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The Nature of Lessons Learned from Argentina's 2001 Financial Crisis

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The Nature of Lessons Learned from Argentina's 2001 Financial Crisis

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Abstract

This paper makes the argument that though Argentina's 2001 financial crisis was influenced by several factors, it is the 1991 Convertibility Plan that most strongly pushed the nation to the point of needing outside financial assistance. Its implementation led to and worked in combination with a multitude of unexpected factors. Together, these created economic conditions that chipped away at the stability of Argentina's economy.

Given the nature of this project, information was gathered solely through research in texts published by both supporters and critics of organizations like the International Monetary Fund. In my readings, I found that there is generally more criticism than praise, though I tried not to be swayed too strongly either way. Ultimately, however, it became clear that a decision on outside organizations did not need to be made. Rather, it was clear that a criticism of policy would suffice.

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Executive Summary

This paper examines the factors that led to the 2001 financial crisis in Argentina. In this examination the claim is made that the 1991 convertibility regime was the main catalyst for the circumstances that led to the dire state of Argentina's economy and ultimately left the nation without credit on a global scale.

Established by President Carlos Menem and Economy Minister Domingo Cavallo, the 1991 convertibility regime was implemented as a response to the decades of economic instability and chronic inflation that Argentina had suffered from. Prior to its installation, the nation's Central Bank had turned towards printing money, instigating inflation and making it an unattractive nation for investors and foreign capital. To remedy this, the convertibility regime limited the Central Bank's ability to print money and tried to create a more appealing economic atmosphere for investors. Pegging the Argentine peso to the U.S. dollar on a one-to-one basis and creating new restrictions did this. The issue was that success was short-term. That is, the expected results were achieved during a limited period of years. However, the benefits of the convertibility plan were ultimately overshadowed by the unexpected consequences.

Upon its implementation, the convertibility plan instigated a series of planned results along with many unintended consequences. Restrictions were put in place, such as limiting the Central Bank's control and forbidding it from printing money. Initially, these aided in achieving the goals of the convertibility plan. Inflation was lowered to single digits within several years and the economy saw significant growth. Additionally, the Real Gross Domestic Product rose to double digits. The Real Gross Domestic Product (Real GDP) looks at the Gross Domestic Product of a nation and adjusts for inflation. Growth in Real GDP is typically a strong indicator of positive movement in an economy. So, it in combination with lowered inflation, imply that the convertibility plan was successful in achieving its goals.

Achievement could also be seen in the influx of foreign capital into Argentina. The US dollar had grown strong over the decades and this made currencies connected to it attractive by association. When the convertibility plan pegged the Argentine peso to the U.S. dollar, investing in Argentina became a more secure and compelling decision for foreign investors. Additionally, the high interest rates in Argentina drew in foreign investors, because they were sure to receive a premium in return for their money. Although this was initially a benefit for Argentina, it ultimately became an area of vulnerability.

Argentina's attractiveness to foreign capital was contingent upon its economic stability. During the 1990s decade, external shocks revealed Argentina's economic insecurity and the extent to which it was affected by events elsewhere around the world. For example, Mexico's Tequila Crisis, Russia's default, and the depreciation of the Brazilian real all translated to economic issues for Argentina. When these occurred, Argentina's economy revealed the extent to which it was dependent upon other economies, particularly those attached to the dollar.

In these moments of weakness, the entry of foreign capital lowered. Argentina's consequent suffering revealed that the nation was too reliant upon it. This was exemplified in the domestic markets' inabilities to support Argentina's financial needs when they most needed to. That is, when foreign capital was not available for use, Argentina's economy could not survive on its own. Here it begins to be clear that the convertibility plan forced Argentina to become reliant upon foreign capital. It simply replaced the action of printing money (the inflationary practices that had previously been employed) with spending with borrowed money. This becomes very clear when considering the nation's debt dynamics and trade balance.

The convertibility plan led Argentina to stifle its own domestic economy while becoming dependent upon and utilizing foreign capital. This is undeniably clear when considering the nation's lowered exportation and sharp increase in importation of goods. Essentially, this means that they were buying more than they were selling—and, what's worse, they were doing so with borrowed money in the form of foreign capital. The fiscal policies of Argentina reflect this irresponsibility, whose unsustainable nature was reflected in federal spending.

The nature of Argentina's institutional and political structure is also attributed to the 2001 financial crisis, although the convertibility regime bears a correlation to this as well. Systematically, Argentina's structure makes it difficult to enforce regulations, such as those that were mandated as restrictions for the convertibility plan. The politics are such that provincial governments have the potential to bypass orders from the federal government, rendering the convertibility regime's limits nearly useless. Additionally, the political system appeared to be relatively unstable with several resignations from major leaders within days of each other. This insecurity registers as overall instability for investors, which leads to the withdrawal of foreign capital. It is here that the unexpected results of the convertibility plan are shown. It was implemented in a nation where structural issues could lead to a failure of upholding restrictions. This, in combination with the vulnerabilities it created, ultimately made it ineffective. Although well intended, the convertibility plan ultimately generated more negative consequences than it did success.

Acknowledgements

For his invaluable amount of help over the past several semesters, I would like to first and foremost acknowledge Professor Fernando Diz. Without his advice, this body of work would be unstructured, uninformed, and unsuitable for presentation. Similarly, I would like to thank my reader, Professor Thomas Barkley, for his guidance throughout this process. Together, they were a most insightful pair that helped me focus on and formulate my capstone project in the best way possible.

The Reneé Crown Honors Program too deserves acknowledgement. The program's advisers—specifically Eric Holzwarth and Kate Hanson—were particularly helpful in supporting my work and myself throughout the past semesters.

Advice to Future Honors Students

My best advice for future Honors students is to pick a topic that you will be able to maintain an interest in and a curiosity for. This process is very long and, at times, its completion can feel impossible. There is no worse decision to make than to choose a topic that you have limited interest in. Equally important is that you are capable of having a dynamic approach to completing your proposed project. For this paper, for example, I initially excelled in finding readings and conducting research, but struggled in constructing my own views on the subject.

Advice that you will likely hear from every present and past Honors student is to work hard early on, so as to make life a little easier when everything else gets piled on. Manage your time wisely and above all, respect what your adviser has to say!

Preface

Nearly every nation in Latin America has suffered economic turmoil over the past century. While economic turbulence certainly extends further beyond this in history, it is over the past few decades that a distinct pattern has developed in which very similar remedies were employed in each troubled nation. The implemented solutions are typically heavily neoliberal and are instilled under the recommendation of international organizations such as the International Monetary Fund and the World Bank.

This Capstone Presentation began with my intentions of researching the policies and patterns implemented in Latin America. My beginning research led to a decision to narrow my scope, which I did by specifically choosing the nation of Argentina and its 2001 economic collapse. What began as research on implemented neoliberal policies, ultimately led to the decision to examine the factors leading to Argentina's economic collapse, the subsequent responses and solutions of both the nation and are drafted International Monetary Fund.

Although many of the contributors to the demise of Argentina's economy were specific to the nation, many were also due to the nation's contingency upon the success of other nations and transactions. This made the research very interesting and, perhaps more importantly, translatable to other situations. It is here that I made the decision to draw comparisons between the current situation in Greece and this past interaction. Although the writing is largely focused on Argentina's financial crisis (because it has been the regional and economic focus from the start), the inclusion of a cross-examination of Greece offers a more dynamic approach and superior subject matter for this paper.

Given this connection, this paper is meant to explore and express the delicate balance that is the result of an increasingly globalized and interconnected economic world. Certainly, there are benefits and in many cases reduced risk when there is a financial system supported by and/or bearing connections to other currencies or nations. For example, many consider Greece's fate to not be sealed only because of its use of the Euro and its ability to fall back on stronger nations such as Germany and France. Some extremists, however, argue that Greece's situation will lead to the demise of the Euro-using nations altogether. Although both of these arguments, particularly the latter, are relatively extreme, the overarching theme is that there is a strong correlation between nations and their fates are somewhat tied to one another. An examination of Argentina's past issues, alongside Greece's present ones, exemplifies this. It is in drawing attention to this that this paper succeeds in bringing light to an important connection from which much can be learned.

Introduction

According to the Independent Evaluation Office, “Until the depositor runs started to accelerate in the spring of 2001, the Argentina banking system was considered to be a model for emerging market economies in terms of prudential standards, capitalization, and liquidity.[1]” The question remains, what transitioned Argentina’s system from exemplary to insolvent? The reality is that there are a multitude of accused factors that together worked to create a climate that provoked the demise of Argentina’s economic reforms. In an evaluation of the circumstances performed by the aforementioned Independent Evaluation Office (although it bears a connection to the International Monetary Fund in its origin, the Independent Evaluation Office [founded in 2001[2]] claims complete independence from the Fund and its past decisions), there have been a total of eight distinct factors indentified, ranging from external shocks to the decline in capital flows.

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[1] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

[2] The Independent Evaluation Office, 2014.

The purpose of this paper is to discuss these conditions existing in Argentina's economy that forced the nation to seek financial help from an external organization. Essentially, put under a spotlight will be the underlying factors that created the imbalance that forced the nation to need financial assistance. Additionally, Argentina's subsequent credit-worthiness will be noted—namely the nation's indebtedness to foreign currency. Given that it is today still unable to re-enter the global credit market, it is clear that the nation's default on debt and currency devaluation has had lasting effects on the nation's success on a global stage. In today's economic world, in fact, it is seemingly used as a cautionary tale for nations with large fiscal deficits that hope to finance large fiscal deficits by accessing global debt markets, like Greece.

Although there are a number of factors typically held responsible for the economic and financial disruptions, I would like to make the argument that the convertibility regime was the central player in the Argentine financial crisis. Certainly other areas of influence existed, but ultimately it was the convertibility plan and both its intended and unintended consequences that contributed the most in creating the nation's difficult financial climate.

Chapter One:

The Convertibility Plan

The Origin and Actions of the Plan

Established in April 1991, the Convertibility Plan seems to have paradoxically contributed to both the support and the demise of Argentina's economic structure. In its creation, the Convertibility Plan was intended as a solution to the chronic inflation problem that the nation faced. It seems that irresponsible money printing from the Argentine Central Bank, in combination with several other factors, had led to decades of inflation and economic insecurity for the nation. Subsequently, it was globally viewed as an unstable investment for foreign investors.

The nation was in need of a change and they found it in the form of the convertibility regime. So, what exactly was the convertibility regime? In short, "President Carlos Menem and Economy Minister Domingo Cavallo established a new exchange regime for the Argentine *peso* to the U.S. dollar and limited the Central Bank's ability to create new money by requiring it to back the monetary base with foreign exchange reserves[3]."

According to *Argentina and the Fund: From Triumph to Tragedy*, "The essential objective of the plan was to end decades of financial and economic instability by ensuring that Argentina would have sound money. This was to be accomplished by linking the value of the domestic currency at parity to the US dollar, with the guarantee that pesos could be exchanged for dollars at will. The Argentine Central Bank was given independence from the government, under the mandate that it maintain convertibility by holding dollar reserves against its domestic monetary liabilities (currency and commercial bank reserves)."[4] Pegging the peso to the US dollar offered a more appealing currency for foreign investors to rely on, whose subsequent capital would benefit Argentina. A very similar experiment had been tried in the 1970s by Economy Minister Martinez de Hoz and Central Bank president Adolf Diz with less extreme but almost identical consequences.

Originally, this currency board system, which matched the US dollar to the peso on a one-to-one basis[5], was an appealing solution to Argentina—and was later even supported by the International Monetary Fund.[6] In addition

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[3] Joseph P. Joyce, *The IMF and Global Financial Crises: Phoenix Rising?* (2012), 127.

[4] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002), 20.

[5] Global Finance in Emerging Market Economies, Todd A. Knoop, 2013, page 133.

[6] The Role of the IMF in Argentina, IEO, 2003.

to being pegged to the U.S. dollar, the peso would be fully backed by foreign reserves in order to maintain confidence in the currency[7].

Professor Knoop of Cornell College explains the expected outcome: “The idea behind this currency board was to credibly reduce money growth and inflation while at the same time fixing the exchange rate of the peso to the dollar. In addition, the currency board promised to protect the independence of a Central Bank that had shown itself to be part and parcel of the volatile Argentinian political system. In other words, the currency board would be a way to force the Central Bank of Argentina to make the tough decisions it had never been able to make in the past.[8]”

Restrictions

Defense mechanisms were put in place to aid in the avoidance of the inflation that Argentina’s economy had often fallen prey to. For example, in emergency situations a 100 percent reserve requirement could easily transition to an 80 percent requirement, while the Central Bank could hold up to 20 percent of its assets in government debt.[9] Additionally, the Central Bank was forbidden from printing money to finance governmental expenditures, thus

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[7] Todd A. Knoop, *Global Finance in Emerging Market Economies* (2013), 133.
[8] Todd A. Knoop, *Global Finance in Emerging Market Economies* (2013), 133.
[9] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).

building a mechanism to avoid the aforementioned perpetual problem in Argentina of expeditious inflation.[10]

The above limits and others installed were intended to prevent a defense against the past issues that the Argentine and similar economies had suffered from. They, along with the entire convertibility regime, were representative of a progression away from old toxic habits and towards new opportunities.

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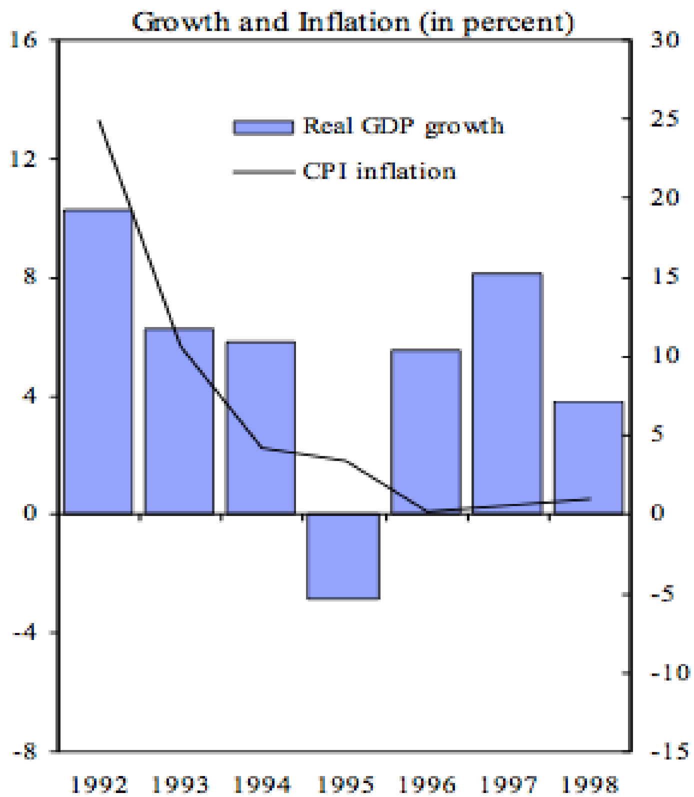
[10] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).

Chapter Two:

The Intended Results

Tackling Inflation

The convertibility regime's implementation followed decades of economic and financial unrest in Argentina. One of the largest blanket issues that the plan aimed to tackle was inflation. This issue is typically derived from the lack of political independence of the Central Bank. In the case of Argentina, the Central Bank had been chronically been charged as the arm of the government for achieving social goods. The measures taken under the convertibility regime, it seems, were initially effective. According to the Independent Evaluation Office, "After the adoption of the Convertibility Plan, stabilization was achieved quickly and with the aid of structural reforms, the economy grew at an average rate of 6 percent per year through 1997.[11]" As can be seen in the diagram[12] below, inflation did somewhat drop off with these installments.



In fact, Argentina's inflation fell to single digits by 1993. This is the result of the initial monetary stability that came with the outcomes of the convertibility regime. In its implementation, the plan led to an influx of foreign capital based on its attractiveness and stability to foreign investors.

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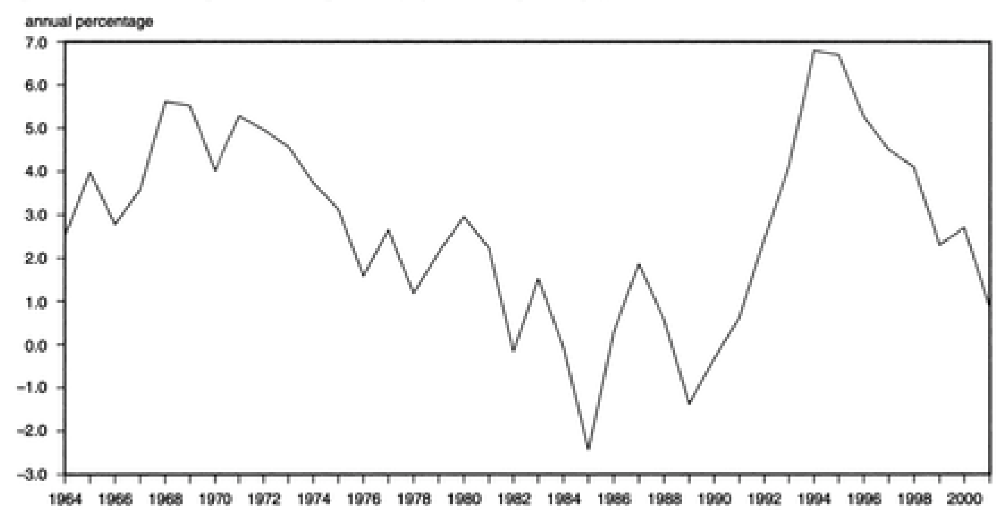
[11] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003, 3.
[12] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

Real GDP Growth

In addition to the above alteration in inflation, the convertibility plan originally resulted in Real GDP growth—a relative contrast to the trends in the 1980s. This can also be seen in the previous chart, particularly the rise to about 10 percent in 1992. The chart below looks at a five year moving average of the Real GDP growth for Argentina.[13]

Figure 2.2 Real GDP growth for Argentina (5-year moving average), **1964–2001**



Sources: Economic Ministry of Argentina and author's calculations.

With the exception of changes made by events such as the 1995 Tequila Crisis, which resulted in a plummet of economic activity, the Real GDP

[13] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).

appears to exhibit growth.[14] Both the growth in Real GDP and the lowering of inflation were intended factors for the convertibility regime.

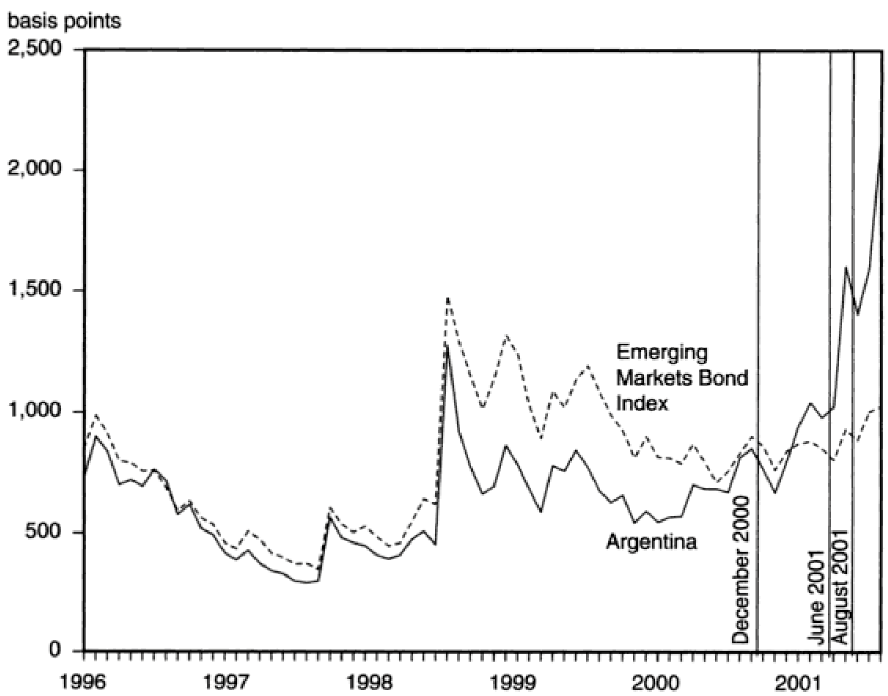
Tapping Global Credit Markets

To its credit, the convertibility regime opened Argentina's doors to opportunities for foreign investors to enter the market. What made the Argentine market so appealing was the peso's backing of the U.S. dollar. The United States' increasing economic stability was rendering it the economic powerhouse of the west. Argentina's attachment to its currency cast a positive light on the peso, making it more attractive. Foreign investors were drawn in by the assurance of such a strong currency and an influx of foreign capital ensued. The aforementioned rise in GDP indicates this. Along with the advantageous attachment to the U.S. dollar, investors were also drawn in by the high interest rates. Note the graph[15] on the following page .The spread of interest rates indicate that foreign investors would benefit from placing foreign capital in the Argentine market. These features were initially beneficial to the Argentine economy, as displayed in the growth of Real GDP and the lowered inflation. In a way, when looking at these aspects and this time period, it could be argued that the convertibility plan was successful. It did, after all, achieve its goals in the short-term. Ultimately, however, the

[14] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).
[15] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).

intended results were short-lived while unintended consequences proved to be far more damaging.

Figure 3.1 Interest rate spreads on Argentine sovereign debt and the Emerging Markets Bond Index



Note: End-of-month values.

Source: Economic Ministry of Argentina.

Chapter Three:

The Unintended Consequences

External Shocks and Decline in Capital Flow

In spite of the positive activity that seemed to be occurring, there were in reality deeper and more negative factors at play. The short-term successes of the convertibility plan were overshadowed by its deficiencies and unintended consequences. The overarching issue with this situation seems to be that while money growth and inflation may have been corrected, it was not a solution to the economic turmoil of Argentina. Rather, the Convertibility Plan seems to have created an artificial access to foreign markets that lulled the nation into a false sense of security. The insecurity of this regime can be exemplified in external episodes that affected the nation's economy. Mexico's Tequila Crisis, Russia's default, and the depreciation of the Brazilin *real* all exemplify the fragility that the convertibility regime impressed upon the Argentine economy. The instability stems from an influx of foreign capital as a result of the peg of the peso to the dollar.

Two of the unexpected consequences of the convertibility regime are strongly intermingled and carry a great deal of power in their ability to translate into modern-day issues. In an increasingly globalized world, there are a plethora of benefits that can come to individuals, firms, and governments. Increased communication and trade on an international scale has led to greater capabilities in terms of efficiency, cost, and so on. However, one could argue that it has also led to a drastic sense of dependency between sovereign nations, firms, and individuals. That is to say, the globalized world has led to a much more fragile and intermingled set of interactions in which activity in one part of the world can greatly affect activity elsewhere. The strong correlation between the decline in capital flows and external shocks exemplify this reliance and the effect that it can have. More so, however, it displays a major unintended consequence of the convertibility plan.

Firstly, let us focus on the decline in capital flows and the phenomenon's effect on the crisis. At the hands of the convertibility plan, Argentina's reliance on capital inflows was too heavy. That is, the nation's domestic financial markets were merely slowly developing and could not support the nation's needs if there were to be an international shift and the capital flows were to falter.

When such a shift did occur, the domestic markets seemed incapable of supporting the financial needs of Argentina[16]. The 2003 I.E.O. report elaborates: "When there was a sharp reduction (or "sudden stop" as it is sometimes called) in global capital flows to emerging market economies in 1998, it became increasingly costly for Argentina to raise funds on international capital markets. When the investors sensed a shift, the money fled. Because of the convertibility regime, and because of the relatively small size of its export sector, Argentina could not easily adapt to the shock through a rapid depreciation of the real exchange rate.[17]"

The unpredictable swinging of global capital flows in combination with the nation's poor domestic financial infrastructure worked together to contribute to the collapse in Argentina's economy. This is exemplified in the intense and continued rise on Argentina's bonds over U.S. Treasuries, as seen in the graph[18] on the following page. It is in this example that we can see the correlation between the decline in capital flows and the series of adverse external shocks—and how their connection is through the convertibility regime.

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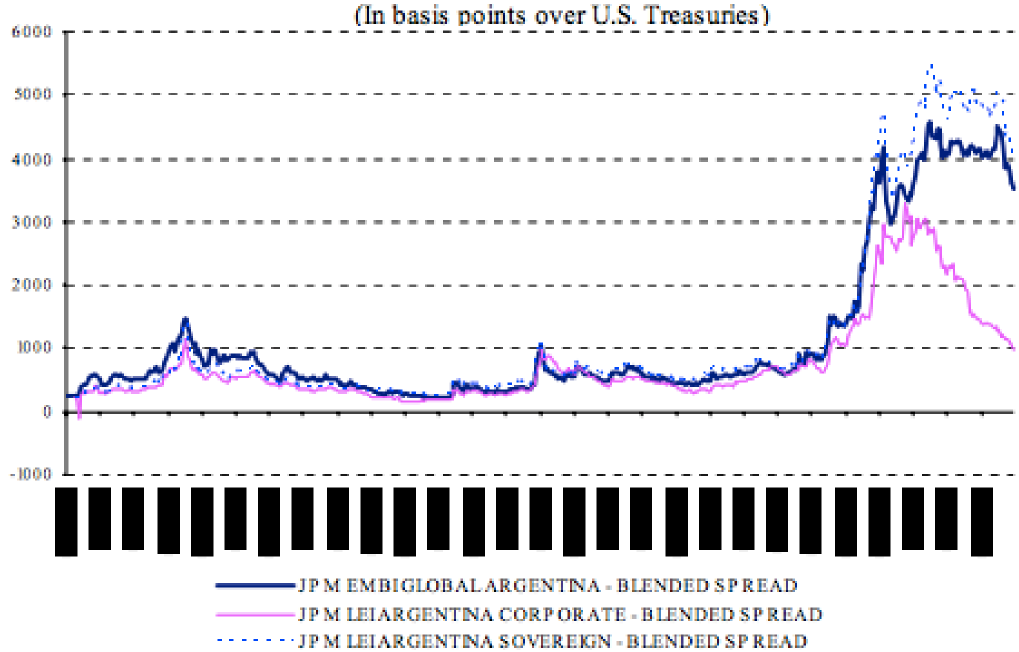
[16] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003, 6.
[17] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003, 5-6.
[18] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003, 4.

Figure 2. Argentina: Weekly International Bond Spreads

(In basis points over U.S. Treasuries)



Source: Data Stream.

The external shocks show Argentina's vulnerability to the decisions of foreign investors. Similarly to the less-stable nations in the European Union (i.e. Greece), Argentina seems to have initially benefited from the performance and conditions of others. During the successful times in Argentina's economic history, it seems to have often been because of favorable conditions elsewhere. External shocks, however, led to the fast deterioration of these favorable circumstances, ultimately leading Argentina—so delicately holding on to the coattails of others—to suffer.

The I.E.O. elaborates with examples: "Among the external shocks were the Russian/LTCM crises of 1998, which led to a reduction in capital flows to emerging market economies and an increase in risk premia; the devaluation of the Brazilian real, which had a negative impact on the competitiveness of Argentina's exports; and the appreciation of the U.S. dollar against most currencies in the late 1990s, which increased Argentina's real effective exchange rate; and the global economic slowdown that started in the beginning of 2001, which depressed the price of Argentina's main exports," [19]. Argentina's performance is contingent upon the success or demise, in Brazil's case, of others. This unintended result of the convertibility regime left Argentina more vulnerable to the global markets than ever. It is in these aspects that Argentina is most commonly used as a cautionary tale for other nations. A delicate balance such as this ought to be maneuvered so that the proportions of international and domestic vulnerability are lowered. The convertibility regime did quite the opposite.

Structural Reform and Debt Dynamics

Somewhat homogenous to the two aforementioned are the issues with structural reform in Argentina's economy. Reportedly, in order to adhere to new policies, there needed to be a liberalization of certain markets (i.e. product markets, foreign trade, utilities and infrastructure[20]) and an overall limitation on imports. A report states, "While many direct and indirect trade barriers were removed, and while exports did grow steadily, by the end of the

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[19] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003, 6.

[20] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

1990s Argentina was still a relatively closed economy."[21] This is directly connected to the aforementioned external shocks and decline in capital flow, given that a balance was lost when the number of exports did not nearly meet the number of imports or use of foreign capital.

The imbalance mentioned above very simply describes an instrumental element of the issue of Argentina's debt dynamics. Essentially, the nature of Argentina's trade balance—and the duly noted trade barriers—created debt to the nations from whom they were importing. Given that exportation was lesser, the imbalance is relatively easily explained.

Consider the Trade and Current Account Balance on the following page.[22] The current account is perpetually negative—though it shrinks during the 1995 Tequila Crisis. Although the trade balance does not have the same negative consistency, it is not necessarily steady in any particular direction. It seems that while the inflation remained low and the Real GDP great throughout the 1990s, as intended by the convertibility plan, the underlying factors outweighed these two benefits in terms of overall influence on the state of the economy.

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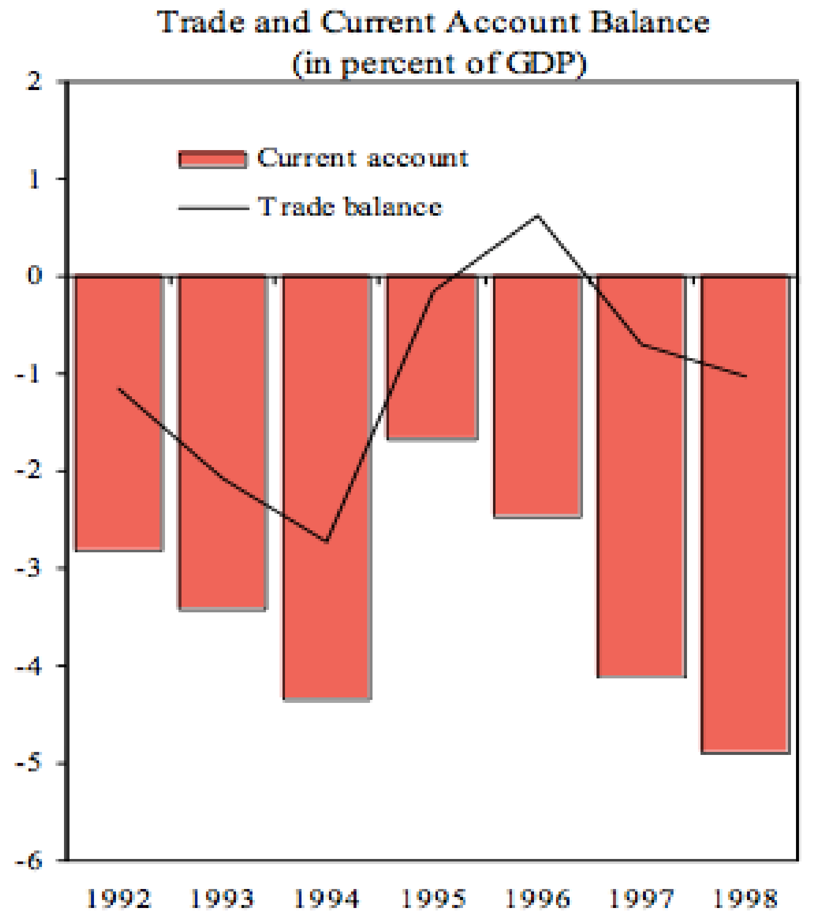
[21] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

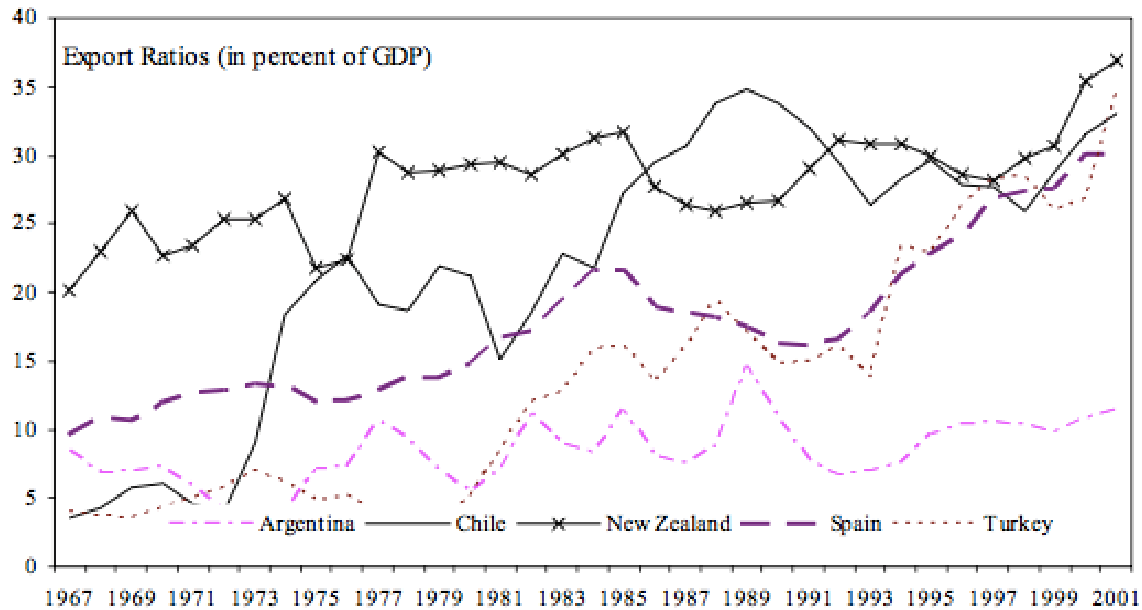
[22] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.



Of the underlying factors, it appears that exports—or lack thereof, comparatively—was one of the largest outcomes of the convertibility plan that affected the state of the balance sheet. This is also reflected in the nation's breakdown of debt.

As can be seen in the graphic[23] the following page, in comparison to the similarly featured nations of Chile, New Zealand, Spain, and Turkey, Argentina has incredibly low export ratio in the years between 1967 and 2001.

Export Ratios (in percent of GDP) 1967-2001: Argentina, Chile, New Zealand, Spain, and Turkey



This lack of export ratio strength or, for that matter, linear growth, is a result of the installment and consequent repercussions of the Convertibility Plan. In the years following the implementation of the convertibility regime,

[23] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

Argentina's exports declined while the number of imports increased relatively dramatically. The largest issue with this is that the increasing number of imports is funded by the savings generated by foreign exchange, not by domestic production. Essentially, these imports are made with borrowed money generated by temporary foreign investment. That is, it is funded by the foreign capital of investors that can easily remove their money when scared. This dependency was created by the convertibility plan and forced the Argentine economy to take on an even greater imbalance between exports and imports.

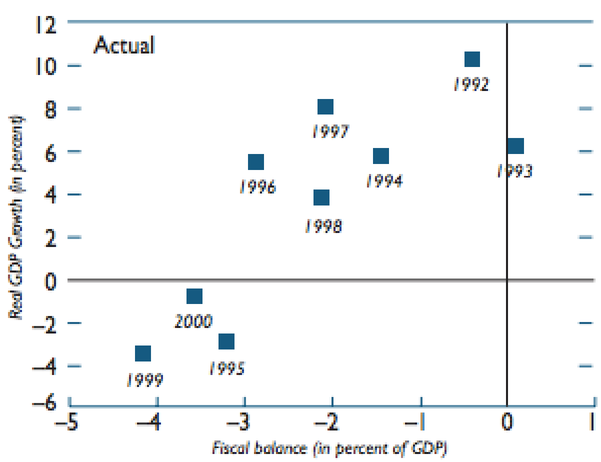
Fiscal Policies

The convertibility regime unintentionally created an atmosphere that perpetuated and even worsened the fiscal policies of Argentina. Often described as chronically unstable, Argentina's unsustainable fiscal policies are seemingly inherent to the nation, given their frequency. On the surface, it is seemingly a simple issue of living beyond their means. That is to say, the Argentine government spends more than can or is collected in taxes when satisfying political needs and pressures[24]. The tendency is to then satiate the political needs and pressures by borrowing domestically and internationally,

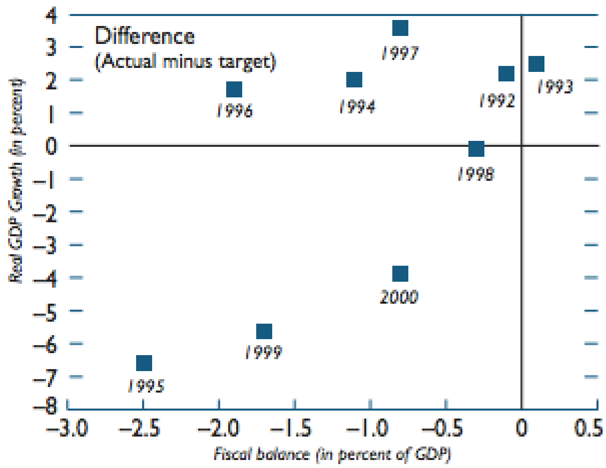
[24] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).

wherever credit is available[25]. In an increasingly globalized marketplace, and because of the dollar-backed peso, credit in the form of investment of foreign capital in Argentina became easily accessible. Naturally, it was made all the more available by the convertibility regime and the appeal that it created for foreign investors. The consequential fiscal realities versus Argentina's targets over the years can be seen graphically[26] below.

Figure 2.3. Comparison of Fiscal Targets and Actuals



[25] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).
[26] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.



With some dramatic liberties, Mussa describes the habits of the Argentine government: "This is what happened during the presidency of Raul Alfonsin, culminating in the hyperinflation of 1990. With some differences in the details, but none of the central substance, it is also what happened in the events that culminated in several earlier financial crises during the preceding 50 years. Thus, in the management of its fiscal affairs, the Argentine government is like a chronic alcoholic—once it starts to imbibe the political pleasures of deficit spending, it keeps on going until it reaches the economic equivalent of falling down drunk.[27]" The fiscal policies of the decade of 1990-2000 seemed to mimic these issues on an even more extreme and more irresponsible level that has continued to affect the nation into today. The unreasonable spending, funded by false currency, worked in unison with the

[27] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002) 10.

other factors to ruin the credit and economic stability of Argentina.

Institutional and Political Factors

The institutional and political factors involved in Argentina are perhaps the least mutable of the contributors to the economic crisis, given their relation to the electoral process and the governmental structure. However, their influence on Argentina's fate became stronger when foreign capital entered following the convertibility plan's implementation. The status of the institution and political figures of a nation can be an indicator to foreign investors of the stability. That is, when there are low turnover rates for positions and responsible decisions are made, investors see security. This connection is an unanticipated and detrimental result of the convertibility plan.

In the 1990s and well before then, the federal government was incapable of strongly implementing and adhering to any new fiscal policies, particularly those regarding austerity measures. An I.E.O. report indicates that firstly the issue of the electoral politics existed.[28] That is, the need for votes led to activity from elected officials to be lax.[29] Similarly, there remained an issue with the provincial governments. It seems that the provincial

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[28] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

[29] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

governments were given both too much power and responsibility, particularly in comparison with the federal government. That is, "In general, the considerable power of the provincial governments, in a context where provinces had been entrusted with major public expenditure responsibilities, greatly reduced the flexibility of fiscal policy."[30]

Systematically, the institution of Argentina's politics makes it very difficult for policies to be strictly adhered to. During this decade of Argentina's economic turmoil, the nation also appeared to be plagued by low retention rates for political leaders. The constantly altering cabinet members in Argentina's federal government seemed to drastically lower confidence from both the domestic and international point of view. For example, the resignation of Vice President Carlos Álvarez in October 2000 and the successive resignations of two ministers of economy (José Luis Machinea and Ricardo López Murphy) occurred all within twenty days in March.[31] The lowered confidence is best exemplified in the aforementioned reduction in capital flows. Lowered confidence as the result of institutional and political instability can be detrimental to a nation, as they the income of capital can shift or cease altogether.

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[30] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

[31] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

Chapter 4: The Result

The Banking System

As part of the convertibility regime, the Central Bank of Argentina was meant to act as a lender only as a last resort.[32] For example, in emergency situations a 100 percent reserve requirement could easily transition to an 80 percent requirement, while the Central Bank could hold up to 20 percent of its assets in government debt.[33] However, the combined economic factors (e.g. the flight of foreign capital, external factors, etc.) essentially forced the nation to turn back to their Central Bank.

A report elaborates: "By the end of 2001…. the cumulative effects of several years' recession, a year's capital flight and a series of controversial

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[32] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

[33] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (2002).

policy moves had left the banking system vulnerable to any further blows to public confidence. It has widely been argued that the manner in which authorities tried to manage the exit from convertibility—including the legally ambiguous measures to block deposits, and the forced conversion of dollar-denominated bank assets and liabilities into pesos at asymmetric rates—compounded these weaknesses. As a result, Argentina entered 2002 with not only a currency and sovereign debt crisis, but a banking crisis as well."[34] The picture that is painted is reflective of the reality that the convertibility plan was unsustainable and inappropriate for Argentina's economy. Further, it depicts the overarching message that the convertibility regime resulted in far more unintended and harmful outcomes than it did positive results.

Conclusion

When considering any financial situation, it is difficult to distinguish or pinpoint one overarching reason for the ensuing economic disarray. In the case of the Argentine crisis, the Independent Evaluation Office found eight factors: fiscal policy, the convertibility regime, decline in capital flows, structural reform, institutional and political factors, external shocks, debt

[34] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

dynamics, and the banking system[35]. Although each of these influences were all intricate pieces in the ensuing economic environment, one stands out as having the strongest impact on the economic stability of Argentina. This influential element is the convertibility regime and the false sense of security that it created.

Pegging the peso to the US dollar intentionally made investment in the Argentine economy more appealing to those with foreign capital. The high interest rates, backed by the US dollar, make a comfortable situation for a foreign investor. From the Argentine perspective, it seems that only the income of money was seen, and not the fragility that resulted**.** The growth in the Gross Domestic Product and trade account essentially allowed Argentina to finance the governmental and national needs with borrowed money from foreign investors.

It appears that the influx of foreign capital did not spark the production expected in the economy, but rather financed the continued and increased importation of goods. This, in combination with the poor institutional factors and political decisions brought Argentina to its knees. And the majority of this was at the hands of the 1991 Convertibility Plan. While other influences were certainly at hand, it is ultimately the plan's intended and more powerful unintended consequences that forced Argentina into a position in which it needed to turn to the International Monetary Fund for financial assistance.

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[35] The Role of the IMF in Argentina, 1991-2002: Issues Paper/Terms of Reference for an Evaluation by the Independent Evaluation Office, IEO, July 2003.

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