

Argentina's Crisis: The Costs and Consequences of Default to the International Financial Institutions

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Argentina missed an \$805 million payment to the World Bank last week, bringing it one step closer to default on a loan to that institution. At the same time, the failure to reach agreement with the IMF on a new loan agreement after 11 months of negotiation has raised questions about Argentina's access to foreign credit in the near future.

It is generally assumed that Argentina desperately needs foreign financing from the IMF and World Bank in order to recover. Furthermore, it is often said that the IMF stands ready to help Argentina with new loans, but is holding out to make sure that its conditions are met, so that such new credit will not be misspent and will actually contribute to economic recovery. All of these assumptions are more questionable than is widely believed.

Economic Recovery in Argentina: How Much Does It Depend on Financing from the International Financial Institutions?

Argentina's failure to make an \$805 million payment due to the World Bank last week is the latest round in a standoff between the government and the International Financial Institutions (IFIs). The government made a \$79 million interest payment on the loan as an indication of its willingness to continue payment, so as to argue that it is not defaulting to the World Bank. But Argentine officials insist that they cannot afford to dip into the countries' remaining \$9.8 billion of reserves in order to make this payment, and are looking for a rollover from the IMF of the approximately \$14 billion due to the Fund over the next year.

Argentina defaulted on \$95 billion of public debt last December, but did not technically default on debt to the IFI's. The IMF itself has postponed payments on some \$4.85 billion of debt that was due during the last year. It is generally assumed that a cut-off of credit from these institutions would be a severe blow to the Argentine economy. However, this may not be true, for several reasons.

First, Argentina has been cut off from this credit for more than a year, and there are signs that the economy -- which has been in recession for more than four years -- is beginning to recover on its own, without foreign financing.

Figure 1 shows quarterly real GDP numbers for 2002, seasonally adjusted. Although the figures for the third quarter are very preliminary, they show real (after-inflation growth) of 1.5 percent, or 3 percent at an annual rate. This is an encouraging sign, after four years of recession, especially after the first quarter GDP was down 16.3 percent from the previous year.

Similarly, the Ministry of the Economy's Monthly Industrial Estimator shows a 5 percent increase from April through September 2002. This index of industrial activity is still down more than 22 percent from its pre-recession, 1997 level.

Exports also grew by 29.3% during the first 5 months of the year, from \$1.8 billion in January to \$2.3 billion in May, although they have since leveled off (See Figure 3).

Of course these increases in economic activity have not been sustained enough to indicate that the economy is in recovery. Nonetheless they are encouraging signs, and there are further reasons to believe that the economy could recover in the absence of any loans from the IFI's.

First, the economy is running a large trade surplus (\$4.67 billion, or 21.8 percent of GDP), as well as a significant current account surplus (\$2.7 billion, or 12.5 percent of GDP).² This means that Argentina does not need financing from external sources.

This is important, because the IMF generally makes loans to countries that are running balance of payments deficits, so that they can adjust to a level of imports that is within their means. (Hence the origin of the term "structural adjustment.") After four years of recession and a steep decline in output, Argentina has already adjusted (at a great economic and social cost). Most of the adjustment took place through the shrinking of imports, which were down 60 percent from the previous year in the first quarter of 2002, and even more than that from their pre-recession levels. This is due to the collapse of aggregate demand.

However, the economy is poised for an export-led recovery, with exports now comprising about 42.8 percent of GDP (as opposed to 11.5 percent of GDP before the devaluation).³ This means that increasing exports could play a much bigger role than previously in the growth of the economy.

Inflation has also been brought under control, remarkably sooner than many people had anticipated. As can be seen in Figure 4, consumer prices rose by a scant 0.2 percent in October. This decline in inflation is quite remarkable, given the size of the devaluation of Argentina's currency. This means that the threat of hyperinflation, which just a few months ago was taken very seriously, is gone. The government can now pursue expansionary fiscal and monetary policy as needed to support an economic recovery, without fear of inflation spiraling out of control.

The International Financial Institutions and the Argentine Crisis

Although Argentina does not need loans from the IFI's to finance its balance of payments requirements, there are other ways in which these institutions can affect the country's prospects for economic recovery. The World Bank and IMF are "preferred creditors" --

² Source: Argentine Ministry of Economy and authors' calculations.

³ Ibid.

their special status obliges that they be paid even in the event of default to other private or public lenders. Official default to the Fund is rare, and has generally been confined to "pariah" or "failed" states (Afghanistan, Congo, Iraq, Liberia, Somalia, and Sudan).

A default by Argentina to the World Bank and/or the IMF would therefore be somewhat unprecedented. A big question would be whether the IFI's would try to make a "pariah state" out of Argentina for defaulting to them, or would succeed if they were to try. If they could do this, Argentina could be denied short-term export credits, which it does need to carry on normal trade. In fact, the failure of exports to grow since May (see Figure 3) despite the country's large devaluation, could be partly attributable to problems in obtaining export credits, and there is some evidence that exporters have been having such problems.⁴

While the IFI's may have the potential power to punish Argentina in this way for a default on their loans, it is not clear that it would be politically feasible to do so. The Argentine population has already suffered greatly over the last four years, with more than 21 percent official unemployment, and more than half the population falling below the official poverty level. On the same day that the government announced that it would miss a payment on the World Bank loan, the major newspapers all ran stories about four children who had died of malnutrition in the Tucuman province.⁵

In addition, many people see the IFI's as having at least joint responsibility for bringing about the depression in Argentina. There is considerable economic basis for this, even according to the Fund's own arguments. For example, the IMF has insisted that "fiscal policy is the root cause of the current crisis."⁶ If this were true, then the 1994 decision to privatize the country's Social Security system would be the primary cause of the crisis, since the central government's budget deficit in 2001 was almost entirely attributable to the lost revenue (plus accumulated interest costs) from privatization.⁷ The World Bank played a significant role in facilitating the privatization of Argentina's Social Security system.⁸

⁴ The head of the Argentine Chamber of Exports, Enrique Mantilla, has signaled a disruption in the terms by which normal credit relations function; Foreign Minister Carlos Ruckauf and other Argentine government officials have also highlighted the lack of export credit. (See "Agonizing week for the peso," by Lourdes Heredia, BBC, March 16, 2002, and "Brazilians Find Political Cost for Help From I.M.F.," by Larry Rohter, *The New York Times*, August 11, 2002).

The World Bank, in recognition of this drying up of export credit, has pledged money for trade financing in its promises of aid, but only once an IMF agreement comes through. (See "Argentina Gets \$100 Million World Bank Emergency Aid," by Mark Drajem, Bloomberg, March 8, 2002).

The Mexican government gave symbolic support to Argentina in July 2002, by providing \$1 million in revolving lines of credit for exports and imports. (See "Troubled South America trade bloc reaches auto deal," by Gilbert Le Gras, Reuters, July 4, 2002).

⁵ See "Tucumán: cuatro chicos muertos por desnutrición," *La Nacion*, November 14, 2002.

⁶ See IMF Press briefing, Buenos Aires, April 10, 2002 (at www.imf.org/external/np/tr/2002/tr020410.htm).

⁷ See "The Role of Social Security Privatization in Argentina's Economic Crisis," Dean Baker and Mark Weisbrot, Center for Economic and Policy Research, 2002.

⁸ *Ibid.*

Even ignoring fiscal policy, the IMF supported the currency convertibility system that is now widely acknowledged as having contributed greatly to the country's economic decline. Although the Fund has since argued that it was only supporting what the Argentine government wanted, it is clear from the last 11 months of failed negotiations that the IMF will not provide support for policies to which it has objections. Furthermore, the Fund's encouragement of fiscal tightening throughout the recession is also widely seen as worsening Argentina's economic crisis.

For these reasons, the IFI's may not find it politically feasible to inflict further economic isolation on Argentina in the event of a default to them. They also have reasons of their own to fear a default, which could cause more harm to them than to Argentina. Even though Standard and Poor's announced that the World Bank's bonds would not lose their AAA rating due to Argentina's partial default -- the Bank's fourth largest debtor country (after China, Indonesia, and Mexico) -- they expressed concern that another such default could prompt a review of the Bank's debt rating, "especially if it appeared that the preferred creditor treatment these institutions have historically enjoyed from their borrowing members could not be relied upon in the future."⁹ Most of the Bank's capital is raised through the sale of these bonds, and this would significantly increase the cost of this borrowing, as well as inflicting capital losses on the Bank's current bondholders. One of the world's largest pension funds, the \$290 billion TIAA-CREF, recently announced that it had sold its holdings of \$5 million of World Bank bonds for economic reasons, according to press reports.¹⁰ A full Argentine default could therefore have a significant impact on the World Bank's long-term financial health.

The IMF also has a significant share of its loan portfolio committed to Argentina. A default to the Fund would also focus public attention on their preferred creditor status, possibly leading to questions as to why the IFI's, in the event of a sovereign debt default such as Argentina's, should be paid before private creditors.

Aside from the question of what the consequences of default would be for Argentina and for the IFI's, the Argentine government must consider whether the conditions attached to an IMF agreement would cause harm to the economy, as has been the case with previous agreements -- either directly, or by exacerbating political unrest. The Fund has put forth various and changing requirements for a loan agreement, sometimes adding new ones after the government had agreed to previous demands.¹¹ Most recently negotiations have stalled over such conditions as increasing the rates charged by private utilities,¹² further fiscal tightening (including tax increases as well as more public spending cuts),

⁹ See "Ratings on Multilaterals Remain Unchanged in Aftermath of Argentina Default," John Chambers and Larry Hays, Standard & Poors, November 14, 2002.

¹⁰ "TIAA-CREF says it sold World Bank bonds for market, not moral reasons," Global Ethics Monitor, a service of AFX News, London and Agence France-Presse (AFP), November 06, 2002.

¹¹ During the course of 2002, the Fund has made demands that Argentina reduce its central government budget, cut provincial government deficits, and repeal bankruptcy and capital flight laws. See again "Argentina Since Default," Cibilis et. al., pp. 13-15.

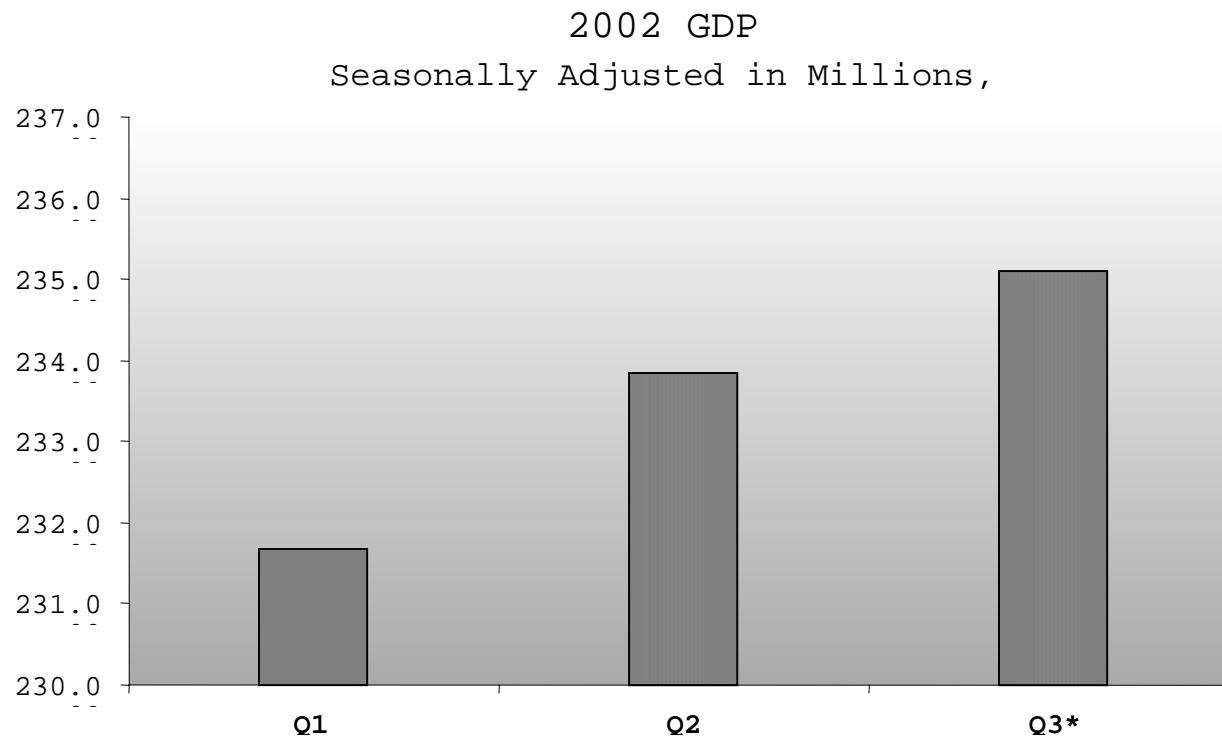
¹² Since these utilities are owned by private companies and their revenues do not directly impact either the government budget or the balance of payments, it is not clear why this is a matter that should concern the IMF. The Fund's jurisdiction over other decisions, such as internal bankruptcy procedures, is also questionable.

privatization and/or downsizing of the publicly owned banks, and foreclosure of hundreds of thousands of mortgages (with the IMF seeking to stop the government from preventing foreclosures).¹³ Any of these conditions, if implemented, could adversely affect the government's ability to support an economic recovery.

For all of these reasons, the government of Argentina has good cause to question whether it should reach an agreement with the IFI's, or dip into its reserves in order to pay the World Bank. The consequences of default may not be worse than the consequences of an agreement that has harmful conditions attached. This is especially true if, as seems presently to be the case, a new agreement with the IMF brings no net new resources, but only serves to pay off existing loans to the IFI's.

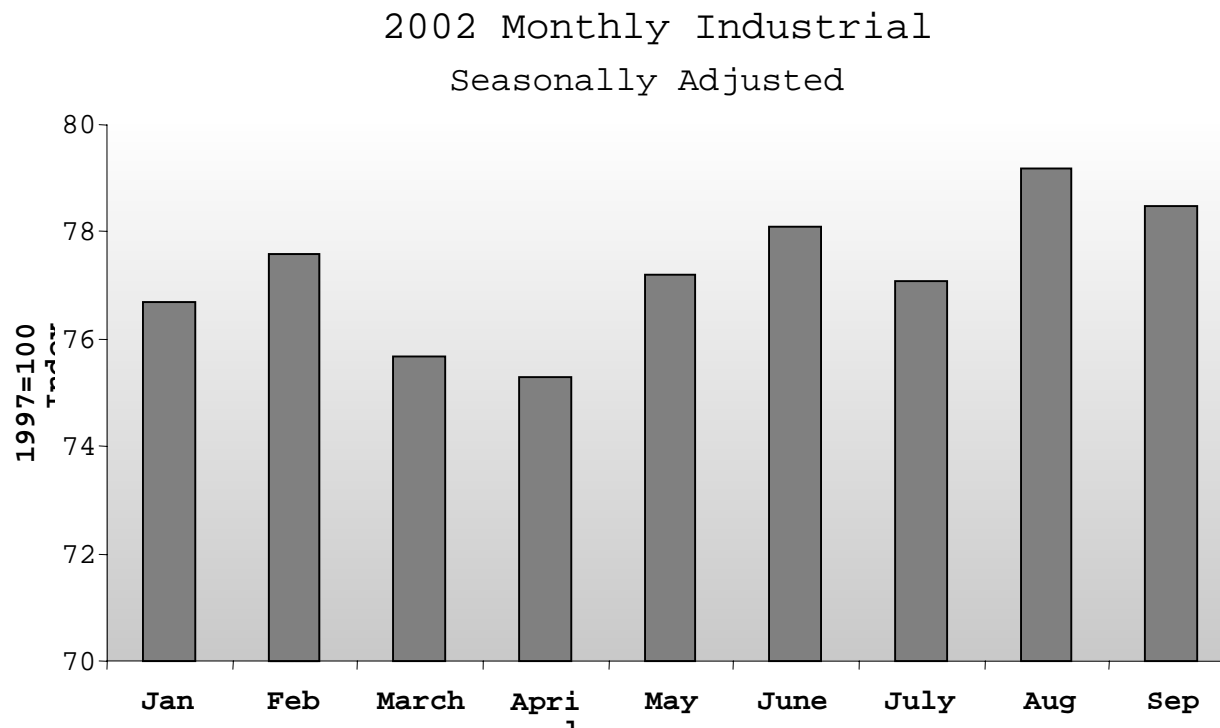
¹³ On November 18th, the President, 20 governors (out of 24), and key members of congress signed a 12 point agreement agreeing to most of the IMF's demands. According to press reports, it is widely believed in government circles that if there is no agreement now it is clearly due the IMF's unwillingness to sign an accord.

Figure 1



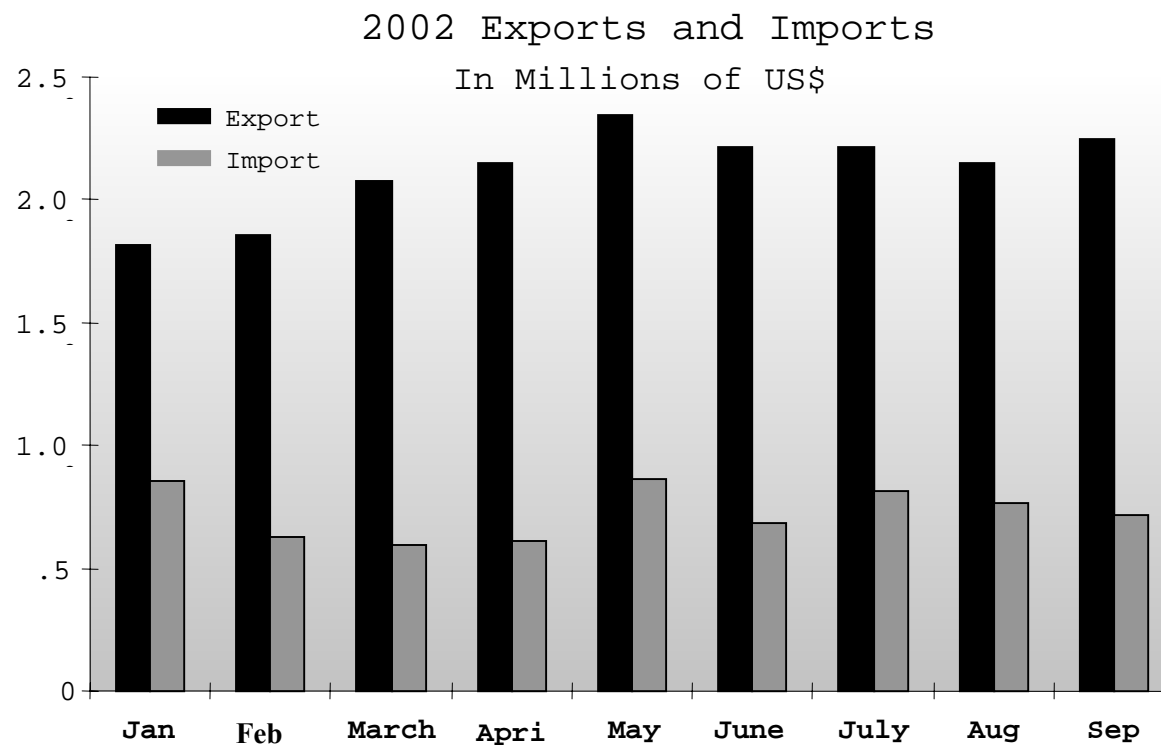
*Preliminary numbers
Real GDP growth Q1-Q3: 1.5 percent (3 percent at annual rate)
Source: Ministry of Economy, Argentina

Figure 2



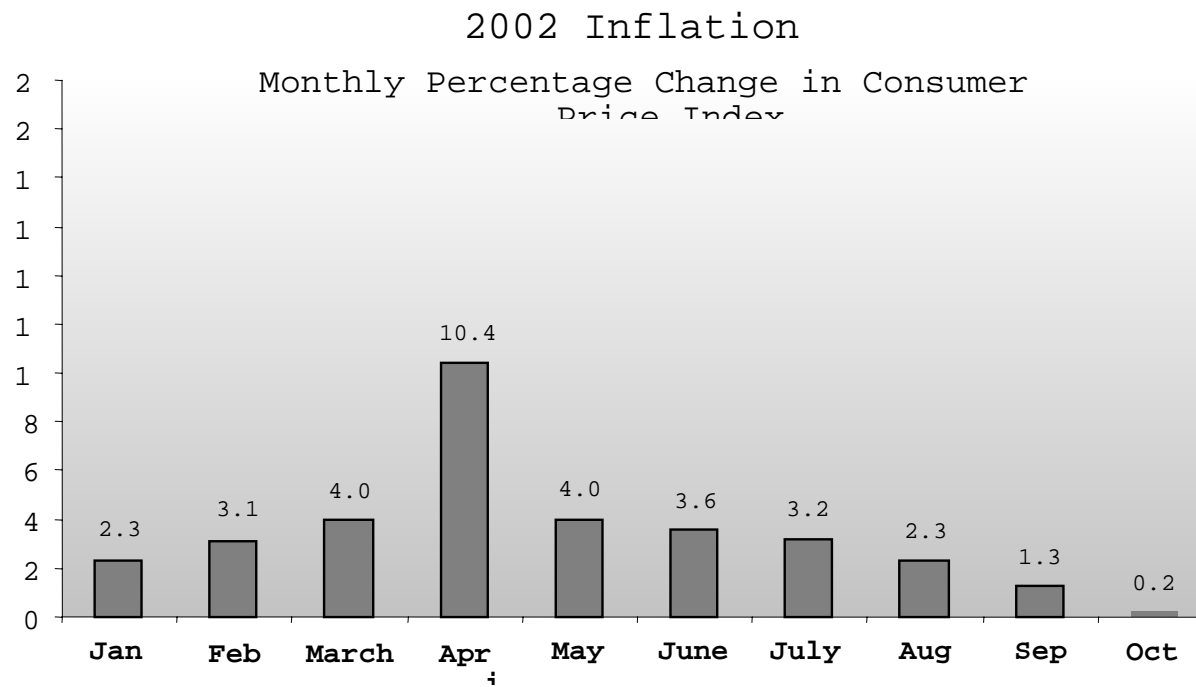
Source: Ministry of Economy, Argentina

Figure 3



Source: Ministry of Economy, Argentina

Figure 4



Source: Ministry of Economy, Argentina