Argentina, short-changed: Why the nation that followed the rules fell to pieces

By Joseph E. Stiglitz

It's a familiar refrain: Another Latin American republic, this time Argentina, can't get its act together. A profligate government and its populist policies have brought the country to ruin. Americans can smugly feel they are immune from such Latin ways.

Bewildered Latin Americans, however, see Argentina very differently. What happened, they ask, to this poster child of neo-liberalism and the notion that free markets would ensure prosperity? This was the country that did everything right. How could it have fallen so far?

There is some truth in both views, but ultimately, the one that's been popularized in America is, I think, misguided.

The crisis that had been brewing in Argentina for several years finally burst out last December. As the official unemployment rate approached 20 percent, with real joblessness substantially higher, workers had had enough. Street demonstrations overturned a democratically elected government. The country could not meet its debt payments. It had no choice but to default, and the economic regime, with the Argentine peso fixed in value to the dollar, had to crumble. Since then, the economy has gone from bad to worse.

Argentina would be better off if there were less corruption in political life and if it had not run deficits; after all, you can't have a debt crisis if you have no debt.

But the real question is, did those large deficits, corruption and public mismanagement cause the Argentine crisis? Many American economists suggest that the crisis would have been averted had Argentina followed the advice of the International Monetary Fund (IMF) religiously, especially by cutting back on expenditures (including at the provincial level) more ruthlessly. Many Latin Americans, however, think that the full IMF plan would have led to an even worse crisis -- sooner. I think it is the Latins who are right.

Like most economists outside the IMF, I believe that in an economic downturn, cutting expenditures simply makes matters worse: tax revenues, employment and confidence in the economy also decline. Argentina is no more exempt from these basic economic principles than were the countries of East Asia in the late '90s. Yet the IMF said make cuts, and Argentina complied, trimming expenditures at the federal level (except interest) by 10 percent between 1999 and 2001.

Not surprisingly, the cuts exacerbated the downturn; had they been as ruthless as the IMF had wanted, the economic collapse would have been even faster. Social unrest would have come earlier. And the calamity that followed the political unrest would almost surely have been every bit as bad. What is remarkable about Argentina is not that social and political turmoil eventually broke out, but that it took so long.

A closer look at its budget also shows how grossly unfair is the picture of Argentine profligacy that has been so widely painted. The official numbers reveal a deficit of less than 3 percent of gross domestic product -- not an outrageous number. Recall that in 1992, when the United States was experiencing a far milder recession than the current Argentine one, the U.S. federal deficit was 4.9 percent of GDP. An economy in recession normally runs a deficit, as tax revenues plummet and safety net expenditures increase; and there should be a deficit, for eliminating it simply plunges the economy into a deeper recession.

But even that 3 percent figure is misleading, because of Argentina's decision to privatize its social security system in the 1990s, a move encouraged by the IMF. With that change, money that had been "inside the budget" moved "outside." In such cases, even if nothing happens to the economy other than the privatization, the apparent budgetary position greatly worsens because the pension plan surplus is taken off the books. Consider this: If we had had a privatized Social Security system in 1992, for example, our deficit that year would have been more than 8 percent of GDP. Had Argentina not privatized, its 2001 budget would actually have shown a surplus. The pension shift did not create a macroeconomic problem. Yet, the IMF saw things as worse.

Even putting this aside, at the centre of Argentina's budget deficits -- however one assesses them -- was not profligacy but an economic downturn, which led to falling tax revenues. Soaring interest rates resulted not so much from what Argentina did but from the mismanaged global financial crisis of 1997-98. All countries were badly affected, even Argentina, which the IMF still considered to be an A-plus student in 1998.

If budget profligacy or corruption was not the problem, what was? To understand what happened in Argentina, we need to look to the economic reforms that nearly all of Latin America undertook in the '80s. Countries emerging from years of poverty and dictatorship were told that democracy and the markets would bring unprecedented prosperity. And in some countries, such as Mexico, the rich few have benefited.

More broadly, though, economic performance has been dismal, with growth little more than half of what it was in the 1950s, '60s and '70s. Disillusionment with "reform" -- neo-liberal style -- has set in. Argentina's experience is being read: This is what happens to the A-plus student of the IMF. The disaster comes not from not listening to the IMF, but rather from listening.

That Argentina has moved to the bottom of the class has much to do with the exchange rate system. A decade ago, it had hyperinflation, which is always disastrous. Pegging the currency to the dollar -- one peso equalled $1, no matter what the rate of inflation or the economic conditions -- acted, almost miraculously, to cure this problem. The IMF supported the policy. It stabilized the currency and was supposed to discipline to the government, which couldn't spend beyond its means by printing money without breaking the peg. It could only spend beyond its means by borrowing. And to borrow, presumably, it would have to follow good economic policies. A magic formula seemed to have been found to tame the seemingly incorrigible politicians.

There was only one problem: It was a system doomed to failure. Fixed exchange rates have never worked. Even the United States couldn't live with a fixed exchange rate, going off the peg to gold in the midst of the Great Depression. Typically, failures do not appear overnight. They are not usually the result of mistakes made by the country, but of shocks from beyond their borders about which they can do little.

Had most of Argentina's trade been with the United States, pegging the peso to the dollar might have made sense. But much of Argentina's trade was with Europe and Brazil. The strong (most would say, overvalued) dollar has meant enormous American trade deficits. But with the Argentine peso pegged to the dollar, an overvalued dollar means an overvalued peso. And while the United States has been able to sustain trade deficits, Argentina could not. Whenever you have a massive trade deficit, you have to borrow from abroad to finance it. Although the United States is now the world's largest debtor country, outsiders are still willing to lend us money. They were willing to lend to Argentina, too, when it had the IMF stamp of approval. But eventually they realized the risk.

The risks were brought home by the Mexican peso crisis seven years ago and more forcefully by the global financial crisis of 1997-98 when, suddenly, the interest rates that Argentina paid to its foreign and domestic creditors soared. Its level of debt seemed far less manageable, though even as late as last December, when it went off the dollar peg, its debt-to-GDP ratio was only around 55 percent. That's far less than that of Japan (where it is now around 130 percent) or many European countries, and even less than the United States not long ago (it was 64 percent in 1992).

As the Asian financial crisis led to crises in Russia, and then Brazil, Argentina suffered more and more. Interest rates soared and with the collapse of the Brazilian currency, Argentina simply could not compete with its neighbour’s cheaper exports.

As if things were not bad enough, a falling euro made it harder for Argentina to export to Europe, and low prices for the commodities it sells further strained the economy. Moreover, while Europe and the United States preach free trade, they have kept their markets relatively closed to Argentina's agricultural goods.

The fixed exchange rate led to a vicious circle. As it became clear that a devaluation was inevitable, lenders in pesos insisted on even higher interest rates to compensate them for this exchange rate risk. The higher interest rates not only heightened the risk of devaluation, but contributed to a new risk of default, which in turn led to even higher interest rates to compensate for that risk.

Some say Argentina's fixed exchange rate system might have worked were it not for the bad luck of global financial crises. But that misses the point. International financial markets are highly volatile. The question wasn't whether the fixed exchange rate system would break, but only when and how.

In the United States, when we have a downturn, everyone agrees that a fiscal stimulus is the remedy. Why is it, then, that the IMF believed that the opposite -- contractionary fiscal policies -- would succeed in getting Argentina out of its problems? The IMF does not release its economic models but it seems to have assumed that if Argentina reduced its deficit, foreign investors would come in, bringing badly needed funds. But that premise is as silly as imagining that a change in our government's deficit would lead investors to put more money into fibre optics, when there is already a vast over capacity.

Given the exchange rate, given the economic depression which the IMF policies had already brought about, given the huge debt, given that the IMF did not provide any convincing economic strategy to get out of the mess, given that there were open capital markets so that anyone who wanted to could move their investments to safer havens elsewhere in the world, it was highly unlikely that anyone -- especially when the government signed an agreement to reduce its deficit further, predictably causing more unemployment and lower output -- would start investing more.

Argentina is a country rich in human and natural resources. Before the crisis, these resources, even with inefficiencies, generated one of the highest GDPs in Latin America. Those resources have not been destroyed by the financial crisis. What is required now is to "restart" the engine. Besides providing the assistance to do this, there is another way the United States can help: On an "emergency" basis, we should open our markets to Argentine goods. More than anything else, it was trade with the United States that brought Mexico out of its crisis. This is a form of assistance that would cost us nothing -- Americans, as consumers would be better off. At the very least, we should stop demanding that the Argentines cut back even more, deepening their already severe depression and adding to the inevitable social problems.

Blaming the victim is not going to help matters.

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