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Briefing Paper

Argentina Since Default:
The IMF and the Depression

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September 3, 2002

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EXECUTIVE SUMMARY

It is now more than eight months since the economic crisis led to demonstrations and riots that toppled the government of President Fernando de la Rúa in Argentina, and the country defaulted on its public debt. Argentina's economy has continued to decline, with the recession now having lasted more than four years. At this moment it is not yet clear when this downward spiral will end.

This paper looks at Argentina's crisis since the default in an attempt to find a way out of the depression. After more than half a year of negotiations, there has been no loan agreement with the IMF, nor is it clear when there may be one. Furthermore, it is not clear if a loan agreement will provide new resources—as opposed to simply providing money for multilateral debt payment. In addition, the costs to the Argentine economy of conditions attached to IMF loans may exceed the benefits. For these reasons, and others detailed below, it is important to consider the prospects for reviving the economy, whether or not an agreement with the IMF is reached.

Background and Origins of the Crisis

The IMF is still insisting that "failures in fiscal policy constitute the root cause of the current crisis,"[2] and recommending fiscal and monetary austerity as a means of reviving investor confidence and thereby stimulating economic recovery. But this approach has failed for more than four years, as the economy remains mired in a depression, with a loss of more than 20 percent of GDP since the last business cycle peak in 1998.

Furthermore, the crisis was not caused by fiscal profligacy: the worsening of the central government's fiscal balance from 1993 to 2002 was not a result of increased government spending (other than interest payments). Rather, there was a decline in government revenue due to the recession, which began in the third quarter of 1998. More importantly, Argentina got stuck in a debt spiral in which higher interest rates increased the debt and the country's risk premium, which led to ever higher interest rates and debt service until its default in December of 2001. The interest rate shocks came from outside, starting with the US Federal Reserve's decision to raise short-term rates in February of 1994, and on through the Mexican, Asian, Russian, and Brazilian financial crises (1995-1999).

Argentina's currency board system contributed significantly to the depression, because economic activity was directly reduced by the large capital outflows during various episodes international financial turbulence.

[2] Press briefing, Buenos Aires, April 10, 2002 (at www.imf.org/external/np/tr/2002/tr020410.htm). Dr. Singh replaced Claudio Loser as Director of the Western Hemisphere department in June.

It is also worth noting that the government's decision to privatize its social security system in 1994 had a major impact on the central government budget deficit: in fact, the lost revenue, plus accumulated interest costs, amounted to nearly the entire government budget deficit in 2001.[3] In spite of all these things, the central government's deficit was never very large, peaking at 3.2 percent of GDP in 2001 (all attributable to interest payments). Much has been made of provincial spending, but the provincial deficits totaled 1.1 percent of GDP in 2000 and peaked at 1.9 percent in 2001. All told, none of this deficit spending is very large in the face of such a deep depression.

This was a truly unviable system. It is difficult to imagine any fiscal policy—assuming it were even politically possible to cut enormous amounts of government spending—that could have avoided the fate of December 2001, given the overvalued currency, the size and growth of Argentina's debt (mostly denominated in foreign currency) relative to export earnings, and the free mobility of capital. Deficit spending did not cause the current crisis, and attempts to bring about an economic recovery through continued fiscal and monetary austerity are not likely to be more successful in the near future than they have been in the past.

The Current Situation

GDP has declined at a record 16.3 percent annual rate in the first quarter of 2002. Unemployment stands at 21.5 percent of the labor force, and real monthly wages have declined by 18 percent over the course of the year. Official poverty and indigence rates have reached record levels: 53% of Argentines now live below the official poverty line, while 25% are indigent (basic needs unmet). Since October 2001, 5.2 million Argentines have fallen below the poverty line, while seven out of ten Argentine children are poor today.

While this is the worst economic crisis in Argentine history, there are a number of reasons to view the economy as poised for a rapid recovery, and one that can take place without external financing. Most importantly, Argentina is running a large current account and trade surplus. Primarily a result of the devaluation, the export sector has vastly expanded as a share of the economy (see below), and is considerably more competitive internationally.

The Road Ahead

Even if the IMF eventually proves willing to reach a new loan agreement with the government of Argentina, it is still an open question whether the country would be better off with an economic recovery program of its own. While there are risks to both paths, it seems that Argentina would be better off declaring a moratorium on its debt and using its available resources to put the economy on a sustainable growth path.

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[3] See Dean Baker and Mark Weisbrot, "The Role of Social Security Privatization in Argentina's Economic Crisis," Center for Economic and Policy Research, 2002.

One risk of going the IMF route is that the policy conditions imposed by the Fund would themselves prolong and/or worsen the depression. As noted above, the recommended fiscal and monetary policies would almost certainly have that effect. Even assuming that the economy recovers, an IMF agreement might well put Argentina into a type of receivership in which slow growth, permanently high interest rates, and a continued unsustainable debt burden cause the country to limp along from one crisis to the next.[4]

What is the alternative to an IMF agreement? Most importantly, the government would have to begin to revive economic activity directly, instead of waiting for foreign or even domestic investment to resume on its own. Once the economy begins to recover, and investors no longer fear a worsening breakdown, private investment would return. (This is not so unusual as it may seem from looking at IMF packages in these situations: in the United States, the most recent (mild) recession and continued economic weakness has been countered by a shift from a Federal budget surplus of about 2 percent of GDP to a deficit of 1.5 percent, or about $350 billion dollars. Business investment has yet to recover).

Demand could be stimulated through public works programs, along with income support for the families of the unemployed and the poor. A subsidy for unemployed workers or at the very least a food stamp program of some sort would be particularly important, due to the lack of access that many poor families now have to adequate food.

The export sector can potentially play an even bigger role in jump-starting a recovery. First, the export sector has gone from a relatively small to a sizeable part of the Argentine economy. Before the devaluation, exports of goods and services were only 11.5 percent of GDP. Now they are about 37 percent of GDP. This is not only because of the contraction of GDP, but mostly because the devaluation makes each dollar of export earnings worth (currently) about 3.6 pesos. Of course the devaluation also makes Argentine exports much more competitive.

The government could work directly with private banks in major export markets (e.g. Brazil) to arrange for letters of credit and allow exports to expand more rapidly.[5]

One of the great advantages that Argentina has over other countries in such situations, in terms of recovering on its own, is that the country is running large surpluses on both its trade and current accounts. For the first quarter of 2002, the current account surplus was $1.5 billion, or 7.1 percent of GDP on an annual basis. The merchandise trade surplus is 3.75 billion dollars, or 17.8 percent of GDP on an annual basis. The current account surplus is not a result of debt default: net foreign interest payments in the first quarter of 2002 actually exceeded those of a year ago.

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[4] This is essentially what happened to Brazil, which was fortunate enough to have its fixed exchange rate collapse three years earlier than Argentina. Nonetheless the extremely high interest rates combined with slow growth have led to an explosive debt burden which now places the country, three and a half years after devaluation, once again on the brink of default.

[5] Brazil's Central Bank recently intervened in this way. (See "Brazil will lend money to troubled companies," by Raymond Colitt, *Financial Times*, August 12, 2002).

What has happened is that imports have collapsed -- for the first quarter of 2002, imports of goods and services are down 60 percent from a year ago, and even more from their level during the 1998 business cycle peak. The importance of this change cannot be over-emphasized. It means that the Argentine economy has already gone through an enormous "structural adjustment," as a result of the depression. In other words, as a result of a steep and painful shrinking of the economy (which automatically reduces imports), Argentina has already accomplished the adjustment that is necessary to set the stage for sustainable and even rapid growth. Furthermore, the current account surplus is not likely to disappear any time soon, since the full effect of the devaluation—in terms of increasing exports and reducing imports—has not yet been felt.

The country is therefore capable of paying for the imports that it needs, for the foreseeable future, without any need for foreign financing. This means that the Argentine economy is ready to recover without new loans from the IMF or other international institutions.

The details of an economic recovery program remain to be worked out, but it is certainly feasible. Aside from meeting the most basic needs of the poor, the most important thing is to come up with a plan that revives production and consumer demand, and allows exports to grow without unnecessary constraints. Even if an IMF agreement is reached it cannot be assured that such an agreement will provide net new resources to the economy, or lead to increased private investment. Moreover, any new credits will almost certainly be disbursed in tranches (installments), with conditions that might hinder or even abort an economic recovery. Therefore, regardless of when IMF and US Treasury officials decide that they are ready to sign an agreement, Argentina must have a viable economic recovery plan of its own. The alternative is to leave the economy at the mercy of the IMF/US Treasury and the forces of economic contraction.

INTRODUCTION

"In our view, failures in fiscal policy constitute the root cause of the current crisis."
--Anoop Singh, IMF Director of Special Operations, Buenos Aires, April 10, 2002

It is now more than eight months since the economic crisis led to demonstrations and riots that toppled the government of President Fernando de la Rúa in Argentina, and the country defaulted on its public debt. Argentina's economy has continued to decline, with the recession now having lasted more than four years. GDP for the first quarter of 2002 was down 16.3 percent from the prior year, the worst decline on record. At this moment it is not yet clear when this downward spiral will end.

This paper will look at Argentina's crisis since the default in an attempt to find a way out of the depression. After more than half a year of negotiations, there has been no loan agreement with the IMF, nor is it clear when there may be one. Furthermore, it is not clear if a loan agreement will provide new resources—as opposed to simply providing money for multilateral debt payment.[6] In addition, the costs to the Argentine economy of conditions attached to IMF loans may exceed the benefits. For these reasons, and others detailed below, it is important to consider the prospects for reviving the economy, whether or not an agreement with the IMF is reached.

The role of the IMF is important, not so much because of its own resources or expertise, but because of its power—together with the US Treasury department[7]—as head of a creditors' cartel that can deny Argentina access to sources of credit. In the rare situation of sovereign default that Argentina faces, the role of the IMF/Treasury is even more pronounced, because there are creditors that are already not lending as a result of the default, and others that are looking to the Fund to represent their interests in negotiating the terms of an eventual debt restructuring and repayment.

ORIGINS OF THE CRISIS

A brief overview of the origins of the current crisis is important for much more than historical reasons. The IMF, which is presently the most powerful voice in the negotiations for an economic recovery program, has a primary explanation on which it bases its policy recommendations. As Anoop Singh (the former head of the IMF's delegation to Argentina and

[6] Economy Minister Roberto Lavagna stated that he did not expect any "fresh cash" from the IMF. (See "Otra etapa en la crisis: Lavagna admitio que no habra "plata fresca" del FMI para la Argentina," *Clarín*, May 14, 2002).
[7] Although the IMF is in principle run by a board of Executive Directors from its member countries and regions, the US Treasury department is the primary decision-maker, especially for Latin America.

now in charge of the entire Western Hemisphere department) stated in an April press conference, "In our view, failures in fiscal policy constitute the root cause of the current crisis."[8]

It follows from this analysis that fiscal tightening is a vital first step on the road to recovery. In the Fund's view, it is extremely important to cut the government (both central and provincial) budget deficits, in order to restore the confidence of investors. This will ostensibly lead to increased investment, both from foreign and domestic residents, and lead an economic recovery.

Table 1 shows the central government's revenue, spending, interest payments, budget deficit or surplus, and primary deficit or surplus from 1993 to the first quarter of 2002. It is difficult to find evidence that the government's fiscal policy played a significant role in bringing about the current economic crisis. Although the government budget does move from a surplus of 2.7 billion pesos in 1993 (1.2 percent of GDP) to a peak deficit of 8.7 billion pesos (3.2 percent of GDP) in 2001, this worsening of the fiscal balance is not a result of increases in government spending.

Table One

Argentina, National Government Spending and Revenues (1993-2002)

In millions of current pesos

	YEAR									
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002-Q1
Total Revenue	**50,726.5**	**51,078.2**	**50,293.6**	**47,668.9**	**55,376.7**	**56,726.1**	**58,455.4**	**56,570.5**	**51,318.6**	**10,519.6**
Total Spending	**47,996.0**	**51,364.3**	**51,666.9**	**52,933.3**	**59,653.3**	**60,799.6**	**63,223.8**	**63,362.1**	**60,037.9**	**13,037.9**
- Total Spending as % of GDP	20.29%	19.95%	20.07%	19.45%	20.37%	20.34%	22.30%	22.29%	22.34%	5.56%
- Interest Payments (included in Total Spending)	2,914.0	3,150.3	4,083.5	4,607.9	5,745.0	6,660.3	8,223.6	9,656.0	10,174.6	668.5
- Interest Payments as % of GDP	1.23%	1.22%	1.58%	1.69%	1.96%	2.23%	2.90%	3.40%	3.79%	.29%
Deficit or Surplus (Rev-Spend)	**2,730.5**	**-285.9**	**-1,373.3**	**-5,264.4**	**-4,276.6**	**-4,073.5**	**-4,768.4**	**-6,791.6**	**-8,719.3**	**-2,518.3**
Deficit or Surplus as % of GDP	**1.15%**	**-0.11%**	**-0.53%**	**-1.93%**	**-1.46%**	**-1.36%**	**-1.68%**	**-2.39%**	**-3.25%**	**-1.07%**
Primary Spending (excl. interest)	**45,082.0**	**48,214.0**	**47,583.4**	**48,325.4**	**53,908.3**	**54,139.3**	**55,000.2**	**53,706.1**	**49,863.3**	**12,369.4**
Primary Surplus or Deficit	**5,644.5**	**2,864.2**	**2,710.2**	**-656.5**	**1,468.4**	**2,586.8**	**3,455.2**	**2,864.4**	**1,455.3**	**-1,849.8**
Primary Spending as % of GDP	**19.06%**	**18.73%**	**18.44%**	**17.76%**	**18.41%**	**18.11%**	**19.40%**	**18.90%**	**18.56%**	**5.28%**
Primary Surplus or Deficit as % of GDP	**2.39%**	**1.11%**	**1.05%**	**-0.24%**	**0.50%**	**0.87%**	**1.22%**	**1.01%**	**0.54%**	**-0.79%**

Source: *Economic Information, Ministry of Economy, Argentina*

Rather, the country was hit with a series of interest rate increases that caused a debt spiral and eventually a default. This can be seen from the data on the government's primary balance (excluding interest payments) in Table 1. The primary balance moves from a surplus of 5.6 billion pesos in 1993 (2.4 percent of GDP) to a surplus of 1.5 billion (0.5 percent of GDP) in 2001. But this worsening of the primary balance was not a result of government decisions to

[8] Press briefing, Buenos Aires, April 10, 2002 (at www.imf.org/external/np/tr/2002/tr020410.htm). Dr. Singh replaced Claudio Loser as Director of the Western Hemisphere department in June.

increase spending. Primary spending was 19.1 percent of GDP in 1993, and 18.6 percent for 2001.

In other words, there was a decline in government revenue due to the recession, which began in the third quarter of 1998. Much more importantly, Argentina got stuck in a debt spiral in which higher interest rates increased the debt and the country's risk premium, which led to ever higher interest rates and debt service until its default in December of 2001.

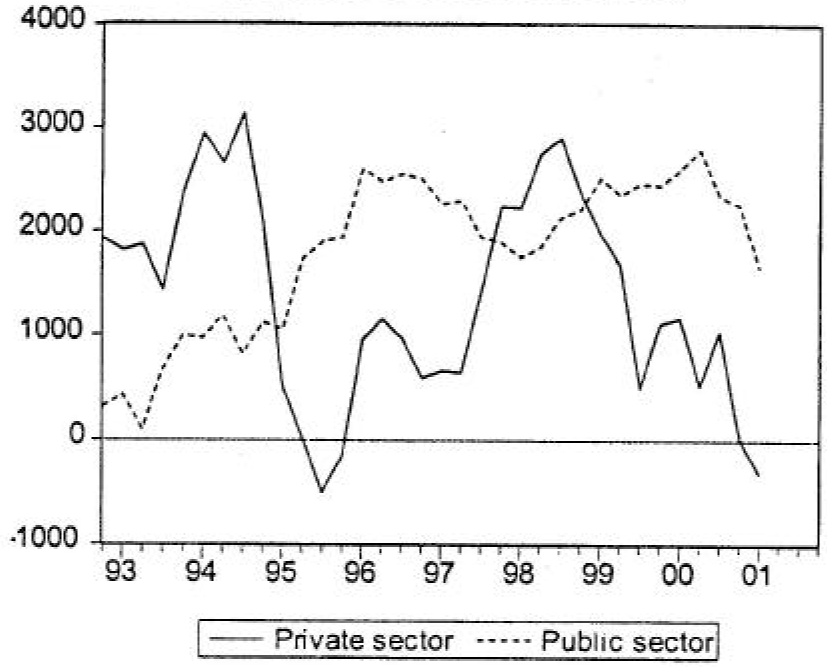
The interest rate shocks were exogenous, starting with the US Federal Reserve's decision to raise short-term rates in February of 1994. US interest rates went from 3 to 6 percent over the following year, and since Argentina's currency was pegged to the dollar, its interest rates rose accordingly, with an additional rise in the risk premium (due to the increased possibility of devaluation and default). This was followed by the Mexican peso crisis (December 1994), itself precipitated by the Fed's rate hikes and resulting capital outflows from Mexico. Capital fled Argentina as well, causing a steep recession, with GDP declining by 7.6 percent from the last quarter of 1994 to the first quarter of 1996.

Capital inflows resumed in the second half of 1996, but the country's risk premium and cost of borrowing went up again with the onset of the Asian financial crisis in August of 1997. The Argentine peso was also growing increasingly overvalued, since the US dollar, to which it was pegged, was overvalued. This worsened the current account, especially in services. The current account was also hit by the interest rate increases: in 1998, when the current account deficit peaked at 14.6 billion pesos, or 4.9 percent of GDP, 71 percent of the deficit was due to interest payments.

Further shocks from the Russian devaluation in October of 1998, and then the floating of the Brazilian real in January of 1999, made Argentina's devaluation and default inevitable. It is clear then, that fiscal policy was not the problem that led to Argentina's economic collapse. Rather it was the result of a series of external shocks, which due to Argentina's unrestricted capital mobility and currency board system—a deadly combination—were impossible for the economy to withstand.

This point must be emphasized, because under a currency board system these external shocks not only increase the risk premium for borrowing (since people believe the overvalued currency will not hold), but macroeconomic activity is also directly reduced by the capital outflows, which reduce the monetary base. Figure 1 shows the net capital inflows in the public and private sector for 1993-2001. There is a recovery from the first huge private outflow (1995), but it takes more than three years; in the meantime, as the graph shows, official creditors such as the IMF and the World Bank increasingly replace the lost private capital flows. The second major private outflow, which coincides with the Asian, Russian, and Brazilian crises, sent the economy into a recession from which it has never recovered.

Figure 1
Balance of payments: Net capital inflows by sector
(moving averages of four quarters
in millions of US current dollars)



Source: Figure 7b, Damill, Frenkel, and Maurizio 2002, p 93

This was a truly unviable system.[9] It is difficult to imagine any fiscal policy—assuming it were even politically possible to cut enormous amounts of government spending—that could have avoided the fate of December 2001, given the overvalued currency, the size and growth of Argentina's debt (mostly denominated in foreign currency) relative to export earnings, and the

[9] Some economists have argued that the economy could have adjusted to the external shocks, and recovered, if only wages had fallen enough: "If Argentina had a more flexible economic system, especially in its labor markets, its economy would have been more able to adapt to the rigors of the Convertibility Plan; unemployment would have been lower; growth would have been stronger; fiscal deficits would have been smaller; and interest rates would have been lower because creditors would have had more confidence in the capacity of the Argentine government to service its obligations." (From Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy*, Institute for International Economics, 2002, p 9). Any macroeconomic policy regime that requires such a fall in nominal wages is, as a practical matter, untenable. Also, it is not clear that such a recovery scenario is plausible in theory, since falling prices would raise the real interest rate.

free mobility of capital. It is also worth noting that the government's decision to privatize its social security system in 1994 had a major impact on the central government budget deficit: in fact, the lost revenue, plus accumulated interest costs, amounted to nearly the entire government budget deficit in 2001.[10]

Since the default some analysts, including IMF economists, have focused on the provincial deficits as the cause of the problem. But this does not fit with the evidence either. First, provincial borrowing was not guaranteed by the central government (and had higher interest rates as a result). Thus a default on the provincial debt would not be expected to cause the central government to default. (In February, the central government did agree to guarantee the debt of the provinces, but this was after the fact and cannot be said to have contributed to the central government's default).[11]

Second, the central government's payments to the provinces were fixed by law as a percentage of central government revenue, and this percentage did not increase as the provinces increased their deficit spending. Finally, the provinces' combined deficit spending was not all that large in any case. Provincial deficits totaled 1.1 percent of GDP in 2000 and peaked at 1.9 percent in 2001.[12] The provinces were picking up some of the burden of counter-cyclical fiscal policy during the recession, since the central government was not carrying it. For a recession of this depth, with more than a fifth of the labor force unemployed, these deficits are not large. (For comparison, the United States government ran deficits of 4.7 percent of GDP in 1992 and 6.1 percent in 1982, coming out of our previous two recessions; the combined deficit of the Argentine federal government and provinces in 2001 was 5.1 percent). All told, this deficit spending was a result of the crisis, rather than the cause of it.

The Argentine recession (now a depression) is currently four years old, and through the whole of it the IMF has asserted that fiscal tightening will restore investor confidence and thereby lead to recovery. It now looks as though the opposite is more likely: that fiscal tightening may have contributed to slower growth, which then lowered government revenue, thus necessitating even more fiscal tightening to balance the budget; and the downward spiral further lowered the confidence of investors.

Finally, it is worth noting the general role of the IMF in the policy decisions that led to this crisis. The Fund and its defenders[13] have insisted that the decisions to establish and maintain the

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[10] See Dean Baker and Mark Weisbrot, "The Role of Social Security Privatization in Argentina's Economic Crisis," Center for Economic and Policy Research, 2002.

[11] The pact President Duhalde signed with the provinces in February 2002 included commitments by the provincial governments to cut their deficits by 60 percent, replaced the guaranteed minimum monthly transfer from the central government with a fixed percentage of tax revenues, and required the central government to absorb the provincial debts, at a 1.40 peso to 1 dollar conversion rate with the debts being refinanced over 16 years at an interest rate of 4 percent. (See "Argentina provinces, government reach revenue-sharing deal, paving way for aid," AFX News, February 28, 2002).

[12] Source: Center for Buenos Aires Studies, with data taken from Ministry of Economy, Argentina.

[13] Thomas Dawson, External Relations Director at the IMF, indicated in May 2002 that the Fund only publicly supported the Argentine government while they dis agreed in private: "When the authorities, without consulting with us, instituted the zero-deficit law, we indicated we thought this was excessive….We were advising them at the time that policy should

currency board, to privatize the social security system, and other policies that contributed to the crisis, were made solely by the Argentine government. They therefore conclude that the Fund has no responsibility for the economic collapse.

The problem with this argument is that the IMF did support Argentina's policy decisions, including the continuation of the currency board through 2001, with tens of billions of dollars in loans, as well as with public statements. The IMF does not generally approve money for policies that it opposes. As can be seen from the current crisis, the Fund has not only refused to lend money for policies it disagrees with, but has used its immense power to pressure the government to adopt a whole set of economic policy prescriptions, to rewrite its laws, and to reinterpret the constitutionally defined relationship between the provinces and the central government.[14] And this is during a time of Argentina's worst ever economic crisis, with the resulting political instability posing a serious threat to the country's democratic institutions. It is difficult to believe, therefore, that Fund decision-makers felt obligated to support the Argentine government's economic policies in the 1990s and through most of 2001, simply because the government chose them, and in spite of their beliefs that these policies were wrong and would fail. While there are certainly differences of opinion among Fund economists about issues such as what kind of exchange rate regime is best, the idea that the Fund was simply going along with whatever policies were chosen by the Argentine government is contradicted by decades of IMF policy-based lending, as well as the Fund's behavior in the last eight months of negotiations with Argentina.[15]

THE CURRENT SITUATION

Table 2 shows the data for GDP, unemployment, consumer prices, wages, gross domestic investment, the exchange rate, central bank reserves, international trade and the balance of payments for 1993-2002. Output peaked in the second quarter of 1998, and has contracted about 20 percent since then.[16] The contraction has accelerated since the default, with GDP down 16.3 percent in the first quarter of 2002, from its year-ago level. If the contraction were to continue at

be relaxed, not tightened….When you make a decision to support a program, your public support has to be full-fledged." (See "Argentine 2001 Budget Cuts Defied IMF, Fund Now Says," by Mark Drajem, Bloomberg, May 20, 2002). Michael Mussa, former Research Director at the IMF, also asserts the government's primary responsibility for mistaken policies in his recent book: "In general, the Fund supported these policies, both with its statements and with its financing, but the Fund did not press the Argentine government to adopt policies that it did not willingly choose to implement." (See Mussa 2002).

[14] Prior to the passage of the 2002 budget, which contained the provisions from the pact Duhalde had signed with the provinces, the central government had guaranteed a minimum monthly transfer to the provinces, as according to the Argentine constitution. The Constitution was essentially reinterpreted to allow for the new law which instead requires a fixed percentage transfer of tax revenues to the provinces. (See also footnote 4 above).

[15] The Fund was also very clear in insisting that the Duhalde government's abandon any attempt at a dual exchange rate, in order to be eligible for an agreement. (See "Argentina Pressed to End Dual Exchange Rate," by Richard Lapper, *Financial Times*, January 17, 2002, p 8).

[16] Since the quarterly GDP data are not seasonally adjusted, and there are large seasonal variations, this number (20 percent) compares Q1 1998 with Q1 2002.

this pace for the rest of the year, the total decline since the last peak would be about 27 percent. For comparison, the loss of output during the United States Great Depression downturn (1929-33) was about 33 percent.

Table Two

Argentina, Economic Data (1993-2002)

	YEAR									
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002[1]
GDP Market Prices (in millions of 1993 pesos)	236,505	250,308	243,186	256,626	277,441	288,123	278,369[2]	276,173[2]	263,997[2]	217,067[2,3]
Unemployment	9.6%	11.5%	17.5%	17.2%	14.9%	12.9%	14.3%	15.1%	17.4%	21.5%[4]
Consumer Price Index (1991=100)		147.49	152.47	152.71	153.52	154.94	153.13	151.69	150.08	193.50[5]
Annual Change in CPI			3.38%	0.16%	0.53%	0.92%	-1.17%	-0.94%	-1.07%	30.5%[5]
Real Wages (in 1994 pesos)		931	909	893	876	879	902	916	914	716[6]
Gross Domestic Investment (in millions of 1993 pesos)			44,528	48,484	57,047	60,781	53,116	49,502	41,650	
Exchange Rate (Pesos to Dollar)	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	3.65[7]
Reserves (in US$)		16,870	14,693	15,401	16,603	17,837	17,665	16,796	19,004	9,060[7]
Trade Balance (in US$)	-2,364	-4,139	2,357	1,760	-2,123	-3,097	-795	2,558	7,507	3,750[8]
Exports F.O.B. (in US$)	13,269	16,023	21,162	24,043	26,431	26,434	23,309	26,410	26,655	5,705[8]
Imports F.O.B. (in US$)	15,633	20,162	18,804	22,283	28,554	29,531	24,103	23,852	19,148	1,955[8]
Current Acct Balance (in US$)	-8,162	-11,157	-5,211	-6,873	-12,333	-14,624	-11,898	-8,864	-4,429	1,511[8]

[1]Latest available data for each category

[2]Estimates

[3]Quarterly data (annualized, not seasonally adjusted)

[4]May data

[5]For the first half of 2002

[6]April data

[7]July data

[8]Q1 data

Source: *National Institute of Statistics and Census (INDEC), Ministry of Economy , and Central Bank, Argentina*

The drop in business investment over the course of the depression has been severe. Real Gross Domestic Fixed Investment for 2001 was down 31 percent from its 1998 peak; measured by the last quarter of 2001, which registered a sharp drop, the decline is 40 percent.

Unemployment stands at 21.5 percent of the labor force, with underemployment at 18.6 percent; real monthly wages have declined by 18 percent over the course of the year.

Official poverty and indigence rates have reached record levels: 53% of Argentines now live below the official poverty line, including 70 percent of children, while 25% are indigent (basic needs unmet). Since October 2001, 5.2 million Argentines have fallen below the poverty line.[17] Children have been particularly hard hit, as noted in recent reports of malnutrition and hunger in various provinces and in the capital's suburbs.[18] Stories of children fainting in school for lack of adequate nutrition, and stories of people hunting down cats, dogs, rats, and horses in order to survive have been commonly reported in the press.[19]

By most measures, this is the worst economic crisis in Argentine history. However there are a number of reasons to view the economy as poised for a rapid recovery, and one that can take place without external financing. Most importantly, Argentina is running a large current account and trade surplus (7.1 and 17.8 percent of GDP, respectively). Primarily a result of the devaluation, the export sector has increased from 11.5 to 37 percent of GDP, and is considerably more competitive internationally. These and other recent changes will be discussed in detail in the last section, which looks at the prospects for recovery.

THE ROLE OF THE IMF SINCE DEFAULT

Due to the secrecy surrounding the IMF's negotiations with borrowing governments, and the lack of transparency within the Fund itself, it is difficult to get complete information about the IMF's actions, demands, goals, and analysis in situations such as this. Nonetheless there is much that is known, both from the IMF's public statements and press interviews with both Fund and Argentine government officials.

<u>Fiscal Policy</u>: The IMF has demanded further fiscal tightening from both the central and provincial governments. The central government's 2002 budget, passed at the beginning of March, cut spending by about 15 percent and set its deficit target at 3 billion pesos (the deficit was $8.7 billion in 2001, with interest payments totaling $10.2 billion). The spending cuts were to include a 10 percent across the board reduction, a 30 percent decrease in outlays for goods and services, and salary and pension cuts of 13 percent for government employees. For the provincial governments, the Fund had put forth deficit reduction targets of 60 percent as compared to last year, or 3 billion pesos. The combined impact of these reductions, if fully implemented, would have a significant contractionary effect on the economy and almost certainly prolong and/or deepen the current depression.

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[17] Source: National Institute of Statistics and Census (INDEC), Ministry of Economy, Argentina. Also see "La Crisis Provocó que haya 5,2 millones de pobres nuevos," *La Nación*, August 22, 2002.
[18] See for example "Despair in Once-Proud Argentina" by Anthony Faiola, *The Washington Post*, August 6, 2002, "Los chicos del país del hambre," by Christian Alarcón, *Página/12*, May 20, 2002, and "Quilmes, a pocos kilómetros de la Rosada," by Alejandra Dandan, *Página/12*, June 6, 2002.
[19] See also "Caballo y perro, parte del menú habitual en una zona de Paraná," by Cristian Alarcón, *Página/12*, May 16, 2002.

Monetary Policy: In April, Anoop Singh called for the central bank to "strictly limit the growth of its own credit" and to move toward establishing "a full-fledged inflation-targeting regime—such as that adopted by other countries, including Brazil after its own difficulties in 1999."[20] Without more information it is difficult to say for certain what the Fund has in mind, but the reference to Brazil's monetary policy since 1999 does not augur well. Brazil's short-term real interest rates have been among the very highest in the world (currently 18 percent nominal with 7 percent inflation). More importantly, given the depth of Argentina's depression and lack of private investment, tight restrictions on credit from the central bank may prevent the government from playing its necessary role in an economic recovery.

Another problem is that the IMF has demanded that the provincial currencies be phased out as soon as possible, with no new issuing of these currencies. These currencies are presently used to pay provincial wages and salaries; eliminating them, together with a 60 percent cut in provincial deficits, could cost hundreds of thousands of jobs at a time of extremely high unemployment. It is worth noting that the provincial currencies do not appear to have contributed to inflation in the past: in 2001, inflation was negative 1.1 percent, despite an estimated 5 billion pesos of provincial currency in circulation. While it is certainly a good idea to go back to a single currency, it appears that the provincial currencies have played a necessary role in this recession, and in their absence the loss of output would have been worse; it would seem that care should be taken in phasing them out.

Changes in Argentine law: The IMF also demanded that Argentina repeal its "economic subversion" law[21], under which the government can investigate broad categories of acts by firms, banks, or business people that cause economic harm to large sectors of the population, or damage the economy as a whole. Among other things, the law was being used to investigate capital flight that violated the banking restrictions implemented over the last year (known as the "corralito"). The targets of investigation under this law have included top executives from major banks, including foreign banks such as Citibank and Bank of Boston.

The IMF has also objected to the Argentine Bankruptcy Code, stating that "the international community could not be expected to support Argentina without the early adoption of a framework that provides an appropriate balance between creditor and debtor interests."[22] According to press reports, the main parts of the law that the IMF objected to were (1) an article that provides those filing for bankruptcy with protection from creditors for 180 days and (2) another article that allows the debtor a 360 day period to request a rescheduling of debt.[23]

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[20] Singh press briefing, Buenos Aires, April 10, 2002 (at www.imp.or/external/np/tr/2002/tr020410.htm).

[21] Both Argentine and worldwide press reported during the IMF's missions to Argentina in spring 2002 led by Singh that the Fund wanted the economic subversion law repealed. (See "Duhalde orders moves to repeal/modify Argentina economic subversion law," AFX News, March 19, 2002, and "IMF to restart Argentine talks in April," by Alan Beattie and Thomas Catan, *Financial Times*, March 23, 2002). Singh disclosed this demand, albeit in softer language, at his April 10 press conference, referenced earlier above: "Other legal reforms that inhibit engagement by the international community should also be undertaken as soon as possible, such as of the economic subversion law."

[22] See again Singh press briefing, April 2002.

[23] See "Time is running out, Argentina admits," by Mark Mulligan, *Financial Times*, May 9, 2002, and "Para dejar tranquilo a Singh," by Cledis Candelaresi, *Página/12*, April 19, 2002.

Over the last few months, the government of Argentina has agreed to the IMF's demands, although it has not been an easy task internally to do so. The fiscal tightening was not popular in Congress, and the repeal of those provisions of the economic subversion and bankruptcy laws that the Fund found objectionable generated even more animosity among legislators.[24] The provinces, at the urging of the IMF, signed an agreement with the Federal government that reduced their revenue sharing payments, and committed them to painful budget cuts.

Yet this wholesale surrender to the IMF's demands has still not brought Argentina a loan agreement with the Fund. It seems that the goal posts have been continuously moved, so that new conditions are added after the government has agreed to satisfy previous ones. The most recent round of IMF demands are that Argentina adopt a freely floating exchange rate regime (with some nominal anchor) and that there be an end to "amparos," judicial injunctions against banks allowing savers to withdraw their deposits. Disagreements between the IMF and Argentine officials led the Fund to send four former central bankers from Europe and Canada to Argentina, dubbed "wise men" in the press, to provide counsel on how Argentina should reform its banking system. The panel's report stressed that "Sacrifices will be needed, probably beyond those with which society has already come to terms."[25]

This raises the question of what the IMF is really trying to accomplish in Argentina. One possibility is that the Fund wants to punish Argentina, so as to discourage other countries[26] from defaulting. The possibility that this is a conscious goal of creditors in this situation was raised by financier George Soros, who noted that in contrast to corporate borrowers, "sovereign states do not provide any tangible security…The only security the lender has is the pain that the borrower will suffer if it defaults. That is why the private sector has been so strenuously opposed to any measure that would reduce the pain…"[27] The official logic, however, behind such punishment is not revenge, or even the protection of creditors from future default risks, but the idea that increased risk of further defaults would lead to reduced capital flows to developing countries. In this view, Argentina must suffer for the greater good of financing for development—to the extent that the existing mix of portfolio capital flows actually does that—in other low and middle-income countries.

Another possibility is that the Fund's failure to reach an agreement with Argentina is the result of divisions among the policy-makers—the IMF, US Treasury Department and the White House (which has gotten more directly involved than usual after the collapse of the De la Rua government). Undersecretary of the Treasury for International Affairs John Taylor and White House chief economic advisor Lawrence Lindsey represent a more "free-market" trend than existed in previous administrations. During Taylor's time at Stanford University he advocated the

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[24] At one point President Duhalde resorted to threatening his resignation, if the economic subversion law were not repealed. (See "Back me or I'll go, says Duhalde," by Thomas Catan, *Financial Times*, May 24, 2002).
[25] See IMF News Brief, July 29, 2002 (at http://www.imf.org/external/np/sec/nb/2002/nb0280.htm).
[26] As of this writing, there are several other countries, most notably Uruguay and Brazil, whose debt problems are severe enough that some kind of default is a very real possibility.
[27] Soros 2002, p 144.

abolition of the IMF.[28] Together with Treasury Secretary Paul O'Neill, this group opposes "bailouts," even if it means that US banks and other creditors suffer greater losses in a crisis or default situation than they did, for example, in South Korea during the Asian economic crisis, where the Fund helped arrange for the Korean government to guarantee the debt of foreign creditors.

However, this group is surrounded by more traditional officials who are more concerned about minimizing the losses of US financial institutions, as well as the continuing economic and political deterioration in Argentina, especially insofar as the latter has political fallout here (since the press and foreign policy establishment expect Treasury and the IMF to "do something.") The current stalemate between the IMF and Argentina may result, at least in part, from the conflicting goals of these factions, one of which (Taylor/Lindsey) may not even want an agreement, especially if it involves net new lending. The Fund's recent decision to approve a $30 billion credit to Brazil, as well as the US loan to Uruguay, indicate that when push comes to shove, the more traditional voices do prevail. It may be that the Bush Administration and Treasury still do not see the economic meltdown in Argentina as politically important enough, in order for the Taylor/Lindsey faction's opposition to "bailouts" to be overridden. Or it may be that there is also general agreement from all factions that the country must be punished, at least for some time, in order to discourage further defaults.

It is important to distinguish these conflicts from the more commonly held view of a debate between those who want to "help" Argentina and those who do not. It is not clear that a traditional "bailout," which would provide funds to resume debt service payments until the next crisis, would help the Argentine economy. The amount of money that the Argentine government is currently asking for from the IMF is the $18 billion in credits that was suspended back in December 2001—though a G-7 official recently speculated that $7.5 billion is more realistic.[29] This would cover their debt service to the multilateral lenders for the rest of this year and the next, but leave no net new funds for anything else. It is easy to imagine a scenario in which such an agreement would lead to further stagnation and depression: the required fiscal and monetary austerity would slow the economy, resulting in continuing social unrest, along with continued uncertainty about further disbursements from the Fund, and investment would continue to stagnate.

The IMF is widely seen as an international lender of last resort, a global role analogous to that of a central bank in the domestic economy. Within a country, the central bank provides liquidity to banks that are in danger of failure due to bad loans, in order to prevent a run on the banking system and a collapse of normal business activity. The Fund is often portrayed as playing a similar role in the global economy, in crisis situations. But this is not generally true. As can be seen from the case of Argentina (as well as the Asian and Russian crises a few years ago), the IMF generally plays an altogether different role: it is the lead negotiator and organizer of a

[28] In a transcript of an interview for Stanford's Hoover Institute-sponsored TV program "Uncommon Knowledge," Taylor asserted that the IMF "should be abolished…in a way that takes some of the talents there and use[s] it in a more effective way." (See www.uncommonknowledge.org/99winter/320.html).

[29] See "Respite for Gasping Argentina as I.M.F. Defers Loan Payment," by Larry Rohter, *New York Times*, July 16, 2002, and "G7 Source Says IMF Aid for Argentina to be US$ 7 Billion," Reuters, August 9, 2002.

creditors' cartel. In this role, it attempts to secure as much repayment of debt as possible, and generally more than would be possible if the individual creditors were left to negotiate on their own with the defaulting borrower.[30]

In Argentina, it is clear that the Fund has done nothing to help the country avoid the breakdown of normal business activity, although there is much that it could have done in the past eight months, including helping to restore the functioning of the banking system, preventing unnecessary bankruptcies and the resulting reduction in employment, and providing much-needed export credits for industries that could actually benefit from the devaluation. Instead, the Fund has played the opposite role: making sure, insofar as it can enforce discipline among lenders, that credit from all sources is denied until an overall agreement—whose terms are sufficiently favorable to creditors, as determined by the IMF—can be reached. Even loans targeted for assistance to social programs—$700 million approved by the World Bank—are being withheld until there is an agreement with the Fund.[31] Most private lenders, as well as European governments, are waiting for IMF approval before they extend credit.[32] Even export credits have become more difficult to obtain, as a result of the lack of agreement between the IMF and the Argentine government.[33]

The IMF itself has about $15 billion of loans outstanding to Argentina. It has deferred payments on these loans three times so far in 2002: $933 million in January, $136 million in May, and $985 million in July. The ultimate threat that the IMF has in this situation, and one of the defining points of its leadership of the creditors' cartel, is the threat of default to the Fund itself. Official default to the Fund is rare, and has generally been confined to "pariah" or "failed" states (Afghanistan, Congo, Iraq, Liberia, Somalia, and Sudan). In such cases, day-to-day trade credits in the private sector, such as letters of credit from banks, which are generally necessary to maintain normal trade flows, can be denied. This is one of the threats that the Fund holds over Argentina; whether it would use this "nuclear option" in any given situation would be determined by political circumstances, including the foreign policy concerns of the US State Department as well as Treasury, and international public opinion. In other words, there are political costs to these actors of administering such a rarely used and extreme punishment, especially given the

[30] One example which illustrates this is Russia, where foreign banks received a small fraction of the debt owed to them, after the government failed to reach agreement with the IMF. (See "Russia reaches debt deal with Western banks," AP, February 11, 2000).

[31] See http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20055157~menuPK:34466~pagePK:34370~piPK:34424~theSitePK:4607,00.html.

[32] See "No Argentina/EU aid talks until deal signed with IMF—Ruckauf," AFX News, May 22, 2002.

[33] The head of the Argentine Chamber of Exports, Enrique Mantilla, has signaled a disruption in the terms by which normal credit relations function; Foreign Minister Carlos Ruckauf and other Argentine government officials have also highlighted the lack of export credit. (See "Agonizing week for the peso," by Lourdes Heredia, BBC, March 16, 2002, and "Brazilians Find Political Cost for Help From I.M.F.," by Larry Rohter, *The New York Times,* August 11, 2002).
The World Bank, in recognition of this drying up of export credit, has pledged money for trade financing in its promises of aid, but only once an IMF agreement comes through. (See "Argentina Gets $100 Million World Bank Emergency Aid," by Mark Drajem, Bloomberg, March 8, 2002).
The Mexican government gave symbolic support to Argentina in July 2002, by providing $1million in revolving lines of credit for exports and imports. (See "Troubled South America trade bloc reaches auto deal," by Gilbert Le Gras, Reuters, July 4, 2002).

IMF's shared responsibility for creating the conditions that led to Argentina's default and ongoing crisis.

THE ROAD AHEAD

Arreglándonos con lo Nuestro? [34]

Even if the IMF eventually proves willing to reach a new loan agreement with the government of Argentina, it is still an open question whether the country would be better off with an economic recovery program of its own. While there are risks to both paths, it seems that Argentina would be better off declaring a moratorium on its debt and using its available resources to put the economy on a sustainable growth path.

This first risk of going the IMF route is the risk of further economic decline before any such agreement leads to recovery. As noted above, the economy has been shrinking at an annual rate of about 16 percent. Negotiations could drag on for many more months, and more importantly, it could be very much longer than that before an agreement has any positive effect on the economy (see below). The costs of delaying economic recovery at this rate of decline are substantial, and would take years to recuperate, even assuming that the resulting disintegration of political and social institutions does not throw further roadblocks in the way of recovery.

Since an agreement would provide little or no net new resources to the economy, but rather allow for resumption of multilateral debt service, the best (hoped for) result of such an agreement would be its positive effect on the investment climate. There are two impacts here: first, a resurgence of investor confidence as a result of the agreement. The idea is that the IMF agreement would serve as a signal to investors, particularly foreign investors, that the country was now safe for investment. Given the current investment climate in Latin America, this impact could be small. The risk premium on Brazil's sovereign debt is now worse than Nigeria's, Uruguay has lost a third of its reserves in the last month, and capital inflows to the region have dropped off sharply over the last year and a half. The United States economy, which has a major impact on Latin America through its demand for imports, is also weak. In these economic environs, it is not clear how long it would take for the IMF agreement to have any significant positive impact on foreign investment in Argentina.

The other impact of an IMF agreement would be to release credit from other sources, and allow for governments, multilateral lenders, and even some private creditors to "lend into arrears,"

[34] The Argentine daily *Clarín* reported in July 2002, “Si no hay acuerdo con el FMI nos arreglaremos con lo nuestro,” or, “If there is no agreement with the IMF we will take care of things with what we have.” The article was referring to a statement made to that effect by governor José Luis Lizurume of the Chubut province. See *Clarín*, July 4, 2002.

which they may not do in the absence of such an agreement. This differs from the first impact (above) in that these are lenders that are refusing to extend credit now, not because of perceived risk, but because they are respecting the creditors' cartel headed by the Fund/US Treasury. Since the IMF's influence here is based on arrangements that are informal and under-the-table—e.g. even the World Bank is not formally required to deny credit to a government that does not meet IMF requirements—it is difficult to estimate the size of this impact. The relevant comparison would depend on how long the cartel would hold up under a serious challenge, i.e., if Argentina sought international support for a reasonable economic recovery program, while suspending its debt payments.

An IMF agreement carries further risks that the policy conditions imposed by the Fund would themselves prolong and/or worsen the depression. As noted above, the recommended fiscal and monetary policies would almost certainly have that effect. Even assuming that the economy recovers, an IMF agreement might well put Argentina into a type of receivership in which slow growth, permanently high interest rates, and a continued unsustainable debt burden cause the country to limp along from one crisis to the next.[35] The debt burden is especially important; Argentina is in default on its international debt, but very little of this debt has been taken off the books. The IMF has been remarkably silent on what the terms of any restructuring, or debt write-down, would be. It is easy to imagine that the Fund, together with other creditors, would keep as much of this debt on the books as possible, in the hope of collecting it in the future; and that this would make the country vulnerable to future debt crises.

In sum, an IMF loan would not necessarily restore growth, and could even delay or abort any economic recovery. There is no telling where the bottom might be. Russia lost half of its national income under an IMF program, and it was only after that program collapsed (with the devaluation of the ruble in 1998) that the economy began to recover. Aside from the danger of the Fund's policy prescriptions, the Argentine economy is in a serious depression, with an attendant political crisis and enormous loss of confidence in its democratic institutions. The government will need all the flexibility that is possible in order to get out of this crisis, and constraints on fiscal and monetary policy could prove much more damaging than they would be in the case of a normal economic downturn.

What is the alternative to an IMF agreement? Most importantly, the government would have to begin to revive economic activity directly, instead of waiting for foreign or even domestic investment to resume on its own. Once the economy begins to recover, and investors no longer fear a worsening breakdown, private investment would return. (This is not so unusual as it may seem from looking at IMF packages in these situations: in the United States, the most recent (mild) recession and continued economic weakness has been countered by a shift from a Federal budget surplus of about 2 percent of GDP to a deficit of 1.5 percent, or about $350 billion dollars. Business investment has yet to recover).

[35] This is essentially what happened to Brazil, which was fortunate enough to have its fixed exchange rate collapse three years earlier than Argentina. Nonetheless the extremely high interest rates combined with slow growth have led to an explosive debt burden which now places the country, three and a half years after devaluation, once again on the brink of default.

Demand could be stimulated through public works programs, along with income support for the families of the unemployed and the poor. A subsidy for unemployed workers[36] or at the very least a food stamp program of some sort would be particularly important, due to the lack of access that many poor families now have to adequate food.

The export sector can potentially play an even bigger role in jump-starting a recovery. First, the export sector has gone from a relatively small to a sizeable part of the Argentine economy. Before the devaluation, exports of goods and services were only 11.5 percent of GDP. Now they are about 37 percent of GDP. This is not only because of the contraction of GDP, but mostly because the devaluation makes each dollar of export earnings worth (currently) about 3.6 pesos. Of course the devaluation also makes Argentine exports much more competitive.

The major constraint on an export-led recovery is credit: i.e., how much does the default and lack of an IMF agreement prevent exporters from obtaining the necessary credit? The monthly data for 2002 show that exports are beginning to respond positively to the devaluation (see Table 3). Total exports increased by 29 percent from January to May. Although some of this is due to seasonal variation, past data indicate that most of it is not. Nonetheless, there have been numerous reports in the press of exporters having trouble getting credit (see footnote 24), and of course there is no telling whether the creditors' cartel will be tightened if Argentina is not able to reach an agreement that is satisfactory to the Fund (and US Treasury). For these reasons it is very important that the central bank and government make arrangements to assist with credit for exporters. The government could work directly with private banks in major export markets (e.g. Brazil) to arrange for letters of credit and allow exports to expand more rapidly.[37]]

Table Three

Argentina, Monthly Export Data (2002)

In millions of US$

	MONTH				
	Jan	**Feb**	**March**	**April**	**May**
Exports F.O.B	**1,812**	**1,855**	**2,075**	**2,146**	**2,343**
PRIMARY PRODUCTS	**473**	**408**	**552**	**549**	**644**
MANUFACTURES - AGRICULTURAL	**559**	**497**	**539**	**647**	**708**
MANUFACTURES - INDUSTRIAL	**523**	**687**	**658**	**613**	**704**
FUELS AND ENERGY	**258**	**263**	**326**	**337**	**287**

[36] One such subsidy has been proposed by the Frente Nacional Contra la Pobreza, or FreNaPo (National Front Against Poverty), which Argentines overwhelmingly voted for in a non-binding popular consultation in December 2001 (3.1million people voted in favor of the proposal). For a full description of this proposal see: http://www.consultapop.com.ar/documentos/propuesta%20del%20frente.doc.

[37] Brazil's Central Bank recently intervened in this way. (See "Brazil will lend money to troubled companies," by Raymond Colitt, *Financial Times*, August 12, 2002).

Source: *National Institute of Statistics and Census (INDEC), Ministry of Economy, Argentina*

One of the great advantages that Argentina has over other countries confronting the creditors' cartel in such situations, in terms of recovering on its own, is that the country is running large surpluses on both its trade and current accounts. For the first quarter of 2002, the current account surplus was $1.5 billion, or 7.1 percent of GDP on an annual basis. The merchandise trade surplus is 3.75 billion dollars, or 17.8 percent of GDP on an annual basis. The current account surplus is not a result of debt default: net foreign interest payments in the first quarter of 2002 actually exceeded those of a year ago.[38]

What has happened is that imports have collapsed—for the first quarter of 2002, imports of goods and services are down 60 percent from a year ago, and even more from their level during the 1998 business cycle peak. The importance of this change cannot be over-emphasized. It means that the Argentine economy has already gone through an enormous "structural adjustment"—this is the true economic meaning of this often misused phrase—as a result of the depression. In other words, as a result of a steep and painful shrinking of the economy (which automatically reduces imports), Argentina has already accomplished the adjustment that is necessary to set the stage for sustainable and even rapid growth. Furthermore, the current account surplus is not likely to disappear any time soon, since the full effect of the devaluation—in terms of increasing exports and reducing imports—has not yet been felt.

The country is therefore capable of paying for the imports that it needs, for the foreseeable future, without any need for foreign financing. This means that the Argentine economy is ready to recover without new loans from the IMF or other international institutions.

But to make this capability a reality, the government will have to cut down on capital outflows. For the first quarter of 2002, these totaled nearly $2.7 billion. Furthermore, reserves shrank by $2.1 billion, and the latest figures (July) show central bank reserves at $9.1 billion, down from $19.6 billion in January. This loss of reserves must be drastically slowed, probably through some form of currency controls. This is another potentially important source of conflict with the IMF, since the Fund generally does not permit currency controls. Although it is not always easy to stop money from leaving the country, there is no reason for the central bank to provide dollars to all who want to convert their pesos, especially for speculative purposes. It should not be that difficult to curtail the net outflow of foreign exchange, and reserves can be kept from depleting to dangerously low levels.

As for the problem of restoring public confidence in the banking system, this is a longer-term project that is not, as the IMF has implied, a pre-condition for economic recovery. Whatever is done about the corralito, it may be some time before the public regains confidence in the banking system. But there is no reason that economic recovery should have to wait until that happens; household savings do not need to be deposited in banks in order for consumption, government spending, or even business investment, to revive.

[38] This is in spite of the official default on the public debt, because private and some public interest payments are still being made.

There is also the problem of exchange rate policy, which in Argentina is complicated by the fact that there is a large amount of informal dollarization that already exists. Unlike Brazil, for example, dollars are accepted almost everywhere, and people keep much of their savings in dollars. This adds to the risk of inflation due to currency depreciation. In other words, if people lose confidence in the peso, and move increasingly to dollars, the peso price of goods and services can rise rapidly even while their price in dollars remains stable. Over the long run, Argentina will probably want to reduce the level of informal dollarization of its economy. For now, the added risk of inflation due to the existing dollarization must be taken into account.

The IMF is also recommending a free-floating exchange rate, without any intervention by the central bank.[39] While intervention to support a falling currency often proves costly and ineffective, it would seem foolish to publicly forsake this option altogether. To do so could encourage speculation against the currency when it is falling, since people would know that there would be no intervention to support the peso. The government might also want to consider the option of deliberately causing the currency to be undervalued for a period of time, as a way of convincing people to hold pesos (as they see it rising). In either case, it would be a mistake to commit to a free-floating currency as an absolute principle.

So far, there does not seem to be any serious risk of hyperinflation. The Consumer Price Index has increased by 30.5 percent over the first 6 months of 2002. However, inflation peaked at 10.4 percent for the month of April; in May it dropped to 4.0 percent, and 3.6 percent for June. For a devaluation of the magnitude that Argentina has undergone—74 percent—this is not in excess of what would be expected.[40] Furthermore, there is little danger of a wage-price spiral that could lead to hyperinflation: real wages fell by 18 percent in the first four months of 2002. The government could minimize the danger of a wage-price spiral by focusing on job creation, rather than trying to reverse the entire wage decline brought on by the devaluation—although the decline will have to be stopped soon to avoid pushing even more of the employed work force below the poverty line. In any case, there seems to be enough room for the government to pursue expansionary fiscal and monetary policies without causing inflation to get out of control.

Of course, the feasibility of a home-grown economic recovery program is still related to international political factors. If the IMF (and the Bush Administration) were to deploy the "nuclear option"—that is, declare Argentina in default to the Fund itself and seek to cut off all sources of credit, this could potentially cause serious harm, to the extent that such a cut-off could be enforced. But this outcome does not seem likely. The government could announce that it fully intends to reach a fair settlement with its creditors, but is temporarily suspending debt payments until the economy recovers. For a country in the throes of a Great Depression, with consequent poverty and even malnutrition, this would seem reasonable to most of the world. It would be

[39] See again IMF News Brief, July 29, 2002 (at http://www.imf.org/external/np/sec/nb/2002/nb0280.htm).

[40] An important factor keeping inflation in check so far has been that privatized utility companies (electric, gas, telephone, water) have not been able to increase their rates. The same can be said for public transportation. At the time of this writing there is an all-out lobbying effort by utilities to renegotiate their contracts. If they win, there could be considerable rate increases (30-50%) resulting in a higher rate of inflation.

very difficult politically for the IMF/US Treasury to declare Argentina to be a "pariah state" and enforce a credit embargo.

The details of an economic recovery program remain to be worked out, but it is certainly feasible. Aside from meeting the most basic needs of the poor, the most important thing is to come up with a plan that revives production and consumer demand, and allows exports to grow without unnecessary constraints. An IMF agreement will probably be reached, but it cannot be assured that such an agreement will provide net new resources to the economy, or lead to increased private investment. Moreover, any new credits will almost certainly be disbursed in tranches (installments), with conditions that might hinder or even abort an economic recovery. Therefore, regardless of when IMF and US Treasury officials decide that they are ready to sign an agreement, Argentina must have a viable economic recovery plan of its own. The alternative is to leave the economy at the mercy of the IMF/US Treasury and the forces of economic contraction.

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