Argentina without Convertibility: Blessing or Curse?

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The abandonment, in January 2002, of the monetary regime Argentineans knew as Convertibility, is an archetypical case of "throwing the baby with the bath water." Surely, the system faced many problems in the second half of 2001, not the least of which was a financial run on the domestic banks. But, its radical and disorderly elimination by the government of Eduardo Duhalde (January 2002-July 2003) created disproportionate costs relative to benefits, including some costs that have not been paid yet.

It would be as if Italy abandoned the Euro in the midst of a recession and a bank panic instead of attempting to find a suitable solution for these problems. Just imagine the consequences of an act like this in Italy, scale them down by the differences in GDP and GDP per capita between the two countries, and you will get an idea of what went on in Argentina.

Critics of the economic reforms introduced in the 1990s (monetary reform being but one of them) argue that Convertibility, which was in place for 11 years, was worn and unsustainable and needed to be eliminated anyway. To support this claim, they contrast the strong growth attained by Argentina in 2003-06 (9% per year) with the 7.2% drop observed between 1998 and 2001. What they do not say is that, in 2002, GDP collapsed (it dropped by 10.4%) as a result of the measures introduced by Mr. Duhalde, which included a hyper-devaluation, sovereign default, and a forcible conversion of all dollarized domestic contracts into pesos.

The purpose of this note is to set the record straight. First of all, if the worst of the depression occurred after the abandonment of Convertibility, it can hardly be attributed to it. Second of all, the post-2002 expansion was fundamentally due to unusually favorable conditions in the world economy and not, as the apologists of the new regime want us to believe, by the implementation of a "new model that promotes real production as opposed to financial speculation." Third of all, thanks to the modernization of the economy in the 1990s under the aegis of the Convertibility Plan, Argentina was able to expand productive capacity and improve total factor productivity is such a way that, when global conditions finally switched from negative to positive, the economy was able to grow faster than most other emerging markets. This is because the prolonged crisis had rendered the productive capacity underutilized, hence providing ample room for aggregate demand to expand without overheating the economy or provoking a new episode of hyperinflation.

To be sure, unemployment, poverty, and income distribution deteriorated much more deeply in 2002 than in the previous three years of recession. Had Argentina maintained Convertibility (along with all the other macroeconomic and microeconomic rules and policies set up in the 1990s), the 2002 depression would have probably not happened. In its place, there would have been a milder recession in the first semester followed by recovery in the second semester. Arguably, observed growth would have been less than

9% per annum in 2003-06. But, today, the level of GDP, both in real and dollar terms would be higher. More importantly, the outlook would be brighter in terms of growth and significantly brighter in terms of inflation.

The question is whether the demise of Convertibility could have been avoided. We believe that it could. Here we explain how.

Dealing with External and Fiscal Insolvency: A Counterfactual

Argentina lost its credit in mid-2001 as a result of external and domestic factors. The external factors are well known. They included the sharp appreciation of the US dollar, the equally sharp depreciation of the Brazilian Real, a strong decline in export prices, and the "sudden stop" of capital flows to emerging markets that began in 1997. The main domestic factor was fiscal expansion, particularly in the provinces, since 1995.

Clearly, the adverse international environment hit Argentina more than other countries because its economy was more vulnerable. However, contrary to what has become established as the conventional wisdom, Convertibility and dollarization per se were not the issue; the growth of public debt was.

By the end of 2001, the provincial governments as a whole owed $16bn to their creditors and were liable for $3.5bn worth of interest payments, reflecting just how high interest rates were. In December of that year, the creditor banks accepted to restructure these assets along the lines of a proposal presented by the Federal Government on November 1st, namely, to convert the provincial loans into so-called National Guaranteed Loans (NGLs). These were owed by the federal government and guaranteed with the earmarking of certain federal taxes, but were paid out of provincial revenues through the federal withholding of co-participation transfers.

In this way, the interest on the provincial debt was reduced from an implicit 22% per year to just 7 % (the coupon set on NGLs) overnight, implying a $2bn reduction in the annual interest bill paid by the provinces. Moreover, the average life of the debt was extended by three years and a grace period was introduced so that the provinces did not have to pay any principal until 2005.

As for the national public debt, the main components were:

1. $30bn worth of multilateral and bilateral loans carrying relatively low interest rates, which could have been refinanced without much difficulty.

2. $39bn worth of NGLs tendered to private (basically, domestic retail and institutional) creditors who accepted the terms of the November 1st exchange offer. As in the case of the provincial debt, the new instruments had interest rates of up to 7 % per year, a three-year grace period, and a similare average life extension.

3. $40bn worth of bonds held by (mostly foreign) creditors who did not participate in the November 1st exchange offer, mainly because the NGLs were not easily tradable and had been issued under local legislation. The average interest rate on those bonds was 10 % per year.

Item 2 implied a $2bn interest cost reduction, this time for the federal budget[1]. In addition, the government of Fernando de la Rúa, who had been elected in 1999, was planning to launch a second exchange offer for the debt included in Item 3. To prepare this offer, a group of financial advisors integrated by Jacob Frenkel from Merrill Lynch, Bill Rhodes from Citigroup, and Joe Ackerman from Deutsche Bank was appointed. Our idea was to introduce exit consent clauses to encourage as much bondholder participation as possible. Our estimate was that a successful second exchange offer would cut annual interest costs by an additional US$2bn.[2]

Putting all these numbers together, the planned reduction in the annual interest bill was $6bn (or about half the previous bill). At US$134bn (US$118 at the national level and US$16bn at the provincial level), the face value of the consolidated public debt was not going to change. However, the reduction in interest payments was going to help the national and provincial government to balance the budget in 2002 and thereafter as required by an emergency law sanctioned by the National Congress in late 2001. To comply with this law, the federal government had proposed a package of primary spending cuts, to be implemented at the national and provincial levels, worth about $6bn on an annualized basis.

The "zero-deficit" target did not reflect a preference for fiscal contraction during a recession by the De la Rúa administration, but a need imposed by reality: as long as the decline in public revenues continued, there would be no voluntary financing of the fiscal deficit from market sources. Therefore, fiscal spending had to fall to meet fiscal revenues. With no deficit to finance, the public debt would have remained constant in nominal terms until 2005. After that, each level of government had to either generate fiscal surpluses or regain access to financial markets to refinance the principal. To smooth the fiscal transition in the provinces, the federal government had authorized the temporary emission of provincial treasury bills (Lecops) carrying low coupons, which could circulate as non-convertible quasi currencies until the fiscal situation was normalized and the provinces could rescue them.

Lifting Exchange Controls

The imposition of exchange controls and restrictions on cash withdrawals from commercial banks in December 2001 was a rather desperate attempt to save the economy from devaluation and default, particularly since the IMF had unexpectedly decided to turn its back on Argentina by suspending a promised and due disbursement in November.

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[1] The reduction was lower than that obtained by the provinces because the contractual rates paid by the latter were substantially higher.
[2] Jurisdiction and future liquidity concerns would justify the 2 percentage point's difference between the 7 % interest rate of the guaranteed loan and the 5 % of the new bonds.

However, this interruption of convertibility was not meant to last long. As soon as confidence improved, which was expected to occur as a result of the completion of the debt-restructuring plan in March 2002, these restrictions were to be eliminated.[3] Those banks that, after the removal of restrictions still faced liquidity constraints, were going to be required to restructure their obligations according to existing legislation, but a generalized freeze on bank deposits, such as the one implemented by the government of Duhalde in January 2002, was to be avoided.

Since the IMF had promised to disburse $3bn from the augmentation approved in September 2001 to facilitate the debt-restructuring program and there was a pending disbursement of $1.25bn from the original loan, the Central Bank expected to have $4bn to assist the commercial banks as lender of last resort.

Finally, in the event that all the measures discussed before were not sufficient to remove expectations of devaluation among the population, the government did not rule out devaluing the peso, but without "pesofying" dollar contracts. This would have required setting in place temporary relief mechanisms for borrowers to prevent domestic loan insolvency. But, the massive redistribution of wealth from creditors to debtors created by the combination of hyper-devaluation and pesofication together with the costly compensation to domestic banks via more government debt would have been avoided.

Concluding Remarks

The policies implemented in 2002 by the government of Eduardo Duhalde, who took office after President De la Rúa resigned in December 2001, succeeded at bailing out highly indebted provincial governments and domestic corporations but failed to resolve the main problems afflicting the Argentinean people while reintroducing old economic problems and distortions. Principal among the latter are inflation, price controls, underinvestment in public services and infrastructure, and myriad contingent liabilities, including with pensioners, holdouts, and direct foreign investors. Given these issues, one can only speculate that the drought in FDI we have seen in the last four years, the strong recovery notwithstanding, is in Argentina to stay. And this is where the main problem lies: not on the wrongs seen so far, which are plenty, but on the ones that remain to be seen.

The current government, led by Nestor Kirchner, claims to have a new model, based on a competitive real exchange rate (in reality, an undervalued peso sustained with high export taxes and strict price controls). Supposedly, this model will produce a sustained expansion of investment and exports and prevent new economic and financial crises. All we can say in reference to this is that the proof of the pudding is in the eating. And while we are somewhat skeptical about the ability of the current strategy to graduate from predictable recovery to sustainable growth, we are willing to give it the benefit of the doubt. Unfortunately, all the evidence we have for the time being is that investment is growing strongly in construction and import-substituting activities and that exports are

[3] The government expected to launch the second and last debt exchange in mid-January and close it at beginning of March.

expanding at a lower rate than in other emerging markets (including Brazil despite the fact that the Real is strong and the peso is weak). Furthermore, export growth has been decelerating.[4] Which is another way of saying: Mr. Kirchner, wake us up when the model is actually working.

[4] From 13.5% in 2005 to 6.4% in 2006