start of the year by the issuance of bonds as a means of payment for services and their use as quasi-currencies. In recent months, and despite the serious underlying imbalances, provincial financial problems have become a secondary concern owing to the above-mentioned rise in revenue (which has allowed transfers to the provinces to be increased) and to the containment of expenditure at the provincial level.

This economic and financial setting has had a far-reaching impact on activity, which declined

at a rate of 16.3% in 2002 Q1 compared with the same period a year earlier. The only positive contribution to GDP has been that of the external sector, whose surplus grew notably, though this was due more to the halving of imports than to the increase in exports, owing in part to the shortage of credit and to the high withholdings taxing exports. The trade surplus thus almost tripled last year, rising to over USD 16 billion.

However, as from Q3 the indicators of activity have stabilised, and they have begun a recovery which has been gaining momentum in recent months, thanks to their low starting point, to surplus capacity and to the strong adjustment of real wages.

3. OUTLOOK AND CHALLENGES FOR 2003

Argentina has moved into 2003 on a more stable footing than a year back. But it should be borne in mind that such stability is based on exceptional arrangements, replete with administrative restrictions and other non-permanent factors such as the suspension of payments on foreign debt in private hands, the favourable impact of inflation on public finances and the positive effect of the depreciation on the trade balance. The work ahead in the coming years will be complex, since the economic system must be brought onto a normal footing, stability must be consolidated and, moreover, progress on the numerous reforms put off during the convertibility regime must be furthered, as the failure to see these through played a determinant role in the crisis. Without reform the Argentine econo-

my might show moderate growth rates in the short run, but its structural weaknesses would once again soon become manifest, thereby limiting potential and actual growth capacity and prolonging excessively the effects of the crisis on income levels in the country (2).

According to the analyses of international financial agencies, a successful strategy for Argentina to emerge from the crisis in the coming quarters will hinge on four aspects: the resumption of international financing, monetary and financial normalisation, banking regulation and restructuring, and the redressing of public finances.

In the current circumstances, with most economic sectors affected by the crisis, and given the public sector's high borrowing requirements (these being largely latent at present owing to the suspension of payments situation) and the lack of domestic resources to kick-start the business sector, Argentina depends on international capital inflows to finance its economic development. However, bringing about the return of international financing will not be easy owing to the widespread breakdown in property rights in the past year and to the suspension of payments on foreign public debt.

Foreign financing may be forthcoming through three channels: foreign direct investment (FDI), financing from multilateral agencies and the international loans and debt market.

Although FDI flows have been negative in net terms in the past two years, their behaviour has been better than expected. Despite economic depression and legal and institutional uncertainty, a substantial portion of foreign investment has remained in the country. FDI flows are highly unlikely to increase substantially in the future; but it should be stressed that, given the cumulative depreciation, costs in Argentine industry are at present very low and Argentine assets are priced more favourably. If the reforms pending are tackled appropriately, investment in Argentina could once again become attractive in the medium term.

Financing flows from multilateral agencies have been important for Argentina in recent years. However, following the IMF arrangement in September 2001, Argentina's negotiations with international financial institutions entered a difficult period. Despite this a transitional accord

(2) See Chart 1. If the economy's growth potential held at 4%, pre-crisis income levels would be recovered by 2007. But if growth potential were limited to 2%, such levels would not be attained until 2012, meaning a new decade would be lost.

has recently been reached with the IMF, which has confined itself to refinancing outstanding debts until August this year (USD 6.78 billion), helping maintain stability during the electoral period. This agreement also includes several measures (mentioned in the following pages) that will allow the economy to move towards normalisation. After the change of government, it is expected that the country will negotiate a more ambitious programme, encompassing far-reaching reforms that will include those sidelined during the decade of convertibility.

Finally, access to international debt markets will continue to be blocked for the public sector for some time after the suspension of payments on sovereign debt has been lifted. That underscores how pressing it is to initiate steps for the restructuring of foreign debt, as mentioned in the transitional agreement. The financing possibilities for the private sector also hinge largely on the successful outcome of this process. The current scale of debt indicates that negotiations will be complicated, since the proportion of debt haircut needed to restore fiscal sustainability might be high.

As has been the case in recent months, and as the pick-up in economic activity and confidence progressively firms, the authorities will foreseeably push through the appropriate measures for the orderly lifting of the restrictions still in place on the functioning of the banking system and foreign exchange controls (which have largely contributed to the stabilisation of financial indicators), and bring about monetary and financial normalisation.

Pivotal to this process is the anchoring of inflationary expectations by means of a coherent monetary strategy. Initially, the Argentine central bank has opted for a system of monitoring monetary aggregates. In the medium term, there is a risk that the prospect of a strong increase in liquidity further to the release of deposits frozen under the "corralito" and "corralón", along with an increase in domestic demand, may generate price pressures. Another aspect of normalisation which might prompt inflationary pressures is the liberalisation of prices in the economy, in particular public utilities' regulated rates, which have been artificially contained to date. Against a background of recovering demand, the liberalisation of wages may also have adverse effects on prices. Therefore, the new agreement with the IMF covers the need to contain the growth of base money, without prejudice to the future consideration of moving, as appears to be the authorities' intention, to a direct inflation targeting framework.

Monetary and financial normalisation will not be feasible unless there is a deep-seated re-

structuring of the banking system. The initial objectives of such restructuring will, under the programme agreed upon with the IMF, involve a far-reaching review of banking regulations and supervision, and the safeguarding of creditors' rights.

Here, most analysts believe the structure of the Argentine banking system should be reconsidered, evaluating bank solvency and analysing the possibilities of reorganisation in the most delicate instances, with the strict application of the fairness principle across the various segments of the banking system.

The role of the central bank in this area will prove fundamental. As indicated in the transitional programme, the central bank will, in designing and implementing a policy of monetary rigour, and as lender of last resort, require greater autonomy in respect of the executive branch and, as regards the second function, a clarification of the conditions in which financial assistance should be granted.

The redressing of public finances, which was not satisfactorily tackled during the nineties and whose structural limitations were among the basic reasons for the crisis, rests on two pillars: the reorganisation of public spending and the reformulation of the nation/provinces relationship. Given future financing requirements, there will evidently be a need to sustain considerable primary surpluses, as stated in the transitional programme (2.5% of GDP for 2003), even in the event of favourable terms for the restructuring of foreign debt. These surpluses cannot be sustained, as has been the case in 2002, on the basis of inflation effects or distortionary taxes such as the withholdings on exports.

In the fiscal realm, there is still much room for improving the effectiveness of the tax system, and the transitional programme has set out the need to broaden the tax base, combating evasion in particular. Turning to expenditure, reforms are required to modernise and increase the effectiveness of the public sector. Moreover, the reforms should in the future consider a revision of social welfare arrangements, since the crisis has affected most adversely the assets of private pension funds, which had been bolstered over the past decade. Finally, as concerns tax relations with the provinces, certain institutional particularities have acted as an obstacle, even during the boom years, to the rationalisation of transfer arrangements. The provinces have tended to weaken fiscal

discipline, as their agreements with government have often not been complied with. The reform of these relations is already included in the transitional programme and it would be aimed at establishing the principle of fiscal co-responsibility.

4. CONCLUSIONS

This article has reviewed developments in the Argentine economy over the past year, analysing the aspects that should prove most important in the near future.

It first describes how the economy has managed to stabilise thanks to a mix of non-orthodox restrictive measures: a freeze on deposits, foreign exchange and price controls, distortionary taxes, etc. These restrictions may have contributed to preventing hyperinflation, but their cost has been high in terms of activity and they have caused, in certain cases, the infringement of property rights and a serious loss of confidence. Moreover, it should not be forgotten that the current recovery is departing from particularly depressed levels of activity, and that the array of restrictions on the normal functioning of the economy acts as a brake on the firming of the recovery, whereby their progressive elimination is a priority. Nonetheless, this process should be conducted with caution, as a delicate balance must be struck between the need for normalisation and the pressures that such normalisation may bring to bear on prices, wages and the financial solvency of certain sectors.

From a more structural perspective, the dependence on foreign capital to resume a path of sustainable growth and the subsequent need to gradually restore domestic and foreign investors' confidence calls for resolute action to redirect economic policies. That inevitably involves economic discipline and, above all, a fresh process of reforms, many of which were not tackled during the years of expansion. The efficiency of the economy will ultimately hinge on this. In any event, a high degree of consensus will be required along with courageous and resolute policy action on the part of the authorities. While initial sacrifices will be inevitable, it is only this way that a path of sustained growth can be pursued, helping to restore the income levels of the nineties within a reasonable time and to prevent the risk of the current recovery petering out in the medium term.

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