Argentina:

A Report on the Economic Crisis of 1998-2002

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Background Information

The Argentine Republic, located in both the Western and Southern Hemispheres, gives the country a wide range of diversity in land and culture. From its arctic regions in the South to the forested jungle regions in the North to its borders on five different countries, Argentina provides an important cultural and economic relationship to South America.

In 1816, the United Provinces of the Rio Plata declared independence from Spain and after Spain, Paraguay, and Uruguay split the remaining area became known as Argentina. Despite its beautiful landscapes, much of Argentina's history is plagued with bouts of internal conflict between Federalists and Unitarians and also between civilian and military forces. Democracy was finally reestablished in 1983 and still exists to this day. The most significant economic event affecting Argentina was a depression that crippled the country's economy from the late 1990's-early 2000's.

With a population of about 42 million, Argentina houses mostly urban communities which account for about 92% of its total population. It also utilizes a civil law system based on Western European legal systems and maintains a government compromised of an executive, judicial, and legislative branch.

This country has benefited from rich natural resources and is very export-oriented in the agricultural sector. In addition, it is well diversified in its industrial base. Approximately 60% of its gross domestic product comes from the service industry, making up for 72% of the nation's employment. Argentina has free trade agreements with many countries including Brazil, China, Chile, and the U.S. where it mainly exports soybeans derivatives, petroleum and gas, vehicles, corn, and wheat. The main imports to Argentina include machinery, motor vehicles, organic chemicals, and plastics. Sources of these imports come primarily from the countries in which they have established free trade agreements. Argentina's major industries include food processing, motor vehicle manufacturing, consumer durables, textiles, chemicals and petrochemicals, printing, metallurgy, and steel.

Currently, Argentina is running a current account balance of $3.573 billion. Previously one of the wealthiest countries in the world, Argentina has suffered from recurring financial and current account deficits in addition to high inflation, high commercial lending rates, significant amounts of external debt, and investor skepticism. Argentina's currency, the peso, in comparison to the U.S. dollar has experienced depreciation in recent years, earning an exchange rate of 3.8983 pesos/dollar.

Argentine Central Bank Background

The Central Bank of Argentina was established through Congress in 1935 and replaced the Argentine Currency Board which had been in place since 1890. Under the fixed exchange rate regime, when the peso was fixed to the US dollar at a rate of 1:1, the Central Bank's responsibilities mainly included keeping the monetary base in tune with international reserves. In recent years after the economic crisis, during the repeal of the fixed exchange rate regime and the devaluation of the peso, the Central Bank's role has been to increase the level of reserves held within the country while satisfying an exchange rate of approximately 3.80 pesos per dollar. This level has been used to help increase the amount of imports into the country while also staying competitive internationally in the export segment.

Data Description

The data used within this country report focuses on the time period between 1998 and 2002; a time where Argentina experienced a series of economic downturns leading them into a recession. Interest rates, money supply, exchange rate, current account and reserves are analyzed on a month by month basis to help paint a clear picture as to how each one affected the other. GDP and inflation data are gathered on a yearly basis and also help explain why Argentina entered this economic trap. The statistics and data gathered are primarily from the Central Bank of Argentina's database.

Triggers of the Depression

Starting in 1998, Argentina was faced with an external situation unfavorable to its economic progress. During this time, Brazil and Mexico were struggling with a devaluation of their currency. In response to this, foreign investment to emerging markets fell and investors had a decrease in confidence towards Latin America as a whole. This lack of confidence led to a devalued Argentine peso in January of 1999. In addition, the U.S. dollar was appreciating in value over this time period. Subsequently, the devaluation of Brazil's currency negatively affected Argentina's exports. Since 30% of Argentina's exports were being traded with Brazil at this time, a decrease in trading activities ensued in Argentina.

Although Argentina was faced with a number of setbacks, late 1999 and early 2000 brought some signs of economic growth. On a year-over-year basis, the rate at which the economy was shrinking slowed from 5.1 percent in the third quarter of 1999 to 0.2 percent in the first quarter of 2000.

A seemingly flourishing economy up until this time, tax increases requested by the new President, Fernando De La Rua, passed in December of 1999 promptly put an end to any economic progress. The new taxes put more pressure on an already struggling economy. The changes in monetary policy reduced confidence in the peso, resulting in soaring interest rates. High interest rates hurt growth by making it costly to do business by using credit to expand.

In December 2001, economic policy started to contaminate the private sector. This contamination included a freeze on bank deposits. Heavy withdrawals on November 30th brought the freeze on December 1st of 2001. The government's difficulty with refinancing its debt led to increased fear of freezing deposits. This freeze brought private-sector spending and investments to a halt rendering businesses and individuals unable to withdraw deposits except for other depositors at the same bank.

The IMF had agreed to a three-month period where $40 billion was given to Argentina in hopes of preventing any further downturn. New policies prolonged the recession and rating agencies reduced the nation's credit rating in July 2001. Interest rates became too high to be able to sustain and the country found itself in a 'debt trap'. The government then announced they were unable to pay back foreign debt and had exchanged bonds for maturity notes with a smaller yield. The international bond rating agencies considered this to be a default on their debt, further propelling the economic crisis.

Money Supply, Reserves, Exchange and Interest Rate Analysis

From April 1st of 1991 through January 6th 2002, Argentina was under a fixed exchange rate regime in which they pegged the Argentine peso to the US dollar at a rate of 1:1. In the late 1990s as the value of the dollar was appreciating and the Argentinean economic crisis pushed forward, the Argentine peso was beginning to experience an overvaluation. This overvalued peso meant that exports were much less competitive as well as much less desirable to the world markets. The massive amounts of debt that Argentina was facing at this time was contributing to this devaluation and despite increases in income taxes in 2000 and a tax levy on financial transactions in 2001, the recession in Argentina only grew worse. At the end of 2001, Argentina devalued the peso while remaining under a revised fix which now pegged the Peso to the dollar at 1.4 to 1. The Argentinean government then began to freeze bank accounts so that people could not withdraw all of their money in US dollars in fear that they would become worthless.

In 2002, they completely eliminated the fixed exchange rate regime that they had been under for just over 10 years. At this point, every account in the country now had to undergo a process known as pesification, where all accounts held in dollars must be converted to pesos. This created a rapid increase in demand for the dollar which only made the dollar stronger against the Argentine peso. This increase in demand for the dollar coupled with the heavy overvaluation of the peso made for a sharp depreciation in the peso's value and drove its exchange rate up from 1.4 to nearly 4 in a matter of months. One of the reasons as to why this exchange rate regime fell apart was because the Argentinean currency board was not acting in an orthodox way when it came to maintaining a fixed exchange rate. There are three main criteria that define a fixed exchange rate regime: the board must maintain a fixed exchange rate with its anchor currency, allowance of full convertibility, and the monetary liabilities of the currency board must be fully backed in hard foreign currency assets; all of which had been violated by the currency board.

To secure their "convertibility" policy the Central Bank of Argentina had to maintain the same amount of U.S. dollar foreign reserves as its own currency currently in circulation. This insured that anyone could go to the bank and convert any amount of pesos into dollars at a 1:1 exchange rate. This steady mandatory level can be seen in the reserves chart prior to 2001 (See Figure 1). Although they had enough reserves to cover all the domestic currency in circulation, they did not have nearly enough to cover all the money in checking and savings accounts. To limit this, under the convertibility policy, it was normal practice that as people began to convert their pesos into dollars the central bank would shrink the money supply by increasing interest rates. This insured that before the bank ran out of US dollar reserves, the interest rates on peso deposits would get high enough that people would rather keep their money in pesos. This was how the central bank planned to maintain its reserve supply of dollars.

The problem with this strategy is that if the government pushed interest rates high enough, as they did, it would inhibit the economy and the current account deficit would remain. In addition, wages were too high and made Argentina's exports uncompetitive. This was further affected by the devaluation of neighboring Brazil's currency. Investors lost confidence in Argentina's economy and the flight of money away from the country began.

In 2001, with people fearing the collapse of Argentina's economy and the peso, they began withdrawing their money from the banks, converting pesos into dollars and sending them out of the country. This run on the banks led the government to enforce a freeze on all bank accounts for a year known as the "corralito", infuriating much of the population.

At the end of 2001 the government defaulted on their public debt which amounted to more than 132 billion pesos. When they defaulted, foreign investment fled the country, capital flow towards Argentina stopped almost completely, and the central bank's foreign currency reserves were nearly exhausted. This run on banks can be seen on the money supply graph just prior to 2002 (See Figure 2).

When Argentina abandoned the fixed exchange rate policy, the peso immediately lost a great amount of its value. An exchange rate was initially set at 1.4 pesos per dollar. The government then enforced that all bank accounts currently denominated in dollars, be converted to pesos at this rate. This further infuriated the public as the value of the money in these accounts greatly depreciated and was now denominated in the extremely unstable peso. This forced exchange increased the money supply as illustrated in the money supply chart at the start of 2002 (See Figure 2). With the exchange rate now floating freely the peso suffered a huge depreciation which caused severe inflation. This also forced an increase in the money supply because Argentina depended heavily on imports and had no means to replace them.

A spike in interest rates can lead to a catastrophic outcome to an economy in a severe recession. The original plan of Ferndando de la Rua’s administration was to lower interest rates, and coupled with a simultaneous increase in taxes; lead the economy to an economic boom. This plan was geared to decrease the large deficit that the government was running. It had the potential to succeed but unfortunately the implementation of this plan was very poorly timed. At this time the world’s interest rates were on a rise and instead of interest rates in Argentina falling to boost to economy, they began to rise with the interest rates of the world only pushing Argentina deeper into recession.

The public began to grow wary of the economic situation and began to fear the possibility of losing convertibility of their currency. When it was announced that Argentina would eventually leave the peg the situation only grew worse. This introduced the fear of losing their pegged exchange rate which would ultimately lead to a strong devaluation of the Argentine Peso. In anticipation of this, Central Bank reserves were being drained at a rapid rate by investors. This decrease in reserves again pushed interest rates higher which only contributed to this economic slump making Argentina's default inevitable.

Inflation Analysis

The Argentine currency board decided to peg the Argentine peso to the US dollar up until 2002. This was done in an attempt to curb hyperinflation which began in 2001 as well as to stimulate economic activity. The spike in inflation in 2001 was due to a large amount of growth in the money supply which was supposed to help cut government deficits. In 1999, Argentina's GDP fell by 3% and the recession was underway (See Figure 7). Interest rates began to rise in order to keep the exchange rate fixed and peaked at the end of 2001 (See Figure 4). At this point in time, government debt had reached 2.5% of GDP. This tied directly to reserves which decreased at an increasing rate from the end of 2000 to 2002.

From 1999 to 2001 there was a period of deflation which was an attempt to contribute to the repayment of the external debt crisis. Wages of workers were frozen and at the same time prices were slowly rising, causing a decrease in purchasing power parity. This in turn led to a decrease in overall demand, employment, as well as production. This rapid deflation was a result of trying to force the economy into an international capitalist system as well as to maintain an anti-expansionary policy. Adding to this problem was the destruction of the welfare and social security systems which were used to pay off debts and in turn decreased the money supply and velocity of money. These social systems were then privatized by the government along with other industries. This caused a major depression across Argentina forcing more than 55% of the population to live below the poverty line.

<u>Balance of Payments Analysis</u>

The balance of payments is a useful economic indicator that includes current account, trade balance, capital account, and foreign investments among other inputs. Here, events that affected the Balance of Payments or BOP for Argentina are discussed. Overall, the BOP equation amounts to a sum of the capital and current account. It is important to note that the data shows a balance of zero for the current account (See Figure 5) from 1998 through mid 2001, which could represent the Central Bank not wanting to report negative data for this indicator.

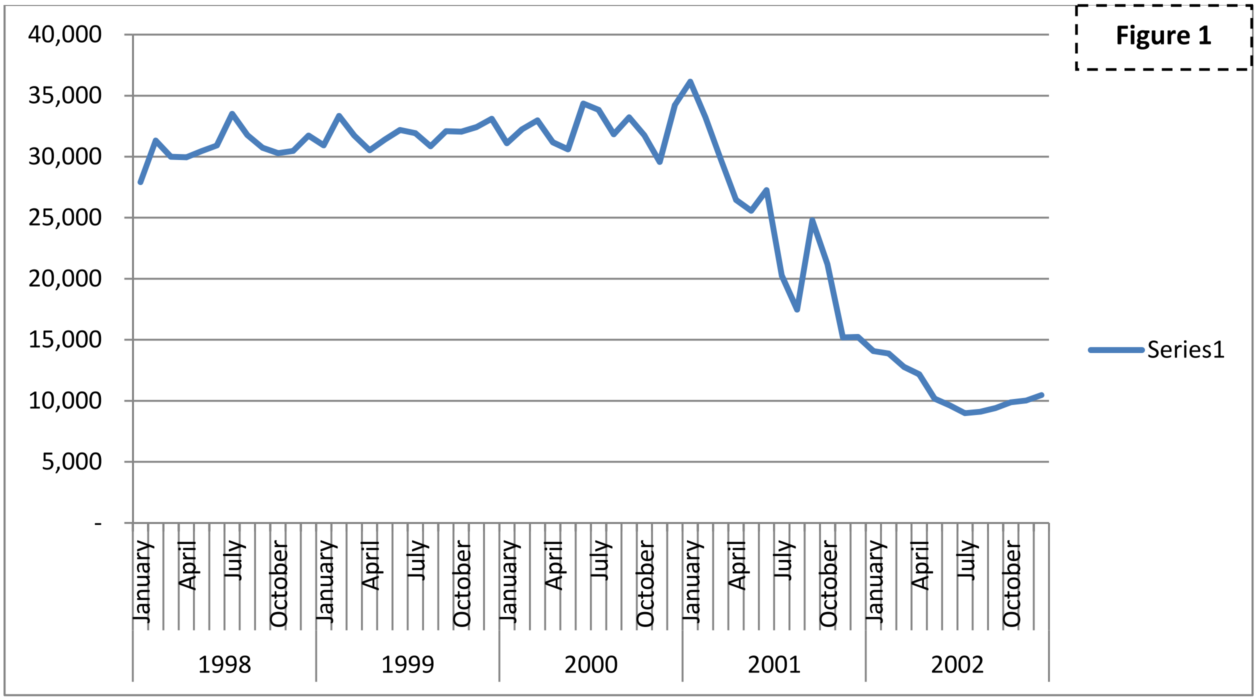
In 1998, the Brazilian economy was at a standstill which negatively affected the export of goods out of Argentina. At the end of this year, international reserves had increased along with the capital account coming from direct investments in the private sector (See Figure 1). In 1999, a decline in commodity prices came along with the devaluation of the Brazilian *real* and an increase in sovereign risk rates. Imports were affected from a decline in domestic spending and slight decline in output (See Figure 7). In 2001, the capital account saw a deficit due to the decrease in foreign investment which would continue to trend downward going forward as investor confidence would continue to fall. High levels of uncertainty led to bank runs which in turn restricted the amount of cash people could withdraw. Riots broke out over the lack of cash available for withdrawal, leaving many dead. The current account balance was positive for the first year of the crisis due to the decrease in imports into the country as well as decreased profitability on a national level. By the end of 2001 the overall deficit was at -4.5%, along with serious declines in imports, tax revenue, and construction.

Conclusion

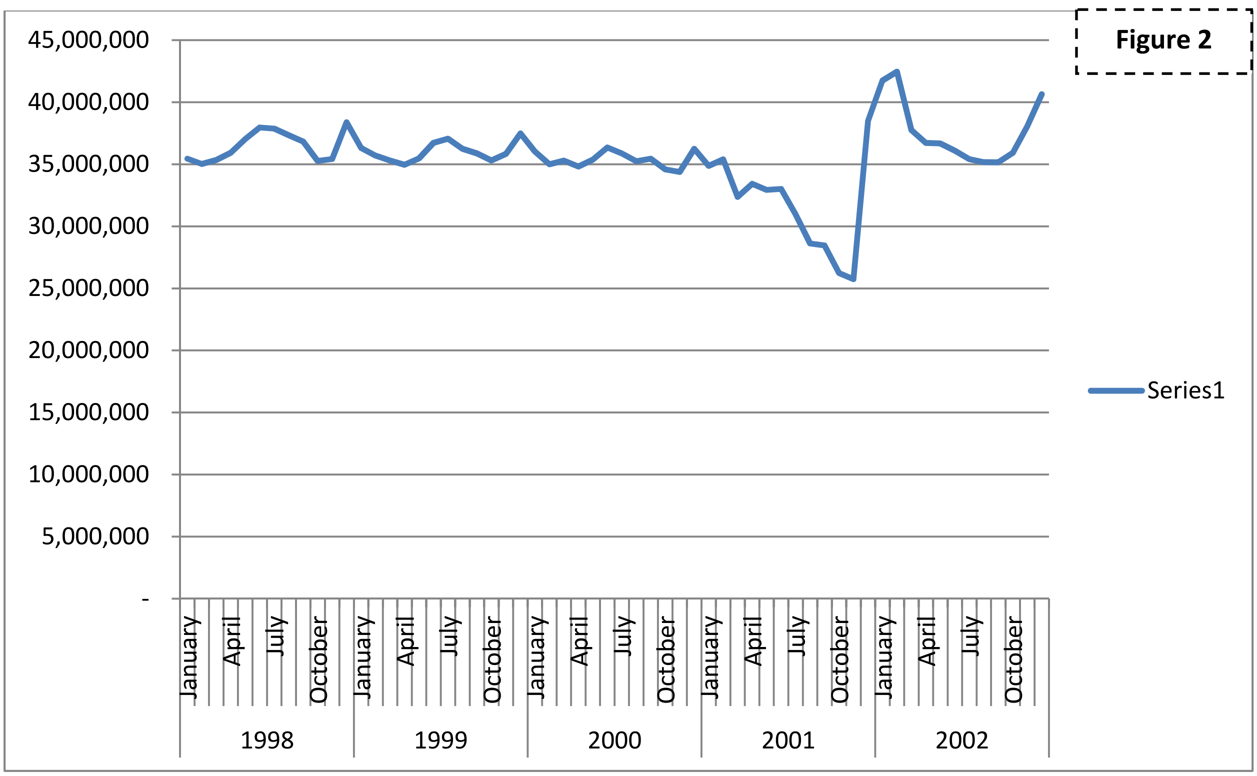
During this economic crisis, none of the economic factors seemed to favor Argentina's recovery; the large deficit that the Argentinean government was facing was only getting worse. The currency board was constantly breaking the standards that apply to maintaining a fixed exchange rate regime. The actions of the government only led to doubt in the minds of the public as well as investors. The currency was overvalued and the world interest rates were increasing leading to a rise in Argentinean interest rates; the exact opposite of what they had hoped for. Instead of the government successfully lowering rates and increasing revenue to decrease the deficit, interest rates spiked and the economy fell deeper into a recession only making the debt more unmanageable.

When the peg was abandoned and the exchange rate sky rocketed, value of the peso and confidence in Argentinean investments sank rapidly putting the crisis at its worst level. In these conditions, it would only be a matter of time before they inevitably had to default on their debt which they did in August of 2002. The economy did start to right itself after the new minister, Roberto Lavagna, who took office in April of 2002. He was able to scheme through old monetary policies and once the government stopped inflicting damage on itself, the economy started to make positive strides.

Reserves- Monthly



Money Supply- Monthly



Exchange Rate- Monthly

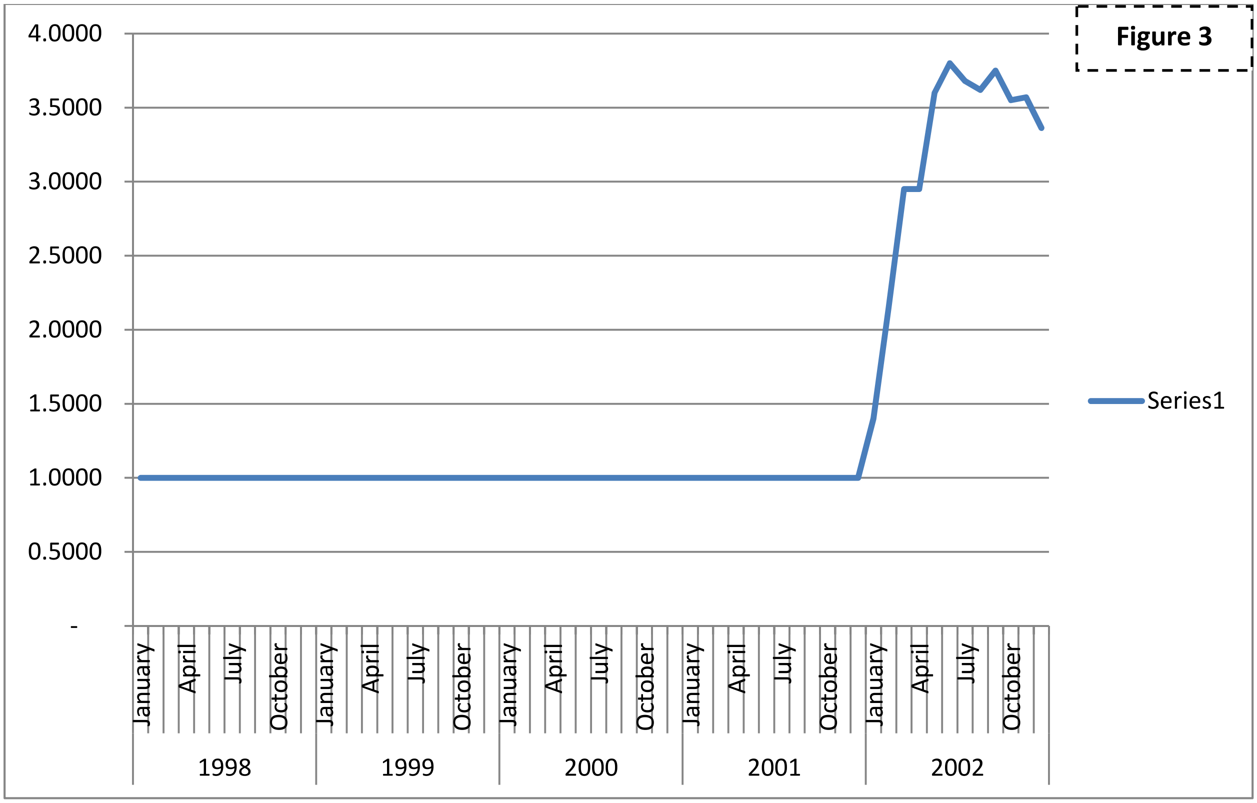


Figure 3

Interest Rate- Monthly

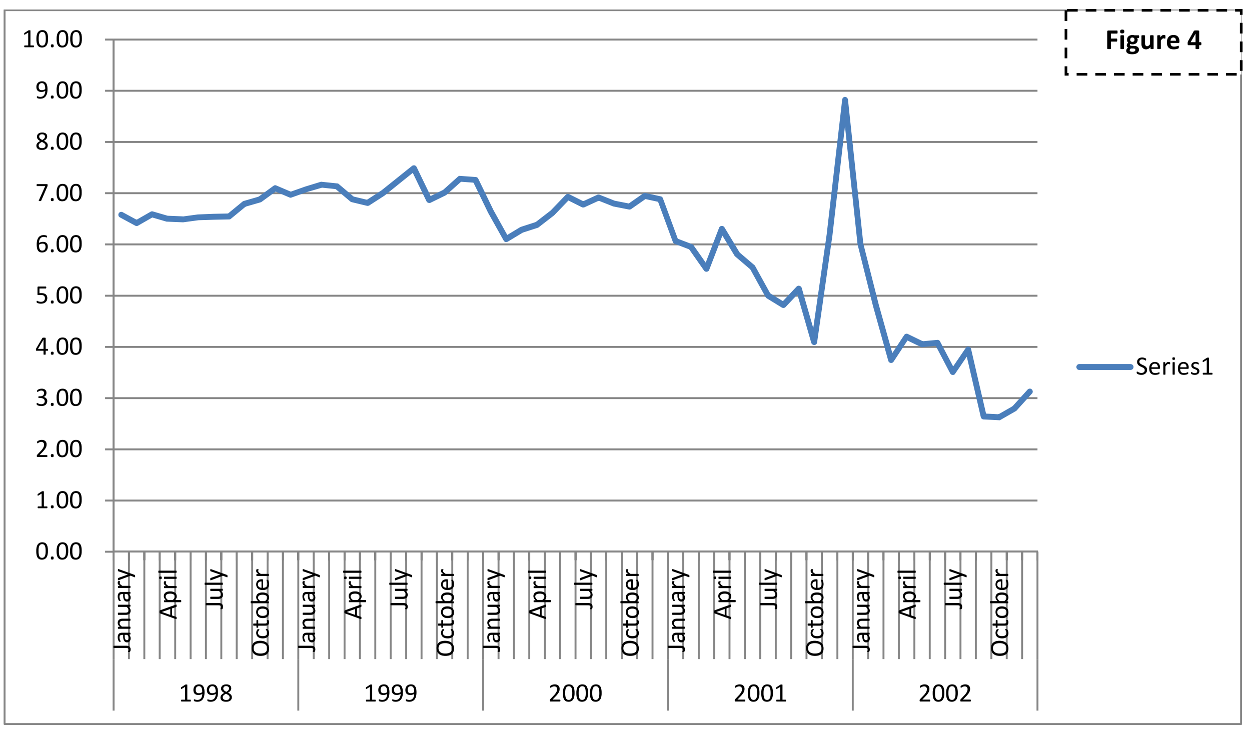
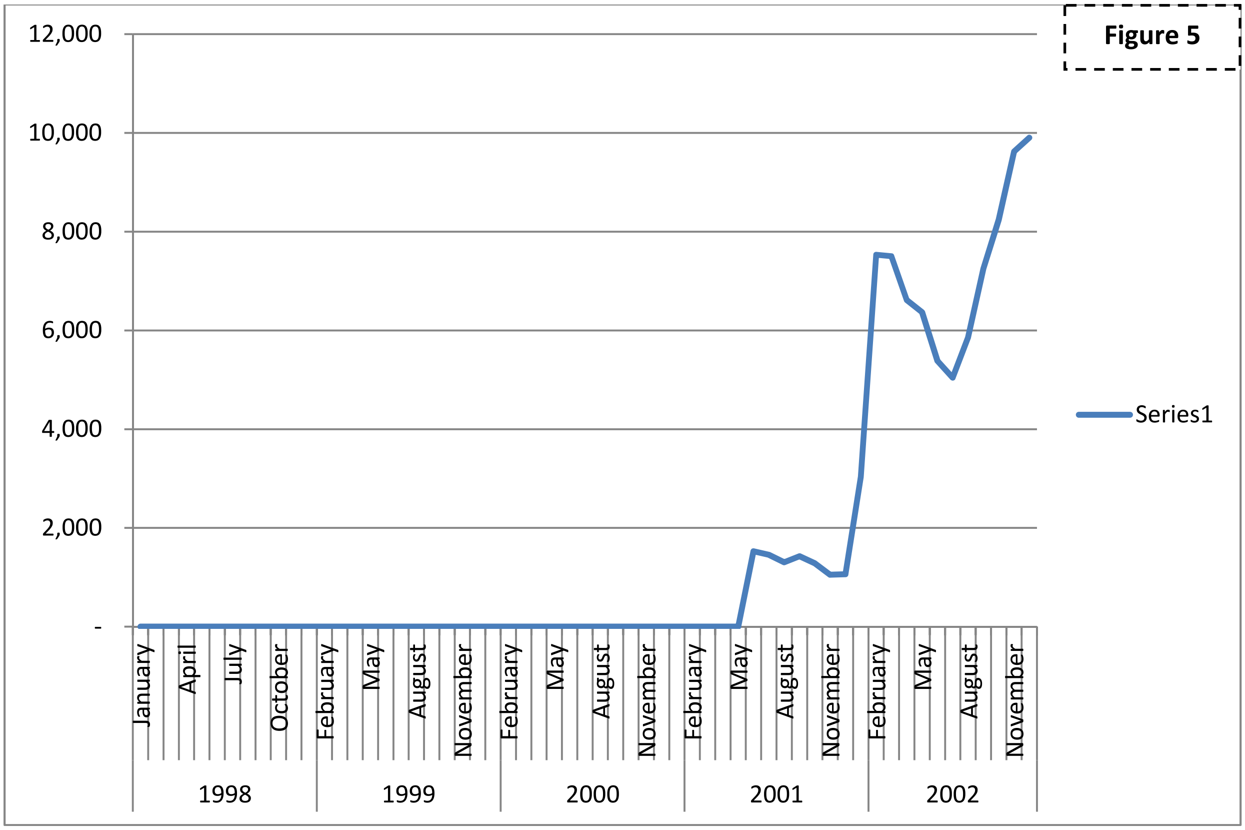
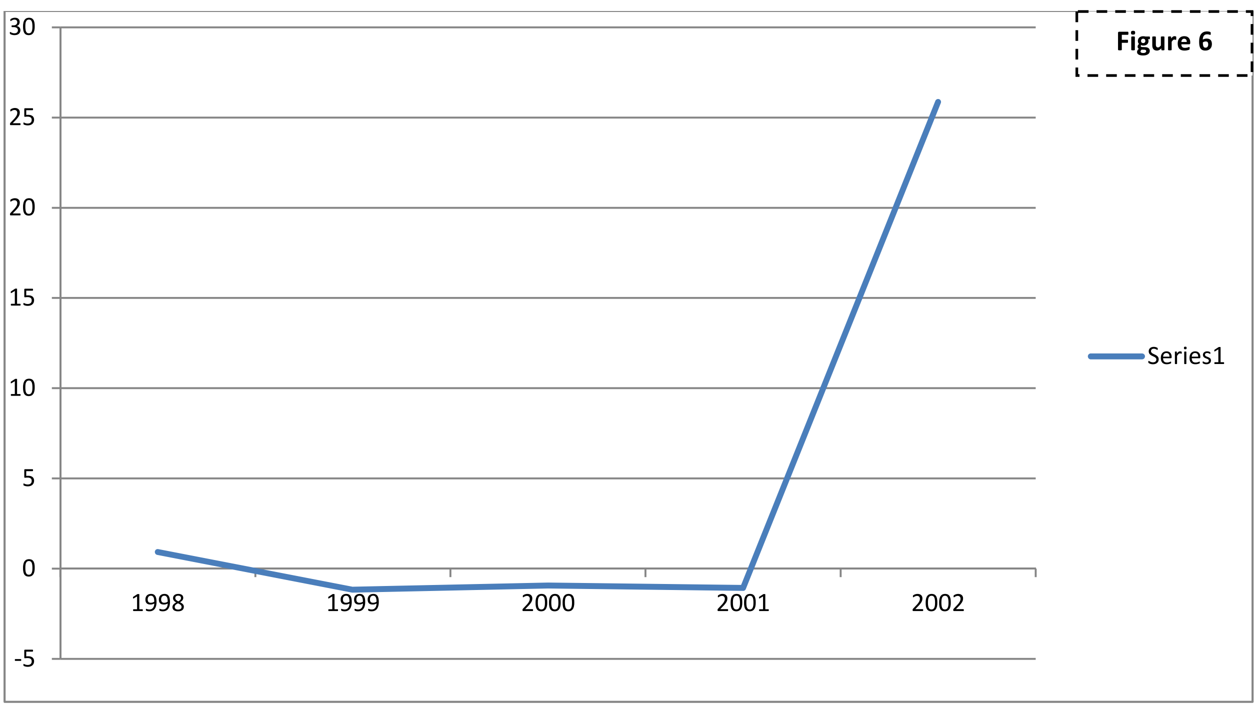


Figure 4

Current Account- Monthly



Inflation- Yearly



GDP- Yearly

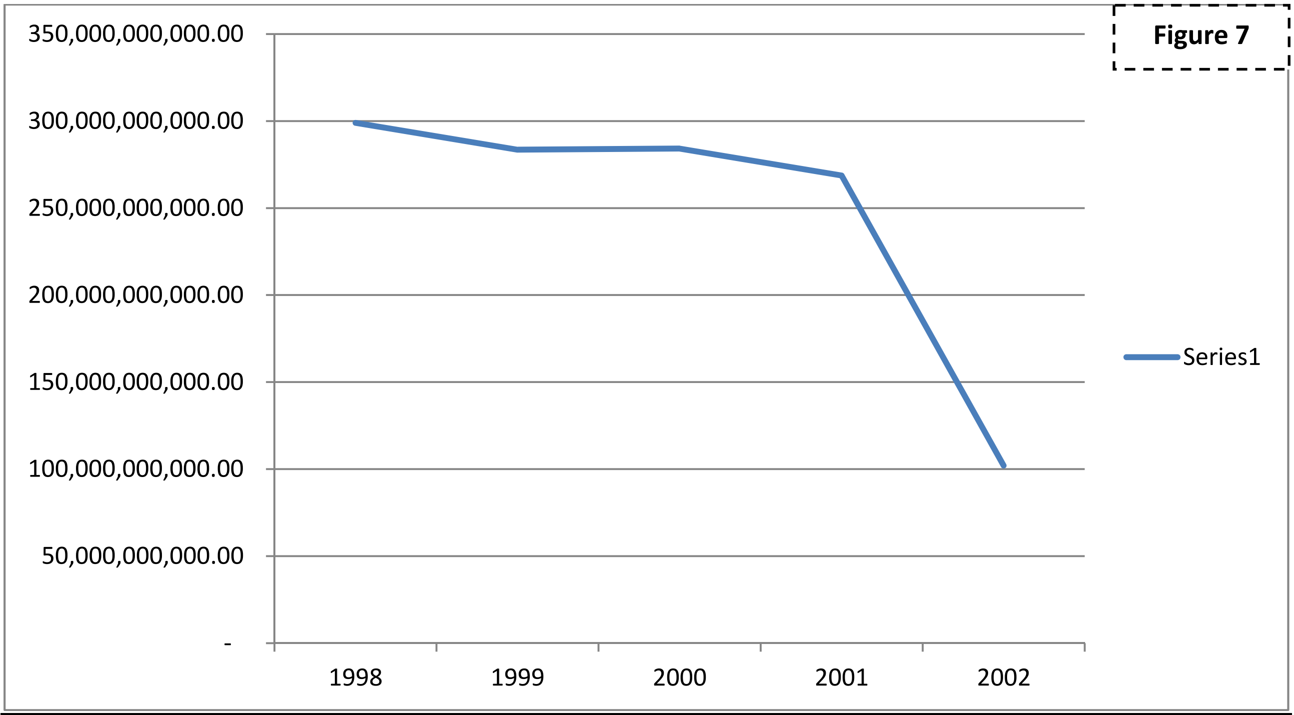


Figure 7

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