Lecture 9
The new "Washington Consensus" that triggered the Argentine Crisis

Domingo F. Cavallo[1]
Harvard University, Cambridge, Massachusetts, U.S.A.
2004

The economic rules set forth by the Convertibility Law helped to tame hyperinflation and definitively curbed inflation, which had been a problem that had haunted Argentina's economy for over four decades. Furthermore, the new rules of the game also created the conditions to attract investment back to the country, which in turn fostered productivity and economic growth. The growth rates enjoyed by Argentina's economy between 1990 and 1998 had only been achieved throughout the first decade of the 20th century.

On top of those positive results, this "new economic order" proved strong. As a matter of fact, it withstood very critical situations, such us the capital flight that followed the Tequila Crisis. Moreover, the system in place was strong enough to overcome the recession suffered in the aftermath of the Mexican crisis and to recoup growth within a year. The best example of how the economy bounced back to economic growth is the behavior of the unemployment rates. In fact, unemployment went down slightly at the beginning, rose considerably during the crisis, in 1995, and went down again from 1995 to 1998.

I contend that the origin of Argentina's more recent economic problems can be traced back to 1999 and recognizes three sources. Firstly, there was a credit crunch, which primarily affected small and medium sized enterprises. Secondly, after Brazil devalued the Real, Argentine products lost competitiveness in relation to their Brazilian substitutes. Thirdly, the depreciation of the euro and other currencies vis à vis the US dollar from 1999 to 2002 clearly resulted in an overvaluation of the dollar-pegged peso.

Let's elaborate on the three sources I mentioned above. As I said, since the second semester of 1998 credit was insufficient to meet the private sector financing needs. This development was the result of two concurrent phenomena. On the one hand, the provinces, especially the Province of Buenos Aires, were spending heavily and financing their expenditures through commercial bank borrowing therefore causing what is named as crowding out. On the other hand, the 1998's Russian crisis dramatically reduced the inflow of foreign capital available to emerging countries. Indeed, the first sign that credit would be restricted was the high lending rates the provinces were charged, which by the way, they seemed keen to accept in order to continue borrowing. In the private sector, however, due to the higher cost of credit investment decisions were put off and small and medium sized enterprises struggled to maintain their reducing working capital. Needless to say, this situation severely impacted employment rates, as SME are mostly labor-intensive.

---

[1] Lecture delivered at the Department of Economics, Harvard University, Spring Term 2004, in the capacity of Robert Kennedy Visiting Professor in Latin American Studies.

The Brazilian devaluation, on the other hand, had a notoriously harmful effect on Argentina, as Brazil had become one of the major Argentina's trade partners since MERCOSUR inception. At the time of Brazil's devaluation, trade with Brazil accounted for almost one third of Argentina's foreign trade. These circumstances severely affected agricultural businesses and manufacturing companies producing import substitutes.

On top of that, the Argentine dollar-pegged peso substantially appreciated from 1999 to 2002 mainly due to the dollar strength with respect to the Euro, which in turn discouraged exports further.

In order to reverse the critical situation, several adjustments should have been made, which unfortunately were decided when it was a bit too late, and therefore, were unable to prevent the crisis. The economic measures, that in my view, should have been taken earlier than 2001 refer to cutting provinces heavy expenditure and stopping their bank borrowing, imposing some restrictions on Brazilian imports and shifting from the dollar-peso peg to a peg to a basket composed by the dollar and the euro.

The Argentine Crisis and the rules of the game implemented during the 1990s

In late December 2001 and January 2002 the economic rules of the 1990s were under attack: Hence, the Convertibility Law, which provided that every Argentine Peso issued be backed by one US Dollar, was revoked, and all contracts and transactions in the economy were compulsorily *pesofied*. To be clear, all US dollar-denominated contracts were turned into Argentine pesos, however, at asymmetrically different exchange rates. The abandonment of the Convertibility and the ensuing pesofication had devastating effects, among which we can mention:

- A sharp nominal devaluation of the Argentine currency. As I mentioned before, 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, which was quite as large as the accumulated decrease the country had suffered from 1998 to 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 in 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 30 billions which were diverted from savers' bank deposits and pension funds to private-sector debtors and Provincial Governments. The Federal Government did not benefited from this redistribution policy, as it incurred more debt to compensate financial institutions for the asymmetric pesofication.

- About 20% of GDP was diverted from workers and service suppliers (including privatized utilities) to the producers of non-agricultural 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 was less than 50 percent of 2001 GDP.

What triggered the crisis?

So far, several explanations have been given in order to explain the 2001 crisis, which shattered the economic rules of the 1990s. The International Monetary Fund argues that the determining factor was the Federal 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 Plan 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 lastly, there are those who claim that it took too long to propose an orderly debt-restructuring program.

The government’s reluctance to cut back expenditures

Michael Mussa, a former chief economist of the IMF, has argued that the factor that triggered the crisis was the USD 2 billion 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 Mussa’s position 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 3 billion fiscal tightening package. This measure along with 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.

Notwithstanding, in July 2001, IMF Managing Director Horst Köhler took notice of Argentine political leaders’ criticism against the Zero Deficit legislation and implied 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 contain another bank run which had started early that month. However, in August we came to an agreement with the provincial governors, and the Zero Deficit Law was finally passed. This proved that the Central Government was working hard in building the necessary internal political support, and at that moment it was not clear that it lacked it. IMF Managing Director Köhler had to reconsider his previous statement and the new loan was finally approved in August 2001.

I contend that, fiscal statistics do not support the idea that Argentina had refused to cut back the expenditures. In 2000, the Federal Primary Outlays decreased by USD 1.5 billion, and in 2001 USD 3.5 billion was additionally trimmed. This cuts included 13% reduction in public sector wages and pensions over USD 500. Furthermore, in 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- took pains in balancing their budgets to achieve a USD 2 bn 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 the abandonment of the economic rules of the 1990s would mean a much tighter and costlier adjustment than the one they were voluntarily applying. Naturally, they knew that otherwise Public Expenditure would have to be reduced by means of inflation. For that reason, to assume 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 several think-tanks like the Argentine CEMA or the Cato Institute, argued 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 was convinced that introducing the US dollar as Argentina's only legal currency was not appropriate for our economy. In 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, were forcefully 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 compulsory pesofication of contracts. My point is that, under the Convertibility Law it would have been possible the dollarization, the "Eurization" and even the pesofication provided that it 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 unfortunately 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 added to the real cause of the crisis and therefore, triggered the collapse much earlier in 2001, and would have provided more powerful political and judicial arguments than the ones used in January 2002. Hence, the decision not to force a dollarization cannot be considered what triggered 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 textbook would give when referring to stabilization plans based on a fixed exchange rate. 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 Secretary of the Treasury Mr. Paul O'Neill made the same mistake when he said to *The Economist*[2] 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 he gave this statement, I pointed out that he might have been misinformed. I explained to him that indeed during the 1990s Argentina's exports performance had been similar as that of Chile, and had almost doubled Brazil performance, not otherwise, as Mr. O'Neill seemed to believe. After this gaffe, he asked the IMF to grant Argentina a USD 8bn package to support an orderly debt restructuring program that would help reduce the country's interest bill. The IMF Board thus approved the monetary aid at the end of August 2001. The IMF USD 5bn disbursement contributed to strengthen the Financial System and contained the bank run that had taken place in July and August, fueled by the uncertainty in regards to IMF support to the Zero Deficit policy.

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

[2] 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".

According to Joseph Stiglitz, it was President De la Rúa's determination to underpin the convertibility plan what actually triggered the crisis. This view was also shared by those, who claimed that the economic collapse did not stem from the unbridled public spending and borrowing but from the Government's decision not to implement Keynesian 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 Keynesian policies, 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 a subsidy of some sort relieve their debt burden and keep them away from bankruptcy.

Background knowledge and experience in relation to the negative consequences of such policies in Argentina in previous decades was so vast that no Argentine political leader or economist seriously proposed such an alternative.

The lack of decision to orderly restructure the public debt

Allan Meltzer and Charles Calomiris[3], among others, have argued that Argentina showed no willingness to restructure its public debt. However, their restructuring proposal of April 2001 was unfeasible in practice. As a matter of fact, Meltzer-Calomiris proposal had assigned the IMF the role of last resort lender. However, the IMF showed no disposition at all to allocate the money necessary to support a last resort-lending scheme. 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 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 2001 total of USD 14bn.

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 7bn instead of 2001 USD 14bn. The USD 7bn cutback in Provincial and National Primary Public Expenditure plus this further reduction in the order of USD 7bn

[3] 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 government running a financial crisis 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.

guaranteed Zero Deficit for 2002. However, this was not enough to prevent the crisis of the economic rules of the 1990s. 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 that actually triggered the crisis: Argentine influential leaders and decision makers' perception that there was external support to conveniently ease all types of debts –including private sector liabilities

At the end of November 2001 it was clear that the Central and Provincial Governments had decided to significantly cut back Primary Public Expenditures, 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 the need to adjust the nominal exchange rate or increase the fiscal deficit[4]. Exports continued to grow and imports had fallen enough to eliminate the deficit of the Current Account of 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 signals coming from abroad? The IMF 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 Federal Government on November 1st, the IMF 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 bank run. 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[5], Moreover, 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.

---

[4] 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.

[5] 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.

In my view, it was in this context, 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 the 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. A recent discussion concerning the "successful" depreciation of the peso sheds new light upon the factor, which actually triggered the crisis of 1990s rules of the game.

Some 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."[6]

"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."[7]

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

"Almost two years after 2001 collapse, Argentina is at an international level the most successful case of devaluation in the world."[8]

Has the devaluation been really successful?

Connecting the three statements quoted above it becomes clear that those who praise devaluation and its effects seem to consider that the redistribution of income and wealth caused by the devaluation was necessary[9], and that the measure of the success lies in the fact that hyperinflation has not occurred. The reasoning that evaluates positively the outcome of the devaluation on the grounds that the economy has eventually stopped falling apart and that social outburst has been contained, underestimates the actual cost of the currency depreciation in terms of the further fall of GDP after devaluation and the 50 percent reduction of GDP in terms of dollars.

---

[6] www.lanación.com.ar, Friday, November 28th, 2003
[7] www.lanación.com.ar, Friday, November 28th, 2003
[8] www.lanación.com.ar, Thursday, November 27, 2003
[9] 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.

I believe that devaluing the peso was an extremely negative policy decision because it redistributed 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 against the Argentine State. As a matter of fact, Argentina faces countless lawsuits as a consequence of the violation of contracts and the unconstitutional modifications in the legislation in place. These disputes are far from being settled; rather they are still awaiting a resolution. In my view, the only reason why hyperinflation has been averted is precisely because so far a final ruling on those legal actions has been postponed. Nonetheless, the income distribution tensions 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 deep enough to balance the Current Account of the Balance of Payments. The additional fall experienced in 2002 caused 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. As a matter of fact, the current Investment level is still insufficient to counterbalance capital depreciation; as a consequence, 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" those leaders who had fueled the riots by granting 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 disappearing 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 heard? From my point of view there exists a latent social discontent, which can manifest itself at any moment.

To attain sustainable growth, it is necessary that Argentina undo most of the effects of the devaluation and rebuild a context of legal certainty so that domestic savings and, after some time, probably foreign savings be once again available to finance high levels of investment.

Rebuilding legal certainty to attract investment

Those who have invested in Argentina whether domestic or foreign investors feel that the country lacks legal institutions able to guarantee property rights, as they saw how their own property rights were destroyed by the devaluation and the ensuing *pesofication*. These circumstances have 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 undo the initial overshooting. This trend would accentuate if the government eventually eliminated 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 reach an agreement. In turn, those who invested in infrastructure and public utilities would start to regain profitability and recover their investments.

What is the main obstacle preventing the implementation of this solution? In practice, the pressure groups, both internal and external, which in 2001 converged to disrupt the economic order of the 1990s and managed to erase most of the economy's liabilities, are still influential.

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

Additionally, in order 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 into pesos before. Indeed, should this be the case, multilaterals would certainly foster the appreciation of the Argentine currency. After all, in the light of the latest agreement between the IMF and our country, it becomes clear that multilaterals' main concern is that they are fully repaid. Nonetheless, 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 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 two years after the collapse, there still is no clear sign of a feasible solution.

The way out of the financial crisis and debt problems was the orderly debt restructuring 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 in 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 bonds held by domestic and some foreign creditors were voluntarily swapped for guaranteed loans which would use tax revenues as collateral and pay interest rates not higher than 7 percent per annum. This restructuring option represented USD 4bn of interest reduction per year. Hence, the second phase of the scheme would require cutting only USD 3bn of the interest bill on the USD 45bn bonds held internationally.

Another part of the debt-restructuring plan consisted of a second offering to be launched by mid January 2002. This offering would take advantage of the voting power attained in the first phase in order to impose exit consent clauses, which in turn 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 have been lifted and the financial system normalized.

In the meantime, we were going to use the pending loans from the IMF (a USD 1,3bn 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.

We foresaw that 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 helped 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 interrupt the restructuring process?

No, it did not. After being appointed as interim President, Adolfo Rodríguez Sáa 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 at lower rates.

But such measures as the devaluation and the *pesofication* undid it all. On the one hand, 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. On the other hand, 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 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 inevitable after savers rushed to exchange their pesos for US dollars?

No, it was not. On December 1st 2001 it became necessary to implement temporary restrictions on cash withdrawals. At that time, peso-denominated bank accounts could be voluntarily converted into dollar deposits. The national reserves at that moment 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".

How would then 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. Private-sector workers in turn could have negotiated with their employers how much of the salary would be paid in dollars and how much 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 bi-monetary 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. Furthermore, if the debt restructuring process had been achieved and the interest bill had been halved, the zero deficit goals would have been met and the issuance of *argentinos* could 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 pressed to have him replaced using 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, only 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. These measures only helped to aggravate the financial crisis and the debt situation, and eventually represented a very high cost that translated into a dramatic GDP fall and increased levels of poverty and unemployment.

Was devaluation necessary to boost exports and promote imports substitution?

No, it was not. Exports grew during the 1990s due to the increased productivity achieved thanks to high levels of investment. The devaluation of the peso itself has not brought any additional expansion in terms of volume. The higher value of exports experienced after the devaluation is due to higher prices not bigger volumes. In fact, the current performance of exports is similar to that of the previous decade. On the other hand, 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 from Brazilian imports favored by the free trade agreement with that country and the sharp depreciation of the Real. To me, these measures prove more consistent and permanent than a devaluation to boost competitiveness. This is so, because, no matter how sharp the depreciation of the currency, devaluation effects are always transitory.