



Argentina's post-2001 economy and the 2014 default



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ABSTRACT

With two sovereign debt defaults within the last thirteen years, Argentina represents an interesting example of the causes and effects of defaults by sovereign states. Argentina has had a history of economic strife for the last one hundred years, largely due to political and economic instability. This paper discusses the economics of Argentina after the 2001 financial crisis that led to the default in 2014. The paper also explains the main legal aspects for the holdouts versus the Argentina trial over the *pari passu* controversy and discusses the different reactions to the trial and consequent default.

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1. Introduction

The 2014 Argentine default is the latest episode in an Argentine economic history that has been turbulent since at least the 1930s. Crises and defaults are ordinary occurrences for Argentina arguably because of its own mismanagement over economic policies. Cerro and Meloni (2013), for instance, examine evidence from crises in Argentina dating back to 1825. They find the major determinants of all the Argentine crises to be fiscal mismanagement, public expenditure expansions, considerable increases in the debt-to-GDP ratio, and declines in the growth of bank deposits. Argentina has defaulted on its debt obligations four times since 1980, including the 2014 default. The origins of the 2014 default can be tracked back to the 2001 crisis, the largest Argentine financial crisis in its history and the largest default in history. Different from previous defaults, the 2014 default occurred after Judge Thomas Griesa's ruling ordering that Argentina must pay its debt to bondholders who did not accept the debt swap offer after the 2001 crisis. The 2014 default has been widely discussed, and we think that it is subject to serious misinterpretations.

What are the economic and political events that led to Argentina's default in 2014, and why did Judge Griesa rule against Argentina? This is the topic of our paper. However, to have a proper understanding of the 2014 default, it is necessary to go back in time and understand the crisis and default of 2001 and the economic context after the 2001 crisis. It could be maintained that the 2014 default is only another episode of the 2001 crisis. The discus-

sion we offer about the Argentine economy and politics from the 1990s through 2014 serves not only as an informative section to the reader interested in the 2014 default but unacquainted with the Argentine economy but also as an explanation of why some bondholders refused to accept Argentina's bond swap offer and why the trial developed as it did.

We show two things in this paper. First, Argentina's problems are the result of its own policies and not the result of external factors. Admittedly, external factors do have an effect on the Argentina economy, but they are not the main driver of this troubled country. Absent negative external shocks, Argentina eventually would have fallen into both defaults. Second, we argue that Judge Griesa decided correctly and that, upon closer inspection of the contract of the defaulted bonds, the negative reactions to his ruling are ill founded. To do this, we divide the paper in three sections. In the first section, we study the domestic and external causes of the 2001 crisis and default. We argue that, given the hyperinflation of the late 1980s, Argentina had no choice but to resort to foreign debt to finance its deficits and that the currency board that operated between 1991 and 2001 was not the cause of the 2001 crisis. The problem was not a constrained central bank, but fiscal imbalances.

In the second section, we analyze the post-2001 economy, particularly under the Kirchner administration that took office in 2003. After the 2001 crisis, Argentina did not correct its structural deficit. In addition, Argentina leans toward anti-market policies. Consequently, most bondholders accepted a haircut that left only 30 cents on the dollar ("holdins"). However, some bondholders declined the offer (holdouts). At first glance, the post-2001 crisis recovery seems impressive. This recovery ends around the 2008 subprime crisis. We show that, again, the economic problems of Argentina are the result of self-imposed inefficient policies and not the result of

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external factors. By 2014, Argentina is already in a delicate economic situation. The economic situation by 2014 provides the context in which Judge Griesa's ruling became definitive. Economic data for Argentina have become increasingly lacking and unreliable. In this paper, we also offer data from alternative sources to provide a more reliable picture of the Argentine economy than official figures depict.

The third and final section explains Judge Griesa's ruling and answers criticisms and misconceptions concerning the 2014 default. Briefly, we argue that the 2014 event is not a technical default but instead a standard default. In contrast to [Stiglitz and Guzmán \(2014\)](#), we argue that Griesa's ruling cannot be considered unfair or impossible to comply with. Finally, we also clarify that Argentina's own *behavior* violated the *different legal interpretations* of the *pari passu* clause and that therefore the concerns about Judge Griesa's interpretation of this clause are unsubstantiated. In fact, Judge Griesa had little real choice in his ruling given the Lock Law, the absence of a *collective action clause* (CAC), and the presence of the *pari passu* clause.

2. The 2001 crisis and default

2.1. Domestic causes

When Carlos S. Menem took over the presidency in July 1989, Argentina was a closed economy with a yearly inflation of 3611%¹. The previous president, Raúl Alfonsín (1983–1989), used the Banco Central de la República Argentina (BCRA) to finance the Treasury's deficit up to the point of hyperinflation. Menem received the country's economy in a condition that gave him no choice but to perform institutional reforms. Menem's reforms were a matter of necessity, not of political conviction.

Three important reforms occurred during Menem's presidency. The first reform was the opening of the economy to international trade. This opening, however, should be understood in terms relative to Alfonsín's presidency. The new average tariff was 14%, a high rate compared with many other countries.

The second reform was the privatization of national companies that were running significant deficits. The proceeds from the privatization were used to finance the fiscal deficit and consequently changed the national companies' deficits into private firms' tax receipts. Two of the privatized industries included telecommunications and the state airline company.

The third reform was meant to restore confidence in the value of the Argentine peso (ARS) through a monetary reform. This occurred in the form of a currency board known as "convertibilidad" (convertibility), under the supervision of the Minister of Economy, Domingo F. Cavallo, which occurred in 2001. Under the currency board arrangement, the Argentine peso became *convertible* at a rate of one Argentine peso (ARS) for one U. S. dollar (USD).

It has been argued that the currency board helped cause the 2001 default. [Kulkarni and James \(2009\)](#) posit that the currency board arrangement restricted Argentina's exports due to the country's overvalued currency. Compared with their main trading partners such as Brazil, the ARS' much higher value than other Latin American countries' currencies made Argentine exports much more expensive. Therefore, importers reasonably chose to take their business elsewhere to buy cheaper goods and services. [Kulkarni and James \(2009\)](#) conclude that the decline in exports produced a shortage of reserves that helped lead to the default in 2001.

Table 1

Source: Instituto Nacional de Estadísticas y Censos (INDEC).

Year	Inflation rate (%)	Year	Inflation rate (%)
1986	82	1994	4
1987	175	1995	2
1988	388	1996	0
1989	4924	1997	0
1990	1344	1998	1
1991	84	1999	-2
1992	18	2000	-1
1993	7	2001	-2

A distinction must be made, however, between orthodox and heterodox currency boards. An orthodox currency board requires two distinctive conditions to hold. First, net reserves should be between 90% and 110% of the base currency. Second, the ratio of the change of monetary base (MB) to change in net reserves (NR) should equal 100% (*pass-through* equals one), $(\Delta MB / \Delta NR) = 100\%$. [Cachanosky and Ravier \(2015, pp. 400–401\)](#) and [Hanke \(2008\)](#) argue that Argentina's currency board violated these two conditions and, therefore, that it should be considered a heterodox currency board. In fact, Argentina's monetary base was rarely backed more than 90% by foreign reserves. Therefore, under this heterodox currency board arrangement, the BCRA continued to have some discretionary power over the money supply rather than completely giving up its monetary policy discretion to the actions of the U.S. Federal Reserve. [Hanke \(2002, pp. 210–211\)](#) maintains that Argentina suffered speculative attacks in the periods when the BCRA deviated more from the behavior of an orthodox currency board. Therefore, the cause for the financial crisis should not be blamed on the convertibility system but rather on the deliberate institutional irresponsibility of Argentina's policy administrators. However, the Argentine currency board continues to be recognized as having been successful in reducing inflation. [Table 1](#) shows the yearly inflation from 1986 to 2001, the last year of the currency board. It should also be noted, however, that the Mexican crisis of 1994, the Russian crisis of 1998, and the devaluation of the Brazilian *real* in 1999 also might have pushed inflation rates downward.

Other domestic policy causes of the crisis are shown by [Kaminsky, Mati, and Choueri \(2009\)](#), who demonstrate that inconsistent monetary and exchange rate policies helped to encourage speculative attacks on the peso and that various capital, interest rate, credit, price, and wage controls also greatly contributed to capital flight and to depreciation of the ARS. Furthermore, [Kaminsky et al. \(2009\)](#) specifically attribute the cause of the 2002 currency crisis (after the abandonment of the currency board arrangement) to Argentina's use in 2000 of contractionary monetary policy in a deep recession. However, [Kaminsky et al. \(2009\)](#) argue that capital inflows had already discontinued by 1998. Although all of the above-mentioned studies have merit, a default is a fiscal problem. To have a default, there must be debt. Without deficit, there is no debt. Menem did not solve the problem of structural deficit. Because the country was restricted by the currency board arrangement, Menem instead used privatization revenues and issuance of foreign debt to finance the fiscal deficit.

[Fig. 1](#) shows the fiscal deficit of Argentina between 1961 and 2013. The shaded area corresponds to the deficit at the national or federal level, and the black line is the consolidated deficit for the nation plus the provinces. The graph shows that Argentina has had a structural fiscal deficit for at least the last 50 years. Each dot marks a crisis, four of which are defaults that occurred after years of fiscal budget deterioration. Despite crises occurring at different levels of deficit, there is a common pattern of the government spending beyond its resources. To summarize, in the 1980s, Alfonsín used the BCRA to finance the deficit through excessive printing of money, and in the 1990s, Menem privatized public companies and issued

¹ The 12-month inflation rate in January 1989 was 387%. By December of the same year, it was 3732%. The peak occurred in March 1990, with a 12-month 20,263% inflation rate.

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