

DRAFT

THE ARGENTINE DEBT CRISIS of 2001-2002:
A CHRONOLOGY and SOME KEY POLICY ISSUES

By

Sebastian Edwards

University of California, Los Angeles

And

National Bureau of Economic Research

Revised: January 25, 2002

The purpose of this note is to present a brief chronology of the process that led to the Argentine currency crisis and debt default of 2001-2002, and to highlight the most important policy issues that arise from this experience. I have made an effort to highlight the most important events in Argentina's economic history during the period 1991-2002. However, in order to provide some background information, the chronology begins with the Austral heterodox stabilization plan of 1985. In preparing this chronology I have tried to focus on those policy issues that, at that particular point in time, were seen by policy makers as well as by external analysts, as particularly worrisome. As will be seen, many of these issues appear in more than one phase. This is a reflection of the fact that during this period Argentina repeatedly failed to address some of its most important and pressing economic problems. I have also listed some of the most important political developments during this period (they appear in *italics*). The second part of the note provides a list of the most important policy issues that emerge from this episode. In organizing these topics, I have tried to keep in mind the need to extract lessons from the experience.

A. CHRONOLOGY

1. Background: A History of Inflation, Mismanagement and Hyperinflation

- 1985-1989: The Austral Plan
- Establishing a credible anchor
- Eliminating inflationary inertia
- Fiscal imbalances and two bouts of Hyperinflation
- *Election of Carlos Saul Menem as president.*

2. 1991: The Convertibility Law

- Establishing credibility
- New Central Bank charter
- The initial exchange rate

3. 1991-94: Basic Reforms: Privatization, Partial Deregulation, Pension Reform, Financial Liberalization and Regional Trade Opening

- Re-igniting growth
- Basic reforms
- Privatization program
- Tax reform
- Law of Co-participation (Provincial public finances) and “Fiscal Pacts”
- Capital inflows, “Dutch disease” and real exchange rate appreciation
- Growing domestic debt

4. 1995-96: The “Tequila Crisis” and Contagion

- Contagion
- Lack of lender of last resort
- Weak banking sector – especially at the provincial level
- Fiscal federalism and a weaknesses Law of Co-participation

- *“Pacto de Olivos” and President Menem’s Re-election*
- Rapidly growing public sector primary expenditure and public sector debt
- Social security reform and increase in public sector debt
- Strengthening the banking sector in a setting without a lender of last resort: Bank mergers, “internationalization” and contracting of contingent credit line with international banks.
- Persistently high unemployment
- *1996: A Change in the Guard: Exits Cavallo and Enters Roque Fernandez*

5. 1996-98: Asleep at the Wheel?

- Growing public sector debt
- Inability to renegotiate the Law of Co-participation
- Overvaluation and lack of international competitiveness
- Persistently high unemployment
- Inability (or unwillingness) to pass labor reform
- The productivity costs of the inefficient social welfare system, including “obras sociales.”
- Deepening MERCOSUR: More trade diversion
- Increasingly large current account deficit in 1998
- Contagion from the attack on Hong-Kong (October 1997)
- Russia and LTCM: The External Environment Turns Hostile
- Terms of trade shock

6: 1999: Politics and a Growing Public Sector Debt

- Presidential and gubernatorial elections: The political business cycle once again.
- Confidence crisis
- Persistently high unemployment

- Terms of trade shock (commodity prices plummet)
- The Brazilian crisis as a competitive devaluation
- Dollarization as an option
- Growth collapses
- “Fiscal Responsibility Law” as a way of improving confidence.
- Inability to renegotiate the Law of Co-participation
- Inability (or unwillingness) to pass labor reform
- *Menem flirts with running for a third term in office*
- Growing public sector debt
- Inability to renegotiate the Law of Co-participation
- *Alianza candidate Fernando de la Rúa is elected president; Jose Luis Machinea is appointed Minister of Economics.*
- Transfers to provinces are re-negotiated. Instead of a proportion of tax-revenues fixed amount is agreed \$ 1.364 billion per month.

8. 2000-2001: The De la Rúa-Machinea Period

- Tax increase (*el “impuestazo”*) as an attempt to reign in the deficit.
- The dollarization debate heats up.
- Persistent terms of trade shock
- No growth
- Persistently high unemployment
- Inability to renegotiate the Law of Co-participation
- Inability to de-regulate
- Partial labor reform is passed (major political scandal).
- Increasing public sector debt; early discussions on debt restructuring
- *Resignation of Vice President, Carlos “Chacho” Alvarez*
- Effort to reduce primary expenditure not enough, given slow growth: perverse debt dynamics’

- Increasing country risk spread.
- Major IMF led-program (November 2000): “el blindaje.”
- February 2001: Machinea resigns. New Minister Ricardo Lopez-Murphy offers “blood, sweat and tears.” He lasts only two weeks in office.
- *Systematic opposition of ex president Alfonsin to any serious adjustment*

9. 2001: Cavallo Returns

- Diagnosis
- Competitiveness plans for different sectors
- Seeking active monetary policy with a currency board, and the ousting of Central Bank President Pedro Pou.
- Expanded “convertibility”
- Mercosur clashes
- The “mega” debt-exchange.
- Federal government salary cuts
- The IMF stands-by Argentina, once again
- *Congressional elections and the myth that politicians will co-operate (October)*
- The collapse of tax revenues
- The ever-increasing country risk spread
- Interest rate caps and domestic debt restructuring
- The run on the banks
- Freezing bank deposits
- The IMF turns its back
- The end

B. POLICY ISSUES and LESSONS

In this section I provide a list some of the most important policy questions that arise from the Argentine experience. I concentrate on a small number of broad issues; each of them covers a large number of topics. Analyzing these issues would allow us to fully understand the dynamics of the Argentine debacle, at the same time as drawing broad lessons for other countries.

1. The Exchange Rate Question and the Convertibility Law

- An old question: credibility vs. flexibility -- Argentina needed both.
- Was the peso overvalued? For how long? By how much?
- Exchange rate anchors and exit strategies: Missed Opportunities?
- Hard pegs, currency boards and competitiveness: deregulation, domestic price flexibility and labor market reform
- The lender of last resort function under a currency board: on the irrelevance of private contingent credit lines
- Claims vs reality

2. Currency Boards and External Shocks: On Contagion and Other Foreign Ills

- Was Argentina particularly vulnerable to foreign shocks and speculative attacks?
- Comparison with other Latin American nations.
- Was it possible to reduce vulnerability?

3. Dollarization: Was it Ever a Real Option?

- What do we really know about dollarization?
- The political economy of dollarization.
- The Connie Mack Bill and seigniorage sharing.

4. Fiscal Federalism and Public Sector Debt Dynamics

- Fiscal federalism and the soft budget constraint
- The illusion of rule-based fiscal policy
- Fiscal adjustment, the provinces and the game of chicken: who blinks first?

5. The Incomplete Reform Program

- Deep privatization
- Half-baked social security reform
- Labor market reform: An Impossible Quest?

6. MERCOSUR: Was Brazil the Wrong Partner?

- MERCOSUR in a historical context: political economy issues
- Trade creation and trade diversion
- Macroeconomic coordination
- Common market of free trade area?

7. The Role of the IMF

- Too permissive?
- The IMF and the “sudden stop”
- The IMF and moral hazard

8. Stagnation and Convertibility: Multiple Equilibria or Poor Fundamentals

9. 2001: Was the Crisis Avoidable?

- Quasi monies: Patacones, Lecops and other beauties
- Was dollarization still possible in December 2001?