Nº 49

Nothing Certain but Debt and Taxes: Lessons From Argentina's Recent Debt Debacle[1]

Alan Cibils and Rubén Lo Vuolo[2]

Buenos Aires, September 2005

[1] Prepared for the Intergovernmental Group of Twenty Four

[2] Alan Cibils and Rubén Lo Vuolo are research associate and academic director at the Centro Interdisciplinario para el Estudio de Políticas Públicas (www.ciepp.org.ar), respectively.

Los trabajos realizados para la elaboración de este documento, son parte de las actividades de los proyectos: "*Distribución progresiva del ingreso y acumulación de capital: conflictos, restricciones y políticas alternativas en el contexto argentino*" (PICT 2003 Nº 2-14112) y "*Les conditions de stabilité de la croissance, L'épargne et la distribution des revenus en Argentine*" (por convenio CIEPP/CEPSEUPMF/ Institut Caisse des dépôts pour la recherche/CNP).

Abstract

This paper examines Argentina's December 2001 debt default and the explosive debt accumulation process that led up to it. The orthodox explanation of runaway fiscal spending as a reason for Argentina's debt build-up is examined and found wanting. Rather, Argentina's debt accumulation process was the direct result of: i) Washington Consensus policies promoted by the International Financial Institutions and enthusiastically implemented by local officials, and ii) a series of exogenous shocks that resulted in skyrocketing debt service payments. Argentina's debt restructuring process formally ended the default, resulting in an overall reduction of interest rates, a substantial capital reduction, and considerably longer debt maturity. However, Argentina's debt service schedule is such that it will continue to be the dominating factor in macroeconomic policy-making for many years. Furthermore, it will likely involve new debt-refinancing agreement with the IMF, which could mean renewed IMF supervision of economic policy-making, with the well known and costly results. The paper concludes with some lessons that can be drawn from the Argentine experience: 1) default can be a viable option; 2) it is easier to default on foreign borrowers than on domestic borrowers; 3) any debt restructuring process should give priority to debt sustainability based on a growing economy with a strong internal market rather than to pleasing financial markets; 4) a return to international capital markets is not a sign of success; 5) ending financial stop-and-go cycles and debt-led capital accumulation should become a priority; 6) debt restructuring should be an opportunity to make deeper changes than those made by Argentina; 7) the success of a debt restructuring process cannot depend on prolonged, large primary fiscal surpluses; 8) the IMF is incapable of predicting financial crises and lacks the tools or knowledge to deal with them once they erupt; and 9) the international financial institutions must be redesigned.

Keywords: Argentina, debt, default, debt restructuring, International Financial Institutions, IMF

Table of Contents

1. Introduction

The terms "Argentina," "debt," "crisis" and "International Monetary Fund" (IMF) have been often linked during the past three decades. Indeed, Argentina's public debt issues have been at the center of the country's macroeconomic policy-making since the mid 1970s and will very likely continue to have that place for decades to come. Argentina's recent debt-restructuring process has not changed that, leaving the country with a hefty debt service schedule for the next thirty years.

Much has been written about Argentina's most recent, spectacular crisis and default and many interpretations put forth as to why these occurred. Despite overwhelming empirical evidence to the contrary, the IMF and the financial establishment still claim that the root cause of Argentina's crisis was the public sector's inability to reduce its deficit.[3] Other explanations have included the more esoteric "debt intolerance" concept (Reinhart et al. 2003, Reinhart and Rogoff 2004), or that the default itself was the cause of Argentina's 2002 economic collapse.

We argue that none of these explanations hold up under scrutiny. Rather, the December, 2001 default and the economic crisis that followed were the logical outcome of a massive debt accumulation process which resulted from two main factors:

1. The negative effects of policy prescriptions by the international financial institutions (IFIs), particularly the IMF and the World Bank (WB), enthusiastically implemented by Argentine officials. In this sense, US-trained Argentine officials and IFI staff acted like a team in which there was a high degree of agreement on the economic policies to be implemented.
2. A series of exogenous shocks which ranged from US interest rate hikes to financial crises in Asia, Russia and, finally, Brazil. These shocks led to spiraling costs of public sector borrowing and to massive capital flight as the system unraveled.

The combination of inconsistent macroeconomic policies and exogenous shocks led to an economic collapse in December 2001 of historical proportions. While the Argentine fixed-exchange rate regime had managed to survive the Mexican and Asian financial crises, the Brazilian crisis proved too much for an economy straining under the effects of an overvalued currency. A recession set in during the last quarter of 1998 which was to become a depression. By the end of the depression in the second quarter of 2002, Argentina had lost almost 20 per cent of its GDP.

Under these conditions, and as a result of the exponential growth of Argentina's public debt, sovereign default was not only a logical consequence; it was also a necessity. Given

[3] "In our view, failures in fiscal policy constitute the root cause of the current crisis," declared Anoop Singh, IMF Director for Special Operations, in Buenos Aires on April 10, 2002, four and a half months after the default. This view is repeated by IMF officials to this day, and is a central part of the IMF's Independent Evaluation Office's report (IMF 2004).

the three year long economic recession, economic reactivation would have been uncertain and perhaps impossible in the absence of such a default. Also fundamental to economic recovery was abandoning the fixed exchange rate regime, allowing for a more realistic set of relative prices. However, the way in which the exchange rate peg was abandoned was a major reason for the ensuing crisis.

While perhaps the most spectacular, this was not the first crisis in Argentina's recent history. Since 1976, when the dictatorship implemented a series of policies that anticipated what came to be known as the Washington Consensus,[4] there have been recurrent financial crises and repeated defaults. In this sense, the stop-and-go cycles that characterized the import substitution industrialization (ISI) years (roughly, 1945-1975) were replaced by financial stop-and-go cycles. During the ISI cycles, expansionist periods frequently began with an increase in real wages, cheap credit, increased economic activity, and optimism in the industrial and commercial sectors. This stage resulted in growing budget and trade deficits (due to increased levels of government spending and imports), accelerating inflation, and growing labor unrest. The process would reach a crisis point when the central bank's reserves were exhausted and the country was unable to meet its financial commitments. Expansion would come to a halt, generally resulting in a devaluation and a new set of relative prices, plus an abrupt return to economic orthodoxy, which emphasized a balanced budget, building investor confidence, and the attraction of foreign capital (Diamand 1986:129–130).

When the ISI period came to an end, economic cycles became linked to financial and debt cycles which resulted from the Washington Consensus-inspired liberalization policies. On the upswing of the cycle, low interest rates in the North, coupled with high interest rates and stable exchange rates in the South, would typically result in large capital flows to Southern countries, as Northern fund managers sought portfolio diversification and higher rates of return.[5] Eventually, increases in Northern interest rates would turn Southern private and public indebtedness unsustainable due to the increased debt service costs, resulting in massive capital outflows and financial crises which often resulted in defaults. Since financial markets are motorized primarily by speculation, as soon as Northern interest rates would begin to drop, capital flows would resume until the next Northern interest rate increase.[6]

[4] The term Washington Consensus was first used by Williamson (1990) to indicate a package of policies promoted by the Washington-based IFIs and the US Treasury. They broadly include trade and finance liberalization, and tight fiscal and monetary policies with floating exchange rates. The terms "neoliberal," and "new orthodoxy" are also used to refer to these policies and subsequent modifications. While the "consensus" appears to be cracking, the term Washington Consensus will still be used due to its succinctness.

[5] While economic, social and political conditions in Southern countries are factors in attracting capital inflows, Calvo et al. (1993, 1996) find that capital inflows are as dependent, if not more so, on Northern financial market conditions.

[6] On financial markets and speculation, see for example Lo Vuolo (2001) and Aglietta and Aglietta and Orléan (1998). Argentina provides a clear and recent example of financial market amnesia. In the two months following the most recent debt restructuring bond swap, and with no IMF agreement in place, Argentina issued $1.5 billion in new debt, and demand for the new bonds was substantially higher than what the government was willing to supply.

External strangulation is a characteristic of both types of stop-and-go cycles. However, in the first case strangulation resulted in a shortage of foreign exchange to finance intermediate inputs and capital goods, while in the financial stop-and-go cycles, strangulation usually results in an inability to service large stocks of public and private debt. As a result, the effects upon the economy and especially income distribution were markedly different. While labor was able to roughly maintain its share of income during the ISI period, it is the very clear loser since 1976.

In this sense there was a radical change in the capital accumulation paradigm between the ISI years and the period which began in 1976. During ISI, capital accumulation was based on industrial development and a strong internal market with a strong labor participation in the share of national income. As we shall see in greater detail below, the dictatorship inaugurated a period in which public indebtedness became the axis of the capital accumulation paradigm, alongside a systematic and still growing erosion of labor's share of national income.

1.1 A brief overview of Argentina's recent debt history

The origins of Argentina's most recent debt troubles can be traced back to the mid 1970s. By that time, Argentina's import substitution industrialization (ISI) program was clearly straining under the pressure of internal and external factors. Among the external factors were the end of the Bretton Woods system and the rise of monetarism in the North. Internal factors included bottle necks inherent to the ISI model, recurrent foreign exchange shortages, a heightened struggle over the distribution of income, and political instability. In 1976, a military dictatorship took power and implemented an economic program which included partial trade liberalization and full financial liberalization. The result was the rise to prominence of financial speculation over industrial production and a sustained worsening of the distribution of income. This change paralleled similar transformations in the international system, and was to dominate the country's economic scene for the next three decades. The fundamental economic policy instrument that enabled this transformation was the accumulation of public debt.

The mid to late seventies were also characterized by high levels of international liquidity and low interest rates, making Northern banks eager to lend. This resulted in substantial capital inflows to the developing world, including Argentina. Initially, most loans were made to the private sector, facilitated by the liberalization process. The crawling-peg exchange rate regime (known as the *tablita*), implemented by the dictatorship between 1978 and 1981, allowed for substantial profits to be made by arbitraging the differential between Northern and significantly higher Argentine interest rates which resulted from capital account liberalization. Financial flows into Argentina served to deepen the process of deindustrialization which began with the dictatorship, and to establish the dominance of financial speculation over productive investment giving rise to what Grabel (1995) has labeled "speculation-led economic development."

Towards the end of the 1970s the Argentine State became an active participant in the debt market in order to finance recurrent balance of payments deficits and as a guarantor for private debt. When international interest rates increased in the early 1980s, the Argentine private and public debt situation became untenable and nearly caused the collapse of the local financial system. The "solution" implemented by Domingo Cavallo,[7] then president of the Central Bank, was for the State to take on most of the private corporate debt, resulting in a phenomenal bailout of the private corporate sector with public funds, and a doubling of the public debt (Basualdo 1987).

In this way, Argentina's public debt, which was $8 billion in 1976 when the military took power, more than quintupled to $45 billion by the time Raúl Alfonsín was elected president and civilian rule was restored in 1983.[8] Given the impact of 1982 debt crisis, when Mexico, Brazil and Argentina had to restructure their debt due to their inability to meet debt service payments, Alfonsín's initial approach was to take a tough negotiating stance with the IMF and to lobby other debtor nations in the region (mainly Brazil and Mexico) into forming a creditor's club. However, both attempts failed after a few months.

Macroeconomic instability and high inflation were constant throughout the 1980s. Several increasingly orthodox stabilization packages were implemented, but none managed to stabilize macroeconomic variables in a lasting way. Indeed, it has been argued that debt service payments were the main cause behind the endemic inflation and resulting instability of the 1980s. This was due to repeated currency devaluations aimed at improving exports and obtaining a trade a surplus to get foreign exchange to meet debt service payments. This process was complemented by increasing interest rates on new issues of public debt to finance a growing fiscal deficit. In this way, government policy contributed to a self-feeding inflationary spiral that resulted in recession, a virtual default on the foreign debt in 1988, and a hyperinflationary episode early in 1989. As a result, President Alfonsín called for elections five months ahead of schedule, and transferred power to his successor, Carlos Menem, in the midst of substantial social unrest and economic instability.

The rest of this paper is structured as follows. In the next section we provide a description of the main reasons behind Argentina's debt accumulation for the period 1990-2001. In section three we evaluate the central role played by the IMF both before and after the 2001-2002 crisis. In section four we discuss the main issues surrounding the debt restructuring process. The paper concludes with a list of lessons that can be extracted from Argentina's experience with debt and default.

2. The 1990s Convertibility Regime and the Debt: From Solution to Explosion

[7] Domingo Cavallo was later to become President Carlos Saúl Menem's Economy Minister in 1991. He was responsible for the implementation of the Convertibility Plan, that included a fixed exchange rate regime and a wide-ranging set of liberalization and privatization reforms. Cavallo was to become Economy Minister once again in 2001 and presided over the collapse of the system he had built a decade earlier.

[8] There were substantial irregularities surrounding both the contracting and use of Argentina's public debt. Loans were often contracted by third level or lower officials and much of it lacks a formal paper trail. Furthermore, it is unclear where many of the funds loaned to the dictatorship ended up. All of this was extensively documented by Alejandro Olmos and summarized in Olmos (1989).

Carlos Menem was elected president in late 1989 after campaigning on a traditional populist discourse, promising higher wages and a "productive revolution." However, as soon as he took office it became clear that his policies would be diametrically opposed to those he had promised just weeks earlier. His first economy minister was Néstor Rapanelli, a senior executive at Bunge y Born, a large Argentine business conglomerate and transnational corporation. Rapanelli was unable to control economic turbulence and high inflation. In December 1989 he was replaced by Erman González, who began implementation of a series of "market friendly" economic policies that would later be greatly expanded under the Convertibility Plan of his successor.

One of González's first acts as minister was to resume debt service payments on Argentina's public debt, which had been in a virtual state of default since 1988.[9] In addition, he implemented a series of orthodox fiscal and monetary policies which included a freely floating exchange rate, a radical reduction of fiscal spending, and the first privatization of state enterprises, such as the telecommunication and national airline companies.

Partly as a result of these policies, towards the end of 1990 there was another hyperinflationary episode, to which the government responded by implementing the "Plan Bonex", a compulsory swap of all private bank deposits for government bonds. The drastic reduction in the money supply which resulted led to a profound recession but was unable to reign in inflation. In early 1991 Menem once again replaced his economy minister with Domingo Cavallo, a Harvard-trained economist. Cavallo promptly implemented a radical stabilization and economic restructuring program known as the Convertibility Plan. The main components of this plan were: i) trade liberalization, ii) financial liberalization and equal treatment for foreign and domestic capital, iii) privatization of all State-owned enterprises, iv) a prohibition to the government from printing money unless it was backed by dollars in the Central Bank's reserves, and v) a pegging of the peso to the dollar by law on a one-to-one exchange rate.

The Convertibility Plan's main stated objective was to reign in inflation and to provide a strong anchor for expectation formation. However, the plan's objectives went much further than controlling inflation. Over the next decade it would produce a profound transformation of Argentine society and economy that would definitively dismantle what was left of the ISI State.

The success of the Convertibility Plan hinged upon attracting foreign capital inflows. Once this was achieved, it would allegedly set off a "virtuous cycle" of economic growth and general welfare improvements for the population (through its trickle down effects) which would then lead to further investment flows and so on. Solving the debt problem was seen as key to attracting foreign capital. Therefore, a "once-and-for-all solution" to the debt problem was devised, which hinged on two main components: first, privatization of state enterprises and second, a debt swap of the old loans for new "Brady" bonds (Kulfas and Schorr 2003). Official faith in such a strategy was such that Minister Cavallo claimed in 1993 that "the public debt will be insignificant by the end of the century."

[9] González committed to paying $100 million per month which, given the stock of debt and accumulated arrears, was essentially symbolic and intended to show Argentina's intention to honor its debt.

The first part of the solution to the debt problem consisted of allowing some of the state enterprises to be privatized to be purchased partly with Argentine public debt bonds. This was the case of the national telephone company, *Entel*, and the national airline, *Aerolíneas Argentinas*. This operation greatly favored holders of Argentine debt, since they were given full credit for bonds that were trading at 15-20 per cent of their nominal value on the open market.

The second component of the solution to Argentina's debt came with the Brady Agreement, signed in December 1992. According to this agreement, Argentina would swap its $21 billion debt to commercial banks plus $8.3 billion in late payments for 30-year Brady bonds, with lower interest rates and an average capital reduction of 35 per cent (Kulfas and Schorr 2003:20). The main result of this swap, as reflected in Table 1, was the atomization of Argentina's creditors from a few Northern commercial banks to hundreds of thousands or millions of bondholders around the world.

How permanent was this solution to Argentina's debt problem? The data in Table 1 show that Argentina's public debt continued to grow at an alarming rate throughout the 1990s, reaching explosive levels towards the end of the century and the much publicized default.[10] Perhaps the main result of the Brady bond swap was that Argentina was able to regain access to financial markets. However, renewed access to these markets simply enabled the debt accumulation process which eventually resulted in the largest sovereign default in history.

[10] Much has been written on the Argentine default. See for example Lo Vuolo (2003) and Cibils et al (2002).

Table 1

Evolution of Argentina's public debt stock, 1990-2001

(In millions de dollars at the end of each period)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Bonds	**8,406**	**7,378**	**11,292**	**41,926**	**47,421**	**58,341**	**68,841**	**74,054**	**78,212**	**85,804**	**93,079**	**97,315**
as % of total debt	14.60%	12.54%	19.22%	65.77%	65.68%	66.47%	70.89%	73.25%	69.61%	70.40%	72.71%	67.37%
IFIs	**8,222**	**7,962**	**7,104**	**10,501**	**11,894**	**15,384**	**16,367**	**16,790**	**19,122**	**20,311**	**21,764**	**32,362**
as % of total debt	14.28%	13.53%	12.09%	16.47%	16.47%	17.53%	16.85%	16.61%	17.02%	16.67%	17.00%	22.40%
Bilateral debt	**8,159**	**8,816**	**9,001**	**9,559**	**10,731**	**11,614**	**10,162**	**8,104**	**7,455**	**5,918**	**4,561**	**4,477**
as % of total debt	14.17%	14.98%	15.32%	15.00%	14.86%	13.23%	10.46%	8.02%	6.64%	4.86%	3.56%	3.10%
Commercial Banks	**30,944**	**32,874**	**30,265**	**1,180**	**1,567**	**1,816**	**1,452**	**1,423**	**3,646**	**5,029**	**2,461**	**2,015**
as % of total debt	53.74%	55.87%	51.52%	1.85%	2.17%	2.07%	1.50%	1.41%	3.24%	4.13%	1.92%	1.39%
Short-term debt	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**3,295**	**4,174**	**5,108**	**6,746**
Other creditors	**1,851**	**1,811**	**1,083**	**580**	**587**	**617**	**283**	**731**	**628**	**641**	**1,045**	**1,537**
TOTAL	**57,582**	**58,841**	**58,745**	**63,746**	**72,200**	**87,772**	**97,105**	**101,101**	**112,358**	**121,877**	**128,018**	**144,453**

Source: Kulfas and Schorr (2003)

What were the reasons behind this explosive debt accumulation? Perhaps the most widespread explanation given for Argentina's December 2001 debt crisis is that the country was unable to reign in its runaway fiscal spending and therefore needed to borrow increasingly large sums to both finance its deficit (since it was unable to finance it by seignorage by law) and to service its rapidly accumulating debt.

According to Anoop Singh, the IMF's Western Hemisphere Director, "failures in fiscal policy constitute the root cause of the current crisis."[11] This view continues to be voiced by high ranking IMF officials, such as First Deputy Managing Director Anne Krueger, and is mentioned repeatedly in the Fund's Independent Evaluation Office's report on the IMF's role in the Argentine crisis (IMF 2004). Many orthodox economists in Argentina and abroad and much of the business media support this view as well.

However, when examined against official data, the contention that Argentina's spiraling debt was caused by runaway fiscal spending becomes untenable. Based on available data, three main causes emerge for Argentina's 1990s debt build-up. The first was the growth in debt service due to external shocks; the second was the privatization of social security; and the third was the growth of private sector demand for foreign exchange.

2.1. External shocks

Table 2 shows the central government's revenue, spending, interest payments, and primary and overall budget deficit or surplus from 1993-2001. It is difficult to find evidence that the government's fiscal policy played a significant role in bringing about the December 2001 debt crisis. Although the government budget does move from a surplus of 2.7 billion pesos in 1993 (1.2 per cent of GDP) to a peak deficit of 8.7 billion pesos (3.2 per cent of GDP) in 2001, this worsening of the fiscal balance is not a result of increases in government spending.

[11] Press briefing, Buenos Aires, April 10, 2002 (at www.imf.org/external/np/tr/2002/tr020410.htm).

Table 2

Argentina, National Government Spending and Revenues (1993-2001)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total Revenue	**50,726.50**	**51,078.20**	**50,293.60**	**47,668.90**	**55,376.70**	**56,726.10**	**58,455.40**	**56,570.50**	**51,318.60**
Total Spending	**47,996.00**	**51,364.30**	**51,666.90**	**52,933.30**	**59,653.30**	**60,799.60**	**63,223.80**	**63,362.10**	**60,037.90**
as % of GDP	20.29%	19.95%	20.07%	19.45%	20.37%	20.34%	22.30%	22.29%	22.34%
Interest Payments	**2,914.00**	**3,150.30**	**4,083.50**	**4,607.90**	**5,745.00**	**6,660.30**	**8,223.60**	**9,656.00**	**10,174.60**
as % of GDP	1.23%	1.22%	1.58%	1.69%	1.96%	2.23%	2.90%	3.40%	3.79%
Deficit or Surplus (Rev-Spend)	**2,730.50**	**-285.9**	**-1,373.30**	**-5,264.40**	**-4,276.60**	**-4,073.50**	**-4,768.40**	**-6,791.60**	**-8,719.30**
as % of GDP	1.15%	-0.11%	-0.53%	-1.93%	-1.46%	-1.36%	-1.68%	-2.39%	-3.25%
Primary Spending (excl. interest)	**45,082.00**	**48,214.00**	**47,583.40**	**48,325.40**	**53,908.30**	**54,139.30**	**55,000.20**	**53,706.10**	**49,863.30**
as % of GDP	19.06%	18.73%	18.44%	17.76%	18.41%	18.11%	19.40%	18.90%	18.56%
Primary Surplus or Deficit	**5,644.50**	**2,864.20**	**2,710.20**	**-656.5**	**1,468.40**	**2,586.80**	**3,455.20**	**2,864.40**	**1,455.30**
as % of GDP	2.39%	1.11%	1.05%	-0.24%	0.50%	0.87%	1.22%	1.01%	0.54%

(In millions of current pesos)

Source: Economic Information, Ministry of Economy, Argentina

Rather, the country was hit with a series of exogenous interest-rate shocks 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 2. The primary balance moves from a surplus of 5.6 billion pesos in 1993 (2.4 per cent of GDP) to a surplus of 1.5 billion (0.5 per cent of GDP) in 2001. But this worsening of the primary balance was not a result of government decisions to increase spending. Primary spending was 19.1 per cent of GDP in 1993, and 18.6 per cent for 2001. Rather, Argentina got stuck in a debt spiral in which higher interest rates increased the debt and the country's risk premium. Argentina's unrestricted capital mobility and currency board system—a deadly combination—made it impossible for the country to withstand the external shocks. A recession that would become a depression began in late 1998 substantially eroding economic activity and fiscal revenues. The government's response, following IMF prescriptions, was to implement increasingly orthodox economic policies which only deepened the recession. This combination of policies and events led to ever higher interest rates and debt service payments until default became all but inevitable in December of 2001.

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." (Mussa 2002:9). Any macroeconomic policy regime that requires such a fall in nominal wages is, as a practical matter, untenable. At any rate, the issue in Argentina during the 1990s was not the nominal wage level but the real wage level in dollars. This issue disappeared after the huge devaluation that took place once the fixed exchange rate regime was abandoned.

Theoretical and political issues aside, suggesting a drop in wages as the solution to the Argentine recession shows a profound lack of knowledge of the workings of the Argentine labor market. Regardless of what the labor legislation says, in reality virtually half of all employment is informal, with no benefits and substantially lower wages than in the formal sector. In other words, the Argentine labor market has had a high degree of flexibility for almost a decade, rendering the argument of lower wages irrelevant.

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.

2.2. Social security privatization

In 1994 the Argentine government partially privatized the public pay-as-you-go social security system that had been in existence since 1967. This decision was strongly promoted and supported by the World Bank and the IMF and had a major impact on Argentina's fiscal accounts.[12] As Table 3 shows, the lost revenue, plus accumulated interest costs, amounted to nearly the entire government budget deficit in 2001.[13]

The reason social security privatization had such a substantial impact on government accounts is really quite simple and should have been easily predicted. The government lost most of the social security contribution revenues which, following privatization, were funneled to the private pension funds. However, the government's expenditures on social security remained the same, as all of the retirees on the pay-as-you-go system continued to collect their pensions from the government. In this way a substantial gap was created which, according to data in Table 3, amounted to one per cent of GDP each year between 1995 and 2001.

Table 3

The Impact of Social Security Privatization on Argentina's Budget

(percent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001
Lost Soc. Sec. Rev	-0.5	-1	-1	-1	-1	-1	-1	-1
Interest Rate	10.0%	10.0%	10.0%	10.0%	14.0%	14.0%	20.0%	20.0%
Interest Costs	-0.01	-0.1	-0.2	-0.3	-0.6	-0.86	-1.59	-2.16
Additional Deficit	-0.51	-1.1	-1.2	-1.3	-1.59	-1.86	-2.59	-3.16
Cumulative Debt	-0.51	-1.62	-2.72	-3.83	-5.35	-7.5	-10.05	-13.49

Source: Baker and Weisbrot (2002)

Because of the restrictions on deficit financing imposed by the Convertibility regime, the government's only option was to borrow to cover the gap. This resulted in a debt spiral which, coupled with the external shocks described earlier, produced an explosive debt accumulation process which collapsed in December 2001.

Ironically, the government ended up borrowing substantial amounts from the privatized pension funds, which ended up with bonds worth 16 per cent of the defaulted debt. This in turn gave the privatized funds substantial bargaining power, since the government

[12] For a detailed analysis of how Argentina's social security privatization failed and a proposal for reform, see Lo Vuolo and Goldberg (2005).
[13] See Dean Baker and Mark Weisbrot, "The Role of Social Security Privatization in Argentina's Economic Crisis," Center for Economic and Policy Research, 2002. See especially the appendix for the assumptions behind the calculations in Table 3.

needed them to participate in the debt restructuring process in order for it to have any chance of success. As a result, all talk about pension system reform has been abandoned by the current administration.

2.3. The balance of payments

A third cause for Argentina's debt build up can be found in the very nature of the convertibility regime itself, which created a growing demand for foreign exchange from both the public and private sectors. The public sector demand for foreign exchange was based on the need to keep Central Bank reserves equivalent to pesos in circulation (as per the Convertibility Law), and on the need to make debt service payments, which were primarily in foreign exchange. Private sector demand for foreign exchange resulted from a need to finance imports, which given the overvalued peso resulted in a growing trade imbalance, only reversed during the recessionary periods.[14] The private sector also showed a growing preference for the dollar over the peso, as witnessed by increasing dollar-denominated bank deposits and the dollarization of many economic transactions.[15]

Table 4

Disaggregated Balance of Payments Data, 1992-2001

(Annual averages in millons of dollars)

	1992-94	1995-99	2000-01	TOTAL 92-01
Current account	-8,908	-10,654	-6,854	-9,370
Private sector	-6,650	-6,818	-1,448	-5,694
Trade balance	-2,633	-380	5,033	27
Financial services	-913	-2,515	-2,411	-2,013
Real and other services	-3,104	-3,924	-4,070	-3,707
Public sector	-2,258	-3,836	-5,406	-3,677
Financial services	-2,141	-3,728	-5,322	-3,571
Real and other services	-117	-108	-84	-106
Capital account	11,842	13,711	2,761	10,960
Private sector	8,595	4,902	-5,309	3,968
Foreign direct investment	4,783	10,602	7,428	8,221
Portfolio and other investment	4,097	-548	-5,814	-208
Capital flight	-3,772	-9,935	-6,170	-7,333

[14] These were the result of contagion from the Mexican peso crisis (1994-1995), the Asian crisis (1997), and the Russian and Brazilian crises (1998).

[15] One of the goals of the fixed exchange rate regime was precisely to strengthen the peso. However, private sector preference for the dollar was an indication that, at least on this point, the convertibility regime had failed.

Foreign debt	3,487	4,783	-753	3,287
Public sector	3,247	8,809	8,071	6,993
Foreign debt	3,247	8,809	8,071	6,993
Balance of payments	2,934	3,056	-4,093	1,590
Private sector	1,945	-1,916	-6,758	-1,726
Public sector	989	4,973	2,665	3,316

Source: Kulfas and Schorr (2003).

As a result, throughout the 1990s both the private and public sector had negative current account balances. The only way to ensure a current account surplus was through sustained capital account surpluses. While foreign direct investment partially satisfied this need, overall it proved insufficient to meet the demand for foreign exchange (Kulfas and Schorr 2003). As a result, the foreign exchange gap was covered with both public and private debt.

Capital flight from the mid 1990s on worsened this situation, resulting in a growing private current account deficit, as shown in Table 4. The private foreign exchange deficit was covered with public sector debt. As a result, private behavior (particularly that of large business conglomerates) worked against the survival of the convertibility regime, which subsisted as long as it did thanks to continued public indebtedness.

In sum, a combination of exogenous shocks, the privatization of the social security system, and capital flight were the main issues responsible for the debt buildup of the 1990s. All of these factors were compounded by the economic recession which began in the third quarter of 1998, which was to become a full-fledged depression, and the recessionary fiscal policies which the government implemented at the behest of the IMF.

2.4. Debt intolerance?

Some have argued recently that Argentina may suffer from "debt intolerance" given that it has "serially defaulted" on its debt throughout its almost two-hundred-year history (Reinhart et al. 2003, Reinhart and Rogoff 2004). According to this perspective, the default and crisis are due to economic characteristics acquired over two centuries, and to the government's irresponsibility in borrowing beyond its level of "debt-tolerance." Damill et al. (2005) have convincingly argued against this view. The country's remote past is, for all practical purposes, irrelevant to the current situation. It is hard to argue that Argentina's financial crisis in the late 1800's had any direct bearing upon the crisis of 2001. By placing the emphasis on the remote past, proponents of this theory tend to ignore the very real policy mistakes of the 1990s that had a direct bearing on debt accumulation and the subsequent default.

Be that as it may, it is interesting that financial markets completely ignored the notion of debt intolerance in Argentina's case, lending far beyond the level that Reinhart et al. (2003) suggest. Furthermore, the IMF itself ignored this, as witnessed by its almost $10 billion loan to Argentina just three months before the collapse. Given Argentina's post-default success with new debt issues, and given that the country's debt-to-GDP ratio is currently greater than 80%, it would appear that financial markets still don't care about debt intolerance.

3. The Role of the IMF

Following the Argentine financial crisis, the IMF went to considerable lengths to try to distance itself from any responsibility for the Argentine catastrophe, claiming that what happened was purely the responsibility of Argentine officials.[16] However, the IMF had substantial participation in Argentina's macroeconomic policy formulation, before, during and after the crisis and is therefore partially responsible for the collapse.

First, as the IMF's Independent Evaluation Office (IEO) report clearly states, the Fund was a staunch supporter of Argentina's policy reforms during the 1990s, including the privatization of social security which caused substantial fiscal problems as described above. Support went beyond mere words, as privatization was included as a condition in several of the IMF agreements of the 1990s. Furthermore, the IMF's invitation to President Carlos Menem to address the Joint Annual Meetings of the Board of Governors of the IMF and the World Bank Group in October 1998 was a clear signal of the IMF's support for and approval of the economic policies implemented in Argentina during the 1990s.[17]

Second, when the depression began in late 1998, the IMF demanded a series of fiscal spending cuts in order to bring the fiscal deficit under control. As we pointed out above, the deficit was not due to increased fiscal spending, but to debt service payments that spiraled out of control as a result of to exogenous shocks. Fiscal spending cuts, implemented repeatedly at the IMF's behest, acted in an entirely pro-cyclical manner, deepening the crisis until the system exploded. How did this cycle operate? Spending cuts resulted in a drop in economic activity, which, given Argentina's tax structure resulted in drops in fiscal revenue and increased the fiscal deficit. At this point further fiscal spending cuts were implemented, and so on and so forth.

Third, the IMF tripled its exposure to Argentina (from $5 billion to $15 billion) just four months before the default. This was enough to buy sufficient time for those vying to take their capital outside the country, deepening the capital flight process which was already taking place and that eventually resulted in the run on deposits of early December 2001.

However, the IMF's active participation in the Argentine catastrophe does not end with the December 2001 default. Following the crisis, the IMF committed very substantial errors in diagnostics, projections, and policy prescriptions, all clearly laid out in an unprecedented official document (Ministerio de Economía y Producción 2004).

[16] The prime example of this is the IMF (2004) Independent Evaluation Office report.
[17] Menem's speech at the IMF can still be downloaded from the IMF's website: http://www.imf.org/external/am/1998/speeches/pr05e.pdf.

Among the substantial projection errors committed by the IMF, the official document mentions:

- IMF economists ignored first, and then refused to accept, clear and substantial empirical evidence presented to them in June 2002. The data showed that economic activity had bottomed out and that there were strong signs of economic reactivation starting in the second quarter of that year. Based on these indications, Argentine authorities projected an 11 per cent drop in GDP for 2002. However, as late as September 2002, IMF technical staff were projecting a GDP contraction of 16-20 per cent. (Actual GDP growth data for 2002 was -10.9 per cent, proving that the IMF's projection was considerably off the mark).
- Despite the IMF's projections of a substantial drop in GDP, they also projected a real exchange rate appreciation. This was to be due to real and nominal exchange rate "overshooting", which the IMF staff believed was substantial due to the chaotic way in which the fixed exchange rate regime was abandoned. As a result of this belief, a real exchange rate appreciation would be imminent. Basically, the IMF staff believed that relative prices would continue to be very close to what they were during the fixed exchange rate regime. In contrast, Argentine officials believed that due to the prolonged recession and the abrupt interruption of capital flows, the equilibrium real exchange rate would be substantially depreciated compared to the convertibility real exchange rate. Once again, Argentine officials were right.

According to the official document, the IMF showed very little support for Argentine official policy initiatives which, as we have shown, were based on a more accurate reading of the economy than the IMF's. As a result, the IMF's policy prescription errors were also substantial:

- In February of 2002, after the fixed exchange rate was abandoned, the IMF insisted on a totally free floating exchange rate regime which Argentine authorities implemented, against their better judgment. The IMF's arguments were that the foreign exchange market would automatically reach its new equilibrium. Just as the Argentine authorities feared would happen, the price of the dollar shot up due to a speculative bubble that appeared to have no ceiling. The price of the dollar stabilized when the Argentine authorities implemented a "dirty float" in April of that year. The IMF rejected the dirty float exchange rate regime adopted by Argentine authorities demanding, in June 2002, that the exchange rate be allowed to float freely.[18] The IMF argued that the Central Bank's international reserves did not actually belong to the country and could therefore not be freely utilized!
- The IMF also opposed the Argentine government's decision to make the swap of frozen bank deposits for bonds optional (the swap was required to normalize the banking system). Instead, the IMF wanted to make the swap compulsory, showing a complete disregard for the highly volatile social and political situation in Argentina during 2002. A compulsory swap would have likely caused more social upheavals at a time when stabilizing policies were badly needed.

[18] This continues to be an IMF demand.

- For the financial system, the IMF recommended the same shock treatment that had failed in Indonesia following the 1997 Asian crisis. The IMF's strategy consisted of a drastic reduction of the number of financial institutions, seeking an accelerated purge of the banking system by closing down banks not deemed viable. The government preferred a gradualist approach, pointing out that the number of banks had dropped considerably since the 1995 Tequila crisis, and that, in time, those financial institutions that were not viable would close on their own.

- As is the norm, the IMF continued to demand fiscal spending cuts following the December 2001 crisis. This demand showed profound ignorance of Argentina's post-crisis reality, since Argentine officials had already implemented the most radical adjustment to fiscal spending in many decades. Furthermore, the default on much of the public debt meant that Argentina would run a primary and overall surplus for the first time in many decades.

In addition, the IMF went considerably beyond its mandate, making recommendations that had nothing to do with Fund's areas of expertise or purview. For example, in the months following the crisis the IMF demanded that Argentina change its bankruptcy law to remove protections for firms filing for bankruptcy and to provide better conditions for creditors. The IMF also demanded the repeal of the "economic subversion" law under which the government could investigate white collar crimes committed by firms, banks, or individuals. At the time, the law was being used to investigate capital flight that had violated banking restrictions implemented during the crisis. Both laws were modified according to the IMF's demands.[19] Finally, the IMF also insisted, and continues to do so, that privatized utilities be allowed to increase fees as desired. These fees had been frozen in the post-crisis months pending contract renegotiations with the privatized utilities, due to systematic and blatant contract violations. Despite the fact that many of these renegotiations are still pending, utility rates have been steadily increasing for the last two years.

The IMF cannot continue to deny its co-responsibility for the Argentine crisis. The Fund actively participated in the design of the macroeconomic policy environment that resulted in the December 2001 collapse. Furthermore, its prescriptions went well beyond economic policy, demanding changes in the legal system unrelated to the issues that the IMF is supposed to address. As a result of the IMF's considerable blunders, Argentine authorities concluded that "the IMF's technical staff appears not to be totally up to the task of dealing with a situation where a large crisis has erupted and should, therefore, give local authorities a greater margin to formulate and implement economic policies necessary to deal with the crisis" (Ministerio de Economía y Producción 2004:10, our translation).

[19] When a country signs an agreement with the IMF it gives up part of its sovereignty with regards to economic policy making since it is the IMF that imposes its conditions and policies in exchange for a loan. However, the IMF also managed to override Argentina's political sovereignty by demanding policies and changes in the legal framework that had nothing to do with the Fund's chartered mandate.

4. The economic costs of default

Some have argued that Argentina's default was too costly, stating that the dramatic drop in GDP in 2002 was a direct consequence of that default.[20] However, Argentina's sovereign debt default provides arguments for a powerful refutation of the conventional wisdom regarding the costs of default. The consensus among orthodox economists and experts in international finance was that Argentina would suffer severe long-term consequences for breaking the rules in such a spectacular way: a huge sovereign default, combined with what was widely denounced in the business press as a refusal to bargain with creditors, and a contentious relationship with the IMF. But the result has been quite the opposite.

Before considering the costs of default, it is useful to spell out the sequence of events in order to better understand the issues. First, Argentina was in an economic depression which had begun in the last quarter of 1998. As a result of the depression, it became increasingly difficult to balance fiscal accounts, a problem that was solved by taking on new debt. It became increasingly clear that the convertibility regime was no longer viable and that it could only keep going as long as foreign capital was available. Second, the abrupt end of foreign credit in late 2001 resulted in the much publicized default and sealed the fate of the convertibility regime. Third, exit from the convertibility regime in early 2002 was unplanned and disorderly. The currency was first fixed at a higher value vis-à-vis the dollar and eventually allowed to float freely, causing substantial dislocation in the economy. When, contrary to IMF prescriptions, a managed float was adopted for the exchange rate in late April 2002, the economy began to emerge from the crisis.

Given the sequence of events, it should be clear that the deepening of the crisis in 2002 was far more due to the chaotic exit from the convertibility regime than to the default. However, even if one insisted on blaming the crisis on the default, a convincing argument can still be made that defaulting was the least costly option available. Over the three months following the December 2001 default, the economy continued to decline, losing about 6.3 per cent of GDP. And that is really an upper bound for the cost of the default, because it is almost certain that, even if the best of all possible non-default solutions had been brokered, there would have been further decline in GDP before the economy recovered. In reality, the cost of Argentina's default was almost certainly less than zero, since any non-default solution reached at that time would most likely have cost the country more, in terms of continued lost output, than did the default.

Within a few months of the default, economic recovery was well under way, and there was positive growth for the last three quarters of 2002. The Argentine economy grew by 8.8 per cent in 2003 and 9 per cent in 2004, and in 2005 it is projected to grow by 7-8 per cent. So if we look at it from the perspective of "shock therapy" -- a harsh adjustment

[20] The costs of default go considerably beyond the purely economic. It is well known that unemployment, poverty and indigence rates reached record levels in 2002. However, here too one must consider what would have been the costs had there not been a default and the depression continued for a few more quarters. We do not have the counterfactual, but it is hard to believe that the latter option would have had lower social costs.

necessary to get the economy back on a sustainable growth path -- the post-default adjustment was very successful, and brought quick results. It is difficult to avoid the conclusion that default was the right choice for Argentina. Furthermore, the country's economic recovery did not depend on the good graces of international financial markets. Official creditors were not necessary--and neither was their capital.

In fact, even taking the worst estimate of the cost of default, 6.3 per cent of GDP, it is practically equal to Mexico's loss from the 1995 peso crisis (6.2 per cent of GDP), where Mexico was assisted with a $40 billion IMF package. It is substantially less than the cost of adjustment during the Asian economic crisis, where Indonesia lost more than 13 per cent of GDP. It is important to remember that the Argentine government received absolutely no outside assistance during the entire crisis. Quite the opposite, in fact: there was a very large net drain of money out of Argentina to multilateral creditors. In 2002, as poverty and unemployment reached record levels and as the recovery was just getting under way, the country made net payments totaling $4.1 billion dollars, or more than four per cent of GDP, to the multi-lateral creditors. For 2003-2004, there were further net payments of 5.9 billion. From a purely economic point of view, the default seems unquestionably a success. Most importantly, the economy was able to get back on a solid growth path, something that could have taken much longer if it had retained its crushing debt burden.

It is hard to imagine that Argentina would have done better by trying to please the Fund and other creditors. The previous four years of depression, as well as the demands put forward by the IMF in its protracted negotiations with Argentina during 2002, indicate that continued stagnation and even further decline were likely possibilities if the country had pursued tighter monetary and fiscal policies. The acceptance of an unsustainable debt burden would also have undermined the confidence of foreign investors. And some of the IMF's other demands -- e.g. regarding higher utility rates and mortgage foreclosures -- were so unpopular that they could easily have caused political unrest and instability as well.

5. Debt restructuring: did it solve the debt problem?

In early 2003 it became clear that Argentina was emerging from its political and economic crisis. As a result, the IMF and defaulted creditors substantially increased their pressure on Argentina for a solution to the $100 billion defaulted debt.

5.1. Leaving the default behind: From Dubai to Buenos Aires

The process to emerge from default began in September 2003, when Argentina issued a set of conditions to creditors under which it was willing to restructure its debt.[21] These included a 75 per cent capital reduction or "haircut", considerably lower interest rates,

[21] The restructuring conditions and other official debt-related information and data can be found at: http://www.argentinedebtinfo.gov.ar/.

much longer maturities, and no recognition of interest payments accrued since the default. Creditors were outspokenly opposed to these restructuring conditions and demanded a higher offer. One of the more outspoken groups, the Global Committee of Argentine Bond-holders (GCAB), teamed up with the IMF to pressure Argentina for a better deal for private creditors.

IMF and creditor pressure resulted in a new offer on June 1st, 2004. Known as the "Buenos Aires proposal," the new offer represented a 100 per cent improvement for defaulted creditors over the Dubai guidelines: interest rates were doubled and the haircut was reduced from 75 per cent to roughly 45 per cent. The Buenos Aires offer was still not accepted by the IMF or the creditors, but the Argentine government stated that the offer was final because the resulting debt service load was the maximum the country could afford to pay based on realistic sustainability assumptions. The debt restructuring proceeded even if, for the first time in the history of modern defaults, it did not have the explicit support of the IMF.

The debt-swap process ended on 25 February, 2005, with a 76.15 per cent acceptance rate. The Argentine government actively promoted this result as a success and declared the default to be definitively over. This was no small accomplishment and did indeed have several important aspects:

1. The deal implicitly recognized the impossibility of servicing the pre-default debt under the terms it was issued;
2. Argentina resisted substantial pressure from the IMF and the financial establishment to improve the offer;
3. The new bonds issued as a result of the debt restructuring were for a lower amount and at lower interest rates, therefore improving Argentina's debt service terms over those existing prior to default;
4. The default was finally resolved after three years of indefinition.

5.2. A solution for how long?

The government presented the debt restructuring swap results as a resounding success. The IMF and creditors owning 24 per cent of the defaulted debt that did not participate in the debt restructuring swap, referred to as the "holdouts", claim that the default is not yet fully resolved. While this is problematic, there are other fundamental problems that Argentina's post debt-swap situation leaves unsolved.

5.2.1. Financial results of the debt restructuring swap

According to the government, Argentina finally had a debt service schedule that it could manage thanks to an historic capital reduction. A dispassionate look at the post-debt swap numbers, however, reveals more uncertainties than the official story admits:

- Of the $81 billion in defaulted debt, $62.318 billion or 76.15 per cent entered the debt swap. Holders of roughly $19 billion did not accept the terms and conditions of the swap and remain as holdouts.[22]
- For the $62.318 billion that entered the swap the Argentine government will issue $35.261 billion in new bonds. That is, the "haircut" or reduction on the nominal value of the defaulted bonds was 43.4 per cent.
- The maturity of the new bonds is considerably longer than the old bonds and the interest rates are considerably lower.
- The currency structure of the new debt also changed considerably. A full 37 per cent of the total stock of post-swap debt is now denominated in pesos. However, the rate of return on these bonds is tied to inflation, making them by far the most profitable investment in the Argentine public debt bond pool.
- The debt to GDP ratio went from 113 per cent at the time of default in December 2001, to 72 per cent after the default. However, this does not take into account the $19 billion which did not enter the debt-restructuring. Therefore, total debt-to-GDP ratio is actually 87 per cent when one takes holdout debt into account.

Even though the capital reduction was considerably less than the 75 per cent proclaimed by the government, one can still consider the debt restructuring to be a success, particularly given the lack of support of the IMF and the G7. Several factors made this result possible. On the international front, low interest rates and a lack of good investment options, the growing lack of credibility of the IMF both within and outside the institution, and a generalized belief that the Argentine fixed exchange rate regime had run its course were all key. Other important factors were the lack of alternatives for private creditors vis-à-vis the Argentine government debt restructuring offer. A sign of this lack of alternatives was the relatively high acceptance rate even in the face of a substantial capital reduction.

As we discuss below, despite this relatively favorable financial result, Argentina's debt burden and resulting fiscal revenue effort required to service this debt represent a formidable challenge for many years to come.

5.2.2. Acceptance of all pre-default debt as valid

Perhaps one of the most troubling aspects of the Argentine government's approach to debt restructuring is that it unquestioningly accepted all pre-default debt as valid. In this way the official strategy ignored not only the substantial irregularities committed when contracting the debt mentioned above, but also validated the financial speculation cycles and scams of the post 1990 era. The cycles typically consist of a period of growing private and public indebtedness, followed by capital flight and eventually the "socialization" of private debt (i.e. the transformation of private debt into public debt) as the financial crisis erupts. The cycle is compounded by repeated debt restructuring episodes which turned out to be major scams in which the financial and corporate sectors

[22] If one adds interest payments due since the default, holdout debt becomes roughly $24 billion.

typically benefit heftily from overpriced bonds, and the public sector, i.e. the taxpayers, are repeatedly and cumulatively saddled with the costs of financial speculation.

Critics have rightfully argued that the government should have used the opportunity provided by the default to do an in depth examination and depuration of the stock of public debt. However, the Argentine government's strategy was to accept all inherited debt as valid. For the government, the main issue was to restructure defaulted debt in such a way as to minimize damage to the local financial system and transfer the debt service load as far as possible into the future.

5.2.3. IFI debt unquestioned

Equally troubling is the treatment of IFI debt. The Argentine government's position has been to fully honor the approximately $32 billion debt to the IFIs (at the time of the debt swap) without even seeking more favorable conditions and a longer repayment timeline. The justification for the official position on IFI debt was that they needed G7 support for the debt swap to be successful. In this view, to challenge the validity of IFI debt would be too costly and could possibly threaten the success of the debt restructuring effort.

As time has shown, this was a questionable strategy. The IMF and the World Bank bear substantial blame for the Argentine crisis: both institutions promoted, and then supported with billions of dollars in loans, mistaken policy prescriptions including the privatization of social security. IFI blunders have been extensively publicized in official documents and speeches. It is therefore contradictory to criticize these institutions while making substantial net transfers to them and accepting all IFI debt as valid.

Contradictions aside, it is clear that the official strategy failed, since the IMF, and the G7, never did back the Argentine debt restructuring process. Furthermore, the IMF inexplicably delayed approval of Argentina's Article IV consultation in August 2004, in spite of Argentina's over compliance with the agreement's quantitative goals. Faced with the IMF's intransigence, the Argentine government decided to "suspend" the agreement until the debt-swap concluded, but at the same time to pay off the IMF (and other IFIs), in full and on schedule. In other words, not only will the IFIs not pay for their considerable mistakes, but, for the time being, they will be paid the full amount of what is owed to them on schedule!

In reality, the IFI debt chapter has not yet been fully written. IFI debt service represents a heavy load in the next three years, and certainly dampens the prospects of Argentine debt service sustainability. Official sustainability projections were all based on an agreement with the IMF which provided for the roll-over of 100 percent of IFI capital payments. Should officials decide to pursue IMF debt refinancing, it would give the Fund undue power over Argentine policy decisions. Fund conditionality could have substantial negative effects on Argentina's future economic performance, as recent history has shown. Furthermore, the IMF's dissatisfaction with the debt-swap acceptance rate has already resulted in substantial pressure, which will undoubtedly continue, on behalf of the holdouts.

In sum, the official strategy on IFI debt implied: i) a larger capital reduction on private creditors; ii) preferential treatment to those who bear substantial responsibility for the

Argentine catastrophe; iii) larger fiscal surpluses (or new indebtedness) in order to face IFI debt service; iv) the possibility of continued IMF supervision should a refinancing agreement be reached, or endangering debt service sustainability due to IFI payments; and v) the possibility of having to negotiate with the IMF under less favorable conditions should Argentina be unable to meet IFI debt service commitments in the future..

5.2.4. Post-default debt fully recognized

Another questionable aspect of the official debt-restructuring strategy refers to the roughly $35 billion public debt issued in the months following the default and devaluation. As a result of the devaluation, the financial system entered a new crisis as many bank customers had dollar-denominated loans. In order to avoid massive bankruptcies, the government converted all loans to pesos at the old rate of one peso to one dollar, and issued bonds to the banks for the difference with the actual nominal exchange rate. In the process, the government bailed out countless large corporations, many of which produce mostly for export markets and make dollars in exchange—corporations that were in no risk of bankruptcy due to the devaluation. (In reality, most of these corporations did very well with the devaluation since their products became a lot more price-competitive internationally overnight).

However, most of this new debt is owned by the local financial system, which explains why the official strategy was to accept all debt as legitimate and to continue to make payments on this debt as originally contracted. At the very least the beneficiaries of this new debt issue should have been identified, and a tax levied against those who benefited unduly. This was not done and, as a result, the Argentine taxpayer and defaulted creditors must pay for this unnecessary corporate bailout.

5.3. Debt and taxes: continued certainty

How much of a solution to Argentina’s decade-long debt problem does this latest debt swap represent? Many issues factor into the answer to this question. Clearly, much depends on the debt service structure in the years ahead, and on other factors such as macroeconomic performance and economic growth, fiscal revenue, the exchange and inflation rates, foreign exchange availability, etc.

Table 5

Argentina Debt Service Schedule, 2006-2015

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Interest payments	**3,153**	**2,645**	**2,226**	**2,224**	**2,029**	**1,805**	**1,580**	**1,433**	**1,968**	**1,899**
IFIs	1,170	759	480	378	309	253	206	166	133	103
Rest (bonds and loans)	1,983	1,886	1,746	1,846	1,720	1,552	1,374	1,267	1,835	1,796
Capital Payments	**15,147**	**11,308**	**6,606**	**8,109**	**6,154**	**6,281**	**4,670**	**2,539**	**2,516**	**2,185**
IFIs	7,591	6,673	2,367	1,467	1,285	1,082	927	749	659	596
Rest (bonds and loans)	7,556	4,635	4,239	6,642	4,869	5,199	3,743	1,790	1,857	1,589
Total (capital + interest)	**18,300**	**13,953**	**8,832**	**10,333**	**8,183**	**8,086**	**6,250**	**3,972**	**4,484**	**4,084**
as % of GDP	9.45%	6.87%	4.07%	4.47%	3.33%	3.11%	2.28%	1.38%	1.48%	1.31%
Assumptions:										
GDP USD	193,568	203,130	217,162	231,037	245,738	260,077	273,929	288,405	303,075	312,167
GDP Growth rate	3.6%	3.4%	3.3%	3.3%	3.3%	3.3%	3.3%	3.2%	3.0%	3.0%
No payments on "holdout" debt										

(In millions of dollars)

Source: Economy Minstry data and authors' calculations

Table 5 contains a schedule of Argentina's debt service obligations for the period 2006-20115. Debt service data presented in Table 5 assumes that, for the time being, no agreement is reached with the holdouts and that no payments are made on that debt. It is also assumed that no agreement is reached with the IMF, which means that Argentina's debt to the IFIs is not refinanced.[23] As a result, capital and interest payments are made on schedule and in full, which is precisely what the Argentine government is currently doing. Argentina's relationship with the IMF continues to be tense and there is no guarantee that an agreement will be reached in the short term. In addition to the usual monetary and inflation targets, the IMF continues to make demands regarding holdouts, privatized utility companies, privatization of public banks, the elimination of export taxes, and substantially higher primary surpluses. While the Argentine government has actually complied with some of these demands (utility rate hikes, higher surplus), they reject other Fund's demands as inapplicable, emphasizing the IMF's major blunders in Argentina in recent years. As a result, it is quite likely that Argentina will try very hard to avoid coming under the direction of Fund economists for the foreseeable future.

That said, several conclusions can be drawn from the data presented in Table 5:

1. Argentina's debt service obligations through 2011 exceed three per cent of GDP, assuming positive yearly growth rates greater than three per cent for the entire period. Furthermore, through 2009 Argentina's debt service obligations exceed four per cent of GDP per year. In the absence of an agreement with the IMF, this means that the government will have to issue new debt in order to meet its debt service payments. New debt issues will result in heftier debt service payments in short- and medium-run, which means that the situation could be considerably worse than what Table 5 shows.
2. Argentina's debt service schedule, augmented by new debt issues, implies that the government will need to have sustained and substantial primary fiscal surpluses for many years to come. This means that public funds, provided by taxpayers, will be siphoned out of the economy and away from badly needed social programs and investment and towards debt service.
3. Assumptions behind the debt service schedule are quite optimistic. For instance, it is assumed that the economy will grow at a steady rate of three per cent for decades. While it is true that the Argentine economy has grown at remarkable rates in 2003 and 2004, and is expected to do quite well again in 2005, assuming that the economy will grow steadily and indefinitely means that Argentina has somehow become immune to economic cycles inherent to market economies. Indeed, such an assumption would also imply that Argentina has broken with its own long history of economic cycles and volatility. Should a recession hit, due to internal or external

[23] Some of the capital payments due to the IMF can be postponed for one year if the Fund's board gives its approval. This is the difference between the "expectation basis" and "obligation basis" schedules on the Fund's web site. The data presented here assumes that payments are made according to the expectation basis schedule.

shocks, Argentina's debt sustainability would be at risk. Debt sustainability also assumes that Argentina will be able to issue new debt, at reasonable interest rates and maturities, in order to finance current debt service. As recent history has shown all too dramatically, external funds are not always available. Furthermore, capital inflows often depend on factors entirely outside the control of local policy makers, and are generally motivated by short-term speculative behavior.

4. Many legitimately ask whether Argentina's current growth performance is due to not being hobbled by an IMF agreement. For example, the stimulus provided by the current exchange rate policy is substantial. It is well known that the IMF does not approve of this policy. If an agreement is signed and a free float adopted, will Argentina be able to sustain the positive growth rates it needs to meet debt service?
5. Perhaps the overriding conclusion is that, in the best case scenario, for the next 30 years debt service will continue to be a dominating factor of Argentina's economic, social, and political life.

It is hard to conclude whether Argentina has finally left its stop-and-go financial cycles of debt accumulation, crises and restructuring behind. However, it is quite clear that the official debt-restructuring strategy does not represent a definitive solution to the debt issue, and that another crisis is not unthinkable should the optimistic assumptions not materialize.

Furthermore, Argentina is still suffering from the effects of decades of Washington Consensus policies. Even though social indicators are very slowly improving, unemployment is still at 15.8 per cent, 40 per cent of the population lives below the poverty line, and 13 per cent of the population is indigent. Still, the Kirchner administration appears unwilling to reform the social security system to remedy the fiscal and coverage distortions caused by privatization. Tax reform is also off the agenda, thus perpetuating a highly regressive system in which the poor make a disproportionate contribution to servicing a public debt load that benefited them little or nothing. Despite its rhetoric,[24] the Kirchner administration has clearly prioritized debt service over income distribution, employment generation, and a sustainable development strategy based on a strong internal market.

6. Lessons from the Argentine case

Argentina's experience with debt and financial crises over the last decade provides important lessons.

1. **Default can be a viable option:** Clearly default is not something to be taken lightly, but it has been and will likely continue to be an option for sovereign borrowers. The

[24] In his inaugural speech on 25 May 2003, Kirchner said: "No se puede volver a pagar deuda a costa del hambre y la exclusión de los argentinos, (aplausos), generando más pobreza y aumentando la conflictividad social." (We cannot go back to paying the debt at the expense of the hunger and exclusion of the Argentine people, generating poverty and increasing social conflict).

Argentine case shows that defaulting was not as disastrous as many had predicted. Indeed, the default helped Argentina to end the unviable fixed exchange rate regime and it freed up resources to deal with the multiple dislocations produced by the structural changes that resulted from the devaluation. Whether the time and resources were put to their best use in Argentina is a different matter, but it is unquestionable that the default was the correct and most efficient option, given the circumstances. As a corollary, public debt should be subject to strict scrutiny and rules, to avoid excessive indebtedness and financial cycles and crises which are costly and undesirable. It is therefore of fundamental importance that the process by which a country takes on new debt be scrutinized by its representative institutions, such as its congress or parliament, and that new debt be subject to extensive sustainability analysis.

2. **It is easier to default on foreign borrowers than on domestic borrowers:** It is clear from the way the privatized pension funds, the banks and the corporate sectors were bailed out that it is much easier to default on foreign bondholders than on domestic bondholders and powerful economic actors. The reason for this should be clear. The main consequence of a default on foreign borrowers is political and perhaps financial. Defaulting on domestic borrowers would almost certainly have substantial economic repercussions in addition to political and financial consequences.
3. **Any debt restructuring process should give priority to debt sustainability based on a growing economy with a strong internal market rather than to pleasing financial markets:** For a debt restructuring process to result in a sustainable and serviceable debt load in the long run it must be based on an economy that grows thanks to a strong internal market. For this to take place it is fundamental to have productive investment and an equitable distribution of income. This is opposite to the Washington Consensus prescriptions, centered on fiscal austerity, financial liberalization and the free flow of speculative funds. These are precisely the kinds of policies that feed the financial stop-and-go cycles that have characterized Argentina's recent history. The results are well known: unsustainable debt loads, financial crises, defaults, and record levels of poverty and unemployment.
4. **A return to international capital markets is not a sign of success:** A return to capital markets should not be taken as a sign of financial health. It is not a good sign when debt sustainability relies too heavily on renewed access to international capital markets. This indicates that debt-dependence hasn't been fully broken, maintaining the country's vulnerability to the financial stop and-go cycles. Rather, sustained, egalitarian growth should be the objective.
5. **Ending financial stop-and-go cycles and debt-led capital accumulation should become a priority:** Argentina is a prime example of the failure of financial liberalization and "debt-led" development policies. Since dependence on foreign indebtedness does not lead to sustainable development, it is of prime importance to abandon these policies in favor of economic policies that promote sustainable and egalitarian growth.

6. **Debt restructuring should be an opportunity to make deeper changes than those made by Argentina:** Given what we have described above, Argentina misused a golden opportunity to get on a track of growth with equity. By approaching the debt issue exclusively in financial terms, the country ended up with a debt service schedule that substantially reduces policy degrees of freedom to undo the nefarious legacy of decades of Washington Consensus-type policies. Furthermore, Argentina also wasted an opportunity to examine its debt accumulation process and to make sure those who benefited unduly were taxed accordingly. Issues like these could have been addressed in a manner that ensured a fairer distribution of the burden of debt service.

7. **The success of a debt restructuring process cannot depend on prolonged, large primary fiscal surpluses:** In the Argentine case, the success of the debt restructuring process depends on high primary fiscal surpluses for a prolonged period of time. This strategy is highly questionable and its chances of success are dubious. First, a large primary surplus drains resources from the economy for debt service. These resources could be used to foster investment and job creation, and to contribute to a more equal distribution of income. Second, market economies are subject to economic cycles, and Argentina is certainly no exception. To assume that an economy will indefinitely have positive growth and primary surpluses is unrealistic. Unfortunately, this is precisely the assumption made in the government's sustainability analysis.

8. **The IMF is incapable of predicting financial crises and lacks the tools or knowledge to deal with the crisis once it erupts:** If there is a lesson that stands out from the Argentine experience it is that the IMF does not possess the know-how or the appropriate theoretical framework to forecast or effectively deal with financial crises. Despite the IMF's refusal to admit this, its "one size fits all" approach to economic policy and crisis resolution has failed repeatedly around the world. Furthermore, the Fund's policies do not result in sustained growth or economic development, as Argentina knows all too painfully after decades of sustained Washington Consensus policies. Deindustrialization, increased income inequality and poverty and persistent, high unemployment are indeed hallmarks of IMF policies. Therefore, if sustained growth is a policy objective, the IMF's advice should be ignored. Asian countries have learned this lesson well, as witnessed by their massive foreign reserve accumulation as insurance against ever having to follow IMF advice again. While reserve accumulation can be costly, it is bound to be less costly than following the IMF's advice.

9. **The international financial institutions must be redesigned:** The IMF's substantial mishandling of the Argentine (and other) financial crises clearly points to a need for institutional redesign. The Fund and World Bank's grossly mistaken policy prescriptions point in the same direction. It is clearly desirable to redesign the IFIs in such a way as to create a true international lender of last resort. Additionally, IFIs should be accountable for the policies they prescribe and the results they produce.

History will tell if the lessons from the Argentine debt debacle will help to modify the current the process of international economic integration and especially the development policies of peripheral countries. If debt default is simply used as a short-cut to return to the liberalized international capital markets, then clearly not much will have been learned. Rather, the task ahead should be to define a development strategy that leaves behind the model of spasmodic debt-accumulation cycles.

References

Aglietta M. and Orléan A., eds. (1998*). La Monnaie Souveraine*. Paris: Editions Odile Jacob

Baker D. and Weisbrot M. (2002). The Role of Social Security Privatization in Argentina's Economic Crisis. Washington, DC: Center for Economic and Policy Research.

Basualdo E. (1987). *Deuda externa y poder económico en la Argentina*. Buenos Aires, Nueva América.

Basualdo E. and Kulfas M. (2000). La fuga de capitales y endeudamiento externo en la Argentina. *Realidad Económica* 173.

Calvo G., Leiderman L., and Reinhart C. (1993). Capital inflows and real exchange rate appreciation in Latin America. *IMF Staff Papers* 40(1), 108–151.

Calvo G., Leiderman L., and Reinhart C. (1996). Inflows of capital to developing countries in the 1990s. *Journal of Economic Perspectives* 10(2), 123–139.

Cibils A., Weisbrot M. and Kar D. (2002). La Argentina desde la cesación de pagos: El FMI y la depresión. *Realidad Económica* 192: 60-86.

Damill M., Frenkel R., and Rapetti M. (2005). La deuda argentina: Historia, default y reestructuración. Buenos Aires, CEDES.

Diamand M. (1986). Overcoming Argentina's stop-and-go cycles. In Jonathan Hartlyn and Samuel A. Morley, eds., *Latin American Political Economy: Financial*

Crisis and Political Change. Boulder, CO: Westview Press.

Grabel I. (1695). Speculation-Led Economic Development: A Post-Keynesian Interpretation of Financial Liberalization Programmes in the Third World. *International Review of Applied Economics*, 9(2): 127-149.

IMF (2004). Report on the Evaluation of the Role of the IMF in Argentina, 1991–2001. Washington, DC: Independent Evaluation Office.

Kulfas M. and Schorr M. (2003).*La deuda externa argentina. Diagnóstico y lineamientos propositivos para su reestructuración.* Buenos Aires, CIEPP-Fundación OSDE.

Lo Vuolo R. (2001). *Alternativas: La economía como cuestión social.* Buenos Aires: Grupo Editor Altamira.

Lo Vuolo R. (2003). *Estrategia económica para la Argentina: Propuestas*. Buenos Aires, Siglo XXI-CIEPP-Fundación OSDE.

Lo Vuolo R. (2005). Canje de deuda y salida del default en Argentina: Los problemas de la estrategia financiera elegida. Buenos Aires, CIEPP, *Serie Análisis de Coyuntura Nº 7*.

Lo Vuolo R. and Goldberg L. (2005). La reforma de la reforma: Un nuevo sistema de previsión social para la Argentina. Buenos Aires, CIEPP, *Serie Documentos de Trabajo Nº 44*.

Ministerio de Economía y Producción (2004). Argentina, el FMI y la crisis de la deuda. *Análisis Nº II*.

Mussa M. (2002). *Argentina and the Fund: From Triumph to Tragedy*. Washington, DC: Institute for International Economics.

Olmos A. (1989). *Todo lo que usted quiso saber sobre la deuda externa y siempre le ocultaron*: *Quienes y cómo la contrajeron.* Buenos Aires, Ediciones Continente.

Reinhart C., Rogoff K. and Savastano M. (2003). Debt Intolerance. Cambridge, MA*: National Bureau of Economic Research* Working Paper Series 9908.

Reinhart C. and Rogoff K. (2004). Serial Default and the "Paradox" of Rich to Poor Capital Flows. Cambridge, MA: *National Bureau of Economic Research* Working Paper Series 10296.

Schvarzer J. and Finkelstein H. (2004). Renegociación de la deuda: un panorama confuso de montos, quitas, pagos y sustentabilidad futura. Buenos Aires, Argentina: *Centro de Estudios de la Situación y Perspectivas de la Argentina*, Notas de Coyuntura Nº16.

Williamson J. (1990). What Washington means by policy reform. In John Williamson, ed., *Latin American Adjustment: How Much has Happened?* Washington, DC: Institute for International Economics.