A QUICK REVIEW OF ARGENTINA'S FINANCIAL CRISES SINCE 1960 AND SOME THOUGHTS ABOUT THE CURRENT SITUATION

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Argentina has had many financial crises throughout its tumultuous economic history. Some were worse than others. This paper examines the most dramatic ones (five in total) of the last 60 years and concludes that all of them had an obvious fiscal root except, perhaps, the Convertibility crisis of 2001-2002, where the fiscal root is less apparent but not necessarily absent.

The episodes examined here are the *Rodrigazo* of 1975, the end of the exchange rate *tablita* in 1981, the hyperinflation outbreaks of 1989 and 1990, the Convertibility crisis of 2001-2002, and the run on LEBACs of 2018. The last of these crises unleashed a period of intense macroeconomic instability that still continues. Recalling why the previous financial debacles occurred and what happened in their aftermaths may help the current authorities to avert a new crisis in 2021.

Note: The reader who is not interested in Argentina's troubled financial history may skip the following sections and go directly to the last one.

Overview

It has been said many times before that Argentina's main macroeconomic problem is fiscal in nature. I have no quarrel with this assertion. Two dimensions of the fiscal problem are an outsized public sector and persistently large fiscal deficits. The total spending of the general government, which includes the central (national) and local (provincial and municipal) governments, has grown from an average 25% of GDP in the 1960s to an average 45% in the 2010s. A public sector this large constrains output growth by sucking resources that would be used more productively by the private sector. High fiscal deficits, on the other hand, are responsible for Argentina's chronically high rates of inflation and its extreme nominal and real exchange rate volatility (see Figures 1, 2, and 3 below).[1]

Unlike the fiscal deficit (DEF/Y), the escalation of government spending to more than 40% of GDP is a relatively recent phenomenon. For the first 45 of the last 60 years, the government spending ratio (G/Y) was below 35% and rarely exceeded 30%. Then, in 2007, it stampeded. By contrast, DEF/Y was lower in the second half of the period than in the first half.

The "Rodrigazo"

Back in the 1950s and 1960s, persistently high fiscal deficits did not typically end in full-fledged financial crises as they do now. When inflation accelerated after a period of sustained fiscal and monetary expansion, a conservative government (typically, a military one) displaced the (often populist) incumbent one and launched a stabilization plan, which usually consisted of three distinct policies: a step devaluation (to correct for accumulated peso overvaluation), wage and price controls (to manage

[1] Annual inflation exceeded 100% in 14 of the last 60 years (the actual numbers are not shown in Figure 2 to enhance the presentation). Also notice the extreme volatility of annual real GDP growth.

inflationary expectations), and an effort to rein in the fiscal deficit (to control aggregate demand and reduce monetary expansion).[2]

FIGURE 1: GOVERNMENT EXPENDITURES AND FISCAL DEFICIT AS % GDP, 1961-2019

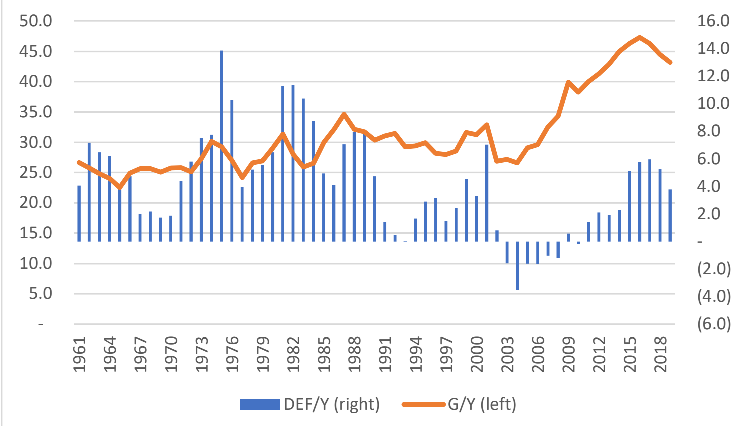


FIGURE 2: INFLATION AND REAL GDP GROWTH, 1961-2019

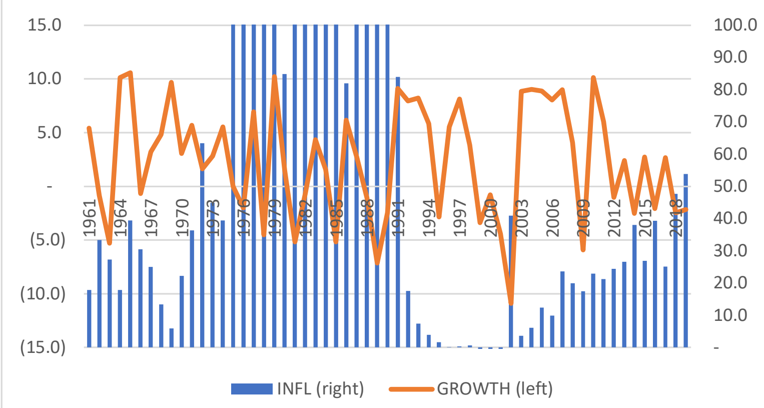
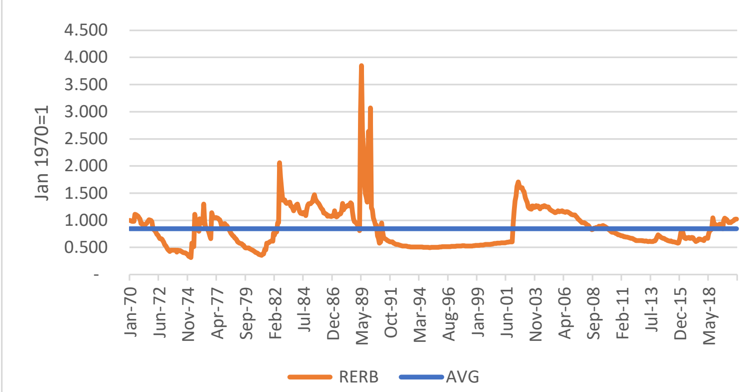


FIGURE 3: REAL EXCHANGE RATE, BILATERAL USD, 1970-2020



[2] Monetary expansion and fiscal deficits were highly correlated because segniorage was a prime way of financing the latter.

A good example of this is the stabilization plan of 1967, which reduced inflation from 28% in 1961-1966 (annual average) to 17% in 1967-1970 while increasing real GDP growth from 2.8% to 5.2%, respectively. This achievement (modest in terms of disinflation but significant in terms of real growth acceleration) was possible because DEF/Y decreased from 5.4% in 1961-1966 to 2.0% in 1967-1970 (annual averages).

The reason why it was possible for the fiscal deficit to be more than 5% of GDP on average for six consecutive years in 1961-1966 without triggering an acute financial crisis was “financial repression,” namely, the ability of the government to borrow at negative real interest rates, mainly from local banks. Financial repression allowed the National Treasury to reduce its dependency on Central Bank financing without building up an onerous public debt in the process. In turn, negative real interest rates existed because the Central Bank capped nominal rates on loans and deposits below actual inflation. Other features of financial repression were high reserve requirements on commercial banks—to optimize inflation tax collection by creating a captive demand for base money—and foreign exchange controls—to keep capital flight in check despite low domestic interest rates, therefore avoiding massive Central Bank reserve losses.

Because exchange controls did not eliminate excess demand for foreign exchange (FX), a black or parallel FX market usually existed, but the premium in that market was never inordinately high because international capital mobility was lower than it is now. In sum, financial repression did not prevent inflation from rising or the real exchange rate from falling as a result of fiscal and monetary expansions, but it kept these variables from rising or falling too much.

The stabilization plan of 1967-1970 began with a devaluation that was compensated by imposing taxes on exports and reducing tariffs on imports. The exchange controls were eliminated but, in all other respects, financial repression continued. This, together with the significant reduction of the fiscal deficit and the management of the nominal exchange rate and some salary and price agreements, helped to reduce inflation.

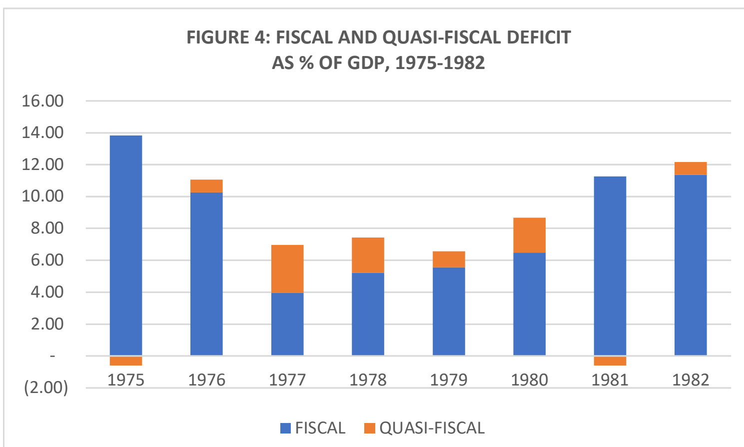
The fiscal moderation of the late 1960s, achieved under the aegis of a military government, was abandoned in the early 1970s. Fiscal policy became particularly expansionary when the populist administration of Juan and Isabel Perón (1973-1976) was in power. DEF/Y increased from less than 2% in 1970 to near 14% in 1975, at which point monetary growth (to collect seigniorage and channel subsidized credit to the private sector) became rampant. The government tried to rein in inflation by controlling prices and keeping the nominal exchange rate fixed, but this resulted in insufficient supply of most goods and a deep overvaluation of the peso that hurt external competitiveness. In June 1975, a year after Juan Perón’s death, the authorities took the unusual decision (for a populist government) of freeing all the nominal variables that were subject to direct controls, including the nominal exchange rate, though without restraining the money supply or the fiscal deficit. The result was a ninefold increase in annual inflation, from 39% in 1974 to 334% in 1975 and 342% in 1976. Real GDP, which had been growing at 4% per year in 1961-1974, contracted by 2% between 1974 and 1976. Unsurprisingly, a military coup d’etat followed ending the chaotic Peronist rule in March 1976.

The End of the “Tablita”

The military government that took office in 1976 eliminated financial repression in one stroke. It devalued the official exchange rate, liberalized the capital account, and removed interest rate ceilings on domestic deposits and loans. What it did not do was reducing the fiscal deficit as much as needed.

Instead, in order to lower inflation, the new authorities actively managed the nominal exchange. Specifically, they set the rate of depreciation below the ongoing rate of inflation. The idea was to force inflationary expectations, hence actual inflation, down. At first (1976-1978), the exchange rate policy was discretionary but, beginning in December 1978, the Central Bank preannounced the (decreasing) nominal rate of depreciation according to a monthly schedule called "tablita." Alas, inflation was more resilient than the government expected and, between 1976 and 1980, the real exchange rate fell by 70% while annual inflation dropped from 342% to (a still very high) 85%. As the external sector lost competitiveness, real GDP growth performance was sluggish, averaging 2.4% per year in the five-year period, with recessions in 1976 and 1978.

Inflation did not fall more because the stabilization plan lacked credibility. At issue was the inconsistency between exchange rate policy, on the one hand, and fiscal and monetary policy, on the other. The non-financial deficit of the public sector fell from 14% of GDP in 1975 to 10% in 1976 and to 4% in 1977, but then it grew again to 6.5% in 1980. In addition, the Central Bank incurred large losses, which were a significant source of additional monetary expansion. This "quasi-fiscal deficit" must be added to the non-financial fiscal deficit to assess the impact on inflation.[3] When this is done, the overall government imbalance rises to 7.4% of GDP on average for the four-year period (see Figure 4).



The National Treasury tried to compensate for the quasi-fiscal deficit by borrowing less from the Central Bank to finance its own deficit, but this did not help. In the absence of financial repression, domestic borrowing was an expensive proposition. External borrowing, on the other hand, was cheaper owing to high international liquidity, but selling dollars to the Central Bank to finance a fiscal deficit primarily denominated in pesos was potentially destabilizing because it increased the rate at which the money supply was growing. Central Bank officials dismissed the idea that this could be inflationary. They reasoned that, since the nominal exchange rate was being managed, any monetary excess would be eliminated via a reduction in foreign reserves without affecting domestic prices. Consistent with this

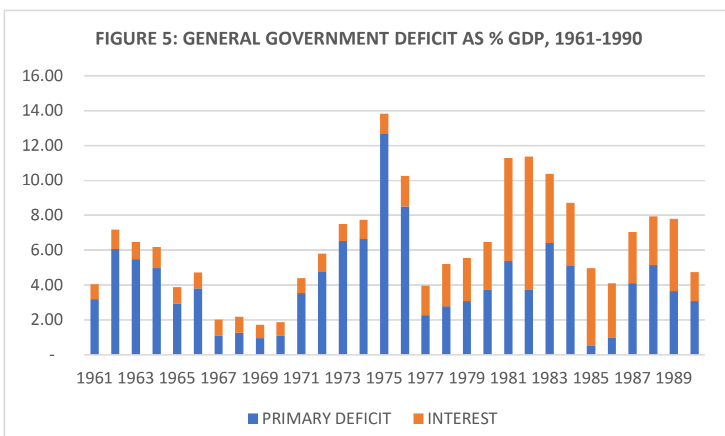
[3] The quasi-fiscal deficit was primarily due to high interest payments on required bank reserves in 1977-1978 and to the bailout of troubled financial sector institutions in 1980.

theory, the national government and some provincial ones borrowed heavily abroad, particularly in 1979 and 1980.

Using foreign money to pay for domestic expenditures increased the availability of domestic credit fueling consumer demand. This delayed disinflation response, but it also made the public sector vulnerable to a sudden stop of capital inflows. When the latter finally occurred, beginning in 1981, as a result of the US Fed's aggressive hike in interest rates to rein in US inflation, the exchange rate tablita had to be abandoned and a series of discrete devaluations took place that increased the nominal exchange rate almost tenfold on average between 1980 and 1982 causing inflation to rise from 85% in 1980 to 214% in 1982 and to 700% in 1984.

Hiperinflation

The collapse of the tablita in 1981 started a period of chronic stagflation that lasted ten years and ended in hyperinflation. Real GDP growth averaged -0.7% per year in the 1980s while consumer price inflation averaged 312% in 1981-1988 before reaching 4,923% in 1989 and 1,344% in 1990. During this "lost decade," the deficit of the general government remained high as percentage of GDP, not only because the primary deficit was high, but also because—as a result of domestic and foreign debt accumulation—the interest bill had increased sharply (see Figure 5). A series of foreign debt renegotiations took place under the auspices of the (US-sponsored) Baker Plan, but they were unsuccessful and the government ultimately defaulted on its external creditors.



To understand how Argentina put itself in this situation, we need to know what happened from 1983 to 1990. The democratically-elected government of Raúl Alfonsín, from the center-to-left Radical Party, replaced the military junta in 1983 after the defeat of the latter in the Malvinas/Falklands War. Mr. Alfonsín inherited a bad economy and made it worse. The fiscal deficit remained high in 1983 and 1984, and so did inflation. Amid great macroeconomic instability and having been rationed out of international credit markets, the only way the new government had to finance the budget deficit was through a combination of seigniorage and expensive short-term domestic debt issuance. The Austral Plan of 1985 reduced annual inflation from 700% in 1984 to 82% in 1986, mainly by fixing the nominal exchange rate and reducing the fiscal deficit from 8.7% in 1984 to 4.1% in 1986, but the fiscal effort proved to be ephemeral and inflation increased again. As the new currency introduced in 1985 (the austral) was discretely devalued in 1987, inflation spiraled out of control, domestic interest rates rose sharply, and the short-term domestic debt ballooned raising the expectation that it would be inflated away. Once this became inevitable, real money demand collapsed and hyperinflation ensued in 1989.

Convertibility and Its End

The hyperinflation crisis of 1989 triggered the resignation of Mr. Alfonsín in July of that year, five months before the expiration of his presidential term. His successor, Carlos Menem, from the Peronist Party, first struggled to control the situation, but then succeeded in an unprecedented way for a Peronist administration. During his first 20 months in office, Mr. Menem—or, actually, the economic team he appointed—implemented a classic monetarist policy consisting of drastically reducing monetary expansion while allowing the exchange rate to float freely. However, since nothing fundamentally sound was done to fix the underlying fiscal problem, monetary contraction was achieved simply by delaying payments to pensioners, suppliers of state-owned companies, and provincial governments. This temporarily reduced inflation but, as soon as the pressure mounted and some of the bills had to be paid, monetary growth exploded again and, in late 1990, hyperinflation resumed.

In early 1991, Mr. Menem appointed a new economic team, and a dramatic and unprecedented transformation occurred. In a short period of time, his government was able to stop hyperinflation in its tracks by signing into law a new monetary regime called "Convertibility," which made the local currency fully convertible and pegged to the US dollar at parity (one new peso = one dollar).[4] To enhance credibility, namely, that the new peso was not devalued, the law required that the Central Bank fully backed the monetary base with international reserves, meaning that the monetary authority could not lend pesos to the National Treasury (or to the private sector, for that matter). Simultaneously with the creation of the currency board for the peso, the Convertibility law authorized the use of the US dollar as an alternative legal tender, including domestic financial intermediation in that currency.

For almost a decade following its implementation, the Convertibility regime worked as intended. Honoring the rule that the Central Bank did not issue money for any reason other than buying foreign reserves was not a problem because, in sharp contrast with the previous three decades, the general government ran a roughly balanced primary budget. This, in turn, was possible because a far-reaching fiscal reform, including extensive privatizations, kept government spending low as a share of GDP and also because, thanks to the unprecedented monetary and price stability Argentina enjoyed in this period, real GDP, hence tax collection, expanded rapidly.

Yet, despite the seemingly solid fiscal situation, the national government began to experience difficulties rolling over its foreign debt in 2000, at which time it had to seek increased financial assistance from the IMF. The rollover crisis aggravated in 2001 engulfing the domestic banking system. Two runs on domestic bank deposits happened that year, one in July and the other in November, which ultimately forced the Central Bank to limit cash withdrawals. This measure, popularly known as the "corralito," was not well received by the population and, in December 2001, the president of Argentina (Fernando de la Rua, who succeded Carlos Menem in 1999 as head of an opposition alliance) resigned amid protests initiated by depositors that metastasized into violent riots perpetrated by social agitators.

[4] Convertibility was, essentially, a currency board system like the one Hong Kong, Singapore, and other economies had at the time. The only difference was the peso could appreciate relative to the US dollar if monetary conditions and the Central Bank allowed it.

Shortly after the presidential resignation, an interim government declared a moratorium on the foreign debt and, in January 2002, it ordered the freezing of dollar bank deposits, which were forcibly converted into pesos at 1.4 pesos per US dollar while dollar loans were “pesified” one to one. As the freeze on deposits was gradually lifted in 2002 and 2003 and depositors tried to get rid of their unwanted pesos, the Argentine peso depreciated sharply. When the nominal exchange rate finally stabilized in the second half of 2003, the peso had lost one third of its value in terms of the dollar, a level that it maintained (with moderate fluctuations along a slight depreciation path) in the following four years.

Since the initial trigger of the crisis was the refusal of private foreign creditors to rollover the national public debt in 2000, it is pertinent to ask why this happened. The Menem administration had inherited a national public debt worth $58bn or 22% of GDP, half of which was with foreign commercial banks and dated back to 1980. In 2000, the debt had grown to $123bn or 40% of GDP. Since, as said before, there was no primary deficit, the increase relative to GDP is explained by two factors. First, the recognition and consolidation of past domestic arrears (the unpaid bills mentioned before that remained outstanding). Second, the compounding of interest in excess of nominal GDP growth, as the former was higher on average than the latter. Since the national debt was rolled over year after year, there was no domestic monetary effect steming from its service, which is why inflation averaged an unprecedently low level of 1.4% per year between 1993 and 2000.

Be as it may, the fact that the public debt was persistently growing as a share of GDP means that its dynamics was unstable. In the absence of seigniorage, stopping the ratio’s growth would have required the general government, including the provinces, to run a structural primary surplus of 1-2% of GDP. However, at 40% of GDP, the national debt did not seem high enough in 2000 to trigger a sudden stop of voluntary lending and, besides, the reason why the primary balance was not stronger was not a lack of fiscal discipline on the spending side, but a combination of tax cuts and social security reform designed to boost long-run economic performance.[5]

Four issues are important to understand why the sudden stop happened in 2000. First and foremost, more than 90% of the national debt was in foreign currency, principally US dollars, making fiscal solvency a function of the real exchange rate. A real devaluation of, say, 50% in 2000 would have increased the debt ratio from 40% to 58%. Second, approximately three fourths of the debt was in bonds, hence subject to the whims of the institutional investors that held it, at a time when markets were jittery, having gone through the qualms of the Asian (1997) and Russian (1998) crises. Third, fears of devaluation of the Argentine peso were triggered by the devaluation of the Brazilian real in early 1999 and by the extraordinary strength of the US dollar, as reflected by the depreciation of the euro from 1999 to 2001. Last but not least, subnational fiscal discipline was abandoned in 1998 and 1999, as local expenditures in some provinces increased for electoral purposes adding another five percentage points of GDP to the consolidated public debt.

The last point is important because the bulk of the provincial debt was in dollars and with local banks, implying that bank solvency depended on the ability of the local governments to repay it. This is, essentially, what triggered the 2001 run on bank deposits. In short, fears of devaluation provoked fears of default, which in turn provoked fears of bank insolvency. But, if this was the problem, the solution

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[5] The government eliminated export taxes immediately after introducing Convertibility, and progressively reduced labor and other taxes to enhance competitiveness. Social security reform, which was enacted in 1993 to stimulate domestic saving, involved a partial shift of the pension system from a pay-as-you-go to a defined-contribution one.

was not to devalue the peso, but to restructure the national and provincial government debts. In fact, this is precisely what the government tried to do in November 2001. Unfortunately, instead of persisting in this effort, the interim government that took over after Mr. de la Rúa made the problem worse by devaluing the currency. Meanwhile, the decision to pesify domestic dollar deposits and loans asymmetrically amid growing inflation and exchange rate depreciation provoked a massive wealth transfer in favor of domestic borrowers and against domestic depositors.

A question that many observers have asked repeatedly in relation to this crisis is whether the peso was overvalued in 2001 when the crisis happened. As shown in Figure 3, RERB, the real bilateral exchange rate, was below the 1970-2020 average not only in 2001 but for the entire Convertibility period, namely, since 1991. Using as reference the 1970-1999 average excluding the months when the real exchange rate was abnormaly high due to hyperinflation, one is tempted to conclude that the peso was, indeed, overvalued, perhaps as much as 40%. However, while some tradable sectors certainly felt the pressure, it is unclear how externally uncompetitive the Argentine economy as a whole was in 2001. After a decade of strong investments in critical sectors of the economy, total factor productivity was arguably much higher than in the previous decade. Moreover, taxes on tradable activities were lower thanks to the elimination of export taxes in 1991 and the reduction of payroll taxes in 1996 and 1997. Finally, export volumes were trending up rather than down before the crisis. In this sense, it is reasonable to argue that the end of Convertibility was a self-fulfilling crisis driven by an exogenous change in exchange rate expectations rather than an accident waiting to happen due to a fundamental deviation of the real exchange rate from equilibrium, as many observers have argued.

The Post-Convertibility Period

Ironically, soon after sovereign debt default and deposit and loan pesification transformed an arguably reversible bank run into a full-fledged financial crisis, global conditions began to improve for commodity exporters such as Argentina thanks to a vigorous increase in import demand, primarily from China. During this period, the US dollar depreciated against the euro, the yen, and other international currencies, and the Brazilian currency appreciated in real terms adding extra layers of competitiveness to the Argentine peso, which became ostensibly undervalued in real effective terms between 2002 and 2007. The commodity boom lasted less than a decade (2003-2011), during which real GDP grew at an average 6.5% per year despite a 5.9% drop in 2009 due to the global financial crisis.

The lucky presidents that governed Argentina during this externally-fueled economic bonanza were Néstor Kirchner (2003-2007) and his wife, Cristina Fernández de Kirchner (2007-2011). Néstor died in 2010 and Cristina was reelected for a second period (2011-2015). Both were Peronists who, unlike Mr. Menem, surrounded themselves with leftist politicians and rather inept collaborators. Inflation increased from less than 4% a year in 2003 to near 24% in 2007. Had it not been for a virtual freeze on the prices of natural gas, electricity, and urban transportation after 2001, inflation would have been higher.

Nominal exchange rate stability, which lasted five years after the massive 2002 depreciation of the peso, began to be tested again in late 2008, when a conflict with farmers concerning a government proposal to raise export taxes took place. However, it was not until 2011 that capital flight returned with a vengeance prompting the Central Bank to re-impose FX controls, which had been inactive for almost a decade. Markets responded, as always, by driving a wedge between the informal or parallel exchange rate and the official one.[6] A 26% devaluation in the first quarter of 2014 did little to calm the FX market, after which persistent exchange rate instability became more or less permanent.

As the China-led boom and its associated increase in commodity prices came to an end in 2011, the economy entered a period of chronic stagflation, where years of slow growth alternated with recession years and inflation was high and volatile. Between 2012 and 2015, real growth averaged 0.4% per year and inflation averaged 29%, notwithstanding price controls, especially on natural gas, electricity, and public transportation, which significantly repressed domestic inflation. In short, the Kirchners era had two distinct periods: one (2003-2010) characterized by the China-led boom, with a brief interruption in 2009 due to the global crisis, and the other (2011-2015), whose main characteristic was stagflation after the China boom ended.

Policy wise, the most remarkable features of the post-Convertibility period were the reversal of most of the structural reforms implemented in the 1990s and the behavior of government spending as a share of GDP. On the first topic, the Kirchners re-nationalized companies that had been privatized, reintroduced distortionary taxes and regulations that had been eliminated, and reversed the social security reform while at the same time adding to the pay-as-you-go system 3.5 million new beneficiaries who had not contributed during their active lives. On the second topic, G/Y rose from 30% to 45%, as mentioned before. At first (2003-2006), the combination of China-led growth, export taxes, and the sovereign debt moratorium resulted in unprecedented fiscal surpluses on a cash basis. This changed abruptly in 2007, when government spending as a share of GDP began to increase rapidly. The first increase took place in 2007-2010 and was accompanied by a commensurate growth in tax collection reinforced by the re-nationalization of the social security system, which had been partially privatized in 1993. Hence, the fiscal deficit did not rise although the tax burden on the economy obviously did. In 2011-2014, the primary surplus disappeared but the overall deficit was a still manageable 2% of GDP on average. Finally, in 2015, the fiscal deficit jumped to 5.1% of GDP owing to large expenses incurred during that year's presidential election.

The Run on LEBACs

In October 2015, after four years of lackluster economic performance due to stagflation, the Peronists narrowly lost the presidential election to a centrist coalition led by Mauricio Macri, which was firmly committed to reinserting Argentina in global trade and finance. Unfortunately, Mr. Macri's government failed in the attempt because, once again, fiscal discipline was neglected.

There were two macroeconomic issues that needed special attention when the new government took office. The first one was a significant (60%) parallel FX premium due to high FX demand amid strict FX controls. The second one was the hefty subsidies that public utility companies received from the government in compensation for keeping their prices well below the levels needed to turn a profit. These subsidies represented 80% of the primary deficit of the central government. Solving the first problem required lifting FX controls and letting the exchange rate system unify via a devaluation of the official rate. Solving the second problem required hiking public utility prices so that government subsidies, hence the fiscal deficit, decreased. The government could not tackle both problems at once because of the effect this would have on inflation, already high at near 30% per annum. In retrospect,

[6] In reality, there was not one parallel or informal FX market but two or three where the rates differed slightly for technical reasons.

the ideal decision would have been to tackle the fiscal problem first and in one shot and the FX problem later and more gradually, but the government chose the opposite strategy.[7] The rationale behind this decision was a belief that domestic prices had already adjusted in anticipation of exchange rate unification, hence the effect on inflation would be minimal. Unfortunately, this was not the case. As the official exchange rate rose by more than 50% in the first quarter of 2016, annual inflation accelerated from 27% in 2015 to 39% in 2016.

Once the passthrough effect dissipated, inflation stabilized at about 2% per month (equivalent to 27% per year), at which point the Central Bank launched an inflation-targeting program aimed at reducing it to 5% per year in 2020. The plan was untimely because, owing to its large fiscal deficit, Argentina was not ready for inflation targeting. Once inflation accelerated on account of exchange rate unification, raising utility prices as much as needed to significantly reduce the fiscal deficit became politically impossible. Far from decreasing, the total deficit, including interest, increased from 5.1% of GDP in 2015 to 5.8% in 2016. In short, by tackling the FX problem first, the incoming administration lost the political momentum needed to cut the fiscal deficit as much as needed.

The official strategy chosen to finance the deficit was to limit Central Bank assistance (i.e., “printing” money) and issue bonds internationally to take advantage of the marked improvement in investor sentiment that the change in government had triggered. Regrettably, this created a situation akin to the one Argentina had experienced in the late 1970s because the bulk of the fiscal deficit was primary, meaning that the government needed pesos rather than dollars to pay its bills. Instead of selling the borrowed dollars in the open market, which would have caused the peso to appreciate, the National Treasury chose to sell the dollars to the Central Bank. This conveniently allowed the Central Bank to build up reserves, the level of which had been all but depleted by the previous administration’s use of reserves to finance the current account deficit and service the dollar debt. This time around, however, the Central Bank decided that, to keep inflation under control, it had to mop up the excess liquidity resulting from its dollar purchases, and for this it issued short-term bills called LEBAC.

Thus, what happened in the end was that the National Treasury increased its debt exposure in foreign currency, albeit at relatively low interest rates and medium- to long-term maturities thanks to favorable global financial conditions, while the Central Bank bought a large amount of FX reserves, for which it paid dearly because, owing to the risk of depreciation of the peso, the interest rate on LEBAC was significantly higher than the return on reserves. Needless to say, a quasi-fiscal deficit soon began to form. To make things worse, some of the LEBACs, which were supposed to be held only by local banks, found their way to nonbank investors including foreign ones, which used them to execute carry-trade transactions that took advantage of the high local interest rate. While, in principle, the stock of LEBAC was backed by a similar amount of increased foreign reserves foreign reserves, investors feared that, in the event of a run, the Central Bank would devalue the peso rather than sell reserves, particularly since there was a growing current account deficit fueled, in part, by an appreciated real exchange rate.

[7] As some observers noted at the time, the Central Bank could have converted the de-facto dual exchange rate regime into a de-jure one by allowing investors and tourists to sell dollars at the freely floating and higher financial exchange rate instead of forcing them to do so at the managed and lower commercial one. Presumably, this would have reduced the exchange rate premium without requiring a maxi devaluation right from the start.

In May 2018, the predictable run on LEBACs materialized for the first time causing the nominal exchange rate to jump 40% amid a significant loss of FX reserves. The Central Bank increased the policy interest rate, but this did not calm investors because, on the one hand, the higher interest rate dampened depreciation pressures but, on the other, it accelerated the speed at which the stock of LEBAC was growing. The depreciation of the peso not only worried LEBAC holders but also foreign investors, as it put into question the ability of the National Treasury to repay the copious foreign debt it had accumulated in the previous couple of years. Once again, the government of Argentina experienced a sudden stop of voluntary credit financing and was forced to seek financial support from the IMF.

The request for an unprecedented $50 billion Stand-by loan from the Fund was quickly approved in June, but monetary conditions remained fragile. A second run on LEBAC in August 2018 triggered an additional 40% devaluation coupled by a new hefty loss of reserves. At this point, having disbursed $15 billion under the Stand-by arrangement and not willing to see more of its dollars flee, the IMF demanded, and the government accepted, a draconian stabilization plan with three pillars: a freezing of the monetary base (M0) until June 2019, letting the exchange rate float without Central Bank intervention, and strenghtening fiscal consolidation. On the monetary front, the immediate effect of the plan was a sharp increase in the short-term interest rate. To prevent a resumption of the carry trade, the Central Bank paid off the LEBAC held by nonbanks and replaced those held by banks by a new instrument called LELIQ, which could only be held by the banking sector. On the fiscal front, the plan to gradually reduce the primary deficit from 2.7% of GDP in 2018 to zero in 2020 was replaced by a more aggressive one that targeted primary balance in 2019 and a 1% of GDP surplus in 2020. In exchange for the new conditionality, the IMF augmented the stand-by loan to $57.1 billion.

Unfortunately, the fiscal reaction came too late and was widely unpopular. As the economy sank deeper into stagflation, Mr. Macri lost his re-election in 2019 to a Peronist formula headed by Alberto Fernández, which had Cristina Fernández de Kirchner (no relation) as the vice-presidential candidate. After disbursing $44 billion of the $57 billion promised under the Stand-by facility, the IMF suspended disbursements in late 2019. Talks have a begun to refinance this debt, possibly by converting the existing loan into a ten-year Extended Funds Facility. Ironically, one of the last measures of the outgoing Macri administration (along with the rescheduling of domestic debt payments and the suspension of external ones pending restructuring) was the re-introduction of FX controls, the elimination of which had been its most distinctive, though poorly timed, accomplishment.

The Current Situation

The Fernández-Kirchner administration has been in power since December of last year. They received a macroeconomic situation not essentially different than the one Ms. Kirchner had bequeathed Mr. Macri four years earlier. In both instances, stagflation was the main underlying condition. The only important differences were the primary deficit and the national debt. The former was lower in 2019 (0.4% of GDP versus 3.8% in 2015) while the latter was higher (54% of GDP versus 23%, respectively).

Early efforts by the new government to improve the macroeconomic situation in the first quarter of 2020 were ineffective. And then COVID-19 hit. As in other countries, the government of Argentina implemented a strict lockdown to fight the pandemic, which caused economic activity to collapse. Seasonally adjusted real GDP decreased 4.2% in the first quarter and 16.2% in the second quarter. For the whole year, real GDP is expected to drop by 12% year on year due to a slow recovery in the second semester.

Given the magnitude of the COVID-19 shock, any semblance of fiscal and monetary discipline had to be abandoned. The primary deficit of the central government increased significantly due to a combination of higher spending and lower revenues. It is now expected to be 8.5% of GDP in 2020, eight percentage points higher than in 2019.

Under pressure, the authorities closed a debt restructuring agreement with private foreign creditors in August that, for the most part, postponed debt payments until 2025. Principal payments on the domestic debt were also rescheduled, and the interest bill was reduced from 3.4% of GDP to 2.0% bringing the 2020 overall deficit to 10.5%, not including the quasi-fiscal deficit of the Central Bank, which is worth another 3.0% of GDP.

Domestic credit conditions, which were extremely tight at the beginning of the year due to the draconian monetary policy implemented in 2019, were loosened as well. The policy interest rate dropped from 63% in December of last year to 38% at present.

In the absence of credit, Argentina had no alternative but to finance its expanded consolidated (Treasury + Central Bank) deficit almost entirely by printing money. However, to reduce the effect on inflation, two thirds of the increase in the monetary base were sterilized through a combination of LELIQ, repo, Treasury bill, and foreign reserve sales. The unsterilized part is expected to increase the money base (M0) by about 50% this year compared to 35% the year before. Inflation, on the other hand, is expected to do the opposite: it will decrease from 54% to 36%. Three reasons explain this seemingly odd result: the COVID-induced recession, a strengthening of price controls by the government, and the parallel FX market. All of them have diminished, or perhaps delayed, the impact of monetary expansion on inflation. In particular, the parallel market premium rose from 60% at the beginning of the year to more than 100% in recent weeks, absorbing some of the effect that excess money supply would have otherwise had on domestic prices.

The problem, going forward, is that these inflation-mitigating adjustment mechanisms are not sustainable. Issuing expensive short-term Central Bank or Treasury bills to absorb excess liquidity leads to an excessive buildup of public sector liabilities in the hands, mainly, of local banks. While these hands are safer (i.e., less volatile) than those of carry traders because banks are subject to Central Bank control, the question is not what banks will do if inflation or devaluation expectations suddenly increase, but what the reaction of depositors will be. Letting short-term public debt grow persistently as a share of GDP is a Ponzi game or, if you like, an extreme version of what Thomas Sargent and Neil Wallace once called “unpleasant monetarist arithmetic.” Remunerated Central Bank liabilities, such as LELIQ and repos, currently represent 55% of bank deposits. It is a matter of time until depositors realize that their money is not safe at the banks and withdraw their deposits to buy dollars before the latter are either inflated away or forcibly swapped into long-term financial instruments that pay lower interest rates. A situation like this happened in the late 1980s, and the solution of the government at the time was to convert 7-day peso deposits paying inordinately high interest rates into a 10-year dollar government bond that paid Libor (the so-called Bónex Plan of December 1989).

A related problem is the gap that currently exists between the parallel and the official exchange rates. At near 100%, there is no room for this gap to increase any further without triggering a massive devaluation of the official rate, which would accelerate inflation quite significantly. Interestingly, unlike other instances in which the parallel premium was as high as it is now, the official exchange rate is currently not low (i.e., the peso is not overvalued in real effective terms). Rather, the large parallel gap is simply a reflection of excess money supply and low confidence in the way the government is managing the economy. At any rate, the near 100% parallel premium causes exporters to delay selling their dollars to the Central Bank, which is the reason why, despite the sharp decline in imports due to the recession, the trade surplus is low and trending down. Should the surplus continue to fall because of import recovery, there would be no alternative for the government other than a maxi-devaluation.

The government takes comfort on the notion that, next year, the primary deficit as a share of GDP will be lower because COVID-related income transfers and health expenditures will fall, as the pandemic dissipates, and fiscal revenues will rise, as the economy recovers. In other words, fiscal revenues will grow faster than expenditures. In fact, the budget bill recently submitted to Congress projects a 44% increase in public revenues and a 20% increase in primary expenditures (both nominal) without really explaining why the growth rates will be so different. The underlying assumptions are that real GDP, consumer prices, and nominal GDP will increase, respectively, by 5.5%, 29%, and 39% in 2021. Using these assumptions, the authorities project that the primary deficit will be 4.5% of GDP and the overall deficit will be 6.0% of GDP.

However, even if this challenging feat were accomplished, bringing inflation down to 29% would require an enormous sterilization effort. This is so because the quasi-fiscal deficit will add another 4.5% of GDP to the financial needs of the national public sector including the Central Bank. Using the budget's projected nominal GDP figure, the 10.5% of GDP consolidated deficit is equivalent to 4 trillion pesos. This compares with a monetary base worth only 2.5 trillion at present. Keeping the monetary base growing at a level commensurate with the authorities' expected increase in nominal GDP would require the stock of LELIQ, repos, and other remunerated Central Bank liabilities to grow by 2.5 trillion pesos. But, if this were the case, the share of these instruments in total deposits would rise from 55% to 66% (assuming the volume of deposits stays constant as a share of GDP). In other words, the government assumes that the Ponzi scheme will not only continue unabated in 2021 but will become even more pervasive. If this unlikely assumption fails to materialize, inflation will spin out of control unless deposits are frozen or converted into longer-term instruments carrying lower coupons.

In short, without a drastic reduction of the primary deficit to the pre-pandemic level of between zero and one percent of GDP, it is not easy to see a solution that does not involve a massive increase in inflation, as in 1975, or the equivalent of a Bónex Plan, as in 1989.