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Argentina's 35 million citizens will not be the only ones to pay a heavy price for that country's latest economic crisis. The fallout may also radically alter economic policies and political relations both within Latin America and with the United States. It is already clear that Argentina will reverse at least some of the favorable economic reforms introduced by President Carlos Menem in the early 1990s. Although Menem's reforms are not responsible for the current chaos, they are a politically convenient scapegoat. Blaming them also provides a rationale for renationalizing Argentine firms, erecting barriers to imports and foreign investment, and increasing government spending.

The current crisis will weaken the prospects for the Mercosur trading arrangement among Argentina and its neighbors (Brazil, Paraguay, and Uruguay) and may kill any chance of a general Free Trade Area of the Americas. Many Argentines are already blaming their troubles on Washington, claiming that U.S. policies got them into this mess and that the United States then abandoned Argentina because, unlike Turkey, it is not of geopolitical significance.

If other emerging-market governments misinterpret Argentina's experience, they too might move away from the promarket policies that hold the best promise of raising future living standards. Gaining a better understanding of the real reasons for the Argentine crisis is therefore essential. Doing so might help Argentina and other emerging countries avoid making the wrong policy choices in the future and reduce the risk of further financial crises.

PEGGED ALL WRONG

An overvalued fixed exchange rate (locked at one peso per dollar since 1991) and an excessive amount of foreign debt were the two proximate causes of the Argentine crisis. Because the exchange rate was fixed at too high a level, Argentina exported too little and imported too much. This trade imbalance made it impossible for the country to earn the foreign exchange it needed to pay the interest on its foreign debt. Instead, Argentina had

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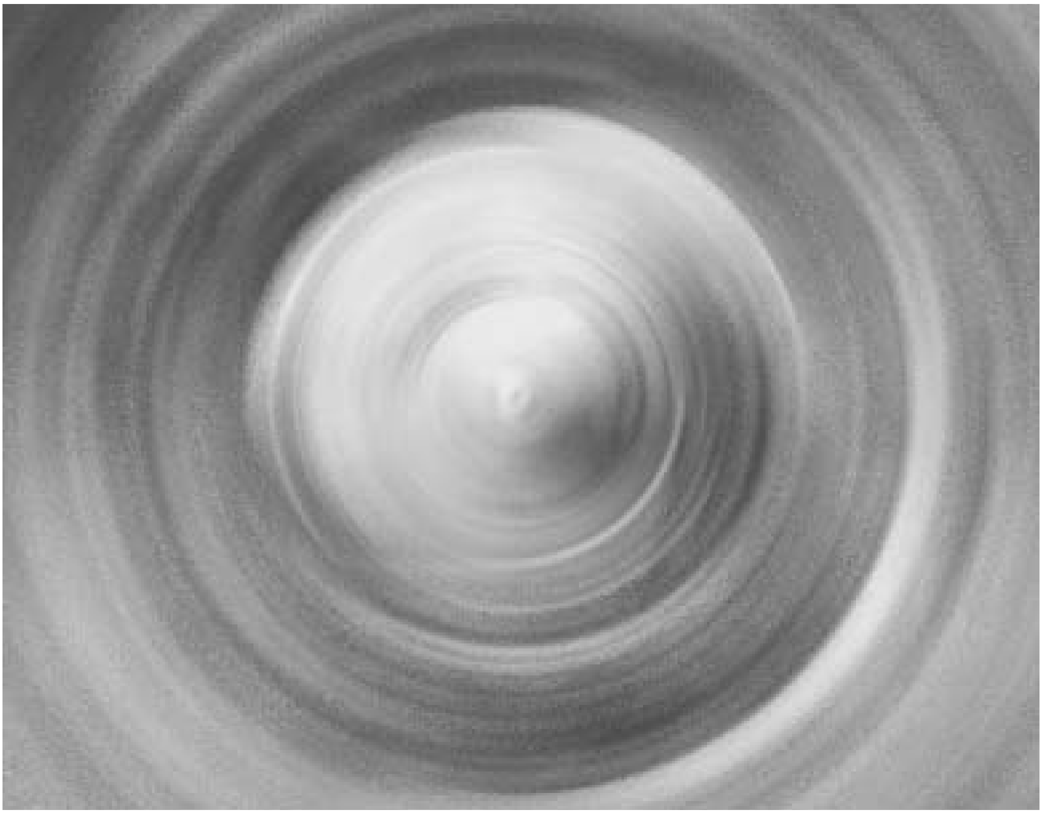

AP/WIDE WORLD PHOTOS

Hoping for a handout: looters empty a food truck, Buenos Aires, December 19, 2001

to borrow to meet those interest payments, causing the debt to grow ever larger. The country's foreign debt, most of which was owed by the central and provincial governments, eventually reached 50 percent of GDP by late 2001 and included $30 billion due in 2002. Once it finally became clear that Argentina could no longer borrow to roll over those debts and pay the interest, Buenos Aires was forced to default and to devalue the peso.

Although the devalued peso will eventually raise Argentine exports, in the near term the weakening of the currency will cause widespread bankruptcies. This is because most local businesses borrowed in dollars. A company that took a loan for one million dollars expected to repay it with one million pesos. But if the peso is devalued by 50 percent, the firm will have to find two million pesos to repay its obligation. Companies unable to afford such an increase in the peso value of their debt will wind up in bankruptcy. Corporate failures will then weigh heavily on the Argentine banks and may cause them to collapse too. The country's already high unemployment rate will increase as a result.

The havoc that an overvalued exchange rate and excessive foreign debt caused in Argentina is certainly not unique. These two conditions, either singly or together, have been the cause of every currency crisis during at least the past 25 years. Similarly, the painful effect that dollar-denominated debt can have when a sharp devaluation occurs was dramatically demonstrated in several Southeast Asian countries during the late 1990s. All of this was well known to Argentine economists and policymakers. Why then did they allow the crisis to develop? Why did Argentina not end its fixed link to the dollar several years ago, allowing the peso to float down to a more competitive level that could improve the trade balance and start to shrink its foreign debts? Had Buenos Aires done so, the current crisis would probably have been avoided.

GREENBACKED

The reason Argentina retained its fixed exchange rate too long is fairly simple, however: such a peg had cured hyperinflation at the end of the 1980s and brought a decade of price stability that provided the framework for strong economic growth. Policy officials feared that breaking the link to the dollar would bring back high inflation and all of the accompanying economic problems of the 1970s and 1980s.

This fear seemed justified. After all, at the beginning of the 1990s—before the currency was pegged—consumer prices in Argentina were rising at a rate of 200 percent per month, or more than 5,000 percent per year. Markets ceased to function and productivity declined. Street riots led President Raúl Alfonsín to step down sooner than normal after the election of his successor, Carlos Menem. With his economy minister, Domingo Cavallo, Menem moved Argentina from an internationally isolated and state-dominated economy to one that encouraged foreign trade and investments and privatized state-owned industries.

In taking such steps, Argentina followed the lead of Chile and Mexico as well as the Southeast Asian nations, all of which had shown that such liberalization would lead to strong economic growth. Argentina's response was thus no exception. Buenos Aires' new policies caused the country's economy to grow at a real rate of more than 7 percent a year from 1991 to 1994, one of the highest growth rates anywhere during those years.

Argentina went further than any of those other countries, however, when it enacted a "convertibility law" that pegged the peso to the dollar at a one-to-one exchange rate and stipulated that everyone had the right to convert as many pesos to dollars as they wanted. To give credibility to that promise, the government provided that each peso in circulation would have to be backed by a dollar (or similar hard currency) at the central bank, the so-called currency board system.

If Menem and Cavallo's strategy had succeeded, Argentina today would be enjoying strong growth, low inflation, and financial stability. The fixed exchange rate could have succeeded, however, only if the peso became competitive enough to generate more exports than imports, so that the net foreign-exchange earnings could be used to pay interest on the outstanding international debt. Although the one-to-one exchange rate made Argentine products uncompetitively expensive, this could still have been remedied if productivity had risen faster than wages, permitting Argentine prices to decline relative to those abroad. Cavallo correctly foresaw that the combination of low inflation and market liberalization would lead to a rapid growth of productivity. Although this was sufficient at first to lead to both rising real wages and increased international competitiveness, eventually rigid labor laws and strong union pressures prevented the further reduction in production costs that Argentina needed to become competitive.

The pegged exchange rate prevented the adjustment necessary to shrink the current-account deficit, but the combination of the currency peg and the rule against creating pesos without foreign-exchange backing did achieve the price stability that was its original purpose. To the average Argentine, the convertibility law made a peso "as good as a dollar"; the two were fully interchangeable in everyday transactions.

WARNING SIGNS

Not everyone was convinced that the peso would remain fixed, however. Some worried about what would happen if investors who saw Argentina's rising current-account deficit and its increasing foreign debt became nervous and wanted to convert their pesos to dollars. (See, for instance, my skeptical comments about the currency board system in my "Self-Help Guide for Emerging Markets," *Foreign Affairs*, March/April 1999.) Although the government had enough dollars at the central bank to back the currency in circulation, it didn't have nearly enough to cover the total amount in checking and savings accounts that individuals might want to convert.

Still, in principle that disparity was not a problem. The currency board rules ensured that as individuals began to convert their pesos into dollars, the central bank would shrink the money supply and cause interest rates to rise sharply. Long before the central bank ran out of dollars, the interest rates on peso deposits would get so high that people would be encouraged to keep their funds in pesos. In that way, the central bank would never exhaust its supply of dollars. Moreover, the high interest rates would weaken domestic demand, causing wages and prices to fall until the peso became competitive again, eliminating the reason for the original investor nervousness.

Although this logic seemed impeccable, a problem remained. If the government was not willing to push interest rates high enough to prevent speculation because of the damage that those high rates would do to the economy, and if wages did not fall sufficiently in response to economic weakness, the current-account deficit would remain and investors would lose confidence in the exchange rate's long-term viability.

Cavallo hoped that the currency board would never be put to this test. In his view, the productivity gains that he foresaw would make Argentine goods competitive internationally. Once confidence in the peso became established, sound monetary policy would then prevent inflation—even if the peso were allowed to float. Ideally, the shift from the pegged rate system to a floating rate would occur when the peso was undervalued, causing the peso to rise when the peg was ended, thereby giving a further boost to price stability.

PRESSURE BUILDING

Unfortunately, these conditions never occurred. Wage increases kept the cost of production in Argentina high, depressing exports and encouraging imports. Argentina's competitiveness worsened as the dollar strengthened relative to most other currencies, pulling the peso up with it. The dollar rose sharply against the Japanese yen after 1995, against the currencies of Southeast Asia after their crises of 1997 and 1998, and against the European currencies in 1999 and 2000. The terms of trade also moved against

Argentina, with world prices for its exports declining relative to the prices of its imports. But the biggest blow to Argentine competitiveness came when Brazil's currency, the real, fell sharply in 1999.

To keep the peso-dollar peg intact as the economy became less competitive, Buenos Aires tightened macroeconomic policy, raising interest rates and pushing the economy into recession. But despite unemployment rates of close to 15 percent, wages did not decline and competitiveness did not improve. The fixed exchange rate made it impossible to increase competitiveness by a traditional currency devaluation (as a variety of countries did, ranging from the United Kingdom in 1992 to South Korea in 1998 and Brazil in 1999) and the resistance of unions to lower wages prevented a fall in production costs that could have achieved the same real devaluation without a change in the exchange rate.

The inevitable result was increasing current-account deficits, which reached nearly five percent of GDP, and therefore mounting foreign debt. The growth of the foreign debt also reflected the combination of low private savings rates, which reduced the domestic pool of investment, and substantial deficits in the budgets of the central and provincial governments. These budget deficits were due to widespread tax evasion and to an inability to control government spending, particularly at the provincial level. The provincial deficits continued despite a constitutional rule requiring revenue sharing, which turned any increase in central government tax revenue into an extra source of finance for provincial spending. Even with these funds, the provinces still required financing through substantial capital inflows from abroad.

As the debt grew, the interest rate that Argentina had to pay foreign creditors also rose, further increasing the annual imbalance and accelerating the growth of the foreign debt. Default became unavoidable. When Argentina finally defaulted on $155 billion of central and provincial government debt in December 2001, it was the largest sovereign debt default ever.

PEG HEADED?

Sophisticated Argentines and foreign investors knew that the peso had to be devalued if future current-account deficits were to be reduced without a continued massive recession. The convertibility law allowed them to shift pesos into dollars and then to take the dollars out of the country. The result was a loss of dollar reserves at the Argentine central bank, making it all the more likely that a devaluation would be necessary. Although a loan from the International Monetary Fund (IMF) in 2001 gave a temporary boost to confidence that stemmed the run on the central bank, this lasted only a few months and the peso was devalued sharply in January 2002.

Why did Argentina not devalue sooner—in 1997, 1998, or even 1999—so that the default could have been avoided, the devaluation smaller, and the adverse effects of devaluation on domestic firms and banks limited? There were three reasons. First was a fear that breaking the peg and devaluing the peso would bring back the high rates of inflation that had plagued the economy before the two currencies were tied. Brazil's experience in 1999 had shown that a country with a long history of high inflation could abandon a fixed exchange rate and avoid inflation by an explicit "inflation targeting" approach to monetary policy—i.e., raising interest rates whenever inflation increased above a low "target" rate. But Argentina's history and the centrality of the convertibility law understandably made officials nervous that its inflation was more sensitive to any departure from the fixed peg.

Second, because Argentine households and businesses had so much dollar-denominated debt, the government feared that a devaluation would prompt widespread bankruptcies and personal defaults by raising the peso value of outstanding debts. This problem would also affect the central and provincial governments themselves, which also had large dollar-denominated debts to foreign creditors that would become more of a burden after devaluation, since tax revenue was collected in pesos.

Finally, there was always the hope that the situation would improve over time. The large U.S. trade deficit suggested that the dollar might experience a sharp decline relative to the yen and the European currencies. If that happened, Argentine products would become much more competitive internationally. But that did not happen. The dollar (and therefore the peso) continued to strengthen in 2000 and 2001.

What was the role of the IMF in all of this? Critics of the fund charge three things: its staff did not adequately warn Argentina of the danger of its policies; it forced Argentina to adopt contractionary policies that led to three years of recession before the crisis hit; and it encouraged the continuation of bad policies by providing a series of large loans.

In reality, the Argentines understood the risk that they were taking at least as well as the IMF staff did. Theirs was a calculated risk that might have produced good results. It is true, however, that the IMF staff did encourage Argentina to continue with the fixed exchange rate and currency board. Although the IMF and virtually all outside economists believe that a floating exchange rate is preferable to a "fixed but adjustable" system, in which the government recognizes that it will have to devalue occasionally, the IMF (as well as some outside economists) came to believe that the currency board system of a firmly fixed exchange rate (a "hard peg," in the jargon of international finance) is a viable long-term policy for an economy. Argentina's experience has proved that belief wrong.

The contractionary policies that Argentina pursued during the past few years were exactly what the currency board system required. They may have been bad and painful policies, but they were inherent in the currency board approach. The real problem with the IMF "conditionality" in Argentina is that it did not achieve the changes that were really needed, especially the changes in such things as the constitutional revenue-sharing rule and the level of provincial spending that continued to contribute to the budget deficit.

The multi-billion-dollar loans that the IMF gave to Argentina, furthermore, permitted Buenos Aires to postpone dealing with its fundamental problems and abandoning the currency board. The IMF clung too long to the belief that the currency board system was viable. It also wanted to show support for Argentina because of that country's previous shift to favorable market-oriented policies. It should be possible, however, for the IMF to show support for a country's promarket reforms without pouring tens of billions of dollars into a losing battle.

LOOKING AHEAD

What lessons can be learned from the Argentine experience? First, a fixed exchange-rate system, even one based on a currency board or other "hard" fix, is a bad idea that is likely to lead to an overvalued exchange rate, a currency crisis, and widespread defaults. A market-determined floating exchange rate is the only way to avoid these problems.

Second, substantial foreign borrowing in dollars is a very risky strategy. This is particularly true of short-term debt but is also a problem with longer-term borrowing. It is a problem regardless of whether the borrower is the government or the private sector. Other forms of capital inflow, in particular portfolio equity investments and direct investments in plant and equipment, do not raise the problems associated with debt.

Third, the opening of the economy to trade, the encouragement of foreign direct investment, and the privatizing of state-owned firms are desirable policies. Those policies did not cause or contribute to Argentina's crisis, and it would be a serious mistake to reverse them now in Argentina or any other emerging market.