

Case memo 03



Argentina alone cannot be blamed for its default; The IMF is equally responsible. Summary: Argentina's Sovereign Debt Crisis was an amalgamation of many factors which lead to the flailing economy's eventual default. When delving into the causes of the debacle, we see that it was influenced by their own economic resolutions as well as the manipulation of bilateral and multilateral donor agencies. Simply implying that a group of economists are to blame would be far from the truth. Argentina's downfall was caused by flawed decisions made by the Finance Ministry, Govt mismanagement and an impractical IMF economic framework.

A Series of Unfortunate Events

Convertibility Plan:

In 1991, the Economics Minister Felipe Cavallo executed the Convertibility Plan for macroeconomic stability in the country. It involved the introduction of free-market reforms, trade liberalization, deregulation and privatization. The key component of this bill was pegging the Peso at par with the US Dollar. This convertibility criterion restricted the growth of money in the system to the level of hard-currency reserves.

Key economic indicators including inflation and GDP appeared to do well under this arrangement.

However, by the end of 1998, the economy started showing signs of lethargy, and excessive budgetary deficits coupled with low revenue generation hampered the economic cycle.

A Fragmented Political Base:

In 1999, Argentina's elected government was a combination of personnel from different parties. The elected govt., assuming fiscal mismanagement to be the root of all evil, implemented a number of policies which focused on

addressing fiscal deficits.

Policies such as tax increments, called Impuestazo, exacerbated the situation, with economic stats falling further, and the recession was kicking in full throttle.

Competitiveness Plan:

Cavallo returned, this time aiming to reduce costs by eliminating distortionary economic taxes. However, his attempts bore little fruit as IMF budgetary targets were still breached.

In the wake of the crisis, rating agencies started down-grading Argentina's public and private paper. This led to the worst bank run Argentina ever witnessed, in excess of \$5.5 billion.

Financial reforms were engaged, including initiating debt swaps, zero-deficit policies and a stand-by loan arrangement with the IMF. Capital flight escalated and Argentina risk premium ascended.

Economic pandemonium ensued, and January 3 2002 Argentina defaulted on its \$141 billion obligations, missing an interest payment of \$28 million, the largest sovereign default in history.

Probable Rationalization for the Debacle

Currency-Board-Like Arrangement:

This par-pegging to the US dollar meant that the country's monetary policy was dependant of that of the USA, abolishing their control of affect interest rates and inflation.

The country's currency became overvalued as the dollar strengthened relatively. However, since the two countries did not have the same trade portfolio, Argentina's trade suffered tremendously.

Fiscal Mismanagement:

<https://assignbuster.com/case-memo-03/>

In the initial years, Argentina had FDI inflows to manage its spending, but when that stopped, they chose to issue debt instead of limiting spending, as witnessed in Exhibit A.

Due to the Peso-Dollar pegs, Argentina was susceptible to external shocks in the form of trade liberalization and currency manipulations.

Structural deficits had become the norm. Tax collection was at a meager 20% to GDP, and no efforts were made to raise the revenue. Debt servicing eroded little revenue collection there was.

The IMF: Another Culprit

The IMF's motives are questionable in this case. Firstly, it had allowed Argentina to continue with its fixed-peg when it itself was a supporter of floating exchange rates.

The strict economic reforms required by the IMF also crippled Argentina's economy. An already declining economic cycle was forced to face a contractionary fiscal policy.

Continuous condoning for Argentina missing out on set targets laid down by the IMF also encouraged the economy to further take on debt, and disregard fiscal discipline.

Conclusion:

Argentina economics cannot be put at blame for this debacle. There were multiple culprits behind it.

Freely floating the Peso might decrease US-Denominated salaries but will boost exports, helping increase FX Reserves. This will stimulate more spending and kick-start the economic cycle.

The focus should be on re-structuring debt, avoiding more multilateral loan agreements, increasing productivity and the investment base, and

monitoring fiscal imbalances more prudently.

The Argentine Govt should realize that external influences will not be beneficial for their economy as they'll be unable to develop their own policies for fiscal and monetary management.

The IMF was a vital player in encouraging the Govt to take on more debt, which created higher debt-to-GDP ratios (Exhibit B). Reducing these levels will restore investor confidence in the system.

Argentina should focus on its own reforms, and create growth through sustainable expansionary policies including tax free zones, easy lending etc. This will attract much needed FDI inflows.

Instead of applying US based economic strategies, they need to discover their own trade niches and work towards boosting exports to earn valuable foreign exchange.

Exhibit A

EIU Country Data, August 2003(Data taken from Exhibit 1a)

Exhibit B

The Anatomy of Multiple Crisis, 2002(Data taken from Exhibit 11)