An End to Argentina's Misery

Barry Eichengreen
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In August I reported in this newspaper on a trip to Argentina and offered a forecast of how the country's crisis would play itself out. Now that events have unfolded more or less as predicted there, the temptation is irresistible to write a follow-up saying "I told you so."

My assessment then was that Argentina's foreign indebtedness was unsustainable and that the days of its currency board were numbered. In the absence of economic growth, political support for the policies of austerity required for their maintenance was bound to wither and die. As confidence in the de la Rua Government's policies evaporated -- along with confidence in the Government itself -- a full-fledged panic was bound to erupt.

I forecast that this panic would break out soon after the midterm elections in October. That the authorities managed to hold on for another month is thus the only surprise. This is evidence, if more was needed, of their exceptional commitment to the maintenance of the status quo. Having reiterated endlessly their mantra of no devaluation and no default, they know that changing course now will inevitably bring down the government and discredit its leaders -- even if that course correction is unavoidable.

But while the authorities could buy a month of additional time, they could not prevent the inevitable. The government's loss of control of the Senate and signs that the IMF would delay releasing additional financial explain the timing of the crisis. But even if these particular events had not occurred, something else would have produced the same result. The economic minister, Domingo Cavallo, is now criticizing foreign economists as unduly pessimistic and blaming them for the country's woes. When the politicians are so desperate that they "shoot the messenger," it is clear that the end is nigh.

My prediction in August was that the authorities would respond to the crisis with the so-called Quadruple D: debt default, deposit write-down, devaluation, and dollarization. That response is now underway. Unfortunately, rather than taking the crisis as an opportunity to fundamentally reorient policy, the government is backing toward the relevant measures reluctantly, in a desperate effort to save its political skin. It is defaulting on the debt, dollarizing the economy and setting the stage for a deposit write-down and devaluation while denying all the while that it is doing so. This policy of "Quadruple D by stealth" will only draw out the agony. The authorities' reluctance means that the benefits of these new policies to the economy and to investors will be diluted.

The government has completed the process of restructuring its $45 billion of domestic debt, getting domestic banks and pension funds, fearful that they will otherwise get nothing, to accept a 7 per cent interest rate. By claiming that this restructuring is voluntary, it hopes to avoid being declared in default by the rating agencies (although it already has been declared as such by several of the major commercial services). On December 3rd Mr. Cavallo released a letter to international investors confirming his intent to similarly restructure their holdings.

Unfortunately, it is harder to get foreign investors to volunteer for a "haircut." Over them, compared to domestic banks and pension funds, the government has little political leverage. Rather than exchanging their old bonds for new ones with 7 per cent coupons, a significant number of foreign investors are certain to insist on full payment, forcing the government to default before negotiating. Because the politicians cannot arm twist foreign investors as effectively as they can lean on domestic institutions, this attempt to avoid further damaging the country's credit rating is bound to fail. In any case, the budgetary savings from the kind of limited debt restructuring the authorities have negotiated with domestic banks and pension funds are not enough to transform Argentina's economic prospects. More likely than not, the foreign debt will be defaulted upon, and the domestic debt will have to be restructured a second time.

The government has now taken steps to encourage the dollarization of bank deposits and loans. The only reason it has not also replaced peso currency with dollars is that this is more complicated politically now that it no longer controls the Senate, and because coming up with the necessary greenbacks is costly and difficult when dollars are hemorrhaging out of the country. Everyone, including the authorities it would appear, agrees that "convertibility," as the currency-board regime is known, is dead. But because the country's economic problems are very different from those of the United States, dollarizing and thereby locking Argentina into an arrangement in which the U.S. dictates its monetary policy is not obviously desirable. However, the alternative of floating the currency is almost certainly worse. Doing so would rekindle fears of hyperinflation in an economy with double digit unemployment and deep political divisions. The blow to confidence would further delay the resumption of growth and undermine support for the new policy regime. An independently floating peso may look more attractive for some stable, placid Argentina of the future. But in today's turbulent conditions, this option is simply too risky. While economists continue to debate the point, it is clear that the authorities are inclined to dollarize the economy, as I forecast in August.

But dollarization by itself will do nothing to restore Argentina's international competitiveness or restart growth. To do this, the government will have to devalue the exchange rate by a third before converting peso currency and contracts into dollars. Reducing Argentine dollar costs by a third is the single most important thing it can do in the short run to restore competitiveness. To be sure, officials who take this step, breaking their "convertibility contract" with the public, will be forced to resign, but at least they will put the economy on the road to recovery. In any case, it is unlikely that they will have a very long political life to look forward to if they do otherwise.

But it is not viable to reduce wage payments and other incomes by a third in dollar terms while leaving dollar bank deposits untouched. These too will have to be written down to prevent the banks from going bust. Argentina now has a mechanism in place: regulations that limit cash withdrawals to $250 a week and prevent residents from taking more than $1,000 out of the country. It also has a precedent, namely, the 1989 Bonex Plan, when then President Menem froze fixed-term deposits and exchanged them for ten-year bonds effectively worth 30 cents on the dollar. The freeze on withdrawals has not been accompanied by a haircut on deposits yet, but this next step is not hard to foresee.

To be sure, none of these policies is very appetizing. But the status quo is no longer viable, and the alternatives are worse. The Quadruple D is the only plan with even a faint hope of restarting growth. But the longer the government waits, the deeper the malaise becomes, and the less will be the benefits for the country as a whole of the inevitable reorientation of policy.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley.