Left Behind

Latin America and the False Promise of Populism

Sebastian Edwards

THE UNIVERSITY OF CHICAGO PRESS | CHICAGO AND LONDON

Chapter 7
The Mather al All Crises
Argentina, 2001-2002

On December 20, 2001, after a week of riots and political unrest, Fernando de la Rua, Argentina's constitutional president, resigned from office. A few weeks later Argentina defaulted on its foreign debt and went through one of the most traumatic currency crises in modern history. In little over two months the peso, which for more than a decade had been pegged to the U.S. dollar at a rate of one peso to one dollar, lost two-thirds of its value. The depth and political ramifications of the crisis were such that in a period of four weeks the country went through five presidents. The consequences of the crisis were profound: the proportion of households living below the poverty line in greater Buenos Aires jumped from 12 percent in 1994 to more than 40 percent in late 2002, and income disparity increased significantly.

In many ways, Argentina epitomizes Latin America's historical proclivity toward macroeconomic instability, trade imbalances, and costly crises. The implosion of the Argentine economy in 2001-2 has become one of the most important arguments against globalization, market reforms, and so-called neoliberalism. Critics such as Nobel laureate Joseph E. Stiglitz have argued that the policies of the Washington Consensus were at the center of these events and that the IMF has a major responsibility in what happened.[1]

The main forces behind Argentina's deep economic problems at the turn of the new century were highly complex and at times seemed reminiscent of a Greek tragedy. Paraphrasing novelist Gabriel Garcia Marquez, if there were ever a death foretold in Latin America, it was the Argentine collapse of 2001-2. As will be seen in the pages that follow, the pegging of the currency was-as it had been in Chile in the late 1970s, in Colombia, and in Mexico-at the center of this drama.[2] In particular, the decision to peg the peso to the U.S. dollar in April 1991-and to maintain the peg even in the absence of supporting fiscal and other key policies-was made by Argentine politicians and

not by IMF officials, U.S. Treasury functionaries, or academics and scholars who supported the Latin American modernization reforms. The fact that Argentina's own policy mistakes were the main cause of the events of 2001 was recognized by President Eduardo Duhalde, who was appointed to the presidency in January 2002 by the Argentine congress. In a 2002 opinion piece in the Financial Times he wrote: "In the case of Argentina, *no one bears more of the blame for the crisis than Argentina itself.*"[3]

A Long History of Instability and High Inflation

The 2001–2 crisis is only the latest in a series of crises, currency collapses, and debt defaults in Argentina. As discussed in chapter 2, during the nineteenth and twentieth centuries Argentina was plagued by repeated currency failures. In the second half of the twentieth century, Argentina implemented a number of stabilization programs aimed at eliminating inflation; all of them failed. Some important historical highlights include the stabilization program of Minister Adalbert Krieger Vasena in 1967 and the so-called Rodrigazo in 1975, which eventually generated a flare-up in the annual rate of inflation to 182 percent. In the early 1980s a major anti-inflation effort was put in place by Minister José Martínez de Hoz. The program attempted to guide inflation down by controlling the rate of change in the exchange rate between the peso and the U.S. dollar. This attempt ended in a serious crisis and heightened political instability. In 1986, a heterodox stabilization program known as the Austral Plan was put in place, but once again it failed due to the government's inability and unwillingness to control fiscal imbalances.

This inflationary saga rooted in fiscal profligacy culminated in hyperinflation in 1989, when the annual rate of price increase exceeded 3,000 percent per year. In Argentina, as in other developing countries that experienced hyperinflation, constant revisions to prices and nearly instantaneous erosion of the purchasing power of the domestic currency were extremely disruptive and eventually led to a collapse in economic activity. Worse yet, hyperinflation eroded the value of wages and incomes of the poor and the middle classes.[4]

Inflation was the most visible manifestation of Argentina's economic malaise. Problems, however, ran deeper and affected all spheres of the economy. For instance, Argentina had serious difficulties keeping its external debt payments current. According to MIT professor Kristin Forbes, Argentina was in

a state of debt default or debt restructuring in 26 percent of the years between 1824 and 1999.[5] This resulted in a high degree of perceived (and real) risk and a reluctance by foreign investors to become involved in Argentina. From 1975 to 1990, foreign direct investment was very low in comparison with East Asian and other Latin American nations, including Chile and Mexico. National savings were also low; productivity gains were minimal, and overall economic growth was meager. Protectionism was generalized, and economic distortions affected every sector of the economy, including labor and financial markets. The extent of Argentina's economic malaise is reflected in the fact that gross domestic product growth per capita was *negative* from 1975 to 1990; during these years the average annual rate of growth per capita income was an astounding −1.4 percent.

Please, Tie My Hands!

In April 1991, as a way of dealing with more than a decade of negative growth and an almost complete lack of credibility in the government, President Carlos Menem enacted the so-called Convertibility Law. Its central feature was pegging the value of the domestic currency—originally the Austral and later the peso—to the U.S. dollar.[6] The initial peg was 10,000 australes per U.S. dollar; once the new peso was issued in 1992, the peg was one peso to one dollar. The Convertibility Law, which was the brainchild of Harvard-trained economist Domingo F. Cavallo, mandated that the central bank use monetary policy strictly to defend this currency peg. This was to be done by limiting the supply of local currency and strictly avoiding inflation. Thus, according to this legislation the central bank could not make any loans to the government and could only expand liquidity if the expansion was fully backed by foreign exchange reserves. For all practical purposes, the Convertibility Law created a currency board system.[7]

From a political perspective the Convertibility Law was a legal mechanism that forced the government to tie its own hands with strict legal limitations on central bank policies. After decades of economic mismanagement the Argentine authorities had come to a sober conclusion: the only way to avoid repeating the traumatic crises of the past was to renounce an independent monetary policy. Only by taking away this tool, which had been systematically abused, would stability be achieved. That Argentina had already had failed experiences

with a currency board system in the late nineteenth and early twentieth centuries (see chapter 2) and that these failures had been the consequence of fiscal profligacy did not deter Cavallo, the architect of the Convertibility Law. Years later, a number of observers asked whether the main flaw of the Convertibility Law was that it only went halfway. In retaining a national currency and thus the option to change the law and liberally print money, a certain amount of risk and uncertainty remained. Some of these analysts argued that a better course of action would have been for Argentina to give up on its currency altogether and adopt the U.S. dollar as legal tender.[8]

In conjunction with the Convertibility Law, Argentina introduced a package of reforms aimed at modernizing financial markets and the productive side of the economy; many of these corresponded to the policies of the Washington Consensus. State-owned enterprises were privatized, regulations on business and investment were partially relaxed, and the economy was somewhat opened to international competition when the country signed a trade pact with Brazil, Paraguay, and Uruguay to form the customs union Mercosur. In addition, a tax reform was implemented, the social security system was partially privatized, and export taxes were eliminated.

A key objective of the Convertibility Law and related economic reforms—including the Law of Reform of the State and the Economic Emergency Law of 1989—was to attract foreign capital.[9] In the early 1990s, after fifteen years of negative per-capita growth, Argentina urgently needed to draw on foreign financing to jump-start the economy and generate positive and sustainable growth. Foreign investment was particularly important to develop Argentina's infrastructure, which had been neglected through the years of successive currency crises in the 1970s and 1980s, and to expand exports. As a way to increase credibility further, during the 1990s Argentina signed more than forty bilateral investment treaties with its most important trading partners. These treaties legally protected foreign investors and established clear arbitration processes in case any dispute might arise in the future.

In the years immediately following the adoption of the currency board and the fixed exchange-rate regime, Argentina's annual inflation rate declined rapidly, from more than 2,000 percent in 1990 to barely 3 percent by 1995. With inflation under control, output experienced a spectacular recovery: gross domestic product growth was 11 percent in 1991, 10 percent in 1992, 6 percent in 1993, and 8 percent in 1994.[10]

Initially the reforms received ample political support from the population. Those hurt by them—including the traditional manufacturing sector—were placated by progress made in other areas that also affected them, including the elimination of inflation, the increased availability of credit, and the creation of the trade pact Mercosur, which allowed them to access the very large Brazilian market. As with all of the Latin American reforms, producers of export goods—in Argentina these were mostly agricultural commodity producers in the provinces—were initially the staunchest supporters of the modernization effort. On the other hand, the most vocal opponents of the reforms were public-sector employees and workers in the scores of state-owned companies that were being privatized, including most of the country's utilities. In 1995, as a consequence of the Mexican crisis, gross domestic product declined slightly. Growth picked up in 1996, when gross domestic product increased at a 5 percent annual rate. Economic expansion continued at 8 percent in 1997 and 4 percent in 1998. In 1999, however, Argentina entered a recession.

The Mexican Crisis and the Weaknesses of the Convertibility Law

Mexico's Tequila Crisis of 1994–95 unveiled some important weaknesses of Argentina's fixed exchange-rate system and its currency board regime. Economists at the World Bank and the IMF as well as independent analysts and observers identified three areas of policy weaknesses in Argentina: large fiscal deficits, especially in the provinces; rigid labor legislation that made both the hiring and dismissal of workers very costly, and thus made the economy's response to foreign shocks such as decline in the country's export prices more costly; and a trade policy that emphasized regional trade through Mercosur and kept Argentina relatively closed to the rest of the global economy.[11]

For a currency board to succeed, fiscal discipline is essential. What is needed is a system that assures the public that, on average, the country will have a balanced public-sector budget. Argentina, however, did not maintain a prudent fiscal policy during 1991–2001. When all sources of expenditures are considered—including those that were kept off the books by the government—the average fiscal deficit during 1991–2000 was a very large 4.1 percent of gross domestic product. This would be a high number even in a country with a flexible exchange rate; for a country with a strictly fixed exchange rate and a currency board, this type of fiscal policy was clearly dangerous.

Countries with fixed exchange rates—especially countries with currency boards—are supposed to run fiscal surpluses during good years when growth is strong. These surpluses should then be used to build up a fiscal reserve fund that can be utilized during lean years. Argentina did not follow this simple countercyclical rule for fiscal policy. During the good years when gross domestic product growth was strong, the country still ran very large deficits. Argentina's rate of economic growth exceeded 5 percent in 1991, 1992, 1993, 1994, 1996, and 1997. The average deficit during these "boom" years was 3.4 percent of gross domestic product, a figure that many would consider excessive for any country at any moment in time, let alone for a currency board country during expansionary years.[12]

A particularly weak aspect of the Argentine economy was the so-called Coparticipation Law, which required the federal government to make large revenue transfers to the provinces. The provinces, however, had no incentive to balance their budgets; indeed, during the Convertibility Law years—1991 to 2001—there were persistent provincial deficits. At the center of the Coparticipation Law—and of the inability to reform it—was an old dispute between the federal government and the provinces. This problem had been identified as early as 1845 by Domingo Faustino Sarmiento as one of the most serious impediments to Argentina's joining the ranks of the civilized nations.[13]

As former *Washington Post* reporter Paul Blustein has noted, officials from the IMF and the World Bank repeatedly told the Argentine authorities that a lax fiscal policy was almost suicidal in a country with a rigid exchange rate. The authorities acknowledged the problem and time after time said that they would address it. Little of substance was done, however; the measures taken were mostly window dressing and did not attack the sources of the fiscal imbalance with sufficient vigor. The reasons for this lack of serious action were mostly political, as any policies geared toward reducing the fiscal deficit would alienate provincial governors and result in a drop in the national government's popularity.[14] This inability to implement fiscal adjustment and build reserves during the good years became particularly serious in light of the reform of social security implemented in 1994. This reform created a hybrid system that combined private accounts with government-supported pensions. After the reform was implemented, a fraction of workers' contributions were deposited in their own personal accounts and were no longer available for financing existing pension obligations. This resulted in a deficit that should have been covered by general revenues, but the Argentine authorities decided, mostly for

political reasons, to cover it by assuming additional debt.[15] It was expected that the cost of paying off that debt would be borne by future administrations.

During most of 1999 the upcoming presidential elections dominated government policy, including budgetary decisions. By then the popularity of the reforms had begun to wane. In particular, exporters, most of whom are in the provinces and who until then had been the major supporters of the modernization effort, were increasingly disappointed. As in other nations, one of the most severe problems had to do with the exchange rate: when measured relative to various other currencies and not just the U.S. dollar, and after properly adjusting for inflation, the Argentine peso had artificially strengthened, which negatively affected exports' competitiveness. In addition, international prices of Argentine exports—including oil, soybeans, and beef—had declined significantly after 1998. Problems, however, were not confined to producers of export goods. Overall unemployment continued to be stubbornly high, and interest rates, which responded to the global market's perception of Argentina's degree of riskiness, had increased substantially.

In an attempt to keep power in the hands of the Peronist Party, as the elections drew near the government of President Carlos Menem increased expenditures significantly, and the fiscal deficit jumped by 71 percent. In 1999 the public-sector debt increased by 6.1 percent of national income, and by the end of that year the government debt reached 51 percent of gross domestic product, up from 33 percent in 1993.[16]

The Fixed Exchange Rate Becomes a Straitjacket

In the early 1950s British economist and eventual Nobel laureate James E. Meade pointed out that countries that gave up exchange-rate flexibility and opted to peg the value of their currency to that of another country had to have very flexible labor markets. This flexibility would allow the economy to redeploy its labor force across sectors and industries in response to changing international prices without creating unemployment. Another way of stating Meade's dictum is that in countries with pegged currency values, labor market flexibility and dynamism are needed as a substitute for exchange-rate flexibility.[17]

Labor markets in Argentina, however, were extremely rigid. According to Nobel laureate James Heckman, the country had one of the most regulated labor markets in the world in the late 1990s.[18] A study sponsored by the World

Bank and published in 2001 reached a similar conclusion: Argentina's labor markets were among the most rigid and inflexible in Latin America.[19] In addition, Argentina's international competitiveness was dragged down by a highly inefficient and overly regulated health care system run by the unions—the so-called *obras sociales*—which significantly increased labor costs.

The de la Rúa government attempted to modernize labor legislation by taking some power away from labor unions and reducing the costs of hiring and dismissing workers. The measures, however, were rather timid and did not change regulations significantly. In addition, a major political scandal erupted in 2000 when the minister of labor was accused of bribing a number of senior senators in order to get enough votes to approve the labor reform.

In the early 2000s, as a result of its inability to introduce policy changes, Argentina continued to have a highly vulnerable economy. At the heart of this vulnerability was the lethal combination of (1) a currency that had strengthened to the point of severely limiting exports' competitiveness, (2) large and expanding fiscal deficits, (3) inflexible labor market legislation, and (4) a relatively small degree of economic openness.

The Inability to Withstand External Shocks in 1999–2001

Beginning in late 1998 Argentina, like the rest of the Latin American countries, was affected by a series of international shocks that slowed down growth, increased unemployment, and negatively affected credibility. On the heels of a recession in the United States that reduced global demand, along with a strengthening of the U.S. dollar in international currency markets, an increase in international interest rates, and the devaluation of Brazil's currency in January of 1999, Argentina experienced a decline in export prices (since the Argentine peso was pegged to the US. dollar, its peso strengthened relative to other major currencies) and a drop in the volume of foreign capital flowing into the country.

Most critics of the Washington Consensus and the IMF have argued that these external shocks were at the heart of the Argentine crisis. For instance, Nobel laureate Joseph E. Stiglitz noted that "suddenly Argentina's fortunes changed. The precipitating event was the East Asian crisis of 1997, which by 1998 had become a global financial crisis. Global interest rates to emerging markets soared. . . . These problems were compounded by the strong dollar; since the Argentine peso was tied to the dollar, it was increasingly overvalued."[20]

What Stiglitz and other critics failed to acknowledge, however, was that these external shocks were not unique to Argentina—they affected all of Latin America—nor were they unexpected or unusual from Argentina's own historical perspective. Moreover, they were temporary shocks that after some time reversed themselves. Indeed, the price of exports fully recovered to historical levels by 2000, the U.S. dollar began to weaken in international markets in 2001, world interest rates started to decline toward record lows in January 2001, the U.S. recession was over by November 2001, and capital flows returned to Latin America in the mid-2000s. If Argentina had built a sturdy currency board and had implemented supporting policies—as it was urged to do by the World Bank, the IMF, and a number of independent observers—it would have been able to withstand the temporary shocks of the late 1990s and early 2000s. And if instead of a rigid exchange rate Argentina had had a monetary system with built-in exchange-rate flexibility, it would have been able to endure these rough months without suffering a deep crisis.

The problem was not the shocks themselves; the problem was that Argentina was ill-prepared to sustain them. The country was unprepared because it had implemented the reforms halfway and had failed to put in place the policies required to support the currency board. As a consequence, these shocks had a very negative effect on the economy: unemployment skyrocketed, national income contracted, interest rates rapidly increased, and credibility declined. In 2000 the rate of unemployment climbed to 15 percent from 7 percent in 1992.

As time passed and the recession deepened, there was a growing sense that the government would renege on its promise to keep the exchange rate at one peso to the dollar and abandon the Convertibility Law by devaluing the peso. As a result of rumors and the perception that something of the sort would happen, the public withdrew its deposits from the banking sector—particularly deposits denominated in pesos. Fewer deposits meant fewer loans, and fewer loans meant further contractions in economic activity, output, and employment.

Faced with a dwindling credibility, the de la Rúa government sought assistance from the multilateral institutions, and in December 2000 it obtained a large loan from the IMF. Both government and IMF officials expected that

Argentina could buy some time and implement the policies required to shore up confidence and reassure investors that the Convertibility Law would not be abandoned. In August 2001 the IMF increased the size of the loan by $8 billion, but by then it was too late; the increase only prolonged the agony, making the costs of the collapse even higher.

Another Foretold Disaster

In late January 2001, a group of investors met in an exclusive Colorado skiing resort for a three-day conference on emerging markets. The keynote speaker was Domingo Cavallo, Argentina's former economic minister and the architect of the Convertibility Law. There was great expectation when Cavallo took the podium, as most of the men and women attending the conference had invested large amounts of their clients' money in Argentine securities.

Cavallo, a self-confident man who at the time was in his mid-fifties, acknowledged that his country was facing serious economic and political problems. However, he said, these difficulties were not related to the fundamentals of his Convertibility Plan. The currency board and the fixed exchange rate, he argued vehemently, should be maintained; they had served Argentina well. What the country needed, he explained, was to introduce some adjustments to the monetary and exchange-rate policies that had been pursued for more than a decade. He then proceeded to list the modifications that, in his opinion, were required: instead of being pegged to the U.S. dollar, the peso should be pegged to a group of currencies; a "competitiveness" plan consisting of higher import tariffs and export subsidies should be put in place; and the requirement that all pesos in circulation be backed by foreign currency holdings at the central bank should be eased. The questions that followed Cavallo's speech clearly reflected the participants' skepticism about the former minister's proposals. Implementation of these policies, one banker after the other said, would undermine whatever was left of the government's credibility and would result in confusion in the marketplace. Some even intimated that if such a plan were put in place they would liquidate all their Argentine investments.[21]

Seven weeks after this conference, President Fernando de la Rúa surprised the world by firing his recently appointed minister of the economy, Ricardo López Murphy, and replacing him with Domingo Cavallo. During the next few months the new minister proceeded to implement a program that closely followed his Colorado proposals. As a number of the investment bankers at the conference had anticipated, these policies had a negative effect on confidence and on Argentina's credibility. In retrospect it is clear that the year 2001 was fraught with mistakes.

Political dynamics during the first ten months of 2001 were dominated by the government coalition's concern about the congressional elections in October of that year. Campaigning required funding, and thus before October of 2001 provincial governors were unwilling to agree on any reforms that implied a reduction of federal transfers to the provinces. No one seemed to care that the large IMF loan was made on the condition that such reforms were indeed implemented; very few politicians even mentioned the fact that if no progress was achieved on the reforms front, the IMF could suspend further disbursements from the loan.

On April 16, 2001, Argentina's congress passed a bill that changed the exchange-rate peg from the U.S. dollar to a combination of the U.S. dollar and the euro. The intent was to effectively let the peso weaken against the dollar. However, this was widely perceived as a first step toward abandoning the convertibility regime, which had been credible precisely because it was based on a simple, transparent, and supposedly inviolable rule. As more and more people believed that the one-peso-to-one-dollar policy would be abandoned, the government was forced to pay increasingly high interest rates to attract investors. Investing in Argentina was rapidly becoming a gamble, and interest rates paid by Argentina in international financial markets skyrocketed, putting further pressure on its fiscal accounts.

In late April the government allowed commercial banks to use Argentine government securities (up to US$2 billion) as part of their liquidity reserves. This meant that a fraction of banks' deposits were now backed by securities issued by a government whose credibility was in doubt, rather than by bonds issued by the United States and other advanced nations with fully convertible currencies. This measure was perceived as a further indication that the de la Rúa administration was not committed to maintaining the currency peg. The change was resisted by central bank governor Pedro Pou, who argued that weakening the foreign currency backing of commercial banks would be destabilizing. On April 25, 2001, Pou was fired, further eroding the credibility of the government.

Between April and June of 2001, the de la Rúa administration tried to alleviate Argentina's short-term debt burden by exchanging bonds that were about to mature for longer-term bonds that would mature in 2006, 2008,

2018, and 2031. Some of the new bonds did not require payments for a few years, but they had very high interest rates; the 2018 bond, for example, paid an annual interest of 15.2 percent. The staff of the IMF Research Department concluded that any short-term savings obtained from the bond swap would be more than offset by extremely high longer-term interest rates.[22] The rationale for this exchange—which was known as the "mega swap"—was that it would ease Argentina's liquidity problems. However, it did not address any of Argentina's long-term economic weaknesses; the Coparticipation Law continued to be as disruptive as before, labor and *obras sociales* regulations were still a drag on competitiveness, trade policy continued to be restrictive, there were still fiscal expenses that were kept off the books, and thus the swap was perceived by the market as a ploy to buy time.

On June 15 the government announced the adoption of a plan aimed at improving competitiveness. This program consisted of subsidizing exports of nonenergy goods and imposing duties on imports. Many saw this policy as an attempt to increase exports without addressing the deeper problems that were keeping down competitiveness and productivity. As with other measures taken during this period, the public was skeptical; many analysts interpreted the "competitiveness plan" as an effort to "devalue without devaluing." The public's skeptical reaction to all these measures was aptly summarized in a *Financial Times* article that asked: "If Argentina's real problem is fiscal, as almost everyone agrees, is Mr. Cavallo just distracting people's attention with financial sleight of hand?"[23]

A month later Cavallo announced a "zero deficit" policy consisting of short-term measures such as a reduction in government employees' salaries and pensions. The Argentine press as well as the public expressed deep doubts and skepticism, as the package did not address the long-term factors behind the crisis and thus was not credible.

Immediately after the congressional elections, on October 15, 2001, the national government sought to reach an agreement with the provincial governors in order to send a signal that a permanent and credible solution to the fiscal problem would be achieved. Cavallo proposed a program that would reform the Coparticipation Law, reduce the size of the public sector, and restructure provincial debts. But once again partisan politics prevailed, and the governors refused to consider reforming the Coparticipation Law or enacting other long-term reforms. As the negotiations dragged on, deposits began to leave the

banking sector at an increasingly fast rate, and Argentina lost additional credibility. Two of the provinces that refused to sign an agreement with the federal government were San Luis, whose governor, Adolfo Rodríguez Saá, became president in December 2001 after the resignation of Fernando de la Rúa, and Santa Cruz, whose governor, Néstor Kirchner, was elected president in 2003.

In November 2001, Standard and Poor's lowered Argentina's long-term sovereign rating to "selective default." At this point, both the Argentine public and international actors lost nearly all confidence in the government of Argentina's willingness to support the currency board.

On December 1, 2001, Cavallo imposed wide-ranging controls on banking and foreign exchange transactions that effectively froze bank deposits. This policy made the commitment to convertibility meaningless. Freezing deposits was a desperate measure that violated the government's social contract with the Argentine public and solidified expectations of devaluation and debt default. On December 9, the IMF suspended its assistance to Argentina, implicitly acknowledging that there was no way of avoiding a major crisis. On December 20, after two weeks of protests and rioting by a disappointed and furious public, Fernando de la Rúa resigned as president of Argentina. Eleven days later Argentina defaulted on its external debt, and a week after that the peso was devalued by 40 percent.

Devaluation, Default, and Pesification

On January, 6, 2002, the so-called Emergency Law was passed by Argentina's congress, and on January 8 the new government officially ended convertibility and devalued the peso. A new fixed exchange rate of 1.4 pesos to the dollar applied for imports and exports; all other transactions were subject to a floating, market-determined rate. In addition, the government converted all dollar-denominated debts that did not exceed $100,000—regardless of whether they were government or private debts—into pesos at the old rate of one peso to one dollar.[24] On February 3, 2002, the government decided to go further and fully pesified all debts at the old exchange rate of one peso to one dollar and pesified dollar deposits at a rate of 1.4 pesos to the dollar. On February 11, 2002, the peso began to float in earnest and lost additional value. By the end of February, the exchange rate stood at 2.1 pesos to the dollar, and by mid-April it was almost 4 pesos per dollar.

By transforming dollar-denominated contracts to peso denominations at different rates—one dollar to one peso for debts and one dollar for 1.4 pesos for deposits—the Duhalde administration consciously benefited some groups and imposed severe costs on others. Corporations and individuals who had borrowed in dollars benefited from pesification, as did those who had dollar deposits outside the country. Those who had dollar-denominated deposits in the Argentine banking sector suffered losses, as did public utilities whose tariffs were transformed from U.S. dollars to pesos at the old unitary exchange rate. The political nature of the devaluation-cum-pesification policy was acknowledged in early 2002 by Duhalde's spokesman Eduardo Amadeo, who said: "At one point we wanted to float the peso but when we saw the social situation we knew this would be politically unsustainable."[25]

The political motives behind the asymmetric pesification were apparent. One of the basic political goals of the Duhalde government was to obtain the support of the middle class, which had become disenchanted with all political parties.[26] The Duhalde government blamed foreign banks, foreign public utilities, and foreign companies in general for the crisis.[27] The pesification of debts also benefited mortgage debtors—many of whom were members of the middle class—as well as large corporate debtors who had borrowed in dollars from Argentine banks. At the same time, the pesification of deposits at a higher exchange rate (1.4 pesos per dollar) provided partial compensation to dollar depositors.

Exporters were also bound to benefit from the devaluation of the currency, as they would get a greater number of pesos for every dollar's worth of goods they exported. The new Argentine government, however, decided to tax most exports and to use the proceeds to pay for transfers to a number of interest groups that had lobbied for a change in government and to end the reform effort.

Since 2002 successive Argentine governments have argued that the IMF was partially responsible for the crisis. According to former minister of economics Roberto Lavagna, the IMF contributed to the notion that during most of the 1990s the Argentine economy was a "stellar performer" but failed to point out with enough force that slippages in fiscal policies were extremely dangerous.[28] In particular, Lavagna argued that the IMF should have warned Argentina that the social security reform, which created individual savings accounts, would result in an increase in the fiscal deficit. Lavagna's remarks,

however, were disingenuous. The fact that a partial privatization of social security creates a fiscal imbalance was well known in the economic literature and was certainly known to the Argentine policy makers during the late 1990s.[29] Lavagna also criticized the IMF for not having assessed the appropriateness of the fixed exchange-rate currency board regime for Argentina, for encouraging complacency, and for not having a contingency plan that contemplated an orderly departure from the fixed exchange rate during early 2001. So much for taking responsibility.

There is little doubt that the IMF made serious mistakes in its dealings with Argentina, including its failure to be forceful enough on the need for truly supporting the currency board through appropriate policies and its granting of loans in late 2000 and in August 2001 that allowed the de la Rúa administration to muddle through. These mistakes have been acknowledged by the IMF's own independent evaluation report and by Michael Mussa, the former IMF chief economist. However, a careful analysis of the historical record indicates that the lion's share of responsibility for the crisis rests with Argentina's economic authorities, as was recognized by President Duhalde.[30] Simply put, the adoption of the fixed exchange-rate regime and the currency board was a decision made by Argentina and not by the IMF—in fact, many World Bank and IMF officials were skeptical about this policy. Moreover, in spite of repeated suggestions and requests by the multilateral institutions and independent observers, the Argentine authorities failed to put in place the type of fiscal, labor, and trade policies required to support and strengthen the currency board.

Blaming the IMF for the country's economic trouble is not new in Argentina. In a remarkably candid 1966 interview, former strongman José Domingo Perón, arguably one of the leading populists in the region's history, blamed the IMF for Argentina's economic crises after 1955. According to Perón, during the 1960s the IMF "robbed" Argentina of half of the financial loans it granted the country. With a great sense of self-importance he said: "Since I left [the government] Argentina has been governed by the International Monetary Fund."[31]

In the months leading to the crisis, a number of economists argued that the most direct and least costly way of avoiding it was for Argentina to give up its own currency and adopt the U.S. dollar as legal tender. The debate over the merits and drawbacks of this policy—usually called "dollarization"—went beyond Argentina and was particularly heated in countries such as Ecuador,

El Salvador, the Dominican Republic, and even Mexico. In the end, despite the support of influential personalities such as Stanford University professor John Taylor, who was then Undersecretary for International Affairs at the U.S. Treasury, Argentina decided not to dollarize its economy; during the 1990s only Ecuador and El Salvador gave up their local currencies and adopted the U.S. dollar as legal tender.[32]

Social Costs, Recovery, and Populism

The social costs of the Argentine saga were substantial: in 2002 the proportion of households in greater Buenos Aires living below the poverty line was 42 percent, three times higher than in 1992; the rate of unemployment skyrocketed to almost 20 percent in 2002. Real wages declined substantially, and other social indicators, including public health indexes, worsened considerably.

Not surprisingly, Argentina's voters were deeply disappointed and very angry. They felt that once again they had been the victims of a major social experiment that had gone tragically wrong, and almost everyone thought of the experiment as nothing more than neoliberal reforms of the Washington Consensus. The public did not have the time or patience to undertake a nuanced analysis and postmortem or to deconstruct the causes of the crisis by making a distinction between the Convertibility Law and the fixed currency value on one hand and the reforms aimed at improving productivity, efficiency, and growth on the other.

The fact that the ultimate cause of the crisis was a weak currency board that was not supported by appropriate fiscal and labor policies was of little solace to Argentine voters. All they knew was that they had been promised stability, growth, and prosperity, but instead they had lost their jobs and life savings and their incomes had declined significantly. Under these circumstances it is far easier—and certainly very human—to find a handful of guilty parties on whom to blame the debacle. In this case the culprits were seen as former president Carlos Menem, Domingo Cavallo, the Washington Consensus, foreign banks and multinationals, and, of course, the IMF.

The sense of frustration and revulsion was such that generally negative sentiments toward all politicians spontaneously emerged, without regard to their political affiliation, ideology, or stance on globalization. In the streets of Buenos Aires and other cities large crowds demonstrated, demanding that

their savings be returned in U.S. dollars and chanting again and again, "*Que se vayan todos*!"—Throw them all out!

In early 2002 political conditions were fertile for the emergence of a populist leader with massive backing from the population. But as is often the case in Argentina, things were more convoluted than even seasoned analysts expected. On January 2, 2002, Eduardo Duhalde, an old Peronist hand and former governor of the province of Buenos Aires, was appointed president by congress. Although he was an experienced politician and had often used populist rhetoric—the BBC described him as "a populist . . . known for blunt language and outspoken remarks"—he was more of a political operator than a natural charismatic leader. In the eyes of many he was seen as a loser, since he had lost the election in 1999 to Fernando de la Rúa.[33] During his sixteen months in office Duhalde made an effort to avoid the return of rapid inflation and implemented a number of measures aimed at undoing the Convertibility Law. As noted earlier, most of these policies affected foreign investors and redistributed income toward those firms and individuals who had become indebted in U.S. dollars.

In May 2003, Peronist Néstor Kirchner, the former governor of the southern province of Santa Cruz, was elected president of Argentina. He obtained 22 percent of the popular vote, the lowest percentage ever obtained by an Argentine president, and was declared the winner once his rival, former president Carlos Menem, withdrew from the runoff election. Kirchner's years in office were characterized by political discourse centered on anti-globalization and the ills of inequality. Like his predecessor, he blamed foreigners, in particular the IMF, for the country's state of affairs. When Kirchner took office international financial conditions had begun to turn in Argentina's favor. Global interest rates declined to an all-time low; prices of Argentina's exports—oil, minerals, and agricultural commodities—increased substantially; and the world economy continued to expand.

Throughout the Kirchner administration the antiglobalization and antiforeign rhetoric continued. The nation's external debt was restructured, and foreign investors were forced to take only 30 cents on the dollar. The combination of unparalleled positive international conditions and a debt that had declined significantly after the default and restructuring helped the country recover rapidly. Between 2003 and 2008 income per capita grew an average of 7.6 percent per year. Slowly, Argentina began to return to normal. For most of

the people the years of the Convertibility Law were a bad nightmare triggered by the adoption of the wrong policies. As time passed Kirchner' popularity increased, thanks to a combination of growing incomes, his strong populist rhetoric, and a personal style that emphasized nationalistic themes. In December 2007, when his term was over and he was replaced by his wife Cristina Fernandez de Kirchner, Néstor Kirchner's approval rating was the highest of any retiring president in the history of Argentina.[34]

But behind this sense of progress and success, serious tensions had been simmering. Given the breach in contracts and hostile attitude toward the business sector, foreign direct investment declined markedly during the first decade of the twenty-first century. This represented a serious problem, since Argentina continued to need large volumes of funds in order to increase investment and productivity and achieve a sustainable rate of growth over the longer run. In 2003, for example, Minister Roberto Lavagna stated that "foreign investment . . . is essential for re-launching economic growth."[35] However, according to A. T. Kearney's prestigious *Foreign Direct Investment (FDI) Confidence Index*, starting in 2002 large international companies had limited interest in Argentina as an investment destination.[36] This contrasts sharply with the situation before the government of Argentina froze deposits, defaulted on its debt, and pesified contracts. In 1998 Argentina ranked eighth in the "investment intentions" of large international companies. In spite of its economic recession, Argentina still ranked fourteenth in 1999 and nineteenth in 2000 and was still ranked among the top twenty-five global investment destinations for large international companies in 2001. The reason for these high rankings was the perception that the country respected contracts and the rule of law. These rankings contrast sharply with those from the most recent A. T. Kearney survey: neither in 2006 nor in 2007 or 2008 was Argentina ranked among the top twenty-five investment destinations for the largest one thousand international corporations.[37] As stated in the 2005 A. T. Kearney index, "lingering political and economic uncertainty and numerous pending international investment disputes are all hindering Argentina's ability to regain the level of investment interest experienced in the late 1990s."[38]

The decline in infrastructure investment in Argentina has already had serious economic consequences. Since 2004 the country has faced natural gas shortages, which have resulted in electricity blackouts and threatened industrial production.[39] Another consequence of the post-2002 decline in investment in infrastructure is that Argentina has reneged on its contracts to export natural gas to Chile, generating diplomatic tensions.[40]

The administrations of the two presidents Kirchner have relied on the old Argentine tradition of taxing the export sector—including the vast agricultural sector—to subsidize urban dwellers, including, in particular, government bureaucrats, teachers, and health workers. Historically, this policy had reached its zenith during populist strongman Juan Domingo Perón's administration in the 1950s. Most experts agree that antiexport policies have historically been behind Argentina's dismal long-term economic performance.[41] As noted in chapters 2 and 3, an antiexport bias generates inefficiencies, low investment in key sectors, and public-sector accounts that are vulnerable to the vagaries of the international economy. This model—which is rationalized on the basis of distributional concerns—transfers incomes to privileged groups that for years have benefited from the state without substantially contributing to economic growth. The most important among these groups is, arguably, teachers' unions, which have systematically blocked any attempt at improving the quality of Argentina's educational system.

Since 2002 Argentina has taxed the majority of exports; the rates of taxation have varied by sector and product, however. For example, in April 2002 exports of some items were subject to taxes at a 5 percent rate (dairy products, processed vegetables and footwear among others); other exports were taxed at a 10 percent rate (fresh fruits, honey, tobacco, cotton fiber, and others); others were subject to a 14.5 percent tax rate (corn products); still other exports were levied a 17.5 percent tax (seeds and oil seeds); and some exports (crude oil) were subject to a 20 percent tax rate. In a paper on the Argentine devaluation of 2002, World Bank senior economist Daniel Lederman and Argentine professor Pablo Sanguinetti said: "There is no convincing economic argument in favor of having a differentiated export tax structure that favors manufactures over other exports."[42] As a result of increased political tension, higher export taxes, and strong antibusiness discourse, a number of investors have decided to move their operations to neighboring Uruguay or to Brazil, which in the mid-2000s surpassed Argentina as the world's largest beef exporter.[43]

Although export taxes are not illegal under the World Trade Organization, it is generally acknowledged that they constitute an inefficient and distortionary way of raising government revenue. Historically export taxes have been avoided by countries seeking to develop a healthy international trade sector

and achieve rapid and sustained economic growth. The fact that export taxes generate significant distortions, reduce exports, and harm economic performance has led a number of countries, including Japan and the nations of the European Union, to suggest that their imposition should be prevented by international treaties.[44]

Increasing reliance on export taxes to finance an expanding public sector generated severe political tensions between the government of President Cristina Fernandez de Kirchner and agricultural producers. These problems became quite serious in March 2008, when the most important agricultural lobby groups called a strike to protest the decline in rural incomes.

The conflict with farmers is not the only problem faced by the administration of the second president Kirchner. In 2007 inflationary pressures began to increase significantly, threatening macroeconomic stability and triggering demands for very large wage increases. The government response appeared to be taken from a manual on populism: instead of acknowledging the problem and implementing corrective measures, the administration claimed that the higher inflation figures were the result of a flawed consumer price index. A number of members of the technical staff of the national statistical office were fired and replaced by political appointees willing to manipulate the data. With such a response the administration seemed oblivious to the fact that the country's dwindling reputation had been damaged further and possibly irreparably.

Part III
The Populist Reaction