A Decade of Convertibility

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Executive Summary

- In the years following the implementation of the Convertibility Plan, debt in Argentina grew much faster than in other countries that pursued similar, albeit successful, exchange rate-based stabilization plans.

- At its conception, the development plan implemented in Argentina during the structural reform period (1991–1995) seemed to be sustainable. The level of domestic private savings was only slightly below the average of the other countries included in this study. Further, Argentinean investment levels were higher (although quantitatively the difference was not very important). Finally, the rate of growth of output was significantly larger than the average growth rate for these other countries.

- As a percentage of national income, exports were much lower than those in other countries with comparable stabilization plans. Given that an appropriate measure of export volume is an indicator of debt repayment capacity, this fact, together with rising debt levels, was an early warning of the trouble that the Argentine economy would be encountering in the future.

- The first test of the Convertibility Plan was the 1995 Mexican crisis. Argentina passed this exam. The temporary nature of the shock, a manageable external debt and fiscal deficit, and the favorable terms of trade enjoyed by export commodities were all important factors that tempered the impact of Mexico’s crisis on the Argentine economy.

- Growth in Argentina’s GDP resumed in 1997. Yet, international credit markets were rolling over the debt at increasing interest rates.
• The collapse of the Convertibility Plan was triggered by both internal and external causes. The most important external ones were:
  o A fall in Argentina’s terms of trade.
  o Currency devaluations in neighboring countries and other emerging markets.
  o A reduction in net capital flows to emerging countries which made debt refinancing more costly.

Among internal factors, the following are noteworthy:
  o Labor market rigidities.
  o The impact of the 1999 presidential campaign on the fiscal deficit and the conflict between the federal and local governments. Both contributed to increased external indebtedness.

• The confluence of these factors increased exchange rate uncertainty, driving down investment levels, making the recession worse, and further weakening the fiscal position of both the federal and local governments. Argentina’s debt repayment capacity had been compromised.

• The collapse was delayed because many creditors believed that the IMF would bailout Argentina. At the end of October 2001, George W. Bush’s administration made it clear that this was not going to happen.
The stabilization plan pursued by Argentina beginning in the early 1990’s, the Convertibility Plan, had as its main goal controlling inflation by fixing the exchange rate with the US dollar. A series of structural economic reforms was undertaken in the 1991-1993 period. The most important included the privatization of state-owned companies and the opening of the economy to both international capital flows and trade in goods and services. Following these reforms, output and consumption growth were evidence of an improvement in economic conditions.

This report develops ideas about some of the factors that triggered the collapse of the Convertibility Plan.

**The Golden Years of Currency Convertibility**

The stabilization plan, and the associated structural reforms, had an immediate positive impact during its first years (1991-1994). With a low level of foreign indebtedness, Argentina regained access to international credit markets when the Brady Plan was signed with institutional investors and multilateral credit agencies at the beginning of the decade. Following Cottani and Llach (1993), we present a comparison, based on macroeconomic data, between Argentina and other countries that carried out similar, and successful, plans throughout the second half of the 20th century. Our main goal is to understand if Argentina was following a plan for sustainable growth and to identify the underlying risks faced by the country in this period.

With this objective in mind, we analyze data on the current account, exports, gross national savings, gross investment, and output growth for Italy in 1950, Germany in 1950, Japan in 1950, Taiwan in 1958, Spain in 1959, Korea in 1964, Chile in 1974, Mexico in 1988 and Argentina in 1991. In each country, the period considered for analysis begins three years before the implementation of the plan and ends six years after implementation.

A comparison of the behavior of the current account\(^3\) is presented in Figure 1. A negative value for the current account implies that the country’s debt to the rest of the world is growing.

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\(^3\) A country’s current account balance is the trade balance (exports minus imports) minus interest payments on debt.
The current account, as a percentage of GDP, is shown for the average of the three years preceding the implementation of the reform and for each of the first four years. Values are also calculated for the average of the three years following the implementation and the three years beginning with the fourth year after the reform.

Argentina’s current account deficit was larger than the average of other countries included in this comparison. This indicates that Argentina was aggressively accumulating debt. However, this is not necessarily a cause for concern. Higher debt levels may be a positive sign if they arise from a sustainable development plan.

This report will concentrates on this aspect of Argentina’s development policy. It is important to note that such a degree of indebtedness must impose constraints on economic activity if a stabilization plan is to be a successful one. Particularly important among these constraints are:

1) The growth in the size of the debt must be only temporary. Note that the probability of success increases when repayment starts sooner. Failure implies subsequent restricted access to international credit markets, with the associated negative impacts on the economy.

2) To avoid the need for drastic falls in consumption aggregates in order to repay debt, a growing level of indebtedness must be associated with increasing investment and productivity. In other words, a debt-financed rise of domestic consumption is sustainable only if the economy is expected to grow fast enough to meet the growing repayment requirements.
3) Given that, as an accounting identity, debt payments must come from current account surpluses, the tradables\(^4\) sector must benefit from increased levels of investment and productivity. The debt can be paid back only by exporting more than is imported and so an increase in the production of tradables is necessary to meet the foreign debt repayment needs and thereby avoid drastic reductions of domestic consumption, investment and government expenditure. These reductions, when combined with labor market rigidities, will result in increased unemployment and lower real wages.

The evolution of domestic savings for the same group of countries is shown in Figure 2.

**Figure 2: Domestic Savings**

![Figure 2: Domestic Savings](image)

During the reforms period, Argentina’s level of domestic saving, as a percentage of GDP, was slightly lower than the average for the rest of the countries. López Murphy, Navajas, Urbiztondo and Moskovits (1996) found that Argentina’s measured savings, relative to other nations, increase when consumer durables are included in the analysis. These goods constitute a form of savings and can therefore be classified as investment goods in the sense that they provide services for several periods. Aggregate domestic saving levels are not that different from those in other countries once this adjustment is made.

\(^4\) Tradable goods are those traded internationally, both as exports and imports.
Another indicator useful in analyzing the sustainability of the Plan is gross domestic investment as a percentage of GDP. This is so because investment levels influence the growth rates and the total investment capacity of an economy.

**Figure 3: Investment and the Debt Repayment Capacity**

![Investment and Debt Repayment Capacity](image)

Investment levels as a percentage of GDP are shown in Figure 3. As with savings rates, Argentina’s level of domestic investment was slightly below the average for the rest of the countries.

As we have seen, the level and evolution of Argentine domestic investment and savings was not very different from that in the other countries undergoing similar stabilization efforts. Even with current account balances showing that Argentina was following a more aggressive indebtedness process, investment and productivity growth rates were in general higher than the average (see Figure 4). This was true even after the impact of the Mexican crisis in 1995.

**Figure 4: Argentine Productivity Levels**

![Argentine Productivity Levels](image)
Thus, given the evolution of macroeconomic fundamentals after reforms were implemented in 1991, the Argentine economy seemed to be following a sustainable plan. While Argentina was taking on high levels of debt, the high level of productivity growth suggests that this debt may not have been excessive.

The first two constraints that are required for a successful growth program (improvements in productivity and plans for rapid repayment) were met. Unfortunately, the third condition was far from being satisfied (see Figure 5).

**Figure 5: Exports as a Percentage of GDP**

The level of Argentine export activity was a clear indication of the deficient repayment capacity of the economy. Three years after the implementation of the reform, total exports were only 5% of the GDP! In my opinion, this was the primary cause of the Convertibility Plan’s failures.

**The Mexican Crisis: The Convertibility Plan’s First Test**

In December 1994 Mexico faced a severe crisis that ended with the devaluation of its currency. Beginning in January 1995, contagion occurred and several emerging economies, Argentina in particular, were also affected. The time path of the average interest rate on deposits and the de-trended industrial production index are shown in Figure 6.
Increasing lack of confidence in the Argentine economy resulted in massive deposit withdrawals during the first quarter of 1995. Although deposits returned to the financial system towards the end of that year, the impact on the real side of the economy was persistent. The Argentine economy did not completely recover from this negative shock for several years.

The Show Must Go On

By 1997 the nation seemed to have completely recovered from the effects of the Tequila crisis. At this time the federal government, along with many local municipalities, took advantage of the improved situation and began to issue bonds as a source of financing. The following table was presented to international credit markets by the federal government.
This shows that, at the time, Argentina was in compliance with the Maastricht criteria, a set of goals for European Community members. Argentina’s rate of inflation, fiscal deficit, and public debt as a percentage of GDP were significantly below the average for European Union countries\(^5\). This set of data points was used as a justification for taking higher external debt.

However, the interest rate on public debt didn’t meet the Maastricht Criteria. At the time, international investors required higher rates to lend to Argentina than those charged to European Union members. This turn out to be important. While the main macro fundamentals showed a favorable trend, international credit markets penalized Argentina’s growing debt levels with higher interest rates.

The country’s overall economic performance was nevertheless relatively good. Thus, it remains for us to determine what went wrong with the Convertibility Plan between 1997 and 2001. As we will show, the problems triggering the collapse of the Plan were brought on by a combination of both external and internal causes.

**External Causes**

- **Fall in the terms of trade\(^6\)**: The value of the commodities typically exported by Argentina fell significantly relative to that of the goods imported. Figure 7 and the comparison of the terms of trade for 1996 and 2001 in particular show how the dollar generating capacity of the agricultural sector, which was already low, was reduced by more than 50%. This led to a deterioration of the country’s debt repayment capacity and increased pressures on the exchange rate.

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\(^5\) It is worth noting here that many people don’t rely on the fiscal deficit indicator for Argentina. The potential inclusion of revenues generated by the privatization of state-owned companies can result in these numbers underestimating the true deficit levels.

\(^6\) Terms of trade: The ratio of price indices for exports over imports. Terms of trade for any country are an indicator of the purchasing power of that country’s exports in terms of its imports.
-Currency devaluations in neighboring and other emerging countries⁷: The value of the dollar in terms of the Argentinean Peso and currencies of other developing economies is shown in Figure 8. Currency devaluations occurred in all cases at some point during the 90’s. We see that only Argentina kept its exchange rate fixed with respect to the dollar.

⁷ A currency is said to have depreciated with respect to the dollar when it loses purchasing power in terms of the latter, that is, when the exchange rate (defined as the price of the foreign currency) goes up.
As a result, Argentina’s export commodities became significantly less competitive in international markets. Trade partners substituted away from Argentine products to others that had become relatively cheaper. Exports were also indirectly affected by the Southeast Asian economies since they introduced more competitive products onto the global market.

The tradable sector in Argentina suffered a significant reduction in its competitiveness during the 90’s. This was due to the fact that the value of the peso with respect to the dollar was kept fixed during this period while the dollar was appreciating significantly with respect to other currencies in the world. Moreover, Argentina was not able to compensate for the loss of competitiveness by reducing the prices of its exports.

-Reduction of the capital flows to emerging markets: After the Russian default, credit markets became more cautious in their lending to emerging economies. Capital flows to these economies were significantly reduced, making external financing more costly to both the private sector and to the government. And financial collapses and devaluations in Southeast Asia exacerbated this situation.

Figure 9 shows how international capital flows to Argentina were reduced after the Russian crisis.
Internal Causes

Among the internal factors that triggered the collapse, the most important ones were:

-Labor market rigidities: Unemployment rates experienced an upward trend during the whole Convertibility period, regardless of whether the economy was in a recession or a boom (see Figure 10). This is a clear indicator of the degree of rigidity of Argentina’s labor markets.

Figure 10: Unemployment in Argentina

An economy with a fixed exchange rate and rigid labor markets (because of legal, cultural or demographic reasons) is not well suited to weathering adverse external shocks such as those faced by this country. When other countries devalue their currencies they are left with only two policy alternatives: 1) regain competitiveness through price and wage reductions, which is more feasible when labor markets are flexible enough, and 2) devalue its currency, that is, abandon the fixed exchange rate system (Convertibility Plan in the case of Argentina).

Rigid labor markets are less disruptive when there are positive inflation rates because both employers and employees are forced to engage in more frequent wage

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8 Guillermo Perry and Luis Servén, “The Anatomy of a Multiple Crisis: Why Was Argentina Special and What Can We Learn From It?”, World Bank, 2002.
renegotiations, something that is good for the economy as a whole. As a result, inflation works as a mechanism contributing to higher wage flexibility, despite of its well-known costs.

-Fiscal deficit: The evolution of the fiscal deficit was an important internal factor in the Argentine economy. In particular, the increase in the government expenditure, including large increases in government outlays that were not designed to increase productivity, proved to be problematic.

Although in 1997 the fiscal deficit as a percentage of GDP was within the levels required by the Maastricht agreement, the presidential election in 1999 and the following conflict between federal and local government significantly worsened the financial position of the government.

![Figure 11](attachment:figure11.png)

The fiscal situation was further aggravated by the inadequate incentive structure provided by Argentina’s co-participation law⁹ and by the fact that the main political leaders focused on the outcome of their own political campaigns. The increase in fiscal deficits experienced during the presidential campaign can be seen in Figure 11. The new president, Fernando de la Rúa, got to power with the support of a coalition of parties formed with the objective of defeating former president Carlos Saúl Menem. Under his leadership fiscal policy change towards expenditure cuts and tax increases. The tax pressure plus the cracks within the coalition showed soon after been responsible for

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⁹ The “co-participation law” is the legal framework that rules the way in which fiscal revenues are distributed among the federal and local governments in Argentina.
debilitating aggregate economic activity and hence worsening the country’s fiscal imbalance. The persistent recession resulted in the resignation of the Economy Minister, José Luis Machinea. After a brief interlude where Ricardo López Murphy held the position, Domingo Cavallo became the new Minister of the Economy.

A sequence of mistakes followed. The most significant is the one related to the fiscal deficit and public debt financing strategies followed by the government. A high proportion of the public debt was short-term debt. To meet its financing needs the new administration relied heavily on the social security system (AFJP) and the financial sector, which was already highly sensitive to exchange rate risks. As a consequence, the government, the social security system, and the financial sector were all exposed to speculative attacks and became heavily dependent on the value of the peso.

Macroeconomic uncertainty, originated in both the internal and external factors mentioned above, scare investments. In turn, this accelerated the drop in aggregate economic activity and caused further reductions in fiscal revenues. Although the collapse of the peso would not occurred until few months later, the economy would find itself trapped.

It is interesting to think about the following questions: Why was the collapse delayed? What made it finally happen? And, what explains the timing of the massive withdrawal of deposits from the banking sector?

The Triggering of the Crisis and the Jump in Country Risk Indicators

Towards the end of 2001, the US government and the IMF opposed to any form of rescue packages for Argentina, common practice during the 90s. In an attempt to reestablish fiscal discipline in emerging economies, no more bailouts would be granted. This would constitute the main difference between the Clinton and Bush administration regarding international financial policy towards developing nations. Bush’s administration wanted to cut the perverse cycle where international investors would irresponsible lend to emerging countries knowing that the IMF would be forced to bail them out when the crisis arrived.

Argentina would be a perfect example, especially since it was a clear case of bad fiscal discipline financed by international investors on Wall Street. Of course, contagion
to neighboring countries had to be avoided and hence this decision needed to be implemented with caution. This is the main reason why the collapse was delayed. It is worth remembering that towards the second half of 2001, the world economy was already anticipating a recession. A contagion effect to all Latin America wouldn’t help. For this reason, Argentina was only denied the IMF help once the US had determined that other countries were sufficiently insulated from the effect of contagion. Indications that the IMF would not bailout Argentina triggered the crisis.\textsuperscript{10} It is for this reason that country risk levels jumped at this point and not before or after.

One country risk indicator, the EMBI\textsuperscript{11} yield, is shown in figure 12 for Argentina, Brazil and the average for emerging countries.

\textbf{Figure 12}

The indicators for Argentina and the average of emerging markets are measured on the left axis. The right axis (on a different scale) corresponds to Brazil. It can be seen that the country risk level for Argentina increased during the period in which Domingo Cavallo was the Economy Minister. One may interpret this as showing international investors’ growing pessimism and lack of confidence in Argentina. It can also be seen that this measure of country risk exploded once the possibility of international assistance was ruled out. This happened because: 1) the Bush administration refused to bailout Argentina (see article cited above), and 2) Brazil’s risk level was increasingly lower than

\textsuperscript{10} See “O'Neill Suggests U.S. Won't Back More IMF Aid For Argentina”, \textit{Wall Street Journal}, October 31\textsuperscript{st} 2001.

\textsuperscript{11} EMBI stands for Emerging Markets Bonds Index.
ours (see the oval in the figure showing the point when this started to happen). The risk of devaluation led Argentineans to withdraw their peso and dollar-denominated deposits in an attempt to protect their lifetime savings. The massive loss of international reserves forced a suspension of banking activities and the resignation of President Fernando De La Rua in December 2001. Moreover, the new interim government devalued the Argentinean Peso by %110 in one day and defaulted on the foreign and domestic debt. The crisis sunk Argentina in one of the deepest crisis of its history.

By 2002, the Gross Domestic Product of Argentina had fallen by 15% with respect to that of 2001, 40% of the population was leaving below basic needs, and the unemployment rate had risen to more than 25%.

Who’s to Blame?

There are two important remarks we shall make before concluding. The fact that international actors refused financial assistance to Argentina is not to blame for the collapse. Argentina had not been implementing sound fiscal policies, nor had it been concentrating productivity growth in the tradable sector, policies which would have been consistent with the success of the Convertibility Plan. This brought into question the nation’s capacity to repay its outstanding debt. Even before the crisis, international investors were penalizing the growing size of our debt with greater financing costs. Thus, the explosion of country risk levels was unavoidable and had become only a matter of timing.

Finally, the default and devaluation of the domestic currency did not trigger the crisis alone. It is highly likely that institutional chaos was a significant and aggravating factor. Without this, the crisis still may have emerged. However, its magnitude would surely have been smaller. Once investors, who had carelessly trusted our country, had internalized their losses, an alternative course would have been for Argentina to receive some international assistance after debt payments were renegotiated. However, such a scenario would have depended crucially on a reliable and credible political leadership capable of making the commitment necessary for such an agreement. Unfortunately, institutional and political necessary conditions for such a scenario are not yet present in Argentina.
References


O'Neill Suggests U.S. Won't Back More IMF Aid For Argentina

Wall Street Journal; New York, N.Y.; Oct 31, 2001; By Pamela Druckerman and Jacob M. Schlesinger;

Abstract:

Argentine Economy Minister Domingo Cavallo had been betting that the growing threat that Argentina would be unable to meet payments on part of its $132 billion government debt would prompt the U.S. to push lenders like the IMF to extend new emergency loans. In recent days, Mr. Cavallo has made the first open hints that Argentina might solve its yearlong debt crisis by stopping or reducing payments on some bonds, while also leaving the door open to emergency loans.

The prospect of a messy Argentine default that could spread to other developing countries led the U.S. to intervene with the August package, even though Mr. [Paul O'Neill] had in principle opposed such bailouts. Yesterday, he rejected suggestions that worries over an Argentine default are hurting other Latin American markets and seemed to dismiss the idea of additional action to diminish any fallout beyond Argentina. "I guess I'm not seeing the same data you are," he said, adding that he has seen little evidence that Mr. Cavallo's gambit is pressuring markets in nearby countries like Brazil and Chile.

Full Text:

WASHINGTON -- Weakening Argentina's hopes of an imminent overseas rescue from its deepening debt quagmire, Treasury Secretary Paul O'Neill suggested that he isn't inclined to support more International Monetary Fund aid for the cash-strapped nation anytime soon.

Argentine Economy Minister Domingo Cavallo had been betting that the growing threat that Argentina would be unable to meet payments on part of its $132 billion government debt would prompt the U.S. to push lenders like the IMF to extend new emergency loans. In recent days, Mr. Cavallo has made the first open hints
that Argentina might solve its yearlong debt crisis by stopping or reducing payments on some bonds, while also leaving the door open to emergency loans.

But in an interview yesterday, Mr. O'Neill suggested that the Bush administration, which reluctantly backed an $8 billion IMF loan for Argentina in August, was willing to let Buenos Aires go through some sort of restructuring of its debt. He wasn't more specific. Part of the August loan was earmarked to underwrite a swap of debt held by investors that would give them new, more valuable bonds in lieu of suffering a default. But economists calculate that additional funds are needed for that operation to succeed.

Asked in an interview whether a restructuring would justify more IMF money, Mr. O'Neill said the current situation "doesn't reach to that judgment." Argentine President Fernando De la Rua and Mr. Cavallo "are apparently developing their own initiative, and what I've seen of it sounds good to me," Mr. O'Neill said, giving the Bush administration's first public comments on the rapidly evolving and tense situation.

Mr. De la Rua, who is preparing new measures to boost Argentina's ailing economy, insisted yesterday that the government will keep up its debt payments and maintain the peso's one-to-one peg with the U.S. dollar. "There will be no devaluation, no default," he said.

The prospect of a messy Argentine default that could spread to other developing countries led the U.S. to intervene with the August package, even though Mr. O'Neill had in principle opposed such bailouts. Yesterday, he rejected suggestions that worries over an Argentine default are hurting other Latin American markets and seemed to dismiss the idea of additional action to diminish any fallout beyond Argentina. "I guess I'm not seeing the same data you are," he said, adding that he has seen little evidence that Mr. Cavallo's gambit is pressuring markets in nearby countries like Brazil and Chile.
IMF spokesman Thomas Dawson said that "the issue of additional or new support has not come up" in discussions with the Argentine government. "A mission was down there over the weekend and has just returned," he said. "We are still working on a mission to go down and review the current program in the near future."

Continuing uncertainty over Argentina's fate kept the nation's bonds at sharply depressed levels yesterday. Bondholders who ordinarily have their ear to the ground on Argentine matters said their contacts in the government haven't been returning calls. Many are assuming that the government isn't talking to them because it doesn't have a clear way out.

"Literally nobody knows what's going on," said a U.S. investor. "Cavallo isn't sharing with anyone what his end game is."

Standard & Poor's lowered two of Argentina's credit ratings yesterday to double-C from triple-C-plus, citing "the increased probability that Argentina will decide to comprehensively restructure its internal and external debt."

Adding to the uncertainty was Monday's resignation of Julio Dreizzen, a top official in the economy ministry who had been part of the debt-management team.

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Michelle Wallin in Buenos Aires contributed to this article.

Credit: Staff Reporters of The Wall Street Journal