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The Argentinian Debt: History, Default and Restructuring

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Task Force on Debt Restructuring and
Sovereign Bankruptcy

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THE ARGENTINEAN DEBT: HISTORY, DEFAULT AND RESTRUCTURING

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We believe that the study of the Argentinean foreign debt is easy to justify. For almost three decades, Argentina's foreign debt was continuously one of the main concerns of economic policy in the country. Despite this, both the record amount of the defaulted debt and the novel characteristics of its restructuring surprised many observers. Therefore, the processes that led to the default on the debt and its subsequent restructuring warrant examination.

However, the Argentinean case also demands attention because it is less well understood than it might seem. The Argentinean experience is often used as an example of general arguments about debt and economic policy that take the country as a notable case in point. The rhetorical power of the example precisely comes from its supposedly well-known characteristics. Yet some of these so-called characteristics of Argentina are not in fact the case. Many are based on second-hand references and in some cases not even that but an author's mere mentioning of a "consensual image". Thus, we are motivated to take a close look at what has actually happened in Argentina.

In the first section below, we present four theses or asserted characteristics about Argentina in the recent period that we think are wrong. These four topics are treated in more detail in the four subsequent sections. In the first of those, we examine the evolution of Argentinean foreign debt since the 1960s and the macroeconomic policies that contribute to explain it. What happened in the nineties receives special attention. The next section is dedicated to the analysis of macroeconomic policy before and after the recent crisis. The section after that presents the evolution of the public sector's financial obligations after the default and describes the government's restructuring proposal. Finally, the last section examines the relationship between Argentina and the International Monetary Fund (IMF) and its repercussions on the international financial architecture.

1. INTRODUCTION: CONFRONTING THEORIES ABOUT ARGENTINA'S DEBT CRISIS

This work is in part a polemic against some of those references that we consider fallacious. Each reference involves claims about certain "facts" that we examine and try to explain. Our criticism also has implications for the general plausibility of the arguments that falsely take the Argentinean case as an example. We think that the plausibility of an argument is strongly questioned when the argument is proved not to apply to the case serving as its notable example.

1.1. Debt Intolerance

First let us consider the argument that takes the Argentinean experience as an example of "debt intolerance." Some economists include Argentina in a grouping of countries that carry an "original sin" of being serial defaulters and consequently suffer from debt intolerance (Reinhart,

Rogoff and Savastano, 2003; and Reinhart and Rogoff, 2004). From this perspective, Argentina's recent crisis and default are due to two factors, the first being the country's own debt intolerance, an inherent characteristic said to have been attained by the country during its two centuries of existence. The second factor is the government's irresponsible behavior, pushing the foreign debt above the country's low limit of tolerance. The diagnostic requires an international financial market willing to lend over that limit. The propensity to do so is considered an intrinsic feature of the financial markets, associated with their pro-cyclical character. In those circumstances, the high risk premium charged by the market and the propensity to sudden stops in providing finance add up to a high probability of default. Argentina's latest default adds to the series, confirming that the original sinners sin repeatedly.

A critique of this vision helps us to set some issues related to the problem of the Argentinean foreign debt in a long-term perspective. The first criticism has to do with the supposed relevance of the remote past. The insertion of the developing economies into the present phase of financial globalization dates from the beginning of the seventies, when the international banks enjoyed plenty of liquidity that they were anxious to lend and Latin American countries became the first recipients of these credits. In this context, what could be the relevance of the memories of the 1930s international crisis? After forty years of practical nonexistence of an international capital market, the Latin American countries' foreign debts were small and mainly owed to governments and multilateral institutions.

In any case, had the remote past been relevant it would have simply improved the risk valuation of Argentina, since in the thirties the country completely fulfilled its financial obligations whereas nine other Latin-American economies fell into default and another four paid only part of their interest due (US Department of Commerce, 1933). Argentina was the exceptional case among Latin-American debtors; it was the country that didn't fall into default in the thirties!

All the Latin-American economies that became indebted to the international banks in the 1970s, including Argentina, required internationally supervised rescheduling and "forced lending" by the banks to prevent outright default in the early 1980s, although Colombia restructured its foreign debts without slipping into the same crisis mode (see Garay, this volume, on the period).

If the remote past is irrelevant and all the indebted Latin American economies fell into debt crises in the early eighties, then only the countries' post-crisis trajectories in the 1990s could explain the differences in risk valuations made by the international financial markets during the latter period. Interestingly, although they came from a common experience of crisis, the countries have evolved in different directions. Which were the most important elements differentiating the countries in the eyes of the international market: reputation or the debt-sustainability indicators?

Let us illustrate our view by considering the four biggest Latin-American debtors that fell into debt crises in the beginning of the eighties: Argentina, Brazil, Chile and Mexico. All of them are classified as serial defaulters in the “debt intolerance” approach. Among these countries, however, only Argentina defaulted later on. Certainly, Brazil and Mexico did suffer from “debt problems” after the crises of the early eighties (and also Argentina in 1995, when the country experienced the “Tequila effect” crisis, in which investor confidence in Argentina was shaken by the debt crisis in Mexico). The others fulfilled their external obligations, albeit, thanks in part to international support, itself a vote of confidence in the countries by official, if not market, authorities during times of stress.

The four mentioned Latin American economies got different—and changing—country risk valuations from the market in the nineties. The countries followed different trade and financial integration paths that led to configurations with different degrees of vulnerability vis-à-vis the market’s volatility and the susceptibility to contagion that had emerged by then. We have argued in other works that those different paths—reflected in dissimilar evolutions of the debt ratios and other indicators of foreign debt sustainability—are to a great extent associated with the different policies followed by the countries from the second half of the eighties (Frenkel, 2003a and 2003b; Damill et.al., 1993). Certainly, fiscal and public debt policies played a significant role, but the exchange rate policy and the management of financial opening—intended to facilitate the preservation of competitive exchange rates—were also singularly relevant.

The extraordinary emphasis that the debt intolerance approach puts on both the remote past and rigid institutional features takes the focus away from what could be the most fruitful perspective in an international comparative analysis of the external debt problem: the different policies followed by the countries in their processes of financial integration into the global system. The four above-mentioned Latin-American economies well illustrate this point. They have a common remote past (with the caveat that Argentina did not default in the thirties), a similar first phase of indebtedness in the seventies and debt crises in the beginning of the eighties. Nevertheless the debt ratios, the foreign debt sustainability indicators and the market’s risk evaluations showed different evolutions in the nineties. An analysis of the differences in the recent past is clearly more interesting than the common features of the remote past.

To demonstrate the point in this work, we pay special attention below to the economic policies that framed Argentina’s external debt growth since the 1970s. We conclude that there is no supporting evidence for the “debt intolerance approach”. We show that by the end of the seventies the country had built up an intolerable debt burden. The origin of the external debt problem was not a remote “original sin” but a more recent original policy mistake—essentially, the combination of capital account opening, a fixed nominal exchange rate and an appreciated real exchange rate. That original policy mistake was repeated again in the nineties.

1.2. Fiscal Profligacy

The second argument we criticize is the one that takes the Argentinean case as an example of how uncontrolled public spending is the main cause of the crisis and default. This is probably the most common, yet false, image of the Argentinean case (Mussa, 2002). We have analyzed this issue in previous works (Damill and Frenkel, 2003; and also Damill, Frenkel and Juvenal, 2003) and will review it below after discussing the thesis briefly here.

A detailed examination of the fiscal accounts will show that the cumulative effects of the interest rate rise, which followed the increase in the country risk premium due to contagion after the Asian and Russian crises, caused the adverse public debt dynamics in the last quarter of the nineties. Interest rates on Argentine public debt rose more than in many other countries in the region. The interest payment item was the main factor explaining the increase in the fiscal deficit in the 1998-2001 period leading up to the default. Indeed, the fiscal deficit increased despite a significant rise in the surplus in the primary balance.

In addition, the deficit of the pension system following the social security reform of 1994, partly privatizing the public system, also contributed to the increase in the fiscal deficit. The fall in the public pension system receipts also resulted from the recession and the employment contraction that started in mid-1998, which as we will see resulted from how policymakers felt they had to handle the new financial perceptions of Argentina.

In other words, the rise in the country risk premium and the interest rate can be associated with the fragile external accounts or, alternatively, with the evolution of public finances, or with both, as the investment fund analysts and the risk rating agencies actually wrote in their reports. However, even if the uncertainties regarding public debt sustainability weighed significantly in the investors' assessments, this should not overshadow the original source of the rise in public deficits and debt in the late nineties. The main source was not mistaken but exogenously chosen expenditure and tax policy, but rather the compounded effects of inherent fragility of the external accounts and their vulnerability to the contagion of crises of confidence elsewhere.

1.3. The Default Was Punishing

In this work, we also question the view that the default was the main factor responsible for Argentina's deep economic crisis in the early part of the twenty first century and its high social cost. Our analysis shows that the abrupt contraction in the activity and employment levels began, to a great extent, before the default, i.e., while the government subjected the country to big efforts to keep the debt servicing on track. The collapse of activity and employment was a consequence of the generalized rush to buy external assets and the resulting liquidity crunch. And then in the first quarter of 2002, the real devaluation owing to the sharp fall in the peso

exchange rate added another contractionary effect. However, the default also turned out to be one of the conditions that enabled the recovery that took place soon after. This was not only due to the positive fiscal effect of the payments suspension, but also a consequence of having freed the economic policy from the need to continuously issue signals aimed at facilitating the rollover of the debt obligations. It allowed the implementation of a pragmatic macroeconomic policy, focused on the stabilization of the exchange market and the quick recovery of fiscal revenues, which became feasible when no further new private or multilateral external fresh funds were needed. The success of this policy provided the base for the recovery. Our conclusion is that when a country faces a crisis motivated by firm expectations of default, what is really costly is the postponement of the default and not the default itself.

1.4. IMF Was “On Target” in Argentina

It is striking that Argentina’s crisis and the massive default took place in a country that for a long time was considered a Washington Consensus success. Almost until the end of the nineties, the IMF and most of the financial market analysts considered Argentina as one of the cases following macroeconomic policy and structural reforms appropriate for the era of financial globalization. In our view, the IMF’s advice was actually not helpful. In fact, the IMF’s commitment to the “convertibility regime” (which we will discuss below)—particularly, the rescue package granted to the country at the end of 2000 and extended in 2001—generated criticisms and conflicts within the institution.²

The relationship between Argentina and the IMF was very different in the period following the default. The debt restructuring took place in the context of a conflictive relationship between the IMF and the country. The most unusual feature in this process was that the IMF did not participate in the design and management of the debt restructuring. Neither did the organization audit the government’s financial projections that justified the call for very deep debt reduction to achieve sustainability. The importance of this novelty is highlighted both by the record amount of debt that was restructured and by the unprecedented haircut, one of the highest in the debt restructuring history of the recent globalization period. Is this the antecedent of a new relationship between the IMF, the emergent-market countries and the markets? If so, it would mark a new phase in the evolution of the international financial architecture.

² These issues motivated a special investigation by the Fund’s Independent Evaluation Office of the convertibility regime period.

2. FINANCIAL OPENING, EXCHANGE RATES AND ARGENTINE PUBLIC INDEBTEDNESS

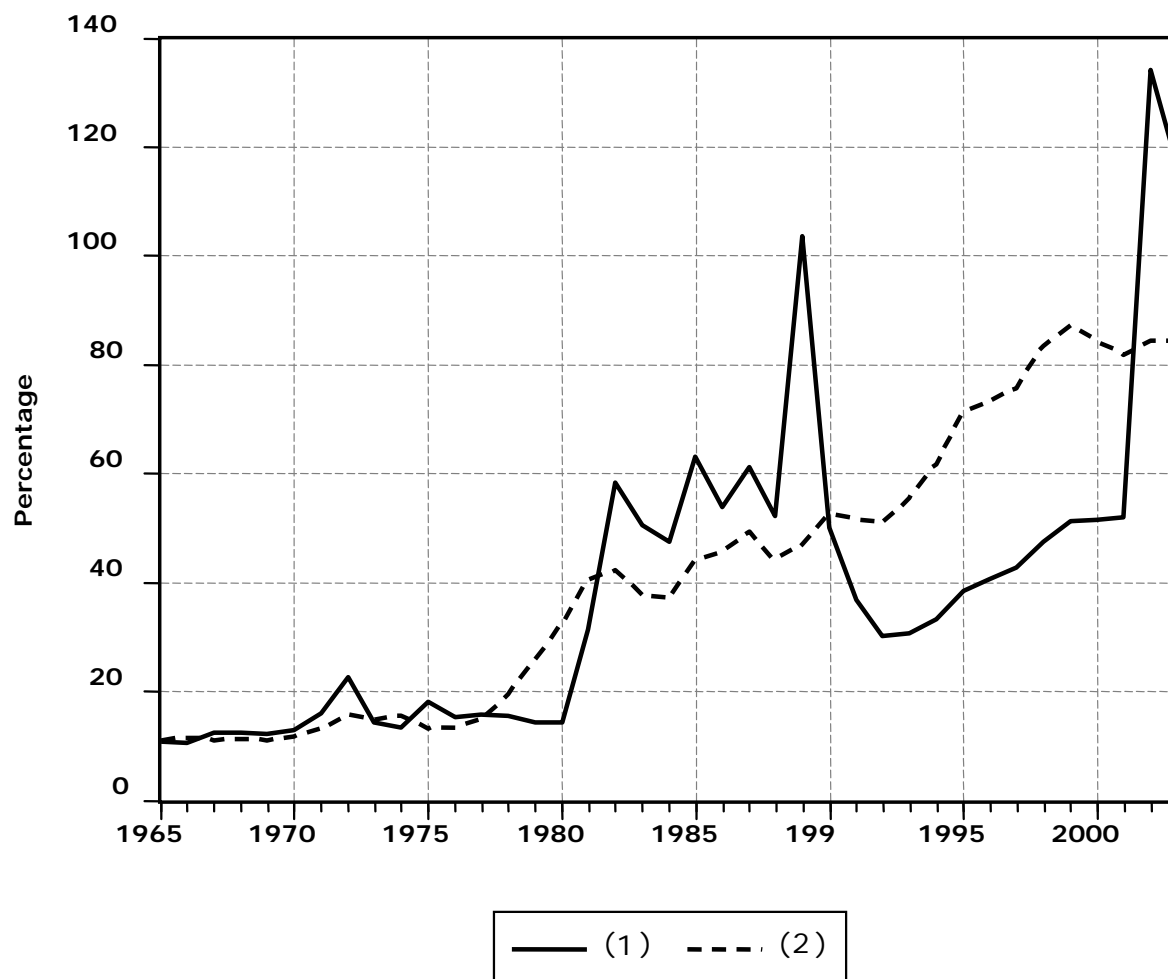
2.1. Argentinean Debt since the 1960s

Before its broad opening to international financial markets, Argentina showed low and stable debt indicators. The foreign debt, public and private, was mostly owed to multilateral organizations and governments.³ It fluctuated in a range of 10% to 15% of gross domestic product (GDP) from the beginning of the sixties to the mid seventies, as can be seen in graph 1.

From the mid seventies on, the confluence of some factors gave birth to a new stage markedly different from the previous one. In the first place, after the oil shock in 1973 the strong expansion of the euro-dollar market opened the way for Argentina's easy access to international credit. Meanwhile, a deep liberalizing financial reform was implemented in 1977 and was followed by the progressive dismantling of foreign exchange controls on private capital flows in 1978-80, while the exchange rate was "fixed" from January 1979 in the sense that it was devalued on an announced fixed declining schedule that was supposed to reach zero in 1981 (the "*tablita cambiaria*"). These changes would jointly operate to completely change the country's links with the international financial markets.

³ This is not to say that Argentina escaped debt-servicing problems in the early post-war period, as such problems led to the formation of the Paris Club in 1956 and it returned to the Paris Club for debt rescheduling in 1962 and 1965 (see Cosío-Pascal, this volume).

Figure 1. Total external debt/GDP ratio



(1) Debt in dollars multiplied by current exchange rate and divided by GDP in current prices
 (2) Debt in dollars multiplied by PPP exchange rate and divided by GDP a current prices
 Note: PPP exchange rate was calculated as the 1935-2003 average real exchange rate, using U and Argentina Consumer Price Indexes.

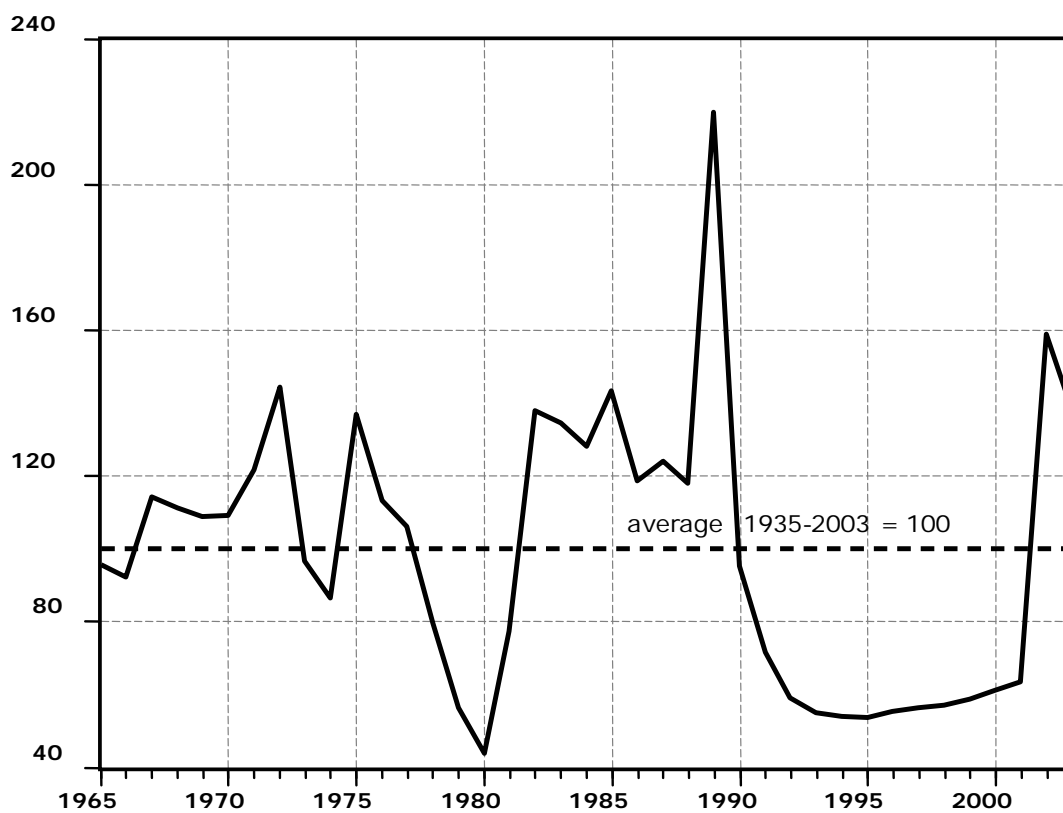
Source: Authors' calculations based on data of the Ministry of Economy.

As can be seen in the graph, the foreign debt/output ratio showed a rising trend between 1976 and 2000. The ratio measured with the PPP exchange rate grew by approximately 3 percentage points of GDP per year in this period. The curve is more volatile when the ratio is measured at current exchange rates, with sharp rises in the beginning and end of the eighties as well as in 2002, and a strong fall in 1990-93. These jumps are due to the real exchange rate instability

experienced in the period, as can be seen in graph 2.⁴

The total foreign debt/exports ratio, another standard debt indicator shown in graph 3, complements the mentioned evidence. It rose abruptly since 1977, especially between 1977 and 1982, and never returned to the previous level. The 1976-2003 average much more than doubled the level registered in the period ending in the mid seventies.

Figure 2. Real exchange rate: current and average of 1935-2003

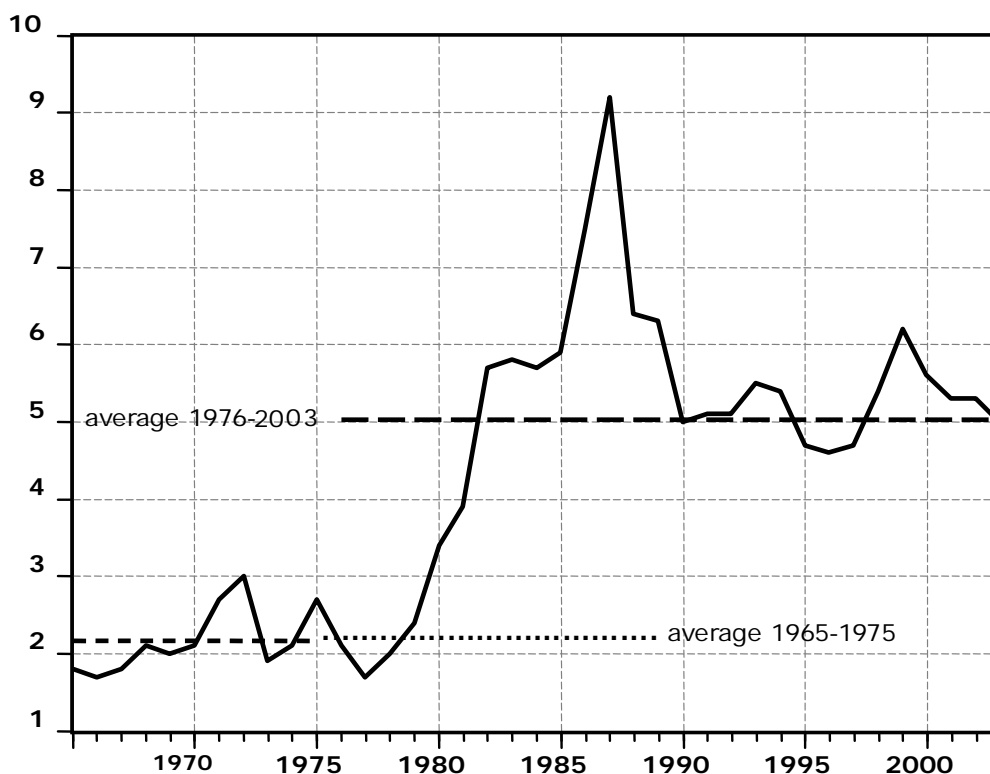


Note: Current real exchange rate is based on consumer price indices in the United States and Argentina.

Source: Authors' calculations based on data of the Ministry of Economy

⁴ Note that the debt ratio is defined as: $(d.P^*E/y.P)$, where d is the debt measured in real dollars, P^* is the international price level, E the nominal exchange rate, y the real GDP, and P the internal price level. Therefore, this ratio is affected by variations of the real exchange rate (EP^*/P). *Ceteris paribus*, the real depreciation increases the debt ratio and the real appreciation reduces it.

Figure 3. Total external debt/good exports ratio



Source: Authors' calculations based on data of the Ministry of Economy

2.2. Three Stages from 1977 to 2001: A Closer Look at the Debt

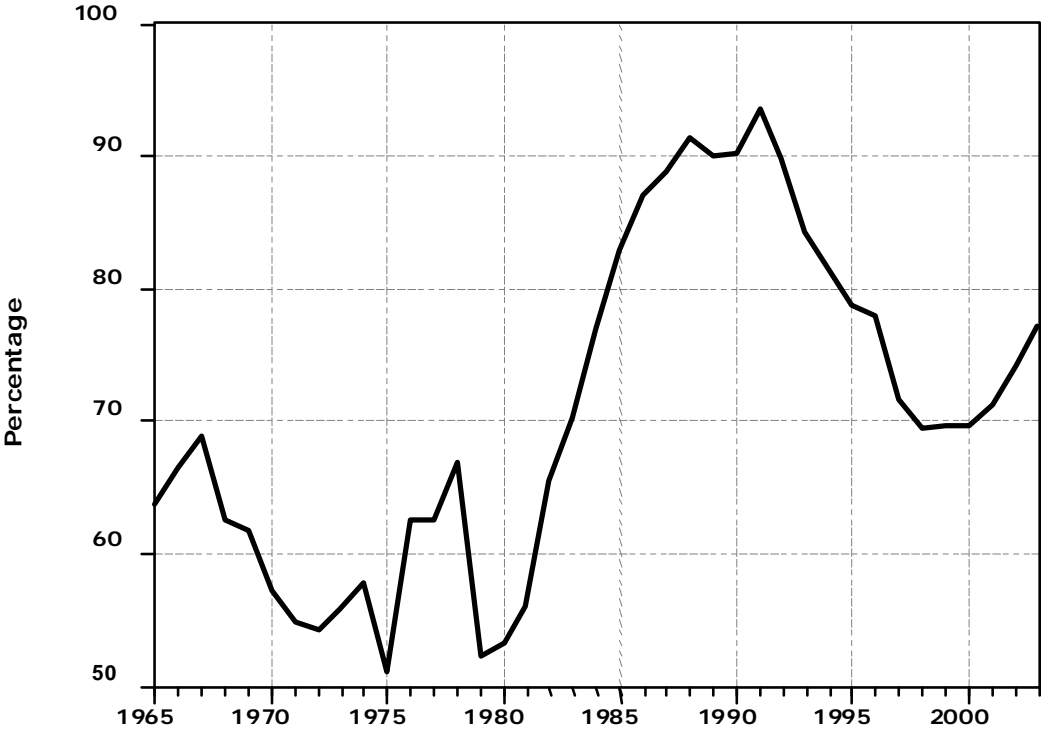
Between the mid seventies and present times, three main stages can be distinguished in the debt evolution.

In the first stage, between 1977 and 1982, Argentina went through a phase of financial opening, as noted above, and accelerated indebtedness that ended up in massive capital flight, exchange rate crisis, devaluation and default. The second stage involved a long period of international credit rationing, between 1982—the Latin American's debt crisis year—and 1990. The third stage comprises the 1991-2001 period. As in the first stage, the third was also characterized by financial opening and accelerated indebtedness and exhibited again many of its features. This is the period of the so-called “convertibility regime,” in which the exchange rate was fixed at one peso to the United States dollar under a type of currency board in which the growth of the supply of money and credit depended on the accumulation of foreign exchange reserves. As in the *tablita* experiment, this period would also end up in capital flight, exchange and financial crises, devaluation and default.

In what follows, we present the main characteristics of the mentioned stages. As we indicated in the introduction, some of them are in conflict with the conventional interpretation of the Argentinean indebtedness process and crisis.

The first fact that deserves to be highlighted is the large role played by the private sector in the generation of external financial obligations. In both stages of accelerated indebtedness this sector was initially the most dynamic one, responding to the incentives of the fixed exchange rate and financial opening in the presence of high domestic interest rates. As can be seen in graph 4, the government's proportion of total obligations declined between 1978 and 1980. Something similar can be appreciated in the period starting in 1991, although in this case the decline was longer. Despite the strong public external debt rise in the nineties, its participation in total debt declined by more than 20 percentage points during that period.

Figure 4. Public sector share over total external debt



Source: Authors' calculations based on data of the Ministry of Economy

A second important element to take into account is the question discussed above whether fiscal disequilibrium was the main cause of the crises and the defaults that followed both phases of accelerated indebtedness. In light of graph 4, we think that this diagnosis lacks solid support. We

will consider this issue further below, when we focus our analysis on the nineties' performance.

A third relevant element for the understanding of the indebtedness process is that Argentina began its financial liberalization in the seventies experiencing high inflation. The same happened in the beginning of the nineties. The opening of the capital account was in both phases adopted together with the launching of anti-inflationary programs (jointly with other liberalizing-reform measures in goods, capital and financial markets). In both cases, the key instrument of the stabilization policy was fixing the nominal exchange rate as an anchor for the stabilization of prices.

A fourth factor relates to the macroeconomic dynamics that results from some of the factors already mentioned: the combination of a liquid external financial context and the stabilization policy based on the fixed exchange rate and the trade and financial opening.

Stabilization programs based on anchoring the nominal exchange rate and financial opening tend to produce a cyclical dynamic (Frenkel, 1983; Taylor, 1998; and Frenkel, 2003a). First, the fixed exchange rate encourages private capital inflows, attracted by the difference between international and domestic interest rates. Aggregate demand expands while inflation declines, although the residual inflation causes the real exchange rate to appreciate. The current account worsens as a consequence of increasing net imports, which is caused by both the exchange rate appreciation and the demand expansion. External financial needs rise and debt accumulates. As a result, the vulnerability of the economy to negative external financial shocks progressively increases. Domestic financial fragility increases as well. Exogenous shocks may then trigger the reversal of the expansion. The expansion can also be ended endogenously, by a domestic financial crisis, as happened in Argentina at the beginning of the eighties. The failed stabilization attempt of the late seventies led to an internal financial crisis that started in early 1980 and developed during that year. When the program collapsed in early 1981, it left a heavy burden of external financial obligations.

Table 1 presents the changes in the debt/GDP ratio, and the factors into which they can be decomposed: the changes in the amount of the debt in dollars, the variations in the real exchange rate and in GDP. It can be seen that between 1975 and 1980 the debt ratio rose by more than 19 percentage points of GDP, measured with the PPP exchange rate (it passed from 13.2% to 32.4%). The figures in the same table show that this result was hidden by the strong exchange rate appreciation, since the debt ratio calculated with the current exchange rate not only did not rise but fell by almost 4 percentage points of GDP in that same period.

Table 1. Debt ratios variations and its sources

Period	External Debt/GDP (in PPP) (Variation in p.p.)	External Debt/GDP (Variation in p.p.)	External Debt (Variation in %)	Real Exchange Rate (Variation in %)	Real GDP (Variation in %)
1975-80	19.2	-3.8	125.2	-67.8	11.8
1980-82	9.9	44.1	37.2	212.8	-8.4
1982-90	10.1	-8.3	4.9	-30.8	-2.7
1990-2001	29.4	2.1	66.6	-33.3	43.0
2001-03	2.6	65.0	1.1	118.0	-3.1

Source: Authors' calculations based on data of the Ministry of Economy

In 1981, the exchange rate anchor stabilization policy (the *tablita*) was abandoned. A new phase followed, characterized by massive devaluations of the peso. These devaluations caused the foreign debt ratio measured in current dollars to reach a peak level close to 60% of GDP in 1982. The figures in table 1 show that the jump in the debt ratio at current prices between 1980 and 1982 (more than 44 GDP points) was to a great extent due to an increase of more than 200% in the real value of the dollar.

Nonetheless, the debt in dollars rose 37% between 1980 and 1982. An important factor behind this increment was the rise in the international interest rates that resulted from the policy of the US Federal Reserve since 1979. That is, Argentina borrowed funds to cover the higher interest obligations on its outstanding foreign debt.

An important jump in the public sector proportion in the country's foreign debt can also be observed in those years (graph 4). In 1981-82 the public sector ended up absorbing a considerable proportion of the private foreign debt, with the approval of the international banks. This to a great extent explains the jump in the participation of the public sector in total debt. It should also be stressed that no haircut provided relief to the public debt in the early eighties debt crisis situation (it would only come late and in "homeopathic" doses with the Brady agreement in 1992-93, as stated below).

In the following period of international private credit rationing, the debt measured with the PPP exchange rate kept on increasing, though at a slow pace. It increased the equivalent of 10 percentage points of GDP between 1982 and 1990 (table 1). The external obligations in dollars continued rising despite the lack of access to the international market (although at a much lower speed than in previous stages). The stagnant output trend also helps to explain the above mentioned rise.⁵

⁵ Although the access to voluntary international funding was closed, part of the interest flows accrued in the eighties were accumulated as new debt, i.e. as involuntary funding, at first provided under agreement by the banks in Argentina's "London Club," and then as arrears that would end up being recognized and capitalized in bonds issued under the Brady Plan.

Later on, in the nineties, the debt's rate of growth accelerated again, especially from 1992. The Brady Plan agreement for Argentina did not provide significant relief from the debt inherited from the mistaken policies of the late seventies. The achieved haircut was practically insignificant. The main favorable impact of the Brady agreement was on the banks' portfolios, since they could transform the defaulted credits into bonds, including the past due interest and then sell the bonds in the market.⁶

During the 1990-2001 period, mainly under the currency board's fixed exchange rate, the foreign debt/GDP ratio, measured with the PPP exchange rate, rose almost 30 percentage points of GDP (table 1). This jump was completely due to the increase in the debt in dollars, which surpassed the accumulated GDP growth. However, it can be seen that the debt ratio measured with the current exchange rate barely rose, as a consequence of the important real appreciation that took place in the period.

2.3. A Deeper Focus on the Third Stage: Public Debt in the Nineties

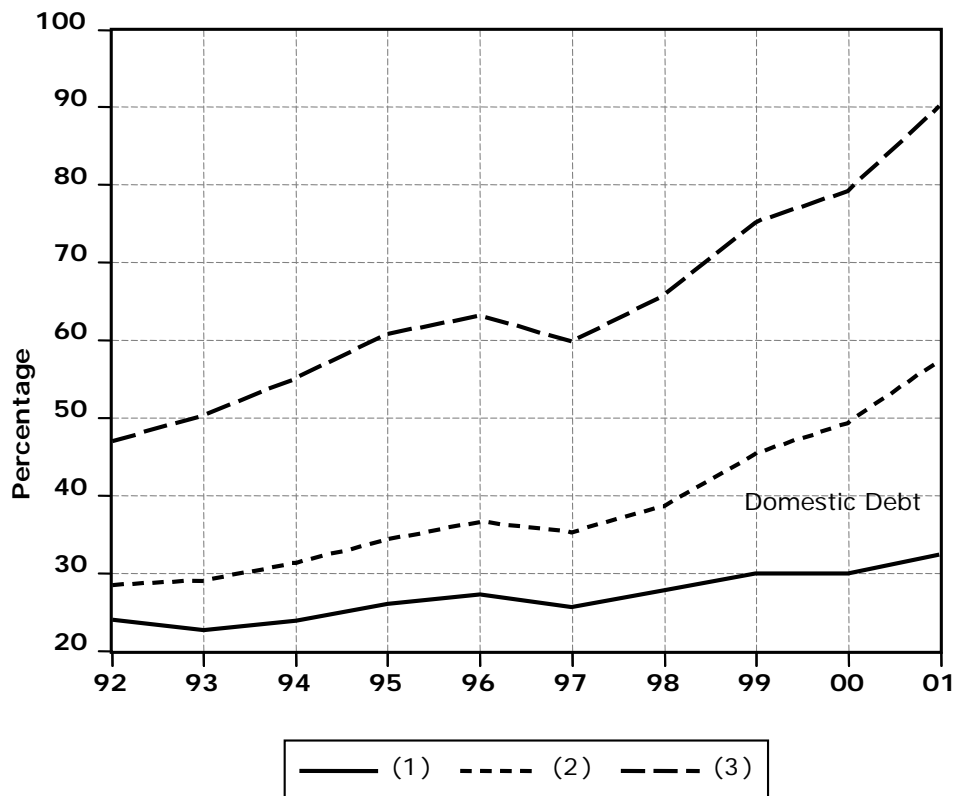
We have seen that the total foreign debt, measured with the PPP exchange rate, increased by almost 30 percentage points of GDP between 1990 and 2001. About 60% of that rise was generated by the private sector. The participation of the private sector was especially strong in the early nineties, responding to the incentives of the convertibility regime: it was responsible for approximately 70% of the increase in the external financial obligations between 1990 and 1995.

The issuance of public sector debt was more significant in the second half of the decade, when international financial conditions worsened. Besides, the placement of public debt in the domestic market started to play a more significant role in those years.

The following graph illustrates the public debt evolution in the period.

⁶ In 1992, before the agreement, Argentine bonds in circulation were only 17% of total public debt, whereas in 1993 they had reached almost 65% of it. Similarly, foreign currency denominated bonds represented less than 13% of the public debt in 1992, but approximately 57% in 1993. The total haircut provided by the agreement has been estimated at about 2.3 billion dollars, equivalent to about 4% of total outstanding public debt at the end of 1992 (Damill, Frenkel and Juvenal, 2003).

Figure 5. Total public debt / GDP ratio (1992-2001)



- (1) External Public Debt
- (2) Total Public Debt
- (3) Total Public debt as a percentage of GDP calculated using the PPP exchange rate.

Source: Authors' calculations based on data of the Ministry of Economy

The series in the graph and the figures in tables 2 and 3 allow us to describe the main facts of the Argentinean public sector indebtedness in the convertibility decade.

Table 2. Consolidated fiscal balance, National Administration Provinces (as a percentage of GDP, annual average)

Period	National Administration				
	Primary Surplus Without Social Security (1)	Primary Surplus	Interest Payments	Total Balance (2)	Consolidated Public Sector Balance (3)
Average 1981-90	nd	-4.4	1.9	-6.2	-7.0
Average 1991-94	2.1	1.3	1.2	0.1	-0.6
Average 1995-97	1.7	-0.3	1.7	-2.0	-2.6
Average 1998-01	3.1	0.5	3.1	-2.7	-4.1
Average 1991-01	2.3	0.6	2.0	-1.5	-2.4

(1) Primary Balance excluding receipts and expenditures of national security system

(3) = (2) + Provinces and Buenos Aires City balances

Source: Authors' calculations are based on data of the Ministry of Economy, Cetrángolo and Jiménez (2003) and Gaggero (2003)

Table 3. Fiscal deficit and total public debt variation (in millions of dollars)

Period	Consolidated Public Deficit (1)	Gross Public Debt Variation (2)	Discrepancies (3)	"Skeletons" (4)	Brady Plan's Haircut (5)	Rescue of debt due to privatization (6)	Others (7)
1992-1994	3,247	25,094	21,847	22,859	2,323	7,111	8,422
1995-1997	20,815	22,659	1,844	3,892	0	40	-2,008
1998-2001	45,835	52,817	6,982	5,947	0	0	1,035
Total	69,897	100,570	30,673	32,698	2,323	7,151	7,449

Note: column (2) does not include Central Bank's debt

(2) - (1) = (3)

(3) = (4) - (5) - (6) + (7)

Source: Authors' calculations based on data of the Ministry of Economy, Melconián et al. (1997), Cetrángolo et al. (2000) and Teijeiro (1996)

The analysis of the fiscal accounts allows us to distinguish three different sub-periods in the nineties. In the first sub-period, a sharp adjustment in the public accounts is observed. The average deficit in the overall public sector, which in the eighties was about 7% of GDP, decreased to less than 1% of GDP in 1991-94. As figures in table 2 show, this was mainly due to an improvement of 6 percentage points of GDP in the national administration balance, 90% of which is explained by the shift in the primary balance.

The year 1994 was a breakpoint in that decade for many reasons, and ushered in the second sub-period. The social security reform that created the Private Pension Funds as an alternative that people could choose to the public system was then put into effect. One of the consequences of the reform was a considerable loss in contributions to the public subsystem. At the same time, the economic expansion that had begun in 1990 was coming to an end: Argentina would go through a recession associated with the Tequila effect in 1995 (i.e., the loss of confidence and capital flight after Mexico's 1994 debt crisis erupted). And finally, the government took several measures aimed at compensating for some of the negative effects of the combination of trade opening and exchange rate appreciation. It did that by lowering the tax burden on the sectors producing tradable goods. All of these factors negatively affected the public finances. In spite of these negative effects, between 1995 and 1997 the average fiscal deficit was only 2 percentage points of GDP higher than the early nineties deficit. This figure is almost equivalent to the increase in the public social security subsystem disequilibrium caused by the reform.

However, after 1997 the fiscal panorama changed significantly, bringing us to the third sub-period. The impact of the Russian and Brazilian crises in 1998 resulted in a new jump in country-risk premiums, which had already started rising in mid-1997, after the East Asian crisis. This, on the one hand, negatively affected internal demand and triggered a new recessionary trend. On the other hand, it increased the financial vulnerability of debtors, including the public sector as well as many private agents that were in a net debtor position.

Before analyzing this stage in more detail, let us take a look at the association between the fiscal results and the public debt evolution using the figures in table 3.

It is important to observe the discrepancy between the growth of the public sector's financial obligations and the accumulated fiscal deficit in the nineties, which represented more than 30 billion dollars. The figures in table 3 show the main reason for this inconsistency, namely the verification and thus inclusion of obligations incurred in previous periods but not properly registered in the fiscal results, especially debt with public sector purveyors and with the social security system's beneficiaries. There had been erroneous liquidations and payment delays, mainly during the 1989-90 period, when the economy experienced two short hyperinflationary episodes and these now had to be financed.⁷

The documentation and inclusion of past debts was mostly concentrated in the initial stage, between 1991 and 1994. Nevertheless, it should be noted that the public debt ratio measured as a percentage of GDP was relatively stable up to 1994, at around 30% in the case of total debt and 25% in the case of foreign debt (graph 5).

⁷ Thus, the government issued special bonds called *bonos de consolidación* (informally called "skeletons") to cover payment of these arrears.

In contrast to the early eighties, the 1991-94 phase could thus be characterized by a significant improvement in the public accounts and by the relatively ordered absorption of a considerable volume of debt that had mostly been generated in previous periods, i.e. by the regularization of liabilities, many of which were litigious. It is clear from these figures that the standard financial vulnerability indicators showed no evidence of fiscal sustainability problems in 1994, when the contagion shock resulting from the Mexican crisis reached the Argentinean economy.

However, it is undeniable that the high debt burden inherited from the previous phase—a sort of original fiscal sin of the nineties—was partially hidden by the real appreciation veil. Graph 5 shows the public debt/GDP ratio calculated with the PPP exchange rate, as well as the ratio using the nominal exchange rate. As it can be seen, the PPP curve intersects the 50% line in 1993 as compared to less than 30% in nominal terms. Moreover, the fact that the public debt was payable in dollars established a direct link between external fragility and fiscal financial fragility, since taxes are paid in domestic currency. The relevance of this link is stressed by the exchange rate appreciation.

Between 1995 and 1997 the public debt/GDP ratio increased, in part as a result of the 1995 recession, and also because of the significant financial aid package led by the IMF, amounting to approximately 11 billion dollars. This support enabled the country to quickly recover from the crisis that followed the tequila effect. As seen in graph 5, in the expansionary phase that followed the crisis, the debt ratio tended to stabilize in 1995-97 again between 35 and 40% of GDP, a relatively low level in comparison to international standards. Again, in spite of the rise in the current deficit and the disequilibrium in the social security system, the standard debt indicators did not suggest fiscal sustainability risk in 1997, before the beginning of the depression. However, the debt ratio measured with the PPP exchange rate had already reached 60% of GDP.

As pointed out above, Argentina's macroeconomic panorama would drastically change soon after, following the August 1998 Russian crisis when Argentina's economic contraction began. The public sector's deficit increased significantly reaching about 6 percent of GDP in 2001, despite the many rounds of contractionary fiscal policies adopted to stop the trend.

Table 4. Comparison between average public deficit of 1998-2001 and 1994 (in millions of dollars)

Consolidated deficit variation	7,112
Social Security deficit variation	4,867
National Administration's primary deficit variation (excluding Social Security)	-5,131
Provincial primary deficit variation	592
Consolidated interest payment variation	6,784

Source: Authors' calculations based on data of the Ministry of Economy and Cetrángolo et al. (2000)

Table 4 helps us to understand some key features of the fiscal evolution in this stage. In table 4 we compare the average disequilibrium of the depression period to the deficit registered in 1994. In 1998-2001 the average accrued annual deficit (amounting to 11.5 billion dollars) was 7.1 billion dollars higher than the deficit registered in 1994. What was the source of this increase? As far as can be seen, it was chiefly due to the rise in interest payments (+\$6.8 billion) and to the increase in the social security system gap (+\$4.9 billion). Contrary to the standard interpretation, a relatively minor figure (+\$592 million) is explained by the disequilibrium in the balances of the provincial administrations, though it is true that they were on an increasing path.

The table also suggests that the pro-cyclical fiscal policies implemented were not ineffective: they produced a substantial increase in the primary surplus that averaged more than 5 billion dollars annually (without including the public social security results), though that was not sufficient to compensate for the rises in the interest item and in the social security system disequilibrium.

The explosive trend in the public debt interest account is also observed in the following table.

Table 5. Comparison between average public deficit of 1998-2001 and 1994 (in millions of dollars)

Year	Tax collection as percentage of GDP	Average interest rate on public debt	Interest payments/tax collections ratio	Sovereign risk premium (annual percentage)
1991	18.8	s.d	5.5	9.6
1991	20.8	6.6	8.3	6.9
1993	21.3	5.0	6.0	4.9
1994	21.1	5.5	6.9	5.9
1995	20.9	6.1	9.2	12.4
1996	19.6	5.8	9.7	6.5
1997	21.0	6.7	10.9	3.3
1998	21.4	7.6	12.2	5.8
1999	21.4	8.3	15.9	7.2
2000	21.9	8.9	18.5	11.5
2001	21.0	9.4	23.4	14.8
2002	19.2	5.2	13.3	- . -
2003	23.1	1.9	9.6	- . -

(1) Includes Security System receipts

(2) Calculated as a ratio between interest payment in period t and debt at the end of t-1.

(3) Tax receipts include those from social security system.

Source: Authors' calculations based on data of the Ministry of Economy and Gaggero (2003)

The amount of tax revenue absorbed by interest payments, which slightly increased after 1994, took a fast upward trend after 1996. In 2000, that ratio was nearly 19%, doubling the ratio registered in the middle of the decade. This was in part due to the decrease in tax revenues caused by the recession, but it fundamentally originated in the rise in the average interest rate paid on the public debt. The average interest rate on total public debt went from 5.8% in 1996 to 9.4% in 2001. Considering that this is an average rate, it is easy to see that the marginal rate rose considerably more.

The rising path of the interest rate is associated with the increasing country-risk premium (the two variables were narrowly correlated in the 1997-2001 period). These rising trends are the main factors behind both the consolidated deficit trajectory and the explosive path taken by the public debt. This is illustrated in graph 5. Between 1997 and 2001, in only four years, the public debt/GDP ratio increased by more than 20 percentage points.

3. MACROECONOMIC POLICY BEFORE AND AFTER THE DEFAULT

3.1. The Nineties: From Euphoria to Depression

The basic plot of the macroeconomic story of the late nineties was quite simple. To start with, the negative financial turnaround in the foreign environment experienced in 1997-1998, after the East Asian and Russian crises, found the Argentine economy with a significant and growing current account deficit, a considerably appreciated currency and a visible lack of policy instruments to deal with these problems, given the rigidities of the adopted macroeconomic policy rule. Not surprisingly, in these conditions the country-risk premium jumped upwards and the access to foreign funds became more and more problematic. As explained in the previous section, the subsequently increased interest burden had a negative impact on all borrowers, including the public sector.

Because of the fixed exchange rate and dependence of monetary conditions on the balance of payments, fiscal policies had to bear the burden of the adjustment to the new situation. The government argued that furthering fiscal discipline would strengthen confidence, and consequently the risk premium would fall, bringing interest rates down. As a result, domestic expenditure would recover pushing the economy out of the recession. Lower interest rates and an increased GDP would, in turn, reestablish a balanced budget, thus closing a virtuous circle. Fernando de la Rúa's administration in 2000 borrowed this entire argument from Carlos Menem's administration which had preceded it, and the IMF gave its seal of approval. All of them failed.

The entire macroeconomic story of the late nineties is about this failure. Despite the strong adjustment in the primary balance of the public sector that we have already mentioned in the previous section, the virtuous circle was never attained. Even worse, the increases in taxes and the cuts in public expenditures reinforced the recessionary trend, thus feeding the negative expectations that prevented realizing the highly anticipated fall in the country-risk premium. Fiscal policy alone was impotent to compensate for the strong macroeconomic imbalances, which laid somewhere else, i.e., in the external sector of the economy. Under this self-destructive fiscal policy orientation, the economy got trapped into a vicious circle for several years, and suffered from the longest recession since the First World War.

3.2. The Balance of Payments and the Public Debt under the Currency Board

In the following graph we present the results of the principal accounts of the balance of payment in the nineties, acting as a complement to our previous discussion by illustrating some important aspects of the performance of the economy under the currency board regime.⁸

Figure 6. Balance of payments: current account, net capital inflows and variation of the stock of reserves (moving averages of four quarters)



- (1) Current Account Balance
- (2) Net Capital Inflows
- (3) Foreign Reserves Variation

Source: Authors' calculations based on data of the Ministry of Economy

⁸ A formal model of the dynamics of the Argentine economy under the currency board regime as well as its econometric estimation can be found in Damill, Frenkel and Maurizio (2002).

Let us start by making a short reference to the early nineties. The macroeconomic performance of the 1991-95 period clearly fit the stylized cycle described in the previous section. The capital inflows-led growth lasted until 1994. In early 1994 the Federal Reserve started to increase the US discount rates, raising domestic interest rates in the US market, affecting the capital inflows to Argentina negatively. As the deficit in the current account kept increasing, foreign reserves stopped growing.

Then, the contagion of the Mexican crisis of December 1994 triggered a massive capital outflow at the beginning of 1995. Foreign reserves fell, as can be seen in Graph 6, tightening domestic credit under the currency board mechanism, sharply increasing Argentine interest rates, and a contraction ensued. However, the recession of the middle nineties was short-lived. As was already mentioned, a strong financial-support package coordinated by the IMF helped to change the negative expectations.

Due to the favorable effects of the external financial support, it was possible to preserve the monetary regime and by late 1995 a new expansion was already starting. The elements of the cyclical dynamics were once again in motion. The expansion phase that followed showed the same broad shape as the first, although this time it was shorter. In mid-1997, after the devaluation in Thailand, the country-risk premium jumped. Then, after the Russian crisis of 1998, a new contraction started.

3.3. Foreign Debt, Public and Private

Beyond the mentioned similarities, the second cycle of the nineties differed from the first one in many respects. We want to highlight one of them here, namely the dissimilar roles played by the public and private sectors in the generation of the capital inflows that fed the accumulation of reserves—a crucial variable under the currency board regime.

During the first economic expansion, in the early nineties, inflows to the private sector were predominant, although the government also took in funds, in particular from the privatization of the most important state-owned companies, which took place during that period. Capital inflows to the public sector became more significant during the recession of 1995, thanks to the foreign financial-support package we have already mentioned. Since then, capital inflows to the public sector were kept at a high level until the end of the period. Thus, the second expansion in the nineties was bolstered mainly by capital inflows directed to the national government.⁹ Meanwhile, net capital inflows directed to the private sector recovered slowly and from mid-

⁹ Unlike typical cases, the main channel was not the foreign financing of public expenditures, but a monetary mechanism: the issuing of new foreign debt by the government surpassed its payments in foreign currency. By selling this surplus to the Central Bank, the Treasury covered the net foreign currency needs of the private sector and fed the accumulation of reserves, essential for the expansion of both the money and credit supplies at the domestic level. The mechanism is discussed in Damill (2000).

1998 on they stopped coming in significant amounts. Actually, an abrupt outflow started in late 2000.

As Table 6 shows, the increase in the foreign public debt (including the central bank) surpassed 35 billion dollars in this period. This amount is quite close to the increase in the foreign financial obligations of the non-financial private sector, which was above 32 billion dollars. If we add the increase in the external liabilities of the domestic financial sector, the amount jumps to more than 44 billion dollars, even including a significant fall in the critical period from the fourth quarter of 2000 to that of 2001. Thus, the rise in the amount of the public foreign financial obligations explains about 44% of the change in the total external debt during that period, or about 38% if the year 2001 is excluded from the calculation. The public sector played, as we have just stated, a crucial role in financing the accumulation of foreign reserves in the nineties. Certainly, there was also a major increase in the foreign debt of the private sector, but a significant portion of it had a counterpart in the private outflows of funds. Thus, while the private debt experienced a considerable increase, so did the external assets of this sector. Table 6 shows that foreign assets grew significantly more than foreign liabilities in the case of the non-financial private sector. As we have analyzed in other works, this sector's net demand for foreign currency was positive in the aggregate (Damill, 2000; and Damill and Frenkel, 2003).

Table 6. Change in foreign debt and foreign assets by sector and period (in millions of dollars)

Period	Changes in						
	External debt of				External assets of		Net External debt of private sector (2)-(3)
	Public Sector (1)	Financial Sector	Private Sector (2)	Total	Financial Sector	Private Sector (3)	
1991:4 to 1994:4	8,529	5,726	10,321	24,575	1,728	566	9,755
1994:4 to 1995:4	5,924	2,952	4,361	13,238	821	11,174	-6,813
1995:4 to 1998:2	9,222	11,579	15,607	36,407	15,307	15,050	557
1998:2 to 2000:4	8,523	-555	3,139	11,107	-4,274	11,876	-8,737
2000:4 to 2001:4	2,975	-8,053	-688	-5,766	-10,665	12,865	-13,553
Total	35,173	11,649	32,740	79,561	2,917	51,531	-18,791

(1) Including the Central Bank

Source: Authors' estimates on the basis of data from the Ministry of Economy

The accumulation of foreign assets by the private sector was small in 1991-94. It rose during the second half of the decade, after the Tequila shock. As can be seen in the table, in the expansionary phase that extended from late 1995 to mid 1998, private debt increased rapidly. It grew by more than 15 billion dollars (for the non-financial sector). But private foreign assets

went up in a roughly similar amount.¹⁰ Furthermore, from then on, net private foreign debt declined substantially. In the whole period, it fell by about 19 billion dollars, according to the figures of the table. In sum, in the late nineties the level of reserves and thus the internal liquidity became more and more dependent on the access of the public sector to foreign funds.¹¹

3.4. The Efforts to Prevent Default and Save the Currency Board Regime

As usually happens during a crisis, its development involved a complex succession of events, including many contradictory policy decisions (especially throughout 2001) and steps both backwards and forward. We will only mention here some crucial aspects of these processes.

In December 1999 a newly elected government took office. As we have already said, the new De la Rúa administration adhered to the belief that the main cause of the economic depression was not the exchange rate appreciation and the financial vulnerability to external shocks, but the fiscal mismanagement. This vision led the government to adopt a tight fiscal policy as a way to, quite paradoxically, take the economy out of the recession. We have presented these arguments and the disappointing results above. However, the failure of this policy orientation should not obscure the fact that huge efforts were made to balance the public accounts and to prevent the default of the government's financial obligations.

Indeed, aiming to reestablish bridges to the international financial markets, successive packages of tight fiscal measures were applied during 2000 and 2001, grounded on the fiscal consolidationist view of the crisis. We do not intend to describe them in detail here, but some episodes deserve to be mentioned as examples of the actions oriented to fulfill the commitments to creditors, both foreign and domestic.

The efforts to prevent the default included, among other measures, a Fiscal Responsibility Law approved in late 1999 that set a mandatory declining trend for the public deficit that would bring it to zero in a few years. Tax increases and expenditure cuts were adopted with that purpose. Later on, by mid 2001 when the credit constraint had strengthened, a “zero deficit” policy was approved determining that the public accounts had to be immediately balanced (so that total expenditures had to be adjusted to total cash receipts). The norm intended to guarantee some basic payments of the state, including interest on the public debt, but it made the non-guaranteed expenditures endogenous, subjecting them to the evolution of public receipts. Besides interest,

¹⁰ Capital flight and the dollarization of private portfolios had also been a central feature of the crisis of the financial opening experience of the late seventies. Thus both policy experiments ended, among other aspects, in a strong denationalization of private wealth.

¹¹ Note, in table 6, the important decline in the financial sector's external assets in the crisis phase, amounting to more than 10 billion dollars in 2001 alone. However, this is basically a reflection of the capital flight of the rest of the private sector. In effect, Argentine banks held the main part of their reserves (“liquidity requirements”) in liquid deposits abroad. Facing deposit withdrawals at home, the banks were forced to use those funds; hence their external assets declined while the external assets of the rest of the private sector increased.

the other “protected” items were legally established transfers of tax receipts to provinces, and wages and pensions amounting to less than 500 pesos per month (or dollars at the ruling parity). The package also included an unprecedented 13% across the board cut in public wages and pension benefits, which hardly contributed to either the social approval of the government policy or the social peace. It should be kept in mind that these measures were taken when the economy was already ending its third recession year. These decisions exemplify the huge efforts made to prevent a default on the public debt.

In any case, the expected positive “confidence shock” never materialized. With the economy suffering from a deep recession and caught in a debt trap, these rounds of contractionary fiscal policies only reinforced the deflationary scenario and the pessimistic expectations, as we have already explained.

During 2000 and 2001 the government attempted to complement its fiscal measures with some initiatives on the financial front. It obtained foreign support and implemented important debt swaps aiming to convince the public that there was no risk of default. Thus, at the end of 2000 an important package of local and external support, for about 40 billion dollars, was announced: (the “*blindaje*”, financial shield). The IMF led the operation with a 13.7 billion dollar extension of the stand-by credit in force since March 2000. Local agents including a group of banks and the private pension funds also had a significant participation. The beneficial effect of this action, however, was very short lived. Two months after its announcement, and following the outburst of a new crisis in Turkey, the country-risk premium started to climb again.

Later in mid 2001, an important voluntary debt swap, the “*mega-canje*” (mega swap) was implemented to “seduce” private creditors (local and foreign). The transaction amounted to about 30 billion dollars in public bonds (24% of the total debt of the national public sector at the time) and had the IMF’s support. The operation made possible some extension in the maturity, but involved an increase in the nominal value of the debt (of about 2 billion dollars) as well as a heavy interest burden, because the newly issued bonds contained dollar interest rates of about 15%. Instead of alleviating the financial constraint, these high interest rates helped consolidate the perception that the debt had become unsustainable.

Finally, there was another voluntary swap of public debt in November (although it would be better to call it “induced” or even, semi-voluntary). This was directed to domestic bondholders (mainly banks and private pension funds), who agreed to swap more than 42 billion dollars in public bonds for the same amount in loans of lower yield but insured by tax revenues. However, the operation could not stop the downward spiral.

The withdrawals from local bank deposits picked up speed in October 2000 with the resignation of Vice-President Carlos Álvarez. Coupled with the net adverse effect of other international

financial flows already noted, international reserves began to fall (graph 6). In March 2001, after the ephemeral recovery that followed the announcement of the *blindaje*, this process became more intense and lasted until mid-June, when the government undertook the *mega-canje*, noted above, aiming at changing expectations. As we have mentioned, the stabilizing effects of this operation were very weak. In the beginning of July, deposit withdrawals and the run against the reserves started again. The intensification of these processes could neither be stopped with an announcement in August of a new extension of 8 billion dollars of the current IMF stand-by credit, nor with the debt swap in November.

Beginning in December the government established hard restrictions on capital movements and on cash withdrawals from banks (the so called “*corralito*”). One of the purposes of these measures was to avoid either the generalized bankruptcy of the banks or the violation of the currency board monetary rule. No bank, domestic or foreign owned, complained. But the main objective of the measures was to hold back the demand for foreign currency, preserve the stock of reserves and avoid the devaluation (i.e. the formal abandonment of the convertibility regime). It was also the last drastic attempt to prevent the default. Yet, the measures actually did represent the end of the regime.

The restrictive December financial measures contributed to a deepening of the already strong social and political tensions. After a few days of social unrest and political commotion the government resigned, followed by a series of ephemeral presidents. One of them announced to the Congress the decision to default on the public debt, only to resign a few days later. In the first days of 2002, with a new president, Argentina officially abandoned the currency board regime and the one-to-one parity of the peso to the US dollar.

3.5. Macroeconomic Policy after Devaluation and Default

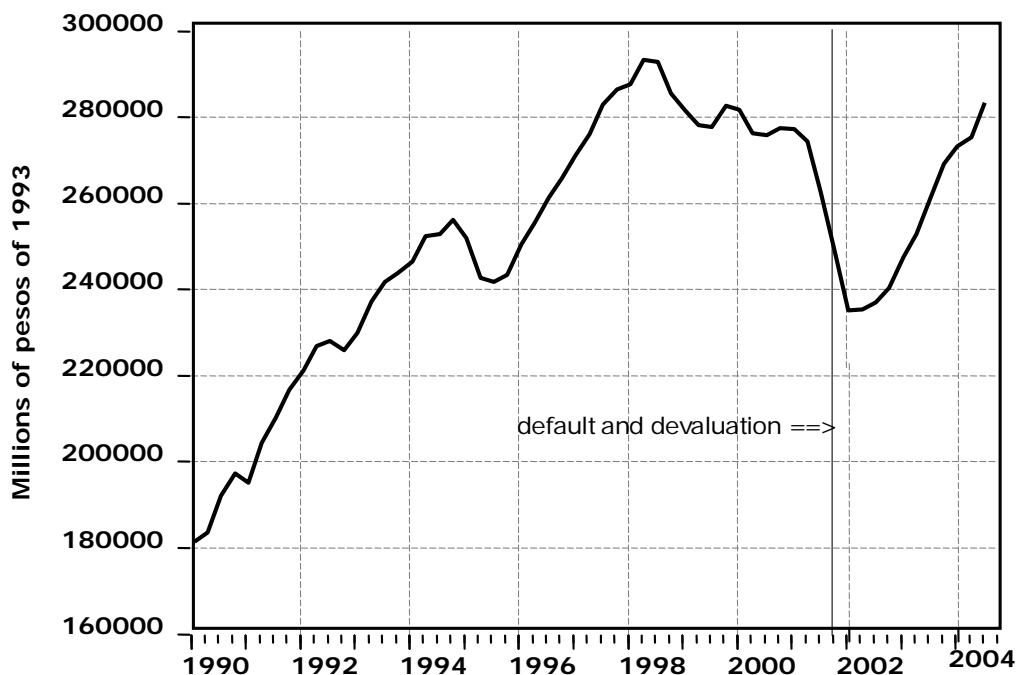
After three years of recession, economic activity had suffered from an additional abrupt decline in the second half of 2001. The massive flight to external assets that took place in the second semester precipitated the collapse of the convertibility regime and resulted in the devaluation of the peso and the default. Graph 6 shows the strong fall in reserves during that year, which rapidly shrank domestic liquidity. The payments chain collapsed after the *corralito* was established. Output and employment followed the abrupt contractive trajectory showed by reserves and liquidity. Social indicators such as the unemployment rate and the poverty and indigence indices—which had considerably worsened during the nineties—suffered from an additional deterioration, adding to the social tensions and the politic crisis that brought the government of the Alianza to an end (Damill, Frenkel y Maurizio, 2003).

3.5.1. The Economic Recovery

The abyssmal fall in output and employment continued after the end of the convertibility regime, but for only a very short period. Certainly, in opposition to most opinions and beliefs—including those of the IMF’s officials—the traumatic episodes that brought the convertibility regime to an end were not followed by a deeper depression. Moreover, an extraordinary quick recovery started only one quarter after the devaluation and default, as can be seen in graph 7.

In the graph, the “V-shaped” trajectory can be seen consisting of the economic collapse phase of the last quarters of the convertibility regime and the following quick recovery. As we have just indicated, the GDP recovery started soon after the exchange rate depreciation (around three months later, as can be seen in the available monthly activity indicators). The recovery was precisely triggered by the sudden change in the relative prices in favor of the tradable goods sectors. In the beginning of this phase the recovery was led by the local production of previously imported goods.

Figure 7. Real GDP (quarterly values, seasonally adjusted 1990:1-2004:3)



Source: Authors’ calculations based on data of the Ministry of Economy.

It is remarkable that the beginning of this new phase started to be perceptible while the country was still immersed in accentuated economic instability and political uncertainty, and when service payments on part of the public debt were interrupted.¹² In other words, the “rebound” took place in spite of this extremely complicated setting and also despite the short-term recessionary effects of the depreciation.

3.5.2. Despite the IMF

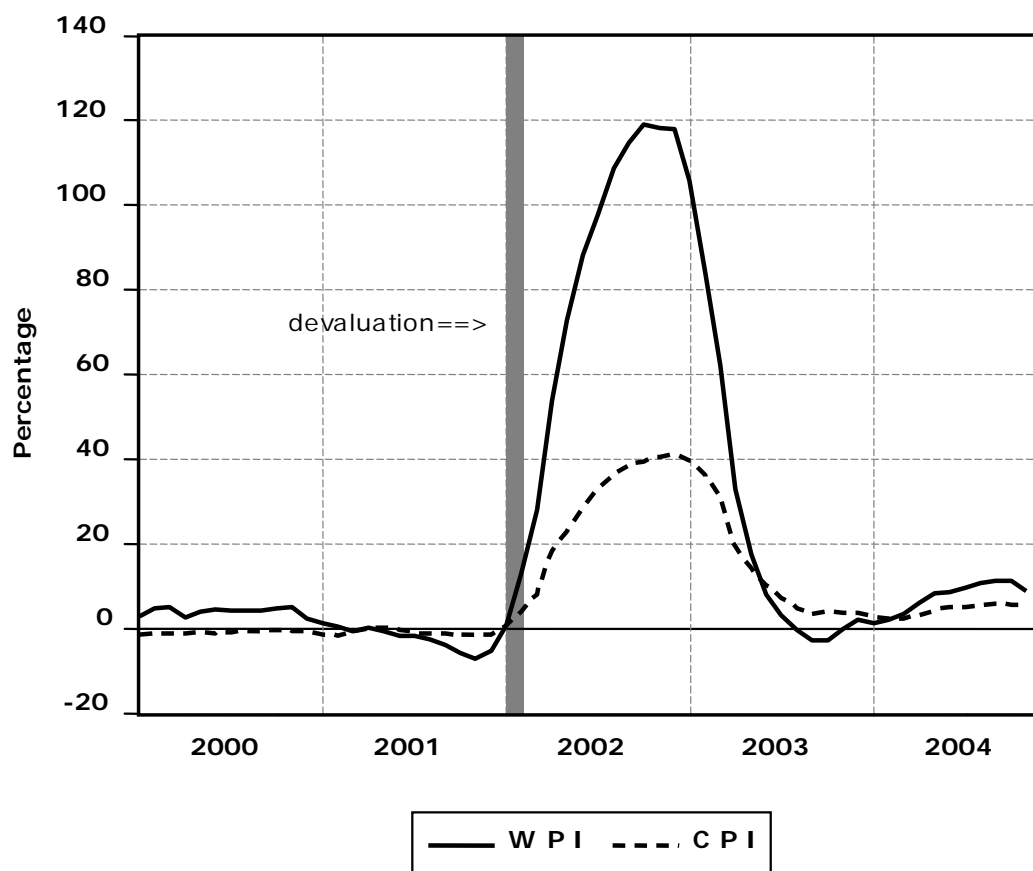
Apart from the shift in relative prices, the quick economic recovery that followed the crisis was also a consequence of a set of policies that, still with flaws and ambiguities, aimed at recovering the basic macroeconomic equilibria.

We discuss the Argentinean relations with the IMF in greater detail below in the next section. However, for the purpose of this section it should be stressed that many of the policies that played important roles in this stage faced opposition from the IMF. Firstly, the imposition of exchange controls: this measure compelled the exporters to liquidate in the local market a considerable part of the international currency generated by their exports and also restricted capital outflows. Secondly, the establishment of taxes on exports (retentions): this absorbed part of the devaluation’s favorable effect on the exporters’ incomes and significantly contributed to the recovery of fiscal equilibrium; it also attenuated the impact of the devaluation on domestic prices and, consequently, on real wages. Thirdly, a flexible monetary policy: this initially enabled assistance to banks in the crisis phase and afterwards contributed to the recovery of money demand, thus helping the recovery. Fourthly, when the foreign exchange market started to show an excess supply of international currency, exchange rate policy attempted to stop the peso from appreciating through the intervention of the Central Bank (and of the Treasury later on).

The IMF particularly insisted on a freely floating peso. For a short period the government adopted this regime. Once the exchange rate was free to float, however, the parity rose abruptly, reaching levels close to 4 pesos per dollar. Reintroduction of exchange controls followed, which was crucial to contain the exchange rate overshooting. The government managed to stabilize the nominal exchange rate by mid-2002 by compelling the exporters to liquidate the international currency in the local exchange market and by limiting the currency outflows.

¹² When the floating rate regime was adopted, the initial devaluation took the parity to 1.40 pesos per dollar, but the exchange rate continued to weaken and further push up nominal domestic prices, while the financial system was going through a deep crisis.

**Figure 8. Consumer (CPI) and Wholesale (WPI) price indexes
Monthly year-to-year variation**



Source: Authors' calculations based on data of the Ministry of Economy

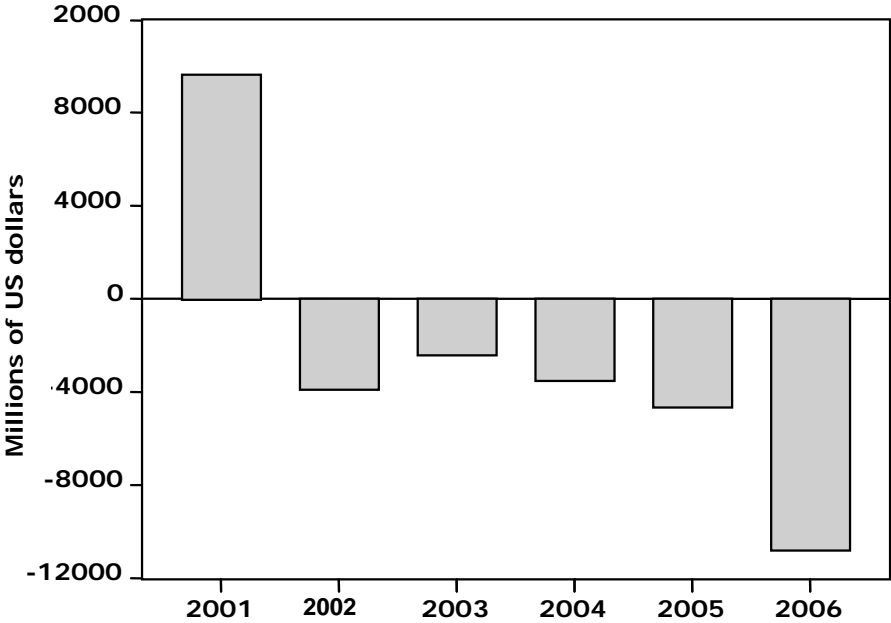
Soon after, when the exchange rate was stabilized, the demand for pesos started to recover and the exchange market began to show an excess supply of dollars. The end of the exchange rate panic put a check on the rise in the domestic prices. The freezing of public utilities rates,¹³ as well as the high unemployment (which kept nominal wages from rising) also contributed to slow the rise in prices. The quick decline of inflation in the second half of 2002 can be seen in the graph 8.

Another important point in the tense relations of the country with the IMF relates to the net flow of funds between Argentina and IMF and the other multilateral organizations. In this regard, a substantial change occurred after the end of the convertibility regime; i.e., in the post default

¹³ Many of which were dollarized and subject to automatic adjustment with the US rate of inflation, as established in the privatization contracts.

phase the net funding from the IMF and the other multilateral organizations became negative. According to the Argentinean Minister of the Economy, the IMF passed from playing the role of “last-resort lender” to play the role of “privileged debt payment collector”. This point is illustrated in the following graph.

Figure 9. Annual net disbursements from IFI's



Note: the figure of 2006 corresponds to the first quarter of the year

Source: Ministry of Economy

Whereas in the 1994-2001, period Argentina received from the multilateral organizations a net funding of more than 23 billion dollars (40% of which were concentrated in 2001), in the 2002-2005 phase the country made net payments amounting more than 14 billion dollars (including interest payments). In 2005 the government of President Kirchner decided to prepay all outstanding liabilities still owed to the IMF, and that explains the significant size of the negative bar attributed to 2006 in the graph.

3.5.3. The Main Characteristics of the Recuperation Phase

The GDP recovery that started in the first half of 2002 had a short first phase in which aggregate demand barely rose and in which every internal component of domestic expenditure (private consumption, public consumption, and investment) kept shrinking, as had also happened, though at a low pace, during the previous depression. Therefore, it was not growth of domestic demand

that stopped the decline in activity level. The expansive factors were mainly the international trade variables: exports and the switching of expenditure from imports to import substitutes—most especially the latter, as local expenditure on local production started to provide an increasing proportion of aggregate demand. This import substitution particularly favored the manufacturing sector. After that short initial stage, the recovery of activity was led by an increase in domestic demand components, especially by investment, which grew at an annualized rate close to 40% between 2002 and 2004, and by private consumption.

It is frequently mentioned that a favorable external environment was an important element behind the economic recovery. In this view, the main part of the rebound is attributed to a set of positive “exogenous” factors. In those interpretations, the recovery would have taken place in spite of what is often considered an economic policy full of mistakes and omissions. Although the contribution of external factors to recovery has been undeniable (in particular some high commodity prices), the fact that a substantial part of the expansion’s dynamism derived from internal demand sources weakens that interpretation.

It should also be stressed that the consumption and investment recovery took place in a context of heightened credit rationing, both external and internal. The investment was apparently financed by higher profits retained by firms, although the “wealth effect” resulting from the significant external asset holdings of the private resident sector, surely contributed as well. These assets—that nowadays surpass 130 billion dollars—increased their value in pesos with the exchange rate depreciation, and also rose in relation to the prices of domestic assets such as real estate and land. This factor also fed the recovery of private consumption expenditure.

3.5.4. Fiscal and external adjustment

The adjustment experienced by the Argentinean external sector took place in part before the devaluation, as shown in graph 6 where the improvement in the current account since 1998 can be seen. However, the end of convertibility generated an important trade surplus. The trade balance exhibited a deficit higher than 3 billion dollars in 1998. It decreased from then on and turned into surplus, due to the reduction in the volume of imports. In 2002 the surplus was higher than 17 billion dollars, and remained over 16 billion in 2003 and over 12 billion in 2004. The trade surplus caused the change of sign in the current account balance. In recent years, the current account has been in surplus even when taking into account the interest obligations accrued by the debt in default (see graph 6). In fact, macroeconomic policy has recently faced the problem of sustaining the real exchange rate parity in order to preserve the incentives to investment in the tradable goods sector with international currency in excess supply, thus pressing for appreciation.

As can be seen in table 7, a strong adjustment in the public accounts has also been taking place alongside the external adjustment process we have just mentioned.

Table 7. Fiscal Adjustment: Results of the Consolidated Public Sector (CPS) (as a percentage of GDP)

	Concepts	2001	2004 (*)	Variation (2004-2001)
National Public Sector	Tax receipts	13.8	18.6	4.7
	Taxes on exports	0.0	2.3	2.3
	Financial tax (**)	0.0	1.4	1.4
	VAT	3.1	3.4	0.3
	Income tax	2.5	3.4	0.9
	Other taxes	8.2	8.1	-0.1
	Other receipts	5.0	4.8	-0.2
	Total receipts	18.8	23.3	4.6
	Total expenditures	22.0	20.5	-1.6
	Primary expenditures	18.2	19.1	0.8
	Interest services	3.8	1.4	-2.4
	Primary result	0.6	4.3	3.7
	Total result of the NPS	-3.2	2.9	6.1
	Provinces (***)	-2.4	1.6	3.9
Total result of the CPS	-5.6	4.5	10.1	

(*) Estimated from the figures of the January-September period

(**) Tax on bank debits and credits

(***) Including the City of Buenos Aires.

Source : Authors' calculations based on the data of the Ministry of Economy

The improvement in the consolidated public sector global balance that took place between 2001 and 2004 was equivalent to 10 percentage points of GDP. This result passed from a global deficit of 5.6% of GDP in 2001 to a 4.5% surplus in 2004.

Which factors explain the adjustment in the fiscal cash flow results? Forty percent of it derives from an improvement in the provinces balances. This improvement comes from the increase in tax collection facilitated by the recovery and the rise in nominal prices, together with the restraint in expenditure. Meanwhile, 60% of the six-points-adjustment in the national public sector's budget is explained by the improvement in the primary balance (+3.7% of GDP). The contraction of interest payments, basically resulting from the default on the sovereign debt, accounts for the rest (-2.4% of GDP).

The rise in the national primary surplus is mainly explained by an improvement in tax revenues (+4.7% of GDP). It is interesting to observe that although the receipts from traditional taxes such as the VAT and the incomes tax rose significantly, they did not increase substantially when measured as a proportion of GDP. Between 2001 and 2004 they increased by 1.2% of GDP taken together. The tax on exports is the item that mostly explains the rise in tax revenues. The soy and derivatives industry generated almost one half of the taxes on exports.

Hence, the public sector absorbed part of the effect of the devaluation on the profitability of the tradable goods sector, and also benefited from the high prices reached by some of the exportable goods, such as soy and oil. The contribution made by the tax on financial operations established in 2001 was also very relevant. The increase in the collection of this tax explains 30% of the improvement in total tax receipts.

The interest payments on the public debt deserve a separate paragraph. As can be seen in table 7, this flow passed from representing almost 4% of GDP in 2001 to only 1.4% in 2004 (without taking into account the accrued interest on the debt in default, as table 7 shows cash flow figures, not accrued flows).

However, the fiscal effects of the suspension of part of the debt service payments are significantly higher than what is shown in the mentioned account. It cannot be calculated with precision because a significant amount of new debt was issued after the suspension of debt payments, as we will describe in the following section. However it can be estimated that the amount of interest on the public debt—valued at the 2004 exchange rate—would have represented, in that year, between 9 and 11 percent of GDP. This is approximately equivalent to one half of the total tax collection of that year. Paying that amount would have certainly been incompatible with the economic recovery. As was pointed out above, a crucial aspect of the fiscal financial vulnerability derived from the extremely high proportion of debt in foreign currency, with the consequent exposure to the impact of exchange rate variation. The substantial exchange rate depreciation in 2002 would have had a harsh impact on the public sector's financial equilibrium. Taking this into account, it can be said that the payment suspension and the following debt restructuring enabled a considerable amount of fiscal savings—either measured in domestic currency or as a proportion of GDP.

However, the most important effect of the default and the end of the convertibility regime was regaining the instruments of macroeconomic policy. This was of crucial importance in moving the economy out of the abyssmal situation generated by the agony and the final collapse of the convertibility regime.

4. THE EVOLUTION OF THE DEBT AFTER DEFAULT AND THE PROPOSALS TO RESTRUCTURE IT

The suspension of the service payments on a part of the public debt was declared on December 24, 2001. The measure initially affected 61.8 billion dollars in public bonds and another 8 billion dollars in diverse liabilities, out of a total debt of 144.5 billion dollars. The rest—mainly debt with multilateral organizations (32.4 billion dollars) and recently issued guaranteed loans (42.3 billion dollars)—remained as performing debt.¹⁴

The devaluation of the peso that followed had a strong impact on the economy, given the important dollarization of contracts inherited from the convertibility period. Thus, a few days after the devaluation, in order to attenuate some of the consequences of the shock, the authorities began to issue new debt, as will be described below. By the end of 2003, Argentina's total public debt reached 179 billion dollars. In this section we examine both the generation of these new liabilities ("non voluntary" and "inertial", as they are called in the official documents) and the restructuring process for the defaulted bonds.

4.1. The Evolution of Public Debt after the Default

The government interventions beginning in early 2002 aimed both to reduce the wealth transfer from debtors to creditors and avoid the collapse that would have resulted from being unable to fulfill contracts set in US dollars. The official intervention intended to manage the "distribution of losses". In many cases the intervention meant that parts of the losses were absorbed by the State by issuing new debt. The evolution of public debt in the period following the default is summarized in table 8.

¹⁴ The November 2001 public debt swap mentioned in the previous section involved the swap of local agents' bond holdings for guaranteed loans to the government.

**Table 8. Evolution of the Gross Public Debt, National Government
(since December 31st 2001 to December 31st 2003, in Millions of Dollars)**

Item	Amount	(1)	(2)
I. Total Debt Stock	144,45	466	53.8
II. Forced and inertial debt increases resulting from the breakdown of the convertibility regime (1+2+3)	28,184		
1. Debt emission as from December 2001	28,525		
To alleviate financial system distress	14,390		
To compensate the banks for the asymmetric pesification	5,904		
To domestic savers	6,086		
To assist Provinces	12,108		
Provincial Warranted Bonds (BOGAR)	9,679		
To rescue provincial quasi-moneys	2,429		
To cancel obligations with public workers, suppliers, and others	2,028		
To give back a 13% wage cut to public workers	873		
Consolidation Bonds (Bocones given to suppliers, etc.)	1,155		
2. Effects of pesification, inflation adjustment (CER) and others	-14,284		
Debt reduction through pesification	-22,086		
Debt increases because of inflation adjustments (CER)	7,325		
Adjustment of Global Bond with Dollar conversion clause	477		
3. Interest Arrears as to December 31st 2003	13,943		
Unpaid interests	9,974		
Capitalized interests	3,969		
III. Amortization, effects of exchange rates' variations and others	6,183		
Debt amortization	-5,411		
Debt reduction through capital net payments to IFI's	-3,340		
Debt reduction through amortizations	-2,071		
Net Central Bank Credit to the National Government	2,851		
Effects of exchange rates' variations and others	8,743		
Total Debt increases between December 31st 2001 and Dec 31st 2003	34,367		
IV. Total Debt Stock (December 31st 2003)	178,820	533	146.0

Source: Authors' calculations based on data of the Ministry of Economy

The main source of the new indebtedness came from the intervention in the financial system,

which involved a 14.4 billion dollar rise in public debt. In February 2002, the government decided to compel the conversion of all foreign-currency bank deposits into pesos at a rate of 1.4 pesos per dollar.¹⁵ Withdrawals from demand and saving deposits were restricted to 1,500 pesos per week. The rest of the deposit balances in the banks as of the end of 2001 was transformed into longer term deposits. This measure included both the deposits recently converted from dollars to pesos and those originally denominated in pesos. Bank credits denominated in foreign currency were converted into pesos at a rate of one peso per dollar. This measure was aimed at avoiding generalized bankruptcies in the private sector. The “asymmetric pesification” of credits and deposits caused a significant loss in banks’ net worth that was compensated by the government.

The government issued 5.9 billion dollars of new debt for this purpose.¹⁶ In addition, many banks had not hedged their financial positions in domestic and international currency at the time of the devaluation. Therefore, the peso devaluation caused an additional loss in the banks’ net worth. The government compensated this effect by issuing 2.4 billion dollars worth of bonds (“*bonos cobertura*”) denominated in foreign currency. In both cases, in exchange for the bonds provided, the banks contracted new (peso) liabilities with the State.¹⁷

The pesification of the private deposits at 1.4 pesos per dollar and the forced reprogramming of their maturities triggered strong claims. The savers demanded the value of their deposits in their original currency denomination and their free availability. In many cases there were judicial decisions favorable to these claims causing a considerable “filtration” of funds out of the banks. To tackle this situation, the government of President Duhalde launched three different proposals for the voluntary swap of reprogrammed deposits into new public bonds.¹⁸ The first two offers involved the swapping of the banks’ debts with the savers for public debt. The third one was intended to free all the reprogrammed funds. In this case the government issued debt papers to the savers for the difference between the deposits’ value in their original currency (dollars) and the amount effectively disbursed by the bank (1.4 pesos per dollar plus an inflation adjustment,

¹⁵ When the measure was sanctioned, the dollar was floating at around 2.15 pesos. Four months later, the dollar exchange rate almost reached 4 pesos, and from then on it followed a smooth descent. From March 2003 on the parity tended to stabilize between 2.8 and 3 pesos per dollar.

¹⁶ Another measure with “asymmetric” effects also affected the banks’ net worth. The government established different inflation adjusting mechanisms for deposits and pesified credits. It was resolved that the deposits would be indexed with an index that follows the evolution of consumer prices (CER, or “Coeficiente de estabilización de referencia”) and that the loans would do so with another index reflecting the evolution of average wages (CVS or “Coeficiente de variación salarial”). Since the consumer price inflation was higher than the nominal rise in wages, the value of the banks’ pesified liabilities grew at a higher rate than the value of the assets. In October 2003 the Congress sanctioned a law that empowered the government to compensate the banks for the “asymmetric indexation” by issuing new bonds (BODEN 2013) for up to 2.8 billion pesos. As of the time of writing in October 2006, the government had not issued those bonds.

¹⁷ The banks were allowed to cover those new obligations as they fell due by depositing funds in the Central Bank or repaying debts that the State previously had extended to them.

¹⁸ The first offer was launched when economics minister Roberto Lavagna assumed his post in June 2002, the second one in September of the same year and the last one in March 2003, two months before the provisional mandate of President Duhalde expired.

following the consumer price index).¹⁹ The three offers as a whole were widely accepted by the savers. This helped to alleviate the financial system's liquidity problem, though at the expense of augmenting the public debt by 6.1 billion dollars in exchange for additional bank debt owed to the State.²⁰

Another source of the public debt increase came from the transfer of liabilities from the provincial governments to the central government. The latter took over 9.7 billion dollars of the provincial governments' debts with the banks. It also undertook to cover the loss derived from the Central Bank rescue of provincial government bonds that had performed as currency ("*cuasi monedas*") between 2001 and 2003.²¹ In this case, the national government assumed a liability of 2.4 billion dollars with the Central Bank, which had issued its own notes in exchange for the provincial bonds. In both transactions, debt servicing would come out of a proportion of the future flow of national tax resources designated for the provincial governments.

During 2002 and 2003 the public debt also rose due to the clearing of 2 billion dollars in obligations to employees, pensioners and suppliers. A ruling of the Supreme Court—stating that a 13% cut in public-sector wages and pensions in July 2001 was unconstitutional—forced the government to issue debt papers for 873 million dollars. At the same time, liabilities to suppliers and other obligations committed before the default amounted to 1.2 billion dollars. All together, the measures that aimed at managing directly or indirectly these consequences of the convertibility collapse entailed a gross debt emission of 28.5 billion dollars.

In addition to the newly issued debt enumerated above, in February 2002 the government converted into pesos all the debt issued in foreign currency under Argentinean law. The measure affected 57.5 billion dollars in debt, most of it constituted by "guaranteed loans" issued in the November 2001 debt swap.²² The government also decided to apply fixed interest rates to the "new" pesified debt that varied from 2% to 5.5%. However, the "guaranteed loans" had been issued with a clause that allowed the holder to turn the asset back into the original bond in case the original emission conditions were changed, which they now were. In 2003 most of the private pension funds (AFJP) and the local insurance firms decided to re-convert their holdings of 17.8 billion dollars of "guaranteed loans" into the original foreign-currency denominated bonds. In spite of that, the pesification of the "guaranteed loans" reduced the value in dollars of the debt issued under local legislation by about 22.1 billion dollars.

Moreover, the pesified debts that were indexed to the consumer price index experienced a rise

¹⁹ The demand deposits frozen under the *corralito* had already been freed in December 2002.

²⁰ The covering mechanism was the same as the one established for the *bonos cobertura*.

²¹ Beginning in the second half of 2001 some of the provincial governments issued bonds that performed as money. When the rescue process started in May 2003, the total stock of *cuasi-monedas* had reached 7.5 billion pesos (2% of GDP).

²² The measure also affected public bonds (Bontes, Bocones, Bonos-Pagaré and Letes), bilateral loans, debt with commercial banks and other obligations that added up to about 15 billion dollars at that moment.

due to the inflation. The same thing happened with the new indexed bonds denominated in pesos that had been issued to manage the losses caused by the exit from the convertibility regime. By the end of 2003, the value of all these obligations rose about 7.3 billion dollars due to the indexation effects. In addition, capitalized past due interest on the defaulted debt added 13.9 billion dollars in new obligations.

In summary, considering the different measures and effects derived from the management of the convertibility collapse and the declaration of default, between December 2001 and December 2003 the gross public debt stock increased by about 28.2 billion dollars.²³

4.2. The Proposals for the Public Debt Swap

In the second half of 2003 the first official steps for the restructuring of the defaulted debt were taken. In September, after reaching an agreement with the IMF, the government took advantage of the annual meeting of the IMF and the World Bank in Dubai to make public the main guidelines and the agenda of their restructuring proposal.

The “Dubai proposal” established that Argentina would offer uniform treatment to every holder of its bonds issued up to December 2001,²⁴ while still fully servicing its multilateral debt and the guaranteed loans noted earlier.²⁵ The government thus recognized a defaulted stock of bonds of about 87 billion dollars. This amount left aside an important volume of past due interest. A 75% haircut was to be imposed on the bonds, according to which new bonds would be issued in a swap that would leave the equivalent of a maximum amount of bonds of about 21.8 billion dollars. Three bonds, called Par, Quasi-Par and Discount, were announced. Although the detailed characteristics of the instruments were not published at the time, their outlines were clear. The Par would preserve the nominal value of the original debt but would have longer maturity and a lower interest rate than the other two. The other two bonds would entail nominal haircuts. The haircut corresponding to the Discount bond would be higher than the haircut of the Quasi-Par. The new bonds would also incorporate mechanisms—which would be specified later on—to reward the bondholders with a coupon tied to the economic rate of growth. The sustainability of the proposal was said to be consistent with a target for the primary surplus that had been recently agreed upon with the IMF (2.4% of GDP for the central government and 3% for the consolidated

²³ This calculation also includes the effect of the conversion into dollars of the 2008 bond in pesos, issued in June 2001 with the *mega-canje* (477 million dollars). It should also be mentioned that the financial assets of the national government (assets against the financial system and provincial governments) increased by about 11.1 billion dollars between 2001 and 2003, mainly due to the reasons mentioned above.

²⁴ This set of obligations was named the “eligible debt”. It consisted of 158 instruments, issued in 7 different currencies (Argentinean peso, inflation-adjusted Argentinean peso, US dollar, euro, yen, pound sterling and Swiss franc) and 8 jurisdictions (Argentina, United States, Great Britain, Japan, Germany, Italy, Spain and Switzerland).

²⁵ A further set of defaulted obligations (bilateral debt, debt with commercial banks and other creditors) remained without restructuring guidelines. This set amounted to about 7.5 billion dollars in December 2003 (including capital and past-due interest). At the time of writing in October 2006, the resolution of this debt was still not decided.

public sector). The government announced that it expected to maintain that target in the long run.

The voices of the financial market expressed strong disapproval. It was said that Argentina was in a position to make a much better offer—from the creditor perspective—by targeting a higher primary surplus. The IMF exerted pressure on the government in many ways and repeatedly called for signs of “good-faith”.²⁶ In June 2004, a few months after the finance ministers of the Group of 7 manifested that Argentina should accelerate the restructuring process and issue “good faith” signals, the government made public a new proposal in Buenos Aires.

Although efforts were made to present the “Buenos Aires proposal” as a refined version of the Dubai proposal, it was in effect a second offer that aimed to get closer to the creditors’ positions. The eligible debt was the same as the one defined in Dubai, although it was now measured at 81.8 billion dollars.²⁷ In exchange for that defaulted debt stock, new bonds would be issued for a total of 38.5 billion dollars, in case the level of acceptance of the swap was lower than 70%, and for 41.8 billion dollars in case the level of acceptance was higher than the 70% benchmark. This offer involved a substantial improvement if compared to the 21.8 billion dollars to be issued according to the Dubai proposal. In spite of it, the government manifested that the 75% haircut on the debt’s nominal value presented in Dubai would be maintained, although the past due interest was now being recognized.²⁸ The announcement created confusion, since it was interpreted that the swap would consist of a new issuing of 38.5 or 42.3 billion dollars in bonds (according to the degree of acceptance) in exchange for an eligible debt that, including the accrued interest, amounted to 99.9 billion dollars or 103.2 billion dollars. As time passed, it was made clear that the swap would comprise only the capital of the defaulted bonds while the past due interests would not be recognized; i.e. liabilities amounting to 81.8 billion dollars would be exchanged for new bonds amounting to 38.5 or 41.8 billion dollars, depending on the level of acceptance.

²⁶ This is an important phrase in the IMF lexicon for cooperative debt crisis resolution, albeit one not well defined as yet (see Herman, this volume).

²⁷ In the Buenos Aires offer, some details were specified that were omitted in the Dubai proposal. It was clarified that the “eligible amount” was comprised of the value of the stock of bonds at December 31, 2001 plus accrued interest up to that date. The difference between the resulting amount and the 87 billion dollar debt announced in Dubai was mainly due to different exchange rates used to convert into dollars the debt in other currencies.

²⁸ In the lower acceptance scenario, past due interest would be recognized for the period until December 31, 2003 (about 18.1 billion dollars); in the higher acceptance case, past due interest would be included until June 30, 2004 (21.4 billion dollars).

Table 9. Characteristics of the restructuring bonds

		The News Bonds (in millions of US \$)			Total
		Discount	Par	Quasi-par	
Issuing of New Debt	Acceptance < 70%	20,170	10,000	8,330 (AR\$ 24,300)	38,500
	Acceptance > 70%	18,470	15,000	8,330 (AR\$ 24,300)	41,800
Haircut		66.3%	None	30.1%	
Currency		For existing securities in U\$\$, Euro and Yen: original currency, U\$\$ and Peso+ CER. For existing peso denominated debt: PESO+CER. For securities in other currencies: U\$\$, Euro and Peso +CER	For existing securities in U\$\$, Euro and Yen: original currency, U\$\$ and Peso+CER. For existing Peso denominated debt: Peso+CER. For securities in other currencies: U\$\$, Euro and Peso+CER	Peso+CER	
Governing Law		New York (Peso and U\$\$), UK (Euro), Japan (Yen) and Argentina (Peso and U\$\$)	New York (Peso and U\$\$), UK (Euro), Japan (Yen) and Argentina (Peso and U\$\$)	Argentina	
Maturity		30 years	35 years	42 years	
Grace Period		20 years	25 years	32 years	
Duration		25.25 years	30.25 years	37.25 years	
Amortization		Equal semi-annual payments during 10 last years (every 30 June and July 31)	Equal semi-annual payments during 10 last years (every 31 March and 30 September)	Equal semi-annual payments during 10 last years (every 30 June and 31 December)	
Interest rates in U\$\$ (accrual)		8.28% (fixed)	3.46% (avg)	5.96 (avg) (3.31% in AR\$)	
Interest payments		Years 1 to 5: 3.97% Years 6 to 10: 5.77% Years 11 to 30: 8.28%	Years 1 to 5: 1.33% Years 6 to 15: 2.50% Years 16 to 25: 3.75% Years 26 to 35: 5.25%	Years 1 to 10: 0% Years 11 to 42: 5.96% (3.31% in AR\$)	
Interest Capitalization		Years 1 to 5: 4.31% Years 6 to 10: 2.51% Years 11 to 30: -.-	No capitalization	Years 1 to 10: 5.96% (3.31% in AR\$) Years 11 to 42: -.-	
Date of interest payment		Twice a year (30 June and 31 December)	Twice a year (31 March and 30 September)	Twice a year (30 June and 31 June)	

Source: Authors' calculations based on data of the Ministry of Economy

The three instruments announced in Dubai were maintained in the Buenos Aires proposal: the Par, the Quasi-Par and the Discount (see table 9 for a detailed description of the bonds). It was established that the issuing date would be December 31, 2003 and that the bonds would accrue interest from then.³¹ The offer to include a coupon tied to GDP growth was also maintained. It was announced that the Par and Discount bonds could be issued in “CER-adjusted pesos,”³² US dollars, euros and yen. The Quasi-Par bond would be exclusively issued in CER-adjusted pesos.

The offer specified a Par bond issuance of 10 billion dollars if acceptance was not higher than 70% and of 15 billion dollars in the opposite case. This instrument would recognize the original nominal value of the defaulted bond, would have a 35-year maturity and would have fixed interest rates (in dollars) rising from 1.33% during the first 5 years to 5.25% in the last 10 years.

For the Discount bond, an issuance was announced of approximately 20.17 billion dollars in the low acceptance scenario and of about 19.87 billion dollars in the more optimistic one. The new bond would entail a 66.3% haircut on the original nominal debt value, would have a 30-year maturity and would yield an increasing fixed interest, part of which would be capitalized throughout the first 10 years.

The Quasi-Par bond was designed to take into account the local institutional holders’ needs—mainly the private pension funds—and involved a 30.1% haircut. The announced issuance amount was about 24.3 billion pesos (about 8.33 billion dollars) independent of the degree of acceptance. The instrument would have a 42-year maturity, yielding a fixed 3.31% interest rate in pesos, with capitalization of interest during the first 15 years.

The announcement made in June also specified the characteristics of the coupons tied to GDP growth (table 10 shows a detailed description of their characteristics). GDP-linked units would be issued in an amount equal to the amount of the bonds effectively swapped. The units could be separated from the bonds and quoted independently 6 months after the swap. Payments depended on the level of real GDP relative to a “base GDP,” which rises over time. The “base GDP” was defined as the GDP resulting from about a 3% average annual growth rate, using the GDP of 2004 as a starting point.³³ The units would then pay a return if real GDP was above the base level and also grew more than 3% in the previous year. Payment to all units together would then be set at 5% of the amount by which GDP exceeded the base level and this amount converted into foreign exchange would be distributed to unit holders in corresponding proportions.

³¹ This issuing date enabled interest payments immediately after the closing of the swap. This plan aimed at including a sweetener in the proposal as incentive for bondholders’ participation.

³² That is, pesos adjusted for inflation according to the consumer price index (Coeficiente de estabilización de referencia”)

³³ Specifically, the planned “base GDP” trajectory establishes an initial 4.3% growth rate in 2005, decreases to 3% in 2015 and remains at this pace until 2034.

Table 10. Characteristics of New GDP-linked Units

Reference Amount	GDP-linked units will be issued in respect of the principal amount of bonds tendered for exchange
Calculation currency	Peso
Payment currency	US\$, Euro, Yen , Peso
Maturity	30 years
Calculation date	Annually on November 1, commencing in 2006
Maturity date	Annually on December 15, commencing in 2006
Payment Amount	5% of excess GDP divided by the average free market exchange rate of Pesos per US\$, Euro or Yen during the 15 days preceding the payment date.
Payment trigger	Actual GDP (expressed in constant Pesos) as of the reference date exceeds the base case GDP, and the annual growth rate exceeds 3%
Maximum Payment Amount	The GDP-linked securities no longer be entitled to any payments if the total amount paid, during its life, per unit of GDP-linked Security exceeds 0.48. This amount will be referred to as the "payment cap for GDP-linked Securities."
Base case GDP	Projected real GDP from December 31, 2004, at an approximate annual growth rate of 3%.

Source: Authors' calculations based on data of the Ministry of Economy.

In comparison to the Dubai proposal, the Buenos Aires proposal involved a tighter path of fiscal policy in the future. Instead of the 2.4% of GDP target in Dubai, the government announced that in order to ensure the offer's financial consistency, it was committed to maintaining a primary surplus target of 2.7% of GDP during the first 5 years—when the service of the debt issued post default was concentrated—and then stabilize the primary surplus at around 2.3% of GDP from 2014 on. With this program and a 3.3% annual average economic growth assumption, the projections indicated that the fiscal effort would finance the interest payments. However, it left aside a relevant proportion of the capital maturities, for which funding sources had to be obtained. If the multilateral organizations agreed to the refinancing of their debt amortizations, the government would still have to obtain annual funding for about 2% of GDP to face other principal payments coming due during the first 10 years after the swap.³⁴

The evidence that Argentina would continue supporting a heavy debt burden after the swap did not ease the creditors' demands. Immediately after the announcement in June, the bondholders' organizations rejected the proposal, claiming that the country should pay more than what was offered. The financial analyses showed that the new offer, including the coupons tied to GDP growth, was between 20 and 27 cents on the dollar. This signified a haircut of about 73% to 80%, which was considered unacceptable by the market participants. The calculation of the haircut compared the nominal value of the defaulted debt with the present value of the new

³⁴ The financial program would be even more demanding if principal repayments to the multilateral institutions had to be made instead of rolled over. In that case the government should get an average funding of 4% of GDP per year during the same period.

bonds and thus the discount rate used in these latter calculations was crucial to the result. Most of the analysts considered it reasonable at the time to use the yield on assets of similar-risk emerging market countries, which at that moment was around 12-14%.³⁵

By late 2004, however, the international capital markets evolution unexpectedly started to play in favor of the Argentinean offer. Growing world liquidity stimulated the appetite for risk, which turned into an increasing demand for emerging market debt and a reduction of the developing countries' risk premium.³⁶ In this new context, the swap looked more attractive. The present value of the offered bonds calculated with the lower discount rate was between 30 and 35 cents per dollar. This present value represented a 65-70% haircut and was similar to the market price of the defaulted bonds.³⁷

The improvement in the financial environment did not stop the pressures for a better offer; but it did pave the way for the government to finally launch the swap, practically without introducing any change to the proposal announced in June 2004. To put pressure on the bondholders, the government mentioned that it would be satisfied with a 50% level of acceptance and warned the bondholders that they would make another offer.³⁸

The swap started on January 14, 2005. As economics minister Lavagna said, "The moment has come for the markets to talk." Six weeks later, the restructuring operation was closed. On May 3, 2005, the government announced that acceptance of its offer had reached 76.15% of the debt in default. This meant that 62.3 billion dollars of the old bonds would be exchanged for about 35.3 billion dollars of new instruments plus the corresponding GDP growth-linked coupons. The maximum amount of the issuing would be 15 billion dollars in the case of the Par bonds, 8.33 billion dollars in the case of the Quasi-Par bonds and about 11.9 billion dollars in the case of the Discount bonds.

³⁵ Brazil's debt was commonly used as a benchmark. Its yield then oscillated around 12%. The debt of Ecuador, a country that had recently restructured its external liabilities, yielded a rate close to 14%. High yields were a consequence of the unfavorable funding conditions that the developing countries faced at that time. The JP Morgan EMBI+ index, which measures a weighted average of emerging market risk, showed an average value of 502 basis points in May-June. In the same period Brazil's country risk-premium averaged 691 basis points.

³⁶ The EMBI+ index decreased to an average of 375 basis points in the last quarter of the year, whereas the Brazilian country risk-premium fell to 417 basis points. The yield of Brazilian debt was about 9-10% and the yield of Ecuador's bonds was about 11-12%.

³⁷ Some financial analysts even opined that lower discount rates should be used, since after the restructuring, the Argentinean debt would turn out to be less risky than the debts of many of the countries used as benchmarks for the calculation.

³⁸ Moreover, aiming at relieving itself from the creditors' pressures, the government relinquished its ability to change the offer in the proposal, by sending a bill to the Congress—quickly approved—that took away the administration's negotiating prerogative. The Congress would have to approve any further modification.

The government expressed satisfaction at the swap's outcome. The operation signified the reduction in the public debt stock by about 67.3 billion dollars³⁹ and attenuated the public finances' exposure to the exchange risk, since around 44% of the new bonds are denominated in local currency.

³⁹ According to the figures announced by Minister Lavagna, at the end of 2004 the debt amounted to 191.2 billion dollars. With the achieved haircut the new debt stock would amount to 123.9 billion dollars. The public debt/GDP ratio would have passed from 113% to 72%.

5. ARGENTINA, THE IMF AND THE INTERNATIONAL FINANCIAL SYSTEM

5.1. Between the Crisis and the Swap

As we mentioned at the beginning of the chapter, it is at first sight striking that the crisis and the massive default took place in a country that for a long time was considered a successful example of the Washington Consensus. Almost until the end of the nineties, the IMF and most of the financial market analysts considered the Argentinean experience as one of the success stories of macroeconomic policy and structural reforms in the financial globalization context.

The default in Argentina took place one year after the IMF gave considerable additional financial support to sustain the convertibility program through its deepening crisis. That rescue package, approved by the IMF Executive Board on January 12, 2001, was the last one approved by the IMF during the period of the Democratic administration in the United States, as a new Republican administration took office on January 20, 2001. In time, it made known it did not favor the policies that the Fund had been following in general and in Argentina in particular. Nevertheless, in August 2001, four months before the default, the US went along with IMF further expanding its arrangement with Argentina by 8 billion dollars. At that moment the crisis was reaching a peak. Devaluation and default were openly discussed (particularly in financial and academic settings in the United States) and there was a widespread opinion that the debt and the convertibility regime were not sustainable.

The 2000-2001 IMF program openly showed weak flanks, and was susceptible to criticism from its very conception. It did not involve any substantial change in the current macroeconomic policy (other than the unrealizable promises on fiscal policy noted earlier). In particular, the exchange rate regime was preserved. Far from facing the undeniable complexity and the difficulties that a change in currency regime would have required, the Argentine authorities were completely unwilling to modify it. Furthermore, from the IMF's perspective, the preservation of the regime was consistent with the systematic support of the exchange rate regime that the organization had provided throughout the nineties. The Argentinean currency board was usually mentioned as an example of a feasible "corner solution" for exchange rate policy in an emerging market country (Fischer, 2001).

As noted earlier, the Argentine policy program aimed at recovering confidence through a commitment to fiscal austerity measures. However, implementation of those measures was unlikely and their effects were doubtful. In the middle of the crisis, the recession and the liquidity crunch made fiscal account deterioration, to a great extent, endogenous. It was implausible that issuing signals of intent to increase fiscal austerity would be sufficient to stop the critical trends. In brief, in the moment when this program was approved and even more so in

August 2001—when the program was extended—there was good reason to think that the multilateral resources would end up funding payments to the private creditors and capital flight, without stopping the crisis or preventing default. And that is exactly what happened. Certainly, the IMF rescue packages endorsed policies that were already the focus of critics.

After certain changes in the senior management of the IMF that followed the start of the Republican administration in the United States, in particular, the appointment of a new First Deputy Managing Director, Anne Krueger, the relationship of the IMF to Argentina began to be used as a significant example of the problems that the new US administration had with the previous Fund approach. The issue was important enough to get approval for a special investigation by the Fund's Independent Evaluation Office (IEO, 2004).

The relationship between the IMF and Argentina did change after the devaluation and default, unfortunately, in that the IMF's support was absent precisely when it would have been more helpful, namely, in the period after the devaluation, when efforts to stabilize the economy were at the center of economic policy. Although the criticisms of the Fund's support of the convertibility regime by its new American managers were justified, this did not provide reason for not supporting the post-devaluation stabilization efforts. On the contrary, the self-criticism of the IMF carried an implicit acknowledgement that it shared responsibility for the crisis. Therefore, the organization should have been even more committed to the stabilization attempts.

With new authorities in both the institution and the country, a cooperative attitude by the organization might have been expected. Yet, the institution's orientation was precisely the opposite. The mentioning of “the mistakes that we made in Argentina in the past” helped to justify an extremely reticent attitude to engage further. The financial offers in the Fund negotiations in 2002 and 2003 centered on only one matter: dealing with Argentinean repayments falling due to the IMF.⁴⁰

The role the IMF played in the stabilization and recovery of the economy in crisis was actually very negative. We have already mentioned earlier, for example, that in February 2002, in a context of high political fragility, the IMF staff exerted pressures for the modification of the exchange rate policy adopted by the country after the exit from the convertibility regime. Argentina had adopted a fixed exchange rate system with controls on the purchases of international currency, explicitly as a transitory measure, intended to stabilize the nominal exchange rate while domestic prices absorbed the impact of the devaluation. A flexible exchange rate would be established later. However, the IMF demanded the immediate pure floating of the exchange rate, threatening to forgo negotiations with Argentina while the exchange controls

⁴⁰ More precisely, IMF agreed to extend Argentine repayment obligations in January, July, September and November 2002, and then adopted a “transitional stand-by credit” in January 2003 that lent new funds to make the payments falling due through August 2003. This was succeeded by a three year agreement in September, with the same type of financial provisions, albeit with certain policy conditions that will be discussed in the text below,

were in place. As described in a previous section, the measure demanded by the IMF was adopted. It was followed by an abrupt rise in the price of the dollar, as was clearly expected, and a fast acceleration of inflation. The country got nothing in exchange for that “prior action” (in IMF-speak, a measure taken unilaterally by a country before obtaining an IMF-funded program).

Soon after this, the recently designated economics minister, Roberto Lavagna, introduced a new stabilization program aiming at stabilizing the exchange rate. It preserved the float but added interventions in the exchange market, and reinforced some exchange controls. This policy also faced the opposition of the IMF, though this time the demands of the institution to change the policy were not satisfied. The interventions and the control measures that were adopted, in spite of the opposition of the Fund’s staff, turned out to be crucial for the exchange rate and the inflation stabilization.

Another example of the negative role of the IMF is the orientation that it tried to impose on the management of the banking crisis. When Minister Lavagna took over, the government looked for a gradual exit from the crisis, favoring the generation of voluntary options for the savers and avoiding new shocks to the system. In contrast to this orientation, the IMF staff promoted heroic “solutions” with uncertain outcomes (banks liquidations, the restructuring of the public banks, etc.). This issue led to an open conflict between the government and the Fund’s staff that resulted in the creation of an international arbitrating commission that disappeared as quickly as it had been created, apparently without much effect.⁴¹

The government did not satisfy the main demands of the IMF regarding the management of the banking crisis. It persisted in its orientation, which ended up showing success when the exchange market stabilized and an incipient recovery of the economic activity helped to stabilize the savers’ behavior. The crisis could be managed without other disruptions in a context of gradual growth in bank deposits.

These two examples indicate that the Fund’s staff operated at that time with the diagnosis that the exchange market could not be stabilized, that a hyperinflationary process was unavoidable and that it would be impossible to reestablish some degree of financial intermediation in domestic currency in the near future. The staff publicly acknowledged their diagnostic mistake later on. It is clear that had the economic policy followed the orientation that the IMF wanted, the evolution of the economy would have been more in line with what the IMF expected. The implementation of the measures promoted by the IMF would have transformed its implicit diagnosis into a self-fulfilling prophecy.

⁴¹ It comprised three former presidents of central banks in Europe and Canada and the head of the Bank for International Settlements. They were announced on July 10, 2002, visited Buenos Aires between July 21 and 24, talked to a number of important people and wrote a report, which they submitted to the Managing Director of IMF on July 29 (see IMF, 2002). They were never heard from again.

In the event, however, in the second semester of 2002 the exchange market and domestic prices stabilized, and the data on the activity level and external sector performance started to show positive outcomes. Nevertheless, the IMF sustained its negative view of Argentina. The staff did not waste any occasion to make public its disbelief regarding the sustainability of the stabilization and the recovery of the activity and employment levels. In that regard, the public comment by Deputy Manager Director Krueger was quite memorable, as she indicated that the recovery showed by the data was only “the bounce of a dead cat”. It wasn’t until May 2003 that she publicly confessed to having failed in her diagnosis and manifested having been surprised by the quick economic recovery and by the fact that there was no hyperinflation.

The agreements between Argentina and the IMF in 2002 and 2003, which as noted above financially addressed only Argentina’s maturing repayment obligations, were signed in that context of a great animosity of Fund staff towards the leadership of the Argentine government. They were all short-term arrangements until in September 2003 a three-year agreement was subscribed, albeit again only intended to refinance the amortization of Argentina’s debt with the institution.

The refunding mechanism in the September agreement, as had been the case with a temporary arrangement in January, consisted in creating new loans for the equivalent amount of the principal repayments falling due, except now for a “medium-term” period. This “fresh funding” was subjected to the usual conditionality in IMF arrangements. However, while policy targets were established for the first year, the terms for the following two years were left to be defined in future negotiations. The most important of the committed targets was the consolidated primary fiscal surplus, which was set at 3% of GDP for the first year. The government resisted the pressure to commit to increasing targets for the following years. Other important targets included in the agreement were the redefinition of concession contracts of public service providers and the establishment of new regulations on the public utilities that had been privatized in the nineties, the establishment of new measures to reinforce the financial system, and adoption of a law on the sharing of fiscal revenues between the national and provincial governments. The conditionality also included a clause under which the country committed to act in “good faith” in the treatment of its defaulted external creditors. The ambiguity of the term left the IMF a great margin of discretion in the evaluation of the implementation of this clause.

One year later Argentina had comfortably fulfilled its quantitative fiscal and monetary targets, but not the qualitative conditions. Probably, the most significant target not fulfilled was the finalization of the renegotiation of the contracts and the establishment of a new regulatory framework for the privatized public utilities. Moreover, in June 2004 at the moment that the IMF sent a mission to Buenos Aires for the periodic evaluation of the degree of fulfillment of the conditionality clauses in its agreement, the country was presenting its “Buenos Aires” debt restructuring proposal and organizing the swap. The proposal was controversial, but it was still in

play. The relationship between Argentina and the Fund then reached an impasse, on which we comment next.

The IMF could have terminated the agreement, justifying the decision by the non-fulfillment of the qualitative targets or by resolving that Argentina did not negotiate in good faith with the creditors. That would have signified a serious negative shock for a country in the middle of the debt restructuring process. Nevertheless, in those circumstances, the IMF would have also placed itself in a difficult position. Argentina still was one of the big debtors of the institution and there was a chance that the country would stop giving seniority to the multilateral debt and suspend payments. This would have generated a complex international problem. Furthermore, the interpretation that the IMF was interfering in the country's negotiation with the bondholders would have been unavoidable, in contradiction of the doctrine that says these matters should be solved by the parties involved directly, without the IMF's intervention—this argument was particularly emphasized by the United States government, which was increasingly supporting Argentina against the Fund (see below).

The impasse was overcome by suspending the program, which Argentina requested until 2005. Since the suspension meant cancelling the new loans used to pay maturing obligations, Argentina paid to the Fund all the interest and principal that could not technically be postponed. However, they requested and obtained postponement of the payments that did have this possibility. Moreover, some minor repayments were made that could have been postponed. The Argentinean government did so to avoid the board's discussion of the Argentinean case before the debt swap was finished. In the period 2002-2004 the country made net principal repayments to the IMF of more than 2.1 billion dollars, together with another 1.9 billion dollars in interest.

5.2. The United States Position

Argentina's debt restructuring took place in the context of a conflictive relationship with the IMF. The most unusual feature is that the design and management of the debt restructuring were developed without the intervention of the IMF. The importance of this novelty is highlighted both by the record dimension of the restructured debt and the unprecedented haircut—one of the highest in the history of debt restructuring in the recent globalization period.

The position adopted by the United States government was a crucial element in the process. On the one hand, as noted earlier, a new Republican administration brought a tough policy advocate into the Fund in the person of Anne Krueger, who spearheaded the Fund's approach to Argentina. On the other hand, through its public manifestations and its influence in the IMF, the White House also opened space for the development of the Argentinean strategy. This political attitude had its foundation in the orientation of the American government with respect to the international financial system.

The American administration expressed the view that crises and defaults result from excessive debts, in turn resulting from the irresponsible behavior of both the country and its lenders. This irresponsible behavior was encouraged in the past by the implicit guarantee given by the IMF's rescue packages. We have already mentioned that the relationship between Argentina and the IMF, before the default, was a prominent example of what the new American administration criticized.

The Argentinean government used this vision of irresponsible behavior of previous governments in its argumentation for relief and also mentioned the shared responsibility of the lenders. It requested no intervention of the IMF, basing this last demand on the fact that the restructuring proposal did not involve additional multilateral funding. In addition, the long-term financial program on which the proposal was based did not assume additional multilateral funding in the future. The magnitude of the haircut in part derived from this characteristic.

The United States government did not have trouble with this argument, seeing Argentina as an exceptional case. The proposed high haircut could be seen as proportional to the irresponsibility shown by the market. In this special case, the penalty would not be excessive. Rather, the penalty could be seen as exemplary, as appropriately tough for a case that became an example of irresponsible behavior by the country, its lenders and even the IMF.

For the above-mentioned reasons, the Argentinean strategy did not conflict with the rhetoric of the United States government. On the contrary, throughout its different stages from 2001 on, the country has played an exemplary role for the US administration's new orientation towards a less centralized international financial system. It illustrated both the flaws of a system with a strong IMF and the viability of alternative ways to solve problems. The United States opened space for the implementation of the Argentinean restructuring strategy because the case could provide support to the idea that countries and markets can operate well without the coordination and funds of the multilateral organizations. The high level of acceptance of the swap reinforces that idea.

5.3. Argentina and the IMF after the Successful Swap

In June 2005, after the debt swap, Argentina sought to resume negotiations with the IMF, armed with the asset of a high proportion of acceptance of the swap, which legitimized the operation. In addition, the new bonds were performing well in the financial markets. Indeed, after the swap an important number of bondholders saw the value that a cooperative attitude of the IMF would have in improving the new bonds' market valuation.

However, negotiations with the IMF were not fruitful. The IMF was a prisoner of its institutional logic. In this logic, the principal concern was still the recovery of the country's debt to IMF or its

refinancing, which would again involve the approval of new stand-by arrangements containing conditionality as a quid pro quo for refinancing loans. Actually, the purpose of IMF loans should have been to support a national fiscal program based on autonomous strategic decisions of the Argentinean government, in which the IMF was not a party. Following the latter approach would have been an important innovation, but it was not to be.

There were difficult negotiations that the country and the IMF maintained throughout the rest of 2005, but they did not lead to a new agreement. The government resolved to keep paying all the interest and principal repayments that could not technically be postponed during that year. At the end of the year, it finally adopted the decision to repay all its obligations to IMF, which it did at the beginning of 2006.

If the Argentine experience posed one challenge to the future role of IMF in resolving debt crises, the failure of the proposed Sovereign Debt Restructuring Mechanism (SDRM), at about the same time as the Argentine case, posed another. From the beginning of the eighties, the IMF had actively participated in the restructurings of sovereign debts with the private sector, commercial banks at that time (see Garay, this volume). This process did not seem directly applicable once bond financing replaced most bank financing in the 1990s. The SDRM initiative seems to have been an attempt to specify, formalize and strengthen the function of the IMF in managing debt crises. However, Wall Street and the United States government rejected the SDRM initiative, and thus the role of the institution in cases of sovereign debt default remained undefined. The US government rejection of the SDRM not only frustrated the IMF initiative, but also ended up questioning the very participation of the IMF (and the multilateral development banks) in the restructuring of debts owed to the private sector.

Nowadays, the functions of the IMF in the international financial system are probably more undefined than ever before. The institution lacks a precise orientation. No new function replaced the role of “financial globalization central bank” to which its performance got close in the nineties when bailouts were in favor. On the other hand, as we have already mentioned, the burial of the SDRM initiative was a hard negative shock to the aspiration of a new role for the institution, and nothing came in replacement.

From the point of view of its objectives as a multilateral financial institution, there is no doubt that the IMF should have given positive answers to Argentina’s request for assistance in 2001 and after and contributed to its normalization. However, from the point of view of the institution as a bureaucratic organization with its own interests, the final agreement with Argentina on paying back all its obligations at once in 2006 implied the formal acknowledgement of a much less important role than the one played in the past.

In the past, the developed country governments—with the particular influence of the United States—redefined the functions of the IMF at a time of global change, while trying to deal with immediate and specific problems. That happened, for example, in 1982, when a new function for the IMF arose in supporting the renegotiations of external commercial bank debt after the Mexican case erupted. Something similar happened in 1995, also after a Mexican crisis, when the policy for designing rescue packages for dealing with capital account crises was instituted.

Under the light of the aforementioned tradition, the Argentinean case may be indicating the start of another lasting redefinition of the functions of the IMF in the international financial system.

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