Argentina After the IMF

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I was in Argentina last week when the latest IMF package was announced. Never before have I heard an entire nation breathe a collective sight of relief. The local stock market, the Merval, jumped by eight per cent on the announcement, as jubilant traders shed their pessimism. The streets were bustling that evening and the tango palaces were packed with dancers.

But by the next morning the familiar mood of melancholy resignation had returned. The realization had dawned that the IMF package offered no magic formula for getting growth going again. And without growth, it is hard to see how political support for paying the foreign debt can be sustained.

Some simple arithmetic makes this point. Argentina's external debt is a bit more than 30 per cent of GDP, well below the Maastricht Treaty's definition of what is sustainable. But the Maastricht definition assumes that the economy will grow, typically by 2 or 3 per cent a year, and that the real interest rate -- the market interest rate minus inflation -- will not much exceed the rate of economic growth. Neither assumption is valid in Argentina. The economy has not grown for three years. And interest rates are still in the 15 to 20 per cent range despite the fact that inflation is nonexistent. When interest rates are so much higher than growth rates, even a relatively modest debt burden can rise explosively. The consequent specter of future debt-servicing difficulties keeps interest rates high, which in turn creates the danger of a self-fulfilling prophesy.

President de la Rua and his economy minister Domingo Cavallo have sought to break out of this bind by cutting public spending. In a remarkable feat of political gymnastics, they have gotten a fractured Congress to agree to a zero-deficit law. This requires the budget to be balanced every month. It prohibits current spending, inclusive of debt-service payments, from exceeding current revenues. The government promises that other forms of spending -- on civil servants' salaries and public pensions, for example -- will adjust to ensure the availability of the revenues needed to service the debt. Hence, there should be no question about the country's ability to keep current on its financial obligations. Uncertainty about the government's intentions having been removed, interest rates should come down. And as interest rates fall, consumption and investment will recover. If all goes well, growth will ultimately resume.

The new IMF package is a bet that this gamble can work. By replenishing the government's coffers and thus giving it the resources needed to provide additional liquidity to the country's cash-strapped banks, it gives the current strategy a few more months to work. The main condition attached to the new IMF money is that the zero-deficit rule be extended to the provinces. The provinces receive pro rata shares of federal revenues. Traditionally, the authorities agree on a revenue forecast and on transfers proportional to those notional revenues. Argentina' new program with the IMF requires it to base these revenue-sharing transfers on actual revenues, not on forecast revenues. It thus closes the one remaining loophole in the zero-deficit rule.

But the problem with the government's strategy, which the IMF program does nothing to solve, is that the current government cannot commit future governments, nor can it commit the electorate. Unemployment is already 17 per cent. Pensions and civil-service salaries have already been cut by 13 per cent. Every day sees demonstrations by another aggrieved group.

When I was in Buenos Aires, it was the university teachers and the employees of the national television network who were marching in the streets. On other days it is other groups, all of whom express their opposition to current policies and demand a shift to some unspecified alternative. It is not hard to imagine a generalized political backlash which either brings down the government or forces it to abandon its policies of austerity. Either way, the budget deficit will return, and along with it fears about the sustainability of the debt. The next round of Congressional elections is in October, to be followed shortly by a national plebiscite on government's economic policies. Against this background, it is easy to see why interest rates have not come down and, consequently, why there is no sign of growth on the horizon.

Moreover, the zero-deficit rule only makes the problem worse. Cutting public spending puts more deflationary pressure on the economy. Tax revenues fall as the economy contracts, requiring yet more cuts in public spending. But those further spending cuts cause the economy to contract yet further, in a vicious spiral. And each successive cut in public-sector salaries and pensions fans political opposition to the government's policies of austerity. By extending the zero deficit rule to the provinces, the new IMF program tightens this noose.

Is there an alternative for which the Argentine government, the IMF, and the United States Treasury might have opted? The alternative advocated by some economists in both Buenos Aires and Washington, D.C. is the so-called "Quadruple D": devaluation, dollarization, deposit write-down, and debt restructuring. A one-time devaluation of, say, 20 per cent would enhance the competitiveness of Argentine goods at a stroke. The problem with devaluation is that it would also rekindle fears of inflation and therefore push interest rates up rather than bringing them down. Thus, following devaluation with dollarization -- unilaterally replacing the devalued peso with the U.S. dollar -- would eliminate all prospect of future monetary excesses and contain the shock to confidence.

To prevent the Argentine banking system from being destabilized, it would be necessary to write down dollar deposits in the banks to 80 cents on the dollar, since devaluation will reduce the earnings on the banks' peso-denominated assets by 20 per cent. And since writing down the assets of Argentine residents by 20 per cent while continuing to pay foreigners 100 cents on the dollar is not a political equilibrium, it would be necessary to restructure the external debt as well. If this restructuring was done constructively -- by carrying out good-faith negotiations with the creditors -- the markets would probably settle for 65 cents on the dollar. The country having resolved the debt situation and having put this source of uncertainty behind it, interest rates would then come down. Domestic demand would recover, and growth would resume.

This radical approach should have appealed to the Argentine government on several grounds. It promised to enhance competitiveness overnight, something that no other policy could achieve. It promised to eliminate uncertainty on both the currency and debt fronts. Moreover, it should have appealed to the IMF. External debt restructuring would have required foreign investors to "take a hit," rather than again getting off scot free. This would have addressed the moral hazard problem, instead of encouraging more reckless lending by adding yet one more IMF bailout to the already over-long list.

Why then was the "Quadruple D" rejected? The Argentine government, the IMF and the U.S. government all backed away from it because of implementation difficulties and last-minute doubts. The Argentines insisted that devaluation would break the government's "convertibility contract" with the public -- that is, its promise to never again tinker with the currency which has been the hallmark of its economic policy strategy since 1991. Moreover, given the country's history of inflation, both the Argentine government and the IMF questioned whether devaluation would in fact enhance competitiveness; instead, it might simply feed through into higher prices. Even those within the IMF who favored devaluation realized that they possessed no lever with which to force the policy on a reluctant Argentine government, other than withholding financial support, which they were not yet ready to do.

This problem could have been solved by dollarization, but patriotic Argentines continue to oppose abandoning the peso for the dollar. And the Bush Administration could not make up its mind about whether or not to encourage Argentina to adopt the dollar. It did not offer the country the $1 billion it needs to defray the cost of obtaining the necessary greenbacks.

Moreover, restructuring the public debt would have damaged the banks and pension funds, which hold some of the government bonds in question. These are two of the only strong institutions in the country. And the government has no fiscal surplus to use to repair them. In addition, Argentine companies with assets abroad could become the object of bondholders' lawsuits. Whether this would in fact have happened is unclear. But if it did, attempts to attach these assets would have disrupted their international business, and Argentina's exports could have fallen by half.

For all these reasons, the "Quadruple D" approach implied too many risks for agreement on it to be reached in the short period of time available.

So what comes next? Perhaps Argentine growth will miraculously resume. This is what the authorities in both Buenos Aires and Washington are betting on. But there is no sign yet of light at the end of the tunnel, and the authorities will run out of room by October, at the latest.

The IMF has promised an additional $3 billion for use as collateral in a market-based debt exchange, in the hope that IMF-backed bonds can be issued at lower interest rates, which will in turn reduce the interest charges paid by the Argentine government and allow it to relax its other spending cuts. But $3 billion is a drop in the financial ocean; the government's debt is well over $100 billion. Unless the IMF and the U.S. Treasury have a strategy for turning this $3 billion into $30 billion, the debt-exchange idea is mere window dressing. And the Bush Administration, having been forced to back down once, is unlikely to allow the IMF to offer more money, much less to offer some itself.

The alternative to growth is more deflation. More spending cuts will lead to more unemployment. Unemployment will fan political discontent. And political discontent will presage the abandonment of the zero-deficit rule. As investors see the writing on the wall, they will abandon the country, whose financial difficulties will return with a vengeance.

What will the authorities do then? Clearly, the "Quadruple D" will be back on the table. It may be more feasible the next time around. The banks and pension funds will have had more time to prepare their balance sheets for the looming devaluation. Patriotic opposition to dollarization will have weakened, hopefully, in the face of reality. The Bush Administration may overcome its reluctance to see Argentina adopt the greenback. In this context, a comprehensive debt restructuring, done right, would eliminate the last remaining source of uncertainty, allowing Argentina to put its economic problems behind it and begin growing again.

Hard decisions are taken only when there is no alternative. The Bush Administration was dragged reluctantly into supporting the latest round of IMF assistance for Argentina, but it is clear that this time is the last. Unless growth resumes, which is unlikely, the outcome of the next crisis, in October, will be different. Devaluation, dollarization, and comprehensive debt and deposit restructuring will not be painless. They will not be an occasion for tangoing in the streets. But they will be necessary for Argentina to finally put the crisis behind it and get growth going again.

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