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The Argentine Great Depression

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Abstract
The purpose of this paper is to comprehend the business cycle of the Argentine Crisis (1998-2002). The following paper will outline the crisis, starting off with a comprehensive literature review on the topic, analyzing its causes and consequences, followed by a survey on the policy-responses undertaken by the Argentine government to combat the recession. The crisis will then be analyzed in the context of the IS-LM model of macroeconomics.

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1 INTRODUCTION

By the late 19th century and beginning of the 20th, Argentina was an economic powerhouse. Rich in natural resources, economically successful, with GDP that rivaled European counterparts such as Germany and France, it was an inspiring development story in progress. Nowadays, the story is much different. Argentina's GDP per capita (PPP) is of $20.200[1], different from the German $48.200 or the $42.400 made by the French. What caused a promising young nation to go astray and even fall behind some of its Latin-American neighbors? The causes are multiple. They arise from government instability (Alesina, A., Özler, S., Roubini 1996), leading to poor fiscal and monetary policy. Until this day, Argentina has lived through multiple recessions and periods of hyperinflation, all of which have turned this 19th century powerhouse into an economic miscarriage. This paper explores one of those appalling events: the 1998-2002 crisis that swept Argentina into one of the most disastrous recessions of its history.

During the 80s, hyperinflation was soaring in Argentina, reaching levels of 3079% in 1989[2]. In response, a currency board was enacted—fixing the exchange rate to try to control inflation—fixing the peso to the US dollar. The policy seemed to work, and there was a tad of optimism looking into the 21st century. Nonetheless, international economic conditions proved Argentina wrong. Brazil devalued its currency, making Argentinian goods uncompetitive in the international market. High fiscal budgets raised the interest rate to discouraging levels for investors. Argentina was starting to bury itself into a recession. Considering the economic situation and the artificially appreciated Argentinean Peso, the IMF decided not to support Argentina, terminating any hopes of a bail-out. A devaluation of the Peso seemed logical, leading to a major-bank run[3] as Argentinians tried to get the most US dollars out of their Pesos. And so, Argentina found itself in a recession that, at least in the local level, many consider as severe as the Great Depression. It had catastrophic results: almost 20 years of economic growth

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[1] *The World Factbook.* Report. Central Intelligence Agency. 2016. https://www.cia.gov/library/publications/the-world-factbook/rankorder/2004rank.html.

[2] Corden, W. Max. "Exchange Rate Policies for Developing Countries." *The Economic Journal* 103, no. 416 (1993): 198. doi:10.2307/2234346.

[3] "Countdown to disaster." *The Economist*. March 30, 2002. Accessed May 10, 2017.

where lost[4], the amount of people living under the poverty line was of 52% in 2002, and after a default, Argentina lost much needed credibility in the international markets.

The following paper will outline the crisis, starting off with a comprehensive literature review on the topic, analyzing its causes and consequences, followed by a survey on the policy-responses undertaken by the Argentine government to combat the recession. The crisis will then be analyzed in the context of the IS-LM model.

2 Literature Review

Due to its unprecedented scale, the Argentine crisis from 1998-2002 has been the subject of a vast body of economic literature. However, there is a clear divide on what subparts of the crisis economists decided to research. The dissociation could be summarized as follow:

The effects of the crisis: While an important subfield of economics is devoted to understanding the causes of a recession, as a vague of emerging countries defaulted at the beginning of the 21st century, scholars started to investigate the social and economic cost of a crisis. For example, Bozzoli and Quintana (2014)[5] showed that the birth weight of children from less educated background was heavily correlated with macroeconomic fluctuations. As interestingly, Cavagnero and Bilger (2009), demonstrated that the Argentine public healthcare system disproportionately decreased in efficiency depending on the income-group of the patient, thus leading to a higher level of inequality[6].

The end of currency-exchange: Bajaras et al. (2007), in a working paper for the IMF showed that the banking system was not uniformly affected by the end of the U.S. Dollar party. Depositors were able to determine

[4] *The Argentine Crisis 2001/2002*. Report. RaboResearch - Economic Research, Rabobank. https://economics.rabobank.com/publications/2013/august/the-argentine-crisis-20012002-/.
[5] Bozzoli, Carlos and Climent Quintana-Domeque. "The Weight of the Crisis: Evidence from Newborns in Argentina." *Review of Economics and Statistics*, vol. 96, no. 3, July 2014, pp. 550-562. EBSCO*host*, doi:www.mitpressjournals.org/loi/rest.
[6] Cavagnero, Eleonora and Marcel Bilger. "Equity during an Economic Crisis: Financing of the Argentine Health System." *Journal of Health Economics*, vol. 29, no. 4, July 2010, pp. 479-488. EBSCO*host*, doi:www.sciencedirect.com/science/journal/01676296

the institutions that were the most likely to be at risk. As a result, despite facing the same macroeconomic scenario, comparable banks were affected by varying degrees. Another study from Betty (2010) was able to apply a model linking fiscal solvency with currency exchange rate to explain the sudden fall of the pesos during the crisis[7].

The restructuring of the debt: A common belief in international market is that crisis in one country increases the likelihood of crisis in a different country. However, Melisso (2005) demonstrated by studying the argentine crisis in the context of other crisis among developing countries that the concept of contagion was simply nonexistent. Furthermore, Chen et al. (2011) were able to successfully predict that the likelihood of a debt default among Latin America by looking at closing Credit Default Swaps rates thus allowing both investors and policy-makers to forecast financial markets' behaviors[8].

3 CAUSES OF THE RECESSION

Argentina has had a history of turbulent economic, political and monetary problems. The country experienced rapid economic growth during the periods of early 1900s, mainly due to an enormous increase in exports of goods to the European market. However, due to frequent structural changes in the type of government, the country has for long suffered from unstable political and economic situation. Prior to 1999, the Peso was pegged to the USD in response to the ongoing hyperinflation. The successful growth of the real GDP to 10.3% in 1992 led to an overly optimistic view of the country's future growth potential. [9]However, with major economic changes in other countries, the repercussions on the Argentine economy did not end too well. The policy decision regarding fixed exchange rate caused a major problem later, that triggered the economic crisis of 1999-2002. [10] As

[7] Daniel, Betty C. "Exchange Rate Crises and Fiscal Solvency." *Journal of Money, Credit, and Banking*, vol. 42, no. 6, Sept. 2010, pp. 1109-1135. EBSCO*host*, doi:onlinelibrary.wiley.com/journal/10.1111/%28ISSN%291538-4616/issues.

[8] Chen, Yi-Hsuan, et al. "Default Correlation at the Sovereign Level: Evidence from some Latin American Markets." *Applied Economics*, vol. 43, no. 10-12, April-May 2011, pp. 1399-1411. EBSCO*host*, doi:www.tandfonline.com/loi/raec20.

[9] Geithner , Timothy. Lessons from the Crisis in Argentina . Publication. Policy Development and Review Department , International Monetary Fund. Oct. & nov., 2003. https://www.imf.org/external/np/pdr/lessons/100803.pdf.

[10] Saxton, Jim. "ARGENTINA'S ECONOMIC CRISIS: CAUSES AND CURES". Publication. Joint Economic Committee, United

the economy of the United States became stronger and stronger, USD began appreciating relative to Peso. This led to a fall in the Argentine exports as these goods became more expensive than before. The repercussions of the East Asian currency crisis furthered the likelihood of a recession in the country. Brazil, which was Argentina's largest trading competitor, devalued the Real from 1.21 per dollar to 2.18 per dollar. Due to the depreciation of the Brazilian currency, Argentine products were substituted, and investors and buyers found their dollars could buy more in Brazil than in Argentina. Figure 1.1 illustrates the impact of changes in the Net Exports on the Aggregate Demand and Aggregate Supply graph.

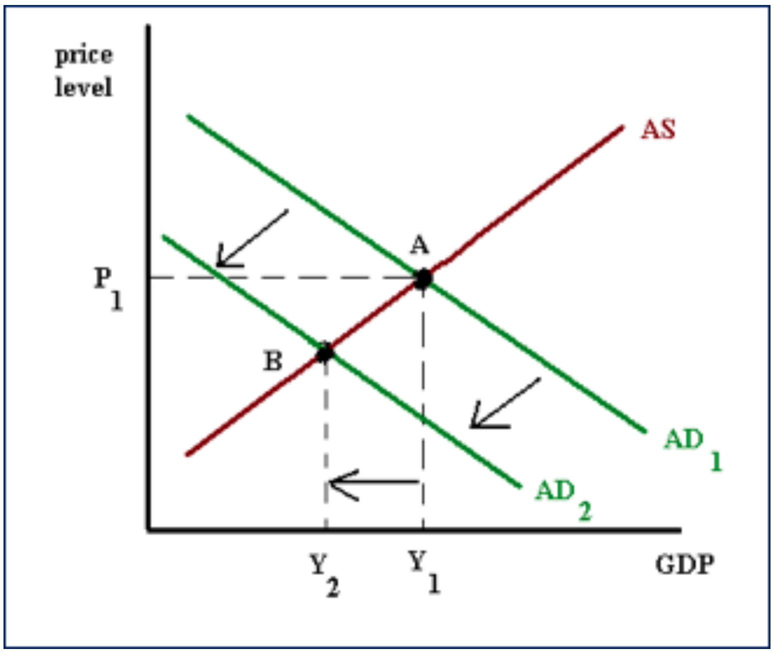

Figure 1.1

Due to a reduction in exports, the Aggregate Demand curve shifts left, thereby reducing overall price level and real GDP of the economy. This signaled the contraction of the economy.

Additionally, policy decisions taken by the government of Carlon Menem focused on extensive borrowing for the sake of increasing spending, something that costed the country a lot in the long run. Table 1 illustrates the

States Congress. Accessed June 2003. http://www.stockssite.com/en/argentina.pdf.

annual government expenditure (as a % of GDP) by the Argentine government from years 1993-2001.[11]

Table 1: Annual Government Expenditure (as % of GDP)

1993	1994	1995	1996	1997	1998	1999	2000	2001
19.0	19.9	19.6	20.1	20.1	20.3	21.9	22.1	23.2

Due to extensive borrowings by the government during the periods of 1995-2001, the total government expenditure as a percentage of GDP increased from 19.6 % in 1995 to 23.2% in 2001. Eventually, the government acquired a lot of debt which soared domestic interest rates. In the 1990s, the government of Menem enforced a system of free enterprise that stimulated a wave of privatization. However, his led to additional problems with regards to unemployment. Around 1998, real wages lost roughly 36% of their purchasing power and unemployment climbed to its highest point since the Great Depression. [12]The main problem came when all these changes began having micro level impact. Due to privatization of many sectors, costs of basic services such as the electricity and phones spiraled upwards causing inflation in the economy. Argentina was clearly in a recession by this time. The debt burden along with the shrinking tax revenues, signaled economic slowdown in the country, and made IMF decide to not bail the country out.

4 Policy Response

4.1 Debt

After three years of continuous recession and month-long riots throughout the country, on the 26th December 2001 the Argentine government publicly announced that it was unable to pay back a total of $85 billion to its creditors, that is the largest sovereign debt default in history. As a result, the quasi totality of foreign

[11] Geithner , Timothy. Lessons from the Crisis in Argentina . Publication. Policy Development and Review Department , International Monetary Fund. Oct. & nov., 2003. https://www.imf.org/external/np/pdr/lessons/100803.pdf.
[12] Agencies, Staff And. "Timeline: Argentina's economic crisis." The Guardian. December 20, 2001. Accessed May 10, 2017. https://www.theguardian.com/world/2001/dec/20/argentina1.

investment inflow ceased, financial markets devalued the pesos to a fourth of its pre-default value, and inflation rose by an estimated 40%. It is believed that the starting point of what would soon become an unprecedented economic turmoil is the inability of the government to meet its financial obligations. In order to understand why such a difficult political decision was made, one has to understand the reasons that lead the government to decide to not repay its debt.

For Miguel Kegel, a former undersecretary of finance of Argentina, two main elements can provide an explanation[13]. First, to restore its competitiveness and solvency, the government attempted to self-induce domestic deflation while decreasing its budget deficit. This policy was intended to put downward pressure on prices while allowing the government to partially repay its debt to international creditors. However, the impossibility to devalue its currency due to a 1-to-1 peg with the American dollars embedded in the law and a strong resistance from the middle-class to decrease real wages led to a failure of this policy. Second, a significant share of short-term liabilities throughout the argentine banking system was expressed in U.S. dollars whereas most liquidity held by banks were labelled in pesos. This undoubtedly put the economy at risk of a run-on banks. Without an international lender of last resorts to cover for the lack of American liquidity, it was virtually impossible for banks to cover the totality of their deposits in dollars. Facing an important pressure from the street as well as an ever accumulation of debt coming from abroad, the government decided to default on its external debt and lifted the American dollar parity.

The expected chaos that would follow did happen. Due to a complete freeze in transaction expressed in dollars without authorization from the central bank, hospitals to local shops soon became unable to access a vast array of foreign goods ranging from medicines to Chilean salmon[14]. The entire chain of payment between customers, business, and suppliers broke down further worsening the economic crisis. Nonetheless, as soon as the

[13] https://www.brookings.edu/wp-content/uploads/2016/06/11_argentina_kiguel.pdf

[14] *"A decline without parallel." The Economist. March 02, 2002. Accessed May 11, 2017. http://www.economist.com/node/1010911.*

default of the debt was pronounced a large-scale plan of debt-restructuring was put in place. A large portion of the external debt was owned by private citizens in Europe who had invested their savings in debts funds. However, while 93% of the bondholders accepted a reduced payment of their investment, nearly 7% of the creditors, as defined by the quantity of debt owned, decided to sue the argentine government for a full repayment. Among them were mostly hedge-funds and vulture funds[15]. Many of these court cases are still even unsettled today. During the crisis and its aftermath, the International Monetary Fund (IMF) was heavily criticized for its lack of support to the government. Despite several attempts from Argentina, the IMF refused to offer the liquidities the country desperately needed. Even after the crisis passed, the IMF made sure that its initial loan was fully repaid despite some precedents of *laissez-faire* during similar cases.

Thanks to a prolonged period of sustainable economic growth Argentina decided in 2005 to refinance for a second time its debt. During this process, most of the bonds were linked to GDP growth which would allow the government to meet its payment only if the economy brought enough budget surplus to do so. Along this process numerous investors including countries such as Venezuela and private banks decided to buy back a total of $62.5 billion of debt therefore ending the sovereign debt crisis.

4.2 Exchange Rate

The Argentinian Peso had been pegged to the dollar on a one to one basis. By 2001, it had been so for almost a decade. The policy was rooted in what seemed sound monetary policy. In 1990, inflation was soaring at a rate of 2,314% a year. By 1994, it had been stabilized to 4% a year[16]. But in the late 90s, the policy proved disastrous. As the US dollar rightfully strengthened, so did the Peso. The East Asian crisis of 1997 and the Russian crisis of 1998 made foreign investors especially wary of developing countries. Foreign investment decreased, and

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[15] *"Argentine Funds Can't Be Seized by Bond Holders, Judge Says". Bloomberg. March 28, 2012. Retrieved August 29, 2013.*

[16] Weisbrot, Mark, and Luis Sandoval. *Argentina's Economic Recovery Policy Choices and Implications* . Report. Center for Economic and Policy Research. October 2007. http://cepr.net/documents/publications/argentina_recovery_2007_10.pdf Bozzoli, Carlos and Climent Quintana-Domeque. "The Weight of the Crisi

with the Argentinian Peso pegged to a high dollar, it became too expensive to conduct business in Argentina, or buy Argentinian goods. Brazil, with a floating exchange rate, was far more competitive. This was one of the drivers of the recession, and the situation was unsustainable. With a devaluation on sight, the government enacted a "corralito" to avoid a major bank-run from Argentinians trying to get the most out of their dollars, that is all bank transactions were frozen and limited to a weekly amount.

As the country prepared for a devaluation, the government fixed and official exchange rate before letting it float. All bank accounts held in Dollars would be exchanged to Pesos on a 1.4 Pesos/USD rate. There was an international outcry, leading to sues against the government.[17] The extent of this policy can be better understood when one looks at the nominal exchange rate in 2002. One dollar was now worth 3.6 pesos. The exchange rate proved propitious for exports; soon after the devaluation, there was a spike in Argentine exports. The devaluation generated serious inflationary pressures on the economy—matter that will be further developed in the next section—and the Argentinian government constantly intervened in the markets to balance the exchange rate. First, it tried to combat inflation by dampening the Peso devaluation. But soon after, as exports increased and the Peso appreciated, it started intervening in the opposite direction. The goal was to stabilize the exchange rate and promote consumption and investment. The policy worked. Consumption and investment were the main drivers of the recovery.

4.3 Inflation

Major volatility in the exchange rate of Peso during the Argentine crisis had enormous impacts on the inflation in the economy. The devaluation of the currency had caused a significant spike in the inflation rate to more than 28% annually. Argentina reached a point where it was on the verge of hyperinflation in an attempt to control fiscal and monetary policies. As explained before, the government realized the importance of the stability

[17] "Argentina loses $1.3bn debt court appeal." BBC News. August 25, 2013. Accessed May 10, 2017. http://www.bbc.com/news/business-23832247.

of nominal exchange rates in order to stabilize inflation and the financial system overall. By 2005, the country had successfully been able to recover. However, the prolonged economic expansion strained the industrial capacity that essentially led to a dramatic drop in the employment rate. According to the 2005 Consumer Price Index (CPI) reports, during the third quarter of 2005, the CPI for Argentine goods spiked to 2.6% quarter of quarter. This suggested inflationary pressures on the economy. [18] As a result, the Argentine government, yet again, chose to enforce diametrically opposite policy implications that led to re-centralization of government control over the market. It directly controlled prices and set stringent regulations on the export of goods in order to sustain prices at low levels. In the short-run, this decision proved to be fruitful in tackling the problem of exorbitant inflation rates, however the long-run results seem uncertain, given the frequent change in the government of the country.

5 Consequences

After four rough years of economic instability, Argentina finally started getting matters under control. Just three months after having a $100 billion debt default, the Argentine economy began growing rapidly. With more than 50% GDP growth, the country became the fastest growing economy in the West. One of the major decisions taken by the government in order to end the crisis was to overturn the policy regarding the Peso beings fixed at a one-to-one exchange rate with the dollar. [19]The exchange rate fixation had caused unbearable burden for the economy over the years, and so with the help of large scale protests in January 2002, the convertibility system was formally abolished. However, three months out of the recession, the Argentine economy was still in financial disarray. It was only due to the massive devaluation of the Pesos against the dollar in 2002, that opportunities for exports re-appeared and the economy finally expanded. The new range of 1.4 to 3.7 pesos per dollar also boosted import based industries in the country. Eventual increase in private consumption and investment that followed up

[18] Solutions, EIU Digital. "EIU Store." Argentina Country Risk. Accessed May 10, 2017. http://store.eiu.com/product.aspx?pubid=820001082.

[19] Weisbrot, Mark, and Luis Sandoval. Argentina's Economic Recovery Policy Choices and Implications. Publication. CEPR, Center for Economic and Policy Research. Oct. & nov. 2007. http://cepr.net/documents/publications/argentina_recovery_2007_10.pdf.

from the export boost, caused the rest of the recovery of the economy. Figure 1.2 illustrates the recovery process of the Argentine economy.

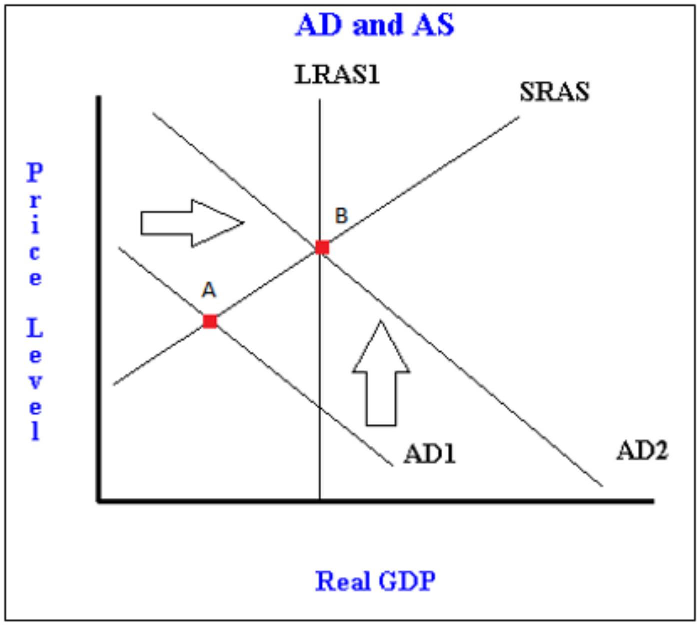

Figure 2.2

By 2005, the Argentine government was successful in restoring both foreign as well as domestic investment credibility. Due to a considerable pressure from the IMF to provide better financial terms post the debt default crisis, the government was finally able to arrange a debt swap that took $67.3 billion debt off the records. Additionally, the Argentine government's willingness to accept an annual inflation rate of more than 28% post the devaluation of Pesos helped stabilize the nominal exchange rate and led to an extensive growth rate. By 2005 the Argentine economy had fully recovered and was growing extensively. Total spending increased dramatically (by 4.6% points of GDP) with the current account being in surplus. Thus, Argentina's recovery from one of its worst recessions was truly rapid.

6 Conclusion

The Argentine crisis of 1998-2002 is known as the Argentine Great Depression. Such a reference, to one of the most devastating economic crisis of modern time, seems appropriate. GDP contracted by 28%, the per capita measurement regressed 20 years. Unemployment reached a peak level of 20%. The number of people living under the poverty line—as defined by the Argentine government—was 52%; 25 out of every 100 Argentinians were considered indigent[20]. The crisis had unprecedented repercussions for what seemed a promising Argentine economy.

The crisis is an example of seemingly good policy gone wrong. Having a currency board seemed a reasonable measure to combat hyperinflation. In fact, it worked, allowing Argentina to have high levels of growth during the 90s, and generate enough confidence in their bonds to emit high levels of debt. But eventually, a Peso pegged to the dollar casted a gloomy shadow over Argentina. The crisis also exemplifies the dangers of sustaining a large government deficit over a prolonged period. A large deficit coupled with uncompetitive exports led Argentina into one devastating recession.

The present investigation has analyzed the Argentinean Great Recession in the context of the aggregate supply and aggregate demand models. As explained, the fall in exports and the burdensome government deficit shifted the aggregate demand curve to the left, decreasing output and generating a recession. The government response, letting the peso float and reducing the deficit, allowed for a recovery in both the export economy and in consumption and investment, both of which increased aggregate demand and shifted the AD curve back to its pre-crisis level. After such a far-reaching recession, it comes into question whether Argentina has learned from its mistakes. Is Argentina's potential still there to achieve? And if so, will Argentina ever achieve it?[21]

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[20] Cruces, Guillermo, and Quentin Wodon. "Argentina's Crises and the Poor, 1995-2002 ." *Distributional Analysis Research Programme* , July 2003. https://core.ac.uk/download/pdf/93952.pdf.

[21] For further reading on Argentina's current state see: "Down Argentina Way." The New York Times. May 03, 2012.

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