

L'ARGENTINA ONE YEAR ON: FROM A MONETARY CRISIS TO A FINANCIAL CRISIS

In the months which followed the exit from the currency board, the Argentine economy was confronted with a major monetary crisis, menacing the survival of its national currency. The strategy to "pesify" the economy, which was decided in February 2002, has succeeded technically. In particular, the slowing of inflation reveals a considerable adjustment of relative prices, which should support the development of the export sector. Today's problems lie more in finance: the way the economy was "pesified" has worsened confusion concerning the solvency of nearly all agents. As a result, it is now very difficult for savers, banks and companies to measure the value of their net assets. Any durable revival of investment and growth will be impossible as long as there is no overall political compromise over how losses will be shared out, over the liquidation of insolvent companies and the return to State solvency.

The economic crisis which Argentina experienced at the end of 2001 was at first monetary: the breakdown of the currency board (11 January 2002) was preceded by depositor runs on banks as of November, which in turn were followed by a freezing of deposits (the *corralito*) in early December and the implementation of tight exchange controls. This provoked a violent social and political shock, and also quite literally suffocated the real economy. The payments system was blocked. The quasi-totality of private and public financial contracts was suspended. Company cash-flows were largely wiped-out. Output fell by 15% during the first quarter of 2002. Inflation surged, as consumer prices rose by 30% over the same period, while unemployment reached 25% in June. The poverty rate rose from 35% to 52% in a year.

During the following months, the key issue for the authorities centred on the survival of the national currency, the peso. Would agents accept to readjust their behaviour using the national currency in the face of the major instability which followed the breakdown of the fixed exchange rate and the bi-monetary regime? Or would there be a rapid shift to the dollar to carry out the two principle functions of money, namely as the unit of account and as the means of payment? In this case, would it not have been better to anticipate full dollarisation rather than let private arbitrage destroy the peso?

The authorities rejected this latter option and decided to implement a compulsory "pesification" of the economy.

They therefore withdrew the functions which the dollar had acquired *de facto* and *de jure* over the previous ten years. Put simply, prices and payments were "forcibly repatriated" into pesos, covering all goods, services, assets, debts and stocks. Three scenarios were then possible¹: i) the complete success of pesification and the progressive reopening of liquidity circuits (access to deposits, the progressive lifting of exchange controls); ii) a rapid failure followed by full dollarisation, and; iii) an intermediate situation with pesification attaining its immediate objective, though within a tightly controlled economic and financial framework.

This last scenario has henceforth emerged. Pesification has succeeded technically. Monthly inflation has fallen from an average of 4.6% during the first half of 2002 to 1.8% in the following four months. The exchange rate against the dollar has stabilised at around 3.6 pesos since May and it was possible to unfreeze current account deposits in early December (though not time deposits). The budget is also more or less in balance and the collapse of production has been halted, with some small signs of an upturn in certain sectors. On this basis, it may even be possible to envisage a more general upswing in 2003.

■ The Technical Success of the Pesification

How is this relative success to be explained? First, there has been a normalisation as regards domestic liquidity.

1. See "Can the Argentine Peso Resist Competition from the Dollar?", *La Lettre du CEPII*, No 209, February 2002, available at <www.cepii.fr>.

The payments system was re-established as of April 2002. A fall in imports of 58% led to a current account surplus of 15% of GDP during the first half of 2002. Then, a number of companies have been able to reconstitute their cash-flow, thanks to a brutal reduction in real wages (down by 20% in the first 10 months of 2002). More surprisingly, there have been some inflows of deposits into banks, which are henceforth in a “post-trauma” state, often observed after major crises. The deposit base is being slowly built up, though banks are still refusing to lend. Consequently they are becoming over-liquid, so that the Central Bank has issued short term paper in order to absorb excess lendable resources. That said, the framework in which the economy is operating is far from being normalised. Deposits made prior to 2002 are still largely frozen², capital controls have been tightened methodically, a large share of private and public financial bonds are in default. Lastly and above all, both the banking system and the State are massively insolvent.

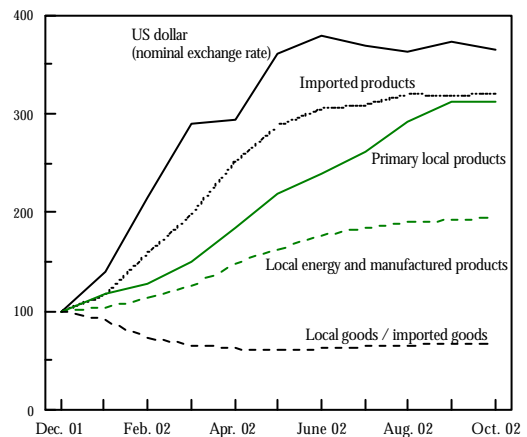
To understand better the present situation and the outlook of the Argentine economy, two principle dimensions of the pesification need to be distinguished, relating respectively to the real economy and to financial balances. The less complex aspect of pesification relates to prices and commercial contracts, and hence to goods markets, labour, property assets etc. Leaving aside symbolic and political considerations, the success of pesification should be judged from a specific point of view, namely the capacity of the exchange rate to adjust in a sustainable manner the terms of trade between tradable and non-tradable goods, so as to influence the competitiveness of the economy.

From the 1970s onwards, this key function had largely been lost: strong inflation had led to substantial dollarisation of all prices. Producers, whether they were exposed to international competition or not, had a strong tendency to establish prices in dollars and then to convert them into pesos at the daily rate. The peso was not therefore instrumental in adjusting terms of trade or price competitiveness. Changes in its value produced a slide in all prices, in other words nearly pure inflation, so that external adjustment was not eased. This neutralisation of the exchange rate was subsequently formalised by the currency board, which explicitly forced producers to adjust directly individual prices and costs, especially salaries, in order to

meet competition. This is a very slow procedure, as the experience of 1999-2001 confirmed, which carries strong social costs: high, rigid prices, adjustments caused substantial losses in output and employment³.

At this point the major surprise of 2002 emerged, highlighting the success of pesification. Inflation slowed during the second quarter, reflecting only in part the slide of the exchange rate (there was a 120% rise in wholesale prices versus a 260% depreciation during the first 10 months of 2002). This reveals a considerable adjustment in relative prices (see Graph): the peso prices of little-traded or non-traded goods (illustrated here by energy and manufactured goods) have risen much less than prices of traded goods (primary products), which have followed the movement of the dollar. This contradicts the standard interpretations of dollarisation, which is generally presented as a consequence of monetary instability and the loss of credibility of public institutions. The paradox needs to be stressed: in the middle of a major monetary disaster, when the risks of hyperinflation were openly discussed, and while Argentines were demonstrating against their government, they nevertheless again adopted the peso as the dominant unit of account for their salaries and for prices. The result, of course, is that the adjustment of relative prices in the short term has led to massive redistribution effects between sectors, in terms of incomes and living costs⁴. However, the main benefit is that there is now more chance of the export sector picking up, provided its profits are repatriated and invested⁵. Remarkably, though under less chaotic circumstances, the same phenomenon of the “de-dollarisation” of a unit of account had

Graph – Changes in the peso exchange rate in 2002 (December 2001=100)



Source: Argentine Ministry of Finance.

2. The whole set of measures freezing deposits is nevertheless subject to substantial legal uncertainty, due to the ability of depositors, which is indeed often employed, to use the courts to reopen their accounts, possibly at the cost of a commission proportional to the volume of deposits and paid to the magistrates. Furthermore, the pesification of deposits is also under scrutiny before the Constitutional Court, which has not ruled on the issue.

3. Between the end of 1998 and end 2001, the Argentine economy experienced thirteen quarters of recession, while prices only began to fall in the last year, hence demonstrating very strong rigidity.

4. Thus, as food and agricultural products are traded internationally by Argentina, their prices in pesos have risen significantly faster than those of the manufacturing sector, as they are far more exposed. The shift in the domestic terms of trade has thus occurred at the expense of urban areas and of the poorest social classes.

5. This seems to be the case at present: during the second half of 2002, Argentina recorded a trade surplus equivalent to 15% of GDP and capital outflows in the order of 18%, due notably to the very partial, repatriation of export earnings. Furthermore, purchases of cash dollars from the American Federal Reserve amounted to about 8% of GDP, which in turn represents an equivalent transfer of income.

already been observed after the Brazilian devaluation of 1999, four and a half years after the end of hyperinflation.

■ The Distribution of Capital Losses

The second dimension of the pesification concerns contracts and financial balances, in short wealth, rather than income. The possible redistribution effects in this area were also enormous. In the wake of the fall of the exchange rate, the very large dollarisation of debts and assets held in the country (nearly 70% of deposits) implied massive transfers of wealth towards agents who held net savings in dollars at the expense of those holding net dollar debts. It is not surprising that the vast majority of the latter have been unable to absorb this shock, especially as many now only received peso-denominated incomes. Not only have the State and the banks become rapidly insolvent, but they have been followed by a large number of companies, provinces, communes and even privatised public services.

Pesification aimed primarily at avoiding the impact of the fall in the exchange rate on private balances⁶. The problem is that if State intervention in private financial contracts, to substitute pesos for dollars as a unit of account, can be justified due to the presence of a valuable public good – the survival of the banking system – it has in practice been a major generator of disorder (see Box).

BOX – PESIFICATION AND THE DISTRIBUTION OF CAPITAL LOSSES

For the sake of example, let it be assumed that under the currency board a given bank had deposits (liabilities) and loans (assets) in both pesos and dollars. In the wake of the 1 to 3 devaluation, the international purchasing power of dollar deposits is stable: if depositors mainly spend their money in Argentina, then they benefit clearly from the devaluation. As for companies indebted in dollars, they suffer a threefold rise in debt, expressed in pesos. If they only sell abroad, so that their earnings are in dollars, then they will not experience any problems. But this is an unusual situation in an economy which is not very open to international trade. Many companies geared to the domestic market took on large dollar debts before 2002, in order to benefit from lower interest rates. In their case, devaluation probably made them instantly insolvent, and weakened the assets held by banks accordingly. Pesification in this case means protecting indebted companies and their banks from exchange rate effects, while annulling the windfall profits earned by dollar. However, asymmetric pesification introduced a bias. If a bank has assets and liabilities of \$100, its asset portfolio will still be worth 100 pesos (which is favourable to companies) but its liabilities (deposits) amount to 140 pesos. Depositors are then less upset, but banks incur capital losses of 40 pesos, which in turn justifies public aid – unless depositors are to lose more money, somewhat later.

To begin with, a reasoned approach would have called for a pesification of contracts before breaking with the exchange rate parity, as the United States did in 1933 when it went off the gold standard. In Argentina, the authorities waited for several weeks after devaluation: it had already amplified massively both the liquidity crisis and the breakdown of balance sheets, causing in turn major, irreversible consequences. Moreover, under pressure from numerous lobbies, pesification became asymmetric: while company assets were exchanged at parity, deposits were converted at the rate of 1.4 pesos to the dollar. In other words, far from striving for neutrality and transparency, pesification actually contributed to the redistribution of wealth, favouring indebted companies. As the banks were subsequently unable to absorb the differences which had emerged between their assets and liabilities, the State, though itself insolvent, announced that it would provide them with “compensation vouchers” in the order of 15% of GDP. Savers holding dollars benefited relatively from the asymmetric pesification. That is one reason why nobody in Argentina, since early 2002, knows what the net value of their assets is, apart from the large majority which has nothing anyway, or those people whose investments are all in Miami.

Other factors have contributed to the general confusion about the real value of assets and liabilities. For instance, over a certain threshold, company debts incurred before 2002 and subsequently pesified, were to be indexed on inflation and to carry a real interest rate of 2%. However, this regulation was still not applied by the end of the year, and it was not known whether it will be applied from the date of its promulgation onwards, or retroactively from the date of devaluation or the pesification onwards. Depending on the decision made, the value of debts may change by nearly 40%, which would again constitute a major redistribution of losses between banks and companies.

The major consequence is that the financial restructuring of the economy is facing gridlock. There is a direct link between the valuation of balance sheets, their restructuring and the resolution of possible insolvencies. As long as the allocation of capital losses and accounting problems have not been solved, no headway can be made. The best example is given by the Central Bank. It is legally obliged to close down all insolvent banks, but has opted since early 2002 for a policy of not knowing, rather than taking real decisions, and so has blocked all information flows relating to bank supervision. Similarly, the law on company bankruptcy has been suspended since February 2002. This can be justified in

6. On top of domestic debt denominated in foreign currency, many agents held significant amounts of debt issued on the international capital markets, which obviously could not be altered by pesification. On 30 June 2002, Argentina's foreign debt stood at \$133 billion, compared to a GDP estimated at \$100 billion. State debt amounts to \$85 billion and private sector debt to \$48 billion, of which more than \$33 billion is held by non-financial sector. \$63.9 billion of the total foreign debt is made up of bonds, \$33.1 billion is owed to multilateral organisations, of which \$10.5 billion is due to the IMF. Total public sector debt (domestic and foreign) stood at \$132 billion during the same period (including “compensation vouchers” linked to the asymmetric pesification of bank balances).

the wake of a systemic crisis. But it also risks leading to a situation of widespread economic uncertainty, as major doubt will surround the viability of any agent. Another, comparable example concerns the parallel currencies that a majority of provinces continue to issue, which also testify to the problems of unsettled insolvency. As they no longer have access to capital markets and are unable to reduce their budget deficits, these local authorities pay part of their wage bills in vouchers, which local public employees may then use to settle their own expenses. Again, the result is to accommodate insolvency and to preserve the *status quo*, though at the same time weakening the monetary and financial system.

It is clear that such a situation cannot go on for long, as it deviates from the elementary rules underpinning any capitalist economy. It thus blocks not only a return to capital accumulation, but everything indicates that if not treated correctly, the situation may lead to even worse disruptions. Already in the early 1980s, banks insolvency was not treated fully, after a first, serious financial crisis occurred, accompanied by external debt default. In the years that followed, the quality of credit allocation was very poor, and the Central Bank progressively supported the banking system with ever-greater injections of money. This led to the first wave of hyperinflation in 1984-85, followed by a second more violent bout in 1989-90. Such risks may re-emerge in the future. An alternative scenario would lead more towards what occurred in Russia during the 1990s, i.e. slow impoverishment, the reduction of real capital stocks, weak or no intermediation, a strong tendency to regional monetary fragmentation, chronic capital flight, and an unstable integration into the world economy due to recurrent State defaults.

■ The Need for a Social Pact

Overall, the Argentine economy is thus faced with a central problem since exiting the monetary crisis. There is an enormous volume of capital losses in the economy. These have to be written into balance sheets, although they are still spread around the economy, subject to political decisions and pressures, that are often opaque. The result is that the management of the crisis is dominated by a political economy of the sharing out of losses, in which it is difficult to identify criteria either of social equity or of economic efficiency. Yet both these imperatives actually require a fairly similar approach. Limiting the risks of an informal redistribution of wealth, whose legitimacy could clearly be contested, needs an ordered and explicit procedure to restructuring banks and restoring public finances. It should include the interests of the shareholders of banks and companies (foreign and Argentine), depositors and taxpayers, future generations (via public debt) as well as Argentina's foreign lenders. The latter hold 72% of public debt, yet negotiations with them have not yet started.

A real social pact needs therefore to be concluded, in order to write-off losses, absorb the financial cost of the crisis, and open up again the economic future of the country. This should lie at the heart of the domestic and foreign negotiations which the country's leaders, who will be elected in April 2003, will have to undertake. The challenge is great, for a country in which political leaders have for too long been misleading, often missing key opportunities.

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