How did the Foreign Debt Trigger the Argentine Crisis?

(or the new "Washington Consensus" that triggered the Argentine Crisis)

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I have been asked by the organizers of this important seminar to discuss Argentina's foreign debt as the triggering factor of the crisis. But I think that the genesis of Argentina's problems could be best focused from another angle, so I decided to analyze it in the light of a question, the one which I chose as the title for this conference. I am persuaded that so as to find a solution to the countless court and out-of-court conflicts derived from the Argentine Crisis it is important to first identify what exactly triggered the collapse. It is from this perspective that a "new" Washington Consensus can be regarded as one important factor in the dynamics of the crisis which aggravated in December 2001 and January 2002, and now poses several difficulties to the solution of such crisis[2].

In my opinion, if the Argentine Crisis is to be attributed to a determining factor, this is the support which provincial political leaders and private-sector entrepreneurs understood to be receiving from abroad in order to get a significant haircut on their mounting debts. I think that Washington's signals at the end of 2001 were thus interpreted by Eduardo Duhalde, Ignacio de Mendiguren, Raúl Alfonsín and Leopoldo Moreau, among others.

To account for this conclusion, I will state the reasons why I dismiss other factors as irrelevant to the crisis. But before concentrating on the reasons, I will discuss the Argentine Crisis that, in a broader sense, had affected the country since 1999. It is the crisis that disrupted the economic rules in operation as from April 1st 1991, when the convertibility plan was implemented, and which were completely altered on January 6th 2002. Those who emphasize the Legal Uncertainty ensuing the crisis are certainly referring to the Argentine Crisis that I mean to describe.

The long lasting crisis which started in the second half of 1998

The economic rules comprised by the Convertibility Law helped to tame hyperinflation and put a definitive end to inflation, a continuous problem that had hit the Argentine economy for over four decades. They also created the conditions to attract investment back to the country, which translated into increased productivity and growth rates that had only been achieved throughout the first decade of the 20th century. Besides, this new economic order proved strong to withstand very critical situations, such us the capital flight that followed the Tequila Crisis and whose recessive effects in Argentina were reversed in less than a year. Employment -which had grown slightly until 1994 and had dropped throughout 1995- increased considerably between 1995 and 1998 after the labor laws were reformed.

The origin of Argentina's economic problems can be traced back to 1999 and, in my opinion, the source of all these problems is a threefold one. In the first place, bank credit became rather limited for the private sector, affecting mainly small and medium sized enterprises; secondly, competition by Brazilian imports after the real's devaluation meant a severe impact on agricultural businesses and manufacturing companies making import substitutes; thirdly, the depreciation of the euro and other currencies vis à vis the US dollar between 1992 and 2002 clearly resulted in an over-appreciation of the dollar-pegged peso.

Bank credit was limited for the private sector as a consequence of two main phenomena. On the one hand, there was the increasingly heavy federal expenditure, especially that of the Province of Buenos Aires, which was financed through bank borrowing. On the other hand, the inflow of foreign capitals had been decreasing since the onset of the Russian Crisis, in 1998. The first sign that credit would be restricted was the high lending rates, which the provinces seemed willing to accept in order to continue borrowing. In the private sector, however, the higher cost of credit translated into less investment and reduced working capital for small and medium sized enterprises, which are mostly labor-intensive. This explains the steady increase in unemployment since 1999.

The Real's devaluation had a notoriously harmful effect on Argentina, because Brazil accounted for almost one third of our country´s foreign trade since the creation of the so-called Common Market of the South -also known as Mercosur-, which provided for the elimination of tariffs among its members.

The Argentine dollar-pegged peso substantially appreciated between 1999 and 2002 owing to the US currency strength, and this discouraged exports.

In order to reverse the critical situation, several adjustments had to be made to complement the economic rules in force since 1991. One of the goals was that provinces cut back heavy expenditure and stopped bank borrowing. Another measure was to impose some restrictions on Brazilian imports, but these would not be stricter than the controls on imports coming from countries outside the Mercosur. A further adjustment was to shift from the dollar-peso peg to one which also included the euro. Unfortunately, these reforms were not implemented early enough to reverse the recession; instead, they were delayed until April 2001.

The Argentine Crisis and the economic rules implemented during the 1990s

In late December 2001 and January 2002 the economic rules of the 1990s were at a crisis: the Convertibility Law –which provided that every Argentine Peso issued be backed by one US Dollar- was revoked, and all the economy was compulsorily *pesofied*, that is, all

US dollar denominated contracts were turned into Argentine pesos at asymmetrically different rates. These measures caused the default on all public and private debts, the ensuing effects being:

- A sharp nominal devaluation of the Argentine currency. By virtue of the Convertibility Law one Peso was worth one US dollar, but after the Law was repealed, the peso depreciated to be worth USD 0.25; nearly two years later it stabilized at approximately USD 0.33.

- A differential and limited inflationary impact. The prices of internationally tradable goods tripled but the value of most other non-tradable goods –including salaries- hardly increased. As a result of differential inflation, real salaries shrunk by 30 percent on average.

- A dramatic fall in consumption and investment. This translated into a further GDP drop throughout 2002, one which was quite as sharp as the decrease accumulated during 1998-2001.

- A fall in exports volumes throughout 2002. However, in 2003 foreign trade has been increasing at the average rate of the 1990s.

- A 60 percent fall of GDP in terms of US dollars, as a consequence of the real effect of devaluation and the decrease in consumption and investment.

- A domestic redistribution of wealth in the order of USD 30b which were diverted from savers' bank deposits and pension funds to private-sector debtors and Provincial Governments. This redistribution policy eventually represented no benefit at all for the Central Government; on the contrary, it incurred more debt because financial institutions had to be compensated for the asymmetric *pesofication* scheme.

- Annual income in the order of 20 percent of GDP diverted from workers and service suppliers (including privatized utility companies) to the manufacturers of non-agricultural internationally tradable goods and import substitutes.

- A stabilized economy and partial recovery of consumption and investment during 2003. Notwithstanding, in terms of US dollars, 2003 GDP is less than 50 percent of 2001 GDP.

What triggered the crisis?

The crisis which affected the economic rules implemented during the 1990s has been ascribed to several facts or series of events. The International Monetary Fund argues that the determining factor was the Central Government and Provincial Administrations reluctance to cut back public expenditure and thus stop borrowing to finance their fiscal deficit. The advocates of the currency-board system and supporters of the forced-*dollarization* policy blame it on the plan to broaden the dollar-peso peg which would eventually become a basket peg, and on the Competitiveness Plans launched in 2001. They insist that the economy should have been fully *dollarized* in the first place. Some consider that the crisis was due to the stagnation of exports caused by an overvalued peso. Others put it down to President De la Rúa's decision to preserve the convertibility policy and to avoid resorting to devaluation as an instrument for financing fiscal deficit. And last, there is those who claim that it took too long to propose an orderly debt restructuring program.

The governments reluctance to cut back expenditure

Michael Mussa, a former chief economist of the IMF, has argued that the factor which triggered the crisis was the USD 2bn fiscal adjustment that the Central Government failed to support in March 2001, while Ricardo López Murphy was Argentina's Minister of Economy. Actually, I do not agree with Mr Mussa's standstill because shortly after Ricardo López Murphy's resignation, I was appointed to take over his position and together with President De la Rúa succeeded in getting parliamentary support for a USD 3bn fiscal tightening package. This measure plus the Competitiveness Plan, which would help to improve the relative prices of internationally tradable goods without abandoning convertibility, allowed us to avert the bank run of March 2001.

Likewise, in July 2001, IMF Managing Director Horst Köhler took notice of Argentine political leaders' criticism against the Zero Deficit legislation and used it to imply that the IMF would discontinue their support to the country and would not approve the Financial Aid Program that Argentina was applying for in order to stem another run on deposits which had started early that month. In August we came to an agreement with the provincial governors and the Zero Deficit Law was finally passed by Parliament. This proved that the Central Government did not lack internal political support, so Managing Director Köhler had to reconsider his previous argument.

The arguments that Argentina refused to cut back expenditure are proven incorrect according to fiscal statistics. In 2000, the National Primary Expenditure decreased by USD 1.5bn and in 2001 USD 3.5bn (inclusive of the 13 percent reduction on public-sector wages and monthly pensions over USD 500) were additionally trimmed. Besides, during the second half of 2001, the provinces -whose primary expenditure in 2000 and the first half of 2001 had shown the same levels of 1999- balanced their budgets to achieve a USD 2bn adjustment. Even without any further tightening, by 2002 National and Federal consolidated primary public expenses would have been USD 7 billion less than in 1999.

Almost all governors and –needless to say- President De la Rúa knew that subverting the economic rules of the 1990s would mean a much tighter and costlier adjustment than the one they were voluntarily applying, because Public Expenditure would have to be reduced by way of inflation. For that reason, to suppose that they refused to make the necessary adjustments only to stir up the crisis and undermine the economic policies of the 1990s is to assume that they were on the verge of political irrationality. And, believe me, they are not irrational –I can tell you from my long time experience working with them.

The Central Government's decision not to force *dollarization* on the economy and the implementation of the Competitiveness Plan

Steve Hanke, the world's main supporter of currency boards, and many other think-tanks like the Argentine CEMA or the Cato Institute, argue that the economic rules of the 1990s were at crisis because I opposed the plan to *dollarize* the economy and launched the "Competitiveness Plan" instead. According to them, this raised doubts as to whether the country would continue to uphold the Convertibility Law.

I did not want to force a *dollarization* policy because I have always been persuaded that introducing the US dollar as Argentina's only legal tender was not appropriate for our economy. And during 2001, in particular, I thought that if the Central Government considered it constitutional to enforce the currency conversion of contracts so that those which had been originally denominated in pesos be honored in US dollars, the reverse could also be valid. In other words, enforcing a *dollarization* process would have set a constitutional precedent for the compulsive *pesofication* of contracts. The Convertibility Law provided that the economy could function in dollars or euros and that contracts could be *pesofied* as long as this was a voluntary decision, not a forced one. The Convertibility Law clearly stated the possibility of using multiple currencies and established no such thing as a conventional currency board, although many economists have persistently mischaracterized it as such.

By promoting a compulsive *dollarization* of the economy, President De la Rúa's Government would have accelerated the crisis which eventually subverted the economic order of the 1990s. A *dollarization* process would have triggered the collapse much earlier in 2001 by means of more powerful political and judicial arguments than the ones used in January 2002. Therefore, the decision not to force a *dollarization* policy cannot be considered the deciding factor of the crisis.

Neither could it be blamed on the Competitiveness Plan. This comprised a series of measures intended to set relative prices right so as to favor tradable goods without undermining the convertibility rules. Indirect taxes and subsidies served as the instruments of this plan, which also eliminated regulations that discouraged investment and productivity. Little could the Competitiveness Plan have contributed to spark the crisis which disrupted the economic order of the 1990s when it was precisely aimed at correcting the maladjustment of relative prices that adversely affected internationally tradable goods. The purpose of the plan was to correct the so called misalignment of the real exchange rate without modifying the nominal exchange rate present in all of the contracts in force. In any case, what raised doubts about the dollar-peso fixed parity was actually the maladjustment of the real exchange rate rather than the attempts to redress the imbalance.

The stagnation of exports

Most of the technical papers that deal with the Argentine Crisis, especially those produced abroad, consider the stagnation of exports to be the result of an overvalued dollar-pegged peso. This is the typical explanation that any theory coursebook would give when referring to stabilization plans based on a fixed rate of exchange. However, those who write on Argentina and ascribe the crisis to the dollar-peso parity seem to have missed or overlooked some of the factual data available on the Argentine case. It is so common a misconception that even US Treasury Secretary Mr Paul O'Neill made the same mistake when he said to *The Economist*[3] in July 2001 [*sic*]: *"Argentines have been off and on in trouble for 70 years or more. They don't have any export industry to speak of at all. And they like it that way. Nobody forced them to be what they are."*

After these statements, I explained to him how misinformed he was because during the 1990s Argentina's exports had been as large as Chile's and almost twice as many as those of Brazil's, although Mr O'Neill had compared them negatively. After this gaffe, he asked the IMF to grant Argentina a USD 8bn package to support an orderly debt restructuring program which would help reduce the interest cost of the country's public debt. The IMF Board thus approved the monetary aid at the end of August 2001 and made a USD 5bn disbursement which contributed to strengthen the Financial System and stem the run on savings of July and August. However, the multilateral's support to the Zero Deficit policy was still uncertain.

President De la Rúa's decision to underpin convertibility instead of devaluing the peso to finance fiscal deficit with currency issuance

According to Joseph Stiglitz, it was President De la Rúa's determination to underpin the convertibility plan what actually triggered the crisis. This view is also shared by those who claim that the economic collapse did not stem from the unbridled public spending and borrowing but from the Government's decision not to implement John M. Keynes' policies to spur economic recovery in 1999, when it became clear that the country had gone into a recession. In my opinion, had President De la Rúa's Administration decided to abandon convertibility and applied Keynes' theories, the economic order of the 1990s would have been subverted two years earlier. This entailed the serious risk of an eventual hyperinflationary process because devaluation with no fiscal austerity and large monetary issuances could have caused so drastic a depreciation that dollar indebted individuals and institutions would have demanded that their contractual obligations be *pesofied* or that their debt burden be relieved by some sort of subsidy aimed at preventing their bankruptcy. Background knowledge and experience from the decades preceding the 1990s is so profuse that no Argentine political leader or economist could have proposed devaluation.

The indecision to orderly restructure the public debt

Allan Meltzer and Charles Calomiris[4], among others, have argued that Argentina showed no willingness to restructure its public debt. However, their restructuring proposal of

April 2001 was unfeasible because the IMF showed no disposition at all to allocate the money necessary to support a last resort-lending scheme in which it was expected to act as the lender of last resort. As I will discuss later in this paper, the factor that actually triggered the crisis of the economic rules of the 1990s started to transpire by the time we launched the orderly debt restructuring option, after the IMF had accepted to support it through the USD 8 bn provision that it approved in August 2001.

By November 30th 2001, Argentina had successfully completed the first phase of the restructuring scheme which covered 55 billion dollars of debt principal (almost 60 percent of the expected restructured value). This included the voluntary swap of old bonds and loans –which in some cases paid interest rates of as much as 20 percent per annum- for guaranteed loans which used tax receipts as a collateral and paid annual interest rates not higher than 7 percent. It also attained a three-year deferment of capital amortization payments. This first tier of the restructuring option brought in USD 4bn worth of annual interest reduction over the USD 14 bn paid in 2001.

The second phase of the debt swap scheme was meant to bring the interest bill down by another USD 3bn so that, in terms of interest, public expenses for 2002 would have totaled USD 7 bn instead of the USD 14bn spent in 2001. The USD 7bn cutback in Provincial and National Primary Public Expenditure plus this further reduction in the order of USD 7bn guaranteed Zero Deficit for 2002. However, this was not enough to prevent the crisis of the economic rules of the 1990s. On the contrary, it seemed to have accelerated the economic downfall. Thus, it could not be alleged that the origin of the crisis was due to the Argentine Government's indecision to orderly restructure its debt.

The reason which actually triggered the crisis: leaders' perception that there was external support to conveniently ease all types of debts –including personal liabilities

At the end of November 2001 it was clear that the Central and Provincial Governments had decided to significantly cut back Primary Public Expenditure, so that during 2002 expenses would be USD 7bn below the levels of 1999. Besides, the Central Government had shown no disposition to prevent the voluntary *dollarization* of the economy, that is to say, people's own decision to convert their pesos into US dollars. The exports incentive policies and the protection concerning imports from Brazil had been successfully implemented, without any need to adjust the nominal exchange rate or increase fiscal deficit[5]. Exports continued to grow and imports had fallen enough to eliminate the balance of payments deficit. Neither the most important Argentine political leaders nor the economists who advised political parties would suggest increasing deficit and abandoning convertibility to finance it through monetary issuance. Furthermore, on November 1st 2001, Argentina had launched the first tier of its Public Debt Orderly Restructuring Scheme, which was gaining considerable support from banks and pension funds, namely, the most important holders of national and provincial bonds.

But which were the signs coming from abroad? The IMF Managing Director's delay to send the assessment mission which would consider whether Argentina had fulfilled the goals for the third quarter of 2001 set in August's program, the lack of IMF public support to the Debt Orderly Restructuring Scheme announced by the Central Government on November 1st, the IMF's informal comments suggesting that bond holders abroad would not be treated in the same way as domestic ones, the overt public discussion concerning a future Sovereign Debt Restructuring Mechanism (SDRM) which implied exchange controls during its implementation, and the diffusion of opinions by former IMF and IADB officials supporting devaluation and advocating *pesofication* were precisely the signals coming from abroad.

All these signs startled bank savers and fueled the outflow of deposits. Besides, heavily indebted companies and provincial governments took such signs as "Washington's" acknowledgement that Argentina's debt problem could only be resolved through significant "haircuts" that domestic and international bond holders would have to accept. Had the message not been clear enough for Argentine leaders, Allan Meltzer mentioned this idea in interviews with the Argentine press[6], and during a trip to Buenos Aires he told national senators that the restructuring process which the Argentine Government had embarked on would not generate enough "haircut" so the country should simply default on all of its debt.

It was in this context, as I see it, that Eduardo Duhalde, the main leader of the Peronist Party, and Ignacio de Mendiguren, then head of the UIA (an organization which represents most Argentine Industries) came to the conclusion that an Institutional Coup – presumably sponsored by the Radical Party against their own political peer, President De La Rúa, to put an end to the so-called "Neoliberalism of the 1990s"- could provide them with the opportunity to "erode" all debts, public and private, held at home and abroad. This could be achieved through what the "new" Washington Consensus seemed to suggest: Devaluing the Argentine Currency and *Pesofying* all of the Economy's Contracts. The recent discussion concerning the "successful" depreciation of the peso throws a new light upon the factor which actually triggered the crisis of the economic rules of the 1990s.

Recent statements by Argentina's Minister of Economy, his 2002 predecessor, and the former Minister of Production.

Former Minister of Production Ignacio de Mendiguren and Former Minister of Economy Jorge Remes Lenicov, who devised the measures implemented early in January 2002, have recently stated:

"Hadn't Argentina devalued its currency, the economy would have been knocked out with a *dollarizing* blow by the Right."[7]

"What was done during those months of 2002 and what Lavagna went on doing has allowed Argentina to stop falling apart, has helped to prevent hyperinflation and contain social outburst."[8]

The day before, Minister of Economy Roberto Lavagna had said:

"Almost two years after the collapse of 2001, Argentina has internationally become the most successful case of devaluation in the world."[9]

Has devaluation been really successful?

After linking the three statements quoted above it becomes clear that those who praise devaluation and its effects seem to consider that it was necessary to significantly reallocate both wealth and income in the way it was done[10], and that success lies in the fact that hyperinflation has not occurred. Under the argument that the economy has eventually stopped falling apart and that social outburst has been contained, they underestimate the actual cost of currency depreciation in terms of the further fall of GDP after devaluation and the 50 percent reduction of GDP in terms of dollars.

I believe that devaluing the peso was an extremely negative policy because it realloted wealth and income in a way that was not only unnecessary but also unfair and inefficient. Such measures as devaluation, *pesofication* and the forced rescheduling of fixed-term deposits have given rise to a huge contingent liability consisting in countless lawsuits against the Argentine State as a consequence of the violation of contracts and the unconstitutional alterations which affect their legal framework, all of which are still awaiting a resolution. In my view, the only reason why hyperinflation has been averted is precisely the postponement of a final judgement for those legal actions. Nonetheless, the struggle for distribution and the ensuing fiscal and monetary derailment entail a potential risk.

Additionally, if the economy stopped shrinking it is simply because the further drop in consumption and investment derived from the peso depreciation was absolutely unnecessary. The 1998-2001 contraction had been enough to balance the current account. The additional fall of 2002 meant a current account surplus stemming from nothing other than a drastic outflow of capital abroad.

It was only natural that the outflow stopped and started to reverse when dollar savers saw that assets, goods and services in Argentina were worth less than one third. However, this cannot be regarded as a sign that the problem is resolved but rather as an indicator that net investment was negative. In fact, investment plunged so deeply that even after the recovery of 2003 it is merely half way below the level it reached during the 1990s. Given the current size of investment, which is still insufficient to counterbalance capital depreciation, the economy's output capacity will continue to fall.

There exists the impression that the so-called social outburst (characterized by people taking to the streets to bang their pots and also by looting and other ways of demonstrating) at the end of 2001 was soon contained for the mere reason that those who had stirred up trouble then took power and -allow me to say- politically "rewarded" leaders who had fueled the riots: they granted them several hundreds of A$150 monthly allowances to allocate in their districts under the "*Jefes y Jefas de Hogar*" welfare scheme. However, one might guess that, far from subsiding, social anxiety must be now deeper than in 2001 because real wages have fallen dramatically and unemployment has gone up. Why is it then that social discontent in 2001 was so deep about the 13 percent reduction affecting only the public sector's monthly money wages over USD 500 and now that all real salaries are 30 percent lower no word of criticism is to be heard? My opinion is that there exists a latent social discontent which can manifest itself at any moment.

To attain sustainable growth, it is necessary that Argentina should reverse most of the devaluation effects and rebuild a framework of legal certainty so that domestic savings and, after some time, probably foreign savings are once again available to finance large investment in the country.

Rebuilding legal certainty to attract investment

Those who have invested in Argentina, be it domestic or foreign savers, feel that the country lacks in legal certainty because their property rights have been affected by devaluation and *pesofication*. This circumstance has given rise to countless court and out-of-court conflicts that remain unresolved. The further the peso depreciates in real terms the more difficult it will become to find a way out of such situation.

For a year now the market has tended to bridge the initial depreciation gap. This trend would accentuate if the government eventually rescinded taxes on exports and allowed the peso to float freely vis à vis any other convertible currency that individuals should choose to employ for financial contracts. For the peso to compete on an equal footing with the other currencies, medium and long term peso-denominated contracts should be indexed by a price index

In those conditions, the peso would most probably appreciate –its present value is around USD 0.50 in real terms (compared to the dollar/peso convertibility rate)- to quickly stand at USD 0.80 approximately, and in the long term, reach a rate that is close to that of convertibility. The fact underlying this estimation is the significant slide of the dollar vis à vis the euro and other currencies throughout 2002 and 2003.

With the peso thus evolving in real terms, it should not be too difficult to find a fair resolution to most judicial conflicts -publicly and privately held debts could be reasonably restructured so that Argentine debtors would be able to honor their obligations, and Argentine and international creditors would eventually accept the settlement reached. In turn, those who invested in infrastructure and public utilities, would start to regain profitability and recover the worth of their investments.

Which is the main impediment to this solution? In practice, the major stumbling block is the power of such forces as the internal and external groups which in 2001 converged to disrupt the economic order of the 1990s and managed to erase most of the economy's liabilities.

The way to erode that power away is that workers, pensioners and ordinary citizens in general understand that behind the praise for a "high dollar-rate" is the intention to maintain a depreciated peso in real terms, which means nothing other than low real wages and poor savings. The reaction by the Public Opinion and by the very Central Government at the Minister of Economy's statement that Argentina's devaluation has been the most successful in the world seems to be showing public awareness about the harmful effects of a highly depreciated currency.

Additionally, so as to prevent Washington from misleading Argentine policymakers in the future, Argentina's debts with multilaterals should be *pesofied* in the same fashion that contracts ruled by Argentine legislation were arbitrarily converted. Indeed, should this be the case, multilaterals would certainly foster the appreciation of the Argentine currency. After all, in the light of the latest accord between the IMF and our country, it becomes clear that multilaterals' main concern is that they are fully repaid, although two years ago they suggested that Argentina's problems would be resolved only if domestic and external creditors suffered a significant write-off.

Questions and Answers

Before I conclude, I would like to answer some of the questions which I have been asked in the last few weeks. They refer to my interpretation concerning the events of December 2001-January 2002.

Was it not imperative to devalue the peso in order to ease the financial crisis and the debt problems which arose at the end of 2001?

No, it was not. On the contrary, the depreciation of the peso exacerbated the financial crisis and the debt problems, to such an extent that until today, that is two years after the collapse, there is still no clear sign of a feasible solution.

The way out of the financial crisis and debt problems was the restructuring plan underway at the moment of President De la Rúa's resignation. As I said before, the goal of the debt restructuring scheme launched on November 1st 2001 was to bring the interest bill down from the USD 14bn paid by the Public Sector (Central and Provincial Governments) in 2001 to USD 7bn payable as of 2002, and to achieve a three-year deferment of all capital maturities.

The first phase of the debt restructuring scheme was successfully finalized on December 15th 2001: around USD 55bn of bonded debt held by domestic and some foreign creditors were voluntarily swapped for guaranteed loans which would use tax revenue as a collateral and pay annual interest rates not higher than 7 percent. This restructuring option represented USD 4bn of annual interest reduction, so the second phase of the scheme would require to cut only USD 3bn of the interest paid on the USD 45bn bonded debt held internationally.

Another stage of the plan was to launch a second offering by mid January 2002, taking advantage of the voting power attained in the first phase of the scheme to impose exit consent clauses which would discourage holdouts. The full restructuring process was meant to conclude by mid February 2002. After this date, the exchange controls implemented on December 1st 2001 could be lifted and the financial system normalized.

In the meantime, we were going to use the pending loans from the IMF (a USD 1,3 bn disbursement which had not been released in November 2001 plus the remaining USD 3bn from the USD 8bn package granted earlier in August) to bring liquidity to the banking system.

Once the debt had been restructured and the zero deficit target secured by virtue of the primary expenditure cut back in the second half of 2001 and the USD 7bn interest reduction, the expectations of savers and creditors who had swapped their bonds would have improved, and funds would have gradually flowed back into the financial system. These conditions would have favored the private sector, whose limited accessibility to credit had contributed to the long lasting recession, as its borrowing capacity had deteriorated since 1998.

Did the default on Argentina's debt announced by President Adolfo Rodríguez Sáa not interrupt the restructuring process?

No, it did not. After being appointed as interim President, Adolfo Rodríguez Saá announced that Argentina would default on its foreign debt. This, however, did not mean that the country should interrupt the orderly restructuring process, because the already exchanged debt was not supposed to be affected by a default. Besides, if the second public offering had been launched as planned -on January 15th 2002-, foreign creditors would have decided to swap their bonds to ensure that they would continue earning interest, though logically lower.

But such measures as devaluation and *pesofication* undid it all. In the first place, because these two policies, coupled with the unilateral decision to slash interest, resulted in a default on the debt that had just been turned into a guaranteed loan. In the second place, because it became clear that Argentina's government did not intend to immediately resume interest payments, not even those concerning the debt which had just been restructured with tax receipts as a collateral.

Needless to say, the default on all of the public debt aggravated the financial crisis. Banks had to face a deluge of lawsuits filed by savers whose deposits had been compulsively *pesofied* and rescheduled.

Was devaluation not inevitable after savers rushed to exchange their pesos for US dollars?

No, because as of December 1st 2001, when it became necessary to implement temporary restrictions on cash withdrawals, peso-denominated bank accounts could be voluntarily converted into dollar deposits. The national reserves at that time sufficed to exchange all the money supply, that is to say, there were enough dollar reserves to back every peso in circulation at that date. Therefore, people could turn their cash into dollars banknotes if they wished. By virtue of their legal rights, Argentineans could decide whether to keep their pesos or exchange them for American currency -it was by no means a "*dollarizing* blow by the Right".

Then how would the Central and Provincial Governments manage to pay their dollar expenses if tax revenues were not enough?

Any possible deficit would be covered by means of the LECOP, a treasury bond meant to replace all other quasi-money issued by provincial governments. LECOPs functioned as a new type of non-convertible currency whose value was not backed by the peso or the dollar. Unlimited issuances of LECOPs would certainly lower their value, but this type of devaluation would not be violating the convertibility law. In any case, the depreciation of LECOPs would only affect those on the public-sector payroll. Regarding the private-sector, workers and employers could have negotiated which percentage of the salary would be paid in dollars and which one in LECOPs. This could have meant some sort of flexibility for wages and would have spared the economy from the overall deterioration caused through devaluation.

In practice, all pesos would have voluntarily been replaced with dollars, and the bimonetary system would have continued to operate with dollars and non-convertible floating LECOPs.

This alternative resembled President Rodríguez Sáa idea of introducing the "*argentino*", a type of currency which would work in the same fashion of LECOPs. According to his words, the plan was to issue 10bn *argentinos* throughout 2002 in order to absorb approximately 3 bn LECOPs and other provincial quasi-currencies in circulation at that time. The *argentino* would have certainly lost value vis à vis the dollar, but such depreciation would have been definitely much lower than the eventual devaluation of the peso derived from the forced *pesofication* of the economy. Besides, as the debt restructuring process concluded and the interest bill was halved, the zero deficit goal would have been met and the issuance of *argentinos* would have been discontinued.

But my personal impression is that as soon as President Rodríguez Sáa chose not to revoke convertibility, pro-devaluation-and-*pesofication* lobbies decided that he be replaced by the same methods applied a few days earlier with Fernando De la Rúa.

I am persuaded that such measures as devaluation and *pesofication* were not actually urged by the prevailing circumstances; on the contrary, they were the motive behind the

Institutional Coup which started on December 19th and finished when Adolfo Rodríguez Sáa resigned, on December 30th, but 10 days after Fernando De la Rúa's own resignation.

I also believe that the decision to devalue the currency and *pesofy* the economy was aimed at redistributing wealth and income in favor of heavily indebted provinces and companies, and to the detriment of savers and workers, though. These measures only helped to aggravate the financial crisis and the debt situation, and eventually represented a very high cost that translated in GDP fall and increased levels of poverty and unemployment.

Was devaluation not necessary as a last resort to boost exports and promote imports substitution?

No, it was not. Exports grew during the 1990s owing to the increased productivity achieved through rising levels of investment. The depreciation of the peso itself has not brought any additional expansion in terms of volume, as investment today is very low. Yet, the value of exports is higher than before mainly because prices have gone up, not because volumes are bigger. In fact, the current performance of exports is similar to the that of the previous decade. Besides, exports taxes will have an increasingly negative effect on all investment directed at traditional exporting industries.

Regarding the production of tradable goods in general and imports substitutes in particular, the "convergence factor" coupled with the competitiveness plan and the 2002-2003 depreciation of the dollar vis à vis the euro would have provided a natural protection factor. In any case, it would have been also necessary to insist on a system of safeguards that prevented the unlimited competition with Brazilian imports, possible because of free trade agreements with that country and the sharp depreciation of the real. These measures prove more consistent and permanent than devaluation to boost competitiveness. Because, no matter how sharp the depreciation, devaluation effects are always transitory.

[1] Conference delivered at the Real Instituto Elcano, Madrid, Spain, December 11-12, 2003 during the series "*La Seguridad Jurídica y las Inversiones Extranjeras en América Latina – El caso argentino*", which included several conferences on legal certainty and foreign investment in Latin America, more specifically on the Argentine case.

[2] During a recent lecture in Harvard University I argued that the original "Washington Consensus" had no incidence on the reforms applied in Argentina from 1991 on. See Cavallo, Domingo, "Argentina and the IMF during the two Bush Administrations", available at www.cavallo.com.ar

[3] See *The Economist*. July 19th, 2001. See also, www.economist.com http://www.economist.com/displaystory.cfm?story_id=701377.
See also interview with CNN, August 17, 2001, quoted in several Argentina mass media (For an example, refer to *La Nación*, August 18th, 2001, Buenos Aires, Argentina. Page 7, Economía; or lanacion-online at www.lanacion.com.ar/01/08/18/de_328554.asp. Also: www.bradynet.com/bbs/argentina/100081-0.html
"And Argentina is now, after a 41 billion intervention, in a very slippery position. We're working to find a way to create a sustainable Argentina, not just one that continues to consume the money of the plumbers and carpenters in the United States who make $50,000 a year and wonder what in the world we're doing with their money".

[4] These authors argued that there could be "default without disruption" and proposed "an IMF-backed facility that stands ready to buy all debt of a crisis government to the private sector at a support price significantly below its expected restructured value". See Lerrik, Adam and Allan H. Meltzer. "Beyond IMF bailouts: default without disruption." Carnegie Mellon Gailliot Center for Public Affairs, Quarterly International Economics Report, May 2001, p. 1.

[5] Brazil had accepted that the imports tariff arising from the so called "*Factor de Convergencia",* a "convergence factor" between the US dollar and the average between the dollar and the euro, be also applied on imports from Mercosur, the Common Market of the South. Likewise, Brazil had agreed to negotiate safeguards for some sectors.

[6] See *Revista 3 Puntos*. Año 4 N. 231. Interview with Allan Meltzer by Pablo Rosendo González. www.3puntos.com/seccion.php3?numero=231&seccion=protagonista.

[7] www.lanación.com.ar, Friday, November 28th, 2003

[8] www.lanación.com.ar, Friday, November 28th, 2003

[9] www.lanación.com.ar, Thursday, November 27, 2003

[10] It would seem that, for Mr De Mendiguren, the intent to "*dollarize* the economy" would have been negative because it would have prevented the re-distribution of wealth and income.