Argentina's Economic Recovery

Policy Choices and Implications

Mark Weisbrot and Luis Sandoval

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Center for Economic and Policy Research
1611 Connecticut Avenue, NW, Suite 400
Washington, D.C. 20009
202-293-5380
www.cepr.net

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About the Author

Mark Weisbrot is co-director and Luis Sandoval is research assistant at the Center for Economic and Policy Research in Washington, DC.

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Introduction

Argentina's current economic expansion is now more than five and a half years old, and has far exceeded the expectations of most economists and the business media. Despite a record sovereign debt default of $100 billion in December 2001 and a financial collapse, the economy began growing just three months after the default and has enjoyed uninterrupted growth since then. The country's GDP during this period has grown by more than 50 percent, making Argentina the fastest growing economy in the western hemisphere during this time. In the process, more than 11 million people, in a country of 39 million, have been pulled back onto the positive side of the poverty line. Furthermore, this recovery was accomplished without any help from the international financial institutions (IFIs) that had (led by the International Monetary Fund) – provided tens of billions of dollars in loans prior to the collapse; and with the use of unorthodox macroeconomic policies.

This paper looks at some of the policies that may have contributed to Argentina's success over the last five and a half years. It also considers briefly some implications of Argentina's experience for other developing countries.

Recession and Recovery

Figure 1 shows Argentina's GDP (quarterly) in constant pesos from 1993 through the first half of 2007. The current recovery began in the second quarter of 2002, following a steep recession that had begun in mid-1998. During that recession (1998-2002), the economy had lost about 20 percent of its GDP, and the poverty rate had risen from 18.2 percent of households (October 1998) to 42.3 percent (October 2002).[1] It was one of the worst economic crises in the history of Argentina, and was not resolvable under the economic policies to which the government at that time was committed.[2] Most importantly, the "convertibility system" under which the Argentine peso was fixed at a one-to-one exchange rate with the dollar, had long been an unbearable burden for the economy, a strait-jacket with regard to monetary policy, and had become unsustainable. Both the exchange rate and the economy were being maintained through increasing international borrowing, which piled up an unsustainable public debt burden.

Both of these policies were overturned when the government was forced to resign in December of 2001. The government at that time, together with the International Monetary Fund (IMF), were operating under the assumption that tightening fiscal policy was the key to resolving the economic crisis.[3]

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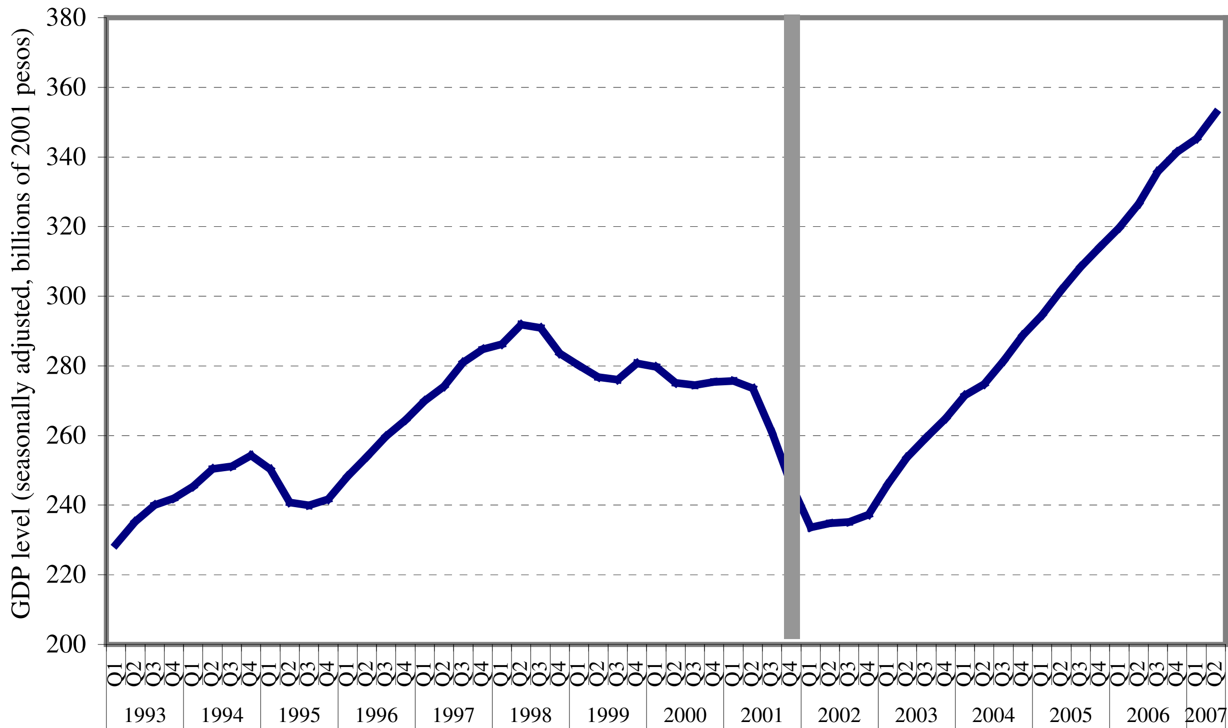
[1] This data is for the Greater Buenos Aires Area, which has about 35 percent of Argentina's population; comparable data for all urban centers or the country is not available for this period.

[2] See Frenkel, Roberto and Martin Rapetti (2007), "Argentina's Monetary and Exchange Rate Policies After the Convertibility Regime Collapse," Center for Economic and Policy Research (CEPR) and Political Economy Research Institute (PERI) [Online at: http://www.cepr.net/documents/publications/argentina_2007_04.pdf]; Weisbrot, Mark and Alan Cibils (2002), "Argentina's Crisis: The Costs and Consequences of Default to the IFIs," CEPR [Online at: http://www.cepr.net/documents/publications/Argentina_Crisis.pdf], Cibils, Alan B., Mark Weisbrot and Debayani Kar (2002), "Argentina Since Default: The IMF and the Depression," CEPR [Online at: http://www.cepr.net/documents/publications/argentina_2002_09_03.pdf] and Weisbrot, Mark and Dean Baker (2002), "What Happened to Argentina?" CEPR [Online at: http://www.cepr.net/documents/publications/argentina_2002_01_31.pdf].

[3] The IMF continued to hold this view well into 2002: "Failures in fiscal policy constitute the root cause of the current crisis"— Anoop Singh (2002), Director for Special Operations, IMF Press briefing, Buenos Aires, April 10, 2002 [Online at: http://www.imf.org/external/np/tr/2002/tr020410.htm].

FIGURE 1
Quarterly Real GDP Level, 1993-2007 (Seasonally Adjusted, Billions of 2001 Pesos)



Source: Dirección Nacional de Cuentas Nacionales (DNCN), Instituto Nacional de Estadística y Censos (INDEC), República Argentina.

The resulting austerity policies, combined with the loss of confidence in the financial system led to large scale protests that drove the government from office. Default on the country's external debt followed, and, in January 2002, the convertibility regime was formally abandoned.

It was commonly believed at the time that Argentina would pay a heavy price for its default, the largest ever for a sovereign borrower; and that this punishment would continue for some years. This belief has persisted through the intervening years, and is still encountered even today. However, the Argentine economy contracted for only three months after the default. The loss of GDP during these three months was steep (about 5 percent). The size of the loss is comparable to, for example, that of the Mexican economy following the 1994-5 peso crisis (about 6 percent of GDP). But it is not clear that most of this loss was attributable to the default, since there were large contractionary effects of the devaluation at the same time.

The real economy began recovering even while the financial system was still in disarray.[4] Part of this was a result of the devaluation – the peso declined very sharply against the dollar, from parity (one to one) to a range of 1.4 to 3.7 pesos per dollar in 2002. This gave a large boost to exporters, and also greatly increased the impact of exports on the economy. At the same time it boosted import-competing industries.

[4] See Frenkel and Rapetti (2007), *op. cit.* Much of the analysis of the recovery in the present paper draws on this work.

TABLE 1
Contributions to GDP Growth, 2002-2007

		Total GDP	Private Consumption	Government Consumption	Investment	Exports	Imports	Net Exports	Domestic Absorption	Net Domestic Absorption
2002Q1 to 2002Q3	*Total real % change over period*	0.6	-2.5	-1.6	1.3	3.3	-15.4	22.1	-1.0	0.2
	Annualized real % change over period	1.3	-5.0	-3.2	2.6	6.7	-28.4	49.1	-1.9	0.4
	Contribution to GDP growth (in %)	100.0	-266.3	-36.7	21.9	71.3	167.8	239.1	-139.1	28.7
2002Q3 to 2004Q2	*Total real % change over period*	16.8	16.7	4.8	82.8	7.5	100.0	-57.3	23.6	18.4
	Annualized real % change over period	9.3	9.2	2.7	41.1	4.2	48.6	-38.5	12.9	10.1
	Contribution to GDP growth (in %)	100.0	65.1	4.1	54.5	6.4	-35.0	-28.6	128.6	93.6
2004Q2 to 2007Q2	*Total real % change over period*	28.4	29.7	18.6	67.0	34.8	64.4	-62.1	31.2	27.4
	Annualized real % change over period	8.7	9.1	5.9	18.7	10.5	18.0	-27.6	9.5	8.4
	Contribution to GDP growth (in %)	100.0	68.6	8.4	41.0	16.2	-22.9	-6.7	106.7	83.8
Total	*Total real % change over period*	50.9	47.6	22.3	209.2	49.7	178.3	-80.2	60.7	51.1
	Annualized real % change over period	8.2	7.7	3.9	4.0	8.0	21.5	-26.6	9.5	8.2
	Contribution to GDP growth (in %)	100.0	63.2	6.4	45.2	13.6	-24.5	-10.9	110.9	86.4

Sources: Frenkel and Rapetti (2007), Ministerio de Economía y Producción (MECON) and author's calculations.

However, relatively little of Argentina's growth over the last five years is a result of exports or of the favorable prices of Argentina's exports on world markets. This must be emphasized because the contrary is widely believed, and this mistaken assumption has often been used to dismiss the success or importance of the recovery, or to cast it as an unsustainable "commodity export boom." **Table 1** shows the relative contributions of the various components of GDP to economic growth, for three phases of the recovery.[5] It can be seen that exports played a major role only for the first six months of the recovery (the first phase), when the economy grew at just a 1.3 percent annual rate.

During this period exports grew at a 6.7 percent annual rate and accounted for 71.3 percent of GDP growth. Imports dropped by more than 28 percent and therefore accounted for 167.8 percent of GDP growth during this period. Thus net exports (exports minus imports) accounted for 239.1 percent of GDP growth during the first six months of the recovery. This was countered mainly by declining consumption, with private consumption falling at a 5.0 percent annual rate.

But exports did not play a major role in the rest of the recovery after the first six months. The next phase of the recovery, from the third quarter of 2002 to the second quarter of 2004, was driven by private consumption and investment, with investment growing at a 41.1 percent annual rate during this period. Growth during the third phase of the recovery – the three years ending with the second half of this year – was also driven mainly by private consumption and investment, as can be seen in **Table 1**. However, in this phase exports did contribute more than in the previous period, accounting for about 16.2 percent of growth; although imports grew faster, resulting in a negative contribution for net exports. Over the entire recovery through the first half of this year, exports accounted for about 13.6 percent of economic growth, and net exports (exports minus imports) contributed a *negative* 10.9 percent.

The economy reached its pre-recession level of real GDP in the first quarter of 2005. As of the second quarter this year, GDP was 20.8 percent higher than this previous peak. Since the beginning of the recovery, real (inflation-adjusted) GDP has grown by 50.9 percent, averaging 8.2 percent annually. All this is worth noting partly because Argentina's rapid expansion is still sometimes dismissed as little more than a rebound from a deep recession.

As can be seen in **Table 2,** the fastest growing sectors of the economy were construction, which increased by 162.7 percent during the recovery; transport, storage and communications (73.4 percent); manufacturing (64.4 percent); and wholesale and retail trade and repair services (62.7 percent).[6]

The impact of this rapid and sustained growth can be seen in the labor market and in household poverty rates. **Table 3** shows the evolution of unemployment and poverty rates during the recovery. Unemployment fell from 21.5 percent in the first half of 2002 to 9.6 percent for the first half of 2007. The employment-to-population ratio rose from 32.8 percent to 43.4 percent during the same period. And the household poverty rate fell from 41.4 percent in the first half of 2002 to 16.3 percent in the first half of 2007. These are very large changes in unemployment, employment, and poverty rates.

[5] This table updates Frenkel and Rapetti (2007) analysis of the contributions to GDP growth during the recovery (p. 11).

[6] This is total real growth from the first half of 2002 to the first half of 2007.

TABLE 2
Main Economic Indicators: 2000 – 2007

	2000	2001	2002	2003	2004	2005	2006	2007	/a
	annual % change								
Real GDP, Total	-0.8	-4.4	-10.9	8.8	9.0	9.2	8.5	8.4	/b
GDP, Main Economic Activities									
Agriculture, Hunting and Forestry	-1.7	0.3	-1.7	7.0	-1.0	11.7	1.5	11.9	/b
Mining and Quarrying	6.7	4.7	-3.7	3.7	-0.4	-0.2	3.0	-2.8	/b
Manufacturing	-3.8	-7.4	-11.0	16.0	12.0	7.5	8.9	6.5	/b
Electricity, Gas and Water Supply	6.6	1.1	-3.0	6.9	6.5	5.0	5.0	5.5	/b
Construction	-9.3	-11.6	-33.4	34.4	29.4	20.4	17.9	10.1	/b
Wholesale and Retail Trade and Repair Services	-2.9	-7.9	-18.5	12.9	13.6	9.8	8.0	11.3	/b
Hotels and Restaurants	0.0	-7.3	-8.3	6.0	7.0	7.9	7.3	7.0	/b
Transport, Storage and Communications	1.7	-4.6	-7.9	8.2	13.4	14.8	13.5	13.3	/b
Financial Intermediation	2.2	-8.9	-19.7	-15.8	-5.5	17.5	22.1	18.6	/b
Real Estate, Renting and Business Activities	0.9	-2.5	-5.6	3.9	4.3	4.5	4.2	4.1	/b
GDP, Expenditure-Based									
Private Consumption	-0.7	-5.7	-14.4	8.2	9.5	8.9	7.8	8.8	/b
Government Consumption	0.6	-2.1	-5.1	1.5	2.7	6.1	5.2	6.4	/b
Gross Fixed Capital Formation	-6.8	-15.7	-36.4	38.2	34.4	22.7	18.2	13.3	/b
Exports of Goods and Services	2.7	2.7	3.1	6.0	8.1	13.5	7.3	8.6	/b
Imports of Goods and Services	-0.2	-13.9	-50.1	37.6	40.1	20.1	15.4	20.1	/b
Current Account	*in % of GDP*								
Current Account Balance	-3.2	-1.4	9.0	6.4	2.1	3.1	3.8	2.3	/b
Merchandise Trade Balance	0.9	2.7	17.6	13.2	8.7	7.2	6.5	4.4	/b
Exports, FOB	9.3	9.9	26.2	23.5	22.8	22.2	21.8	18.2	/b
Imports, FOB	8.4	7.1	8.7	10.3	14.0	15.0	15.3	13.7	/b
Services Balance	-1.5	-1.4	-1.5	-0.9	-0.9	-0.7	-0.4	-0.3	/b
Net Income	-2.6	-2.9	-7.7	-6.2	-6.1	-3.7	-2.5	-2.0	/b
of which: Interest Payments	4.3	4.5	10.6	7.8	6.4	3.6	2.4	2.0	/b
Public Finances /f	*in % of GDP*								
Total Revenue	23.2	22.6	21.2	24.5	26.5	26.9	28.0	30.0	/g
Current Revenue	19.4	18.7	17.6	20.5	23.4	23.7	24.2	25.4	/g
of which: Tax Revenue	14.3	13.8	12.8	16.2	18.7	19.2	19.0	19.9	/g
Total Expenditure	25.5	25.8	22.7	24.0	23.9	25.1	26.2	29.7	/g
Current Expenditure	20.9	21.0	18.4	19.2	19.6	20.1	19.9	22.2	/g
of which: Interest Payments	3.4	3.8	2.2	1.8	1.3	1.9	1.8	1.9	/g
Domestic Debt	0.1	0.0	0.3	0.5	0.4	0.6	0.6	1.0	/g
Foreign Debt	3.3	3.8	1.9	1.3	0.9	1.3	1.2	1.2	/g
Capital Expenditure	1.0	1.0	0.7	0.8	1.3	1.9	2.5	3.1	/g
Primary Balance	1.0	0.5	0.7	2.3	3.9	3.7	3.5	2.4	/g
Overall Balance	-2.4	-3.2	-1.5	0.5	2.6	1.8	1.8	0.2	/g

TABLE 2, *continued*
Main Economic Indicators: 2000 – 2007

	2000	2001	2002	2003	2004	2005	2006	2007	/a
Public Debt Indicators									
Gross Debt (% of GDP)	45.7	53.7	166.4	138.7	127.3	73.9	64.0	62.0	/g
Foreign Debt (% of GDP)	28.6	31.5	95.3	79.2	74.3	34.8	26.3	26.3	/g
Total Interest Payments (% of GDP)	3.4	3.8	2.2	1.8	1.3	1.9	1.8	1.9	/g
Foreign Debt (% of International Reserves)	237.8	555.2	836.2	722.5	568.2	217.0	175.6	156.7	/g
Foreign Debt (% of Exports)	260.2	271.3	300.9	296.8	280.7	131.4	104.3	103.6	/g
Average Maturity of Gross Debt (Years)	7.6	8.3	6.1	6.9	7.8	12.3	12.9	12.9	/g
Additional Items									
Nominal GDP (in billions of current *pesos*)	284.2	268.7	312.6	375.9	447.6	531.9	654.4	835.4	/c
Nominal GDP (in billions of current US$)	284.2	268.7	97.7	127.6	152.0	181.5	212.7	270.4	/c
Average Exchange Rate (*pesos* per US$)	1.0	1.0	3.2	2.9	2.9	2.9	3.1	3.1	/d
Inflation, Consumer Prices (annual % change)	-0.9	-1.1	25.9	13.4	4.4	9.6	10.9	9.1	/e
Short Term Interest Rate (nominal, %) /i	11.1	26.5	53.0	19.1	6.8	6.2	8.6	8.9	/h
Short Term Interest Rate (real, %) /i	12.1	27.9	21.5	5.1	2.3	-3.1	-2.0	-0.2	/h
International Reserves (US$ billions)	36.8	37.2	37.5	37.9	38.2	38.6	39.0	39.4	/j

Source: MECON, BCRA, INDEC.

Notes: a/ Latest available data; b/ First half of 2007; c/ Second quarter of 2007, annualized; d/ Average of monthly nominal exchange rate from January through June 2007; e/ Average of year-over-year, monthly percent change in Consumer Price Index from January through June 2007; f/ Non-Financial Public Sector (includes central and local governments and non-financial public enterprises). Cash basis; g/ As of first quarter of 2007; h/ Average for January through June 2007; i/ 30-day corporate borrowing rate; j/ As of 10/12/2007.

Real wages increased by 40.1 percent over the five years from June 2002 to June 2007.[7] Inequality, as measured by the Gini coefficient, also dropped sharply from 0.537 in 2002 to 0.490 in the second half of 2006. It is worth noting that despite this significant improvement during the recovery, inequality has still not fallen to its level of the early nineties (0.442 in 1992). The same is true for unemployment, which was 6.9 percent in 1992. Part of this results from the structural changes in the economy brought about by the reforms of the 1990s.

TABLE 3
Selected Employment and Social Indicators

		2002 /1	2003 H1	2004 H1	2005 H1	2006 H1	2007 H1
Employed	(% of Total Population)	32.8	37.5	39.9	40.3	42.3	43.4
Unemployed	(% of Total Work Force)	21.5	20.0	15.1	13.4	11.6	9.6
Underemployed	(% of Total Work Force)	18.6	18.4	16.1	13.4	12.3	10.2
Poverty	(% of Total Households)	41.4	42.7	33.5	28.8	23.1	16.3
	(% of Total Individuals)	53.0	54.0	44.3	38.9	31.4	23.4

Source: Instituto Nacional de Estadística y Censos (INDEC).
Note: 1/ 2002 figure is for May, due to change in survey methodology.

[7] Author's calculations using general wage index and inflation data from the Ministry of Economy (MECON).

The Contribution of Economic Policy to the Recovery

A number of government policies seem to have contributed to Argentina's rapid and robust recovery. This is often overlooked, possibly because some of these policy choices are considered controversial. Perhaps the most important of these policies was the government's exchange rate policy. This was important from the second quarter of 2002, when the government strengthened foreign exchange controls and intervened in the foreign exchange market in order to stabilize the currency. At first, the problem was that the peso was too low, as a result of significant exchange rate "overshooting" (see **Figure 2**) that brought the nominal rate to 3.6 pesos/US dollar in May of 2002. The devaluation had caused a sharp spike in inflation, which was then running at a more than 28 percent annual rate. It was important for the government to stabilize the nominal exchange rate – not only to help stabilize inflation but also the financial system. This was done primarily through interventions in the foreign exchange markets (selling dollars), and also by restricting the outflow of pesos from the banking system. The government also required that dollars from export revenues exceeding $1 million had to be turned over to the central bank, thus increasing the supply of dollars that the central bank could use at this time to stabilize the peso.[8] These exchange controls were therefore also an important part of the process of stabilizing the exchange rate, and therefore of the economic recovery.

By the second half of 2002, the government was intervening in the opposite direction, buying dollars to slow the appreciation of the peso. In 2003 the government began to articulate what would become the central bank's exchange rate policy for the rest of the recovery, that of maintaining "a stable and competitive real exchange rate." This was important to the recovery for a number of reasons. First, a stable exchange rate contributes to the predictability of important prices for producers to consider in their investment decisions, with regard to inputs, export markets, and foreign competition. Second, a competitive real exchange rate allows domestic producers of tradable goods and services to compete in world markets.[9] The overvalued currency during the convertibility era was an obvious counterexample: the peso was overvalued when it was pegged to the dollar and became more overvalued (with respect to Argentina's other trading partners, which constitute most of its trade) as the dollar appreciated. Although as we have seen, Argentina's growth during the last five years has not been driven by exports, it is easy to imagine that net exports could have been a significant drag on economic growth if the currency had been allowed to appreciate and fluctuate with capital inflows.

The Argentine government's policy of pursuing a stable and competitive exchange rate was, and remains, unorthodox and controversial. The conventional wisdom among central bankers today is that the central bank should not target the exchange rate, and most central banks would not do it. Most central banks may target inflation itself, or intermediate variables such as short-term interest rates and monetary aggregates, but not the exchange rate. It is generally believed to be incompatible with controlling interest rates in the domestic economy, in an economy with open capital markets.

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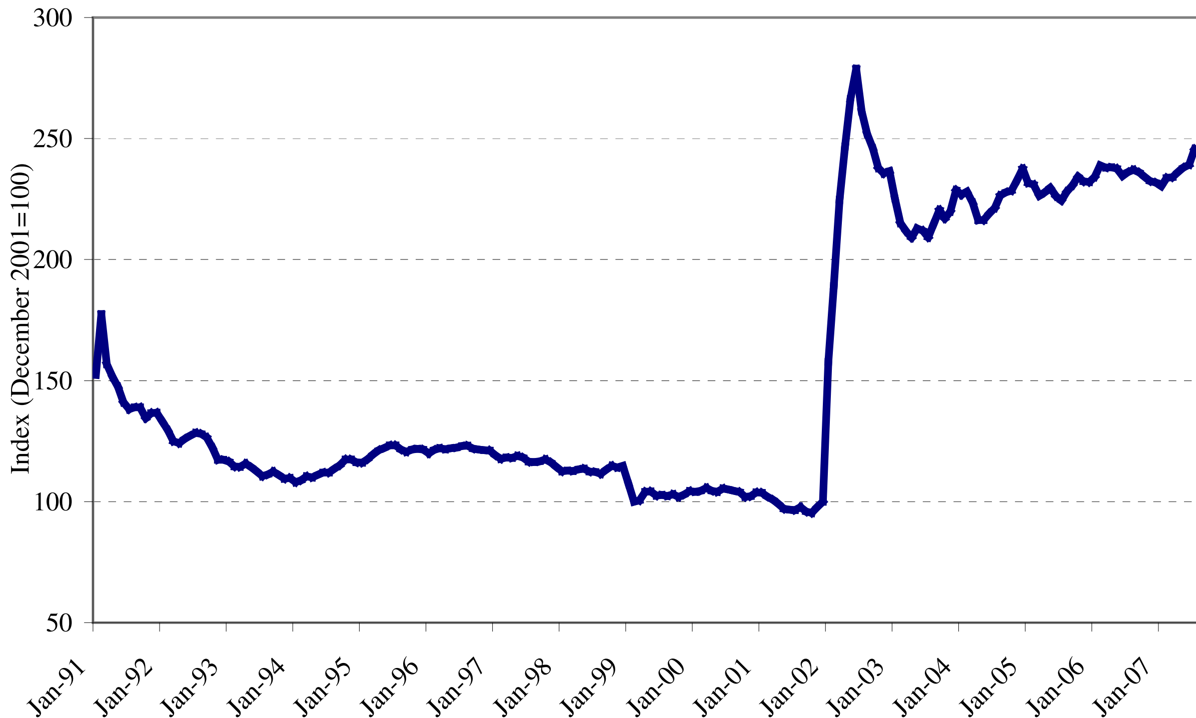
[8] Fore more detail, see Frenkel and Rapetti (2007), pp. 16-20.

[9] Ibid, pp. 21 – 26.

FIGURE 2
Real Effective Exchange Rate (REER), 1991 – 2007 (Index, Base December 2001)



Source: Banco Central de la República Argentina (BCRA).
Notes: 1/ Domestic price of foreign currency. An increase (decrease) in the value of the index indicates a depreciation (appreciation) in the REER.

However, this is not true if there is an excess supply of foreign exchange at the central bank's target exchange rate. The Argentine government has also been able to sterilize its interventions in the foreign exchange market by issuing bonds in the domestic market, and it turns out that this policy is also sustainable.[10] Also, the prevailing orthodoxy is that central banks should be independent of the government.

Another important policy concerns the default and renegotiation of the government's external debt. As noted above, the expectation that Argentina would pay a large and continuing cost for its default did not materialize. On the contrary, the default appears to have been necessary for the country to change its macroeconomic policies so as to restore economic growth. Before the default, the government was focused on tightening its fiscal and monetary policies in a futile – and, probably impossible – attempt to restore credibility among its creditors, an effort that included maintaining the convertibility system. The default enabled the government to pursue a new set of ultimately successful macroeconomic policies.

The Argentine government was subject to considerable pressure from the IMF in the years following the debt default to offer better terms to the defaulted foreign creditors (see below). But in the end, a debt swap in 2005 was arranged that took $67.3 billion of foreign debt off the books. This was a record 65.6 percent "haircut" and was very important to Argentina's recovery. This can be seen by the reduction of the overall public debt, which the swap combined with the rapid economic

[10] See Frenkel (2007), "The Sustainability of Sterilization Policy," Center for Economic and Policy Research (CEPR). [Online at: http://www.cepr.net/documents/publications/RF_MW_SterilizationPolicyPaper.pdf].

growth reduced the public debt from 127.3 percent of GDP in 2004 to 62 percent today (see **Table 2**).

It is easy to imagine that if the government had not taken a hard line with these creditors and their supporters, it would have ended up with an unsustainable debt burden, which could have cut short the recovery. Because of the devaluation, the dollarized debts of the government were vastly increased – Frenkel and Rapetti (2007) note that interest payments on the public debt during the 2002-2004 period would have been between 9 and 11 percent of GDP, or about half of total government tax revenues, if not for the suspension of interest payments.[11]

Two unorthodox taxes levied by the government were also important to the recovery. One was a new export tax which allowed the government to get some of the windfall profits that exporters received as a result of the devaluation. The other tax was already in existence: a tax on financial transactions. As Frenkel and Rapetti (2007) have noted,[12] the two taxes together pulled in about 2.7 percent of GDP, and were responsible for almost the whole national primary budget surplus in 2004. It is also worth noting, as can be seen in **Table 2**, that real short-term interest rates have been negative throughout most of the recovery (since 2003).

Another policy that contributed to the recovery was a program that provided a monthly stipend (150 pesos) to heads of households who were unemployed with children of up to 18 years-old (or disabled of any age), and to those where the head of the household was ill. At its height (2003), the program reached 20 percent of all households, with 97.6 percent of beneficiaries under the poverty line.[13]

The most important challenges facing the economy going forward are in the areas of inflation and energy. As noted above, inflation shot up immediately after the devaluation, but was brought under control relatively quickly and fell to less than 5 percent (monthly, year over year) by August of 2003. However, it began to rise again in the second quarter of 2004, reaching 12.3 in December 2005. There is controversy over what has happened since then; the official figures show inflation at an 8.6 percent annual rate for the third quarter of 2007, but most analysts believe it is significantly higher. As to the measurement problem, it is widely believed that the new government will take steps to correct the Consumer Price Index and restore its credibility in January of next year. For inflation itself, it is likely that the government will seek to bring it down through a combination of tighter fiscal policy, and a "social pact" that seeks agreement among unions, industry, and government on wage and price increases. The government is unlikely, however, to switch to an inflation targeting regime, or use the exchange rate as a mechanism for slowing the economy. It is also unlikely to resort to drastic measures, as has often been the case in Latin America, that would cause a "hard landing" or recession. All of this represents a major break with past policies in Latin America but also the regional and general orthodoxy for central bank policy. While recognizing that steps must be taken to bring inflationary expectations under control, and avoid a wage-price spiral, the government seems willing to live with double-digit inflation for some time as a tradeoff for the rapid real growth of the economy and its enormous positive impact on poverty, employment, and income distribution.

[11] Frenkel and Rapetti (2007).

[12] Page 14.

[13] Golbert, Laura and Claudia Giacometti (2007), "Los programas de transferencia de ingresos condicionados. El caso Argentino," mimeo.

The government also faces challenges in maintaining a sufficient supply of energy to fuel continued high growth rates. Last July, Argentina experienced record cold winter temperatures, including the first snowfall in Buenos Aires in 89 years. Demand for natural gas, which is used for heating homes, outstripped supply. The government responded by rationing natural gas to industry, which caused some production losses, while keeping homes fully supplied. More than half of Argentina's electricity production uses natural gas, and a drought in June and July also cut capacity in hydroelectric generation.
There are indications that private investment in energy projects has been significantly lower since 2001.[14] The government has been reluctant to raise low tariffs for natural gas and electricity, especially at a time of rising inflation, prompting critics to blame the energy shortages on the government's maintenance of low prices. However, it is not clear that sufficient and timely private investment would be forthcoming even if prices were much higher – energy shortages are a regional problem despite much higher prices in neighboring countries. The government has responded to the problem by creating a national energy company in 2004, Enarsa; by limiting exports to Chile and Uruguay; by encouraging energy saving practices among consumers and by rationing the energy supply to industry; subsidizing fuel oil for industrial users as a substitute for natural gas; and by starting a series of projects aimed at increasing Argentina's energy supply, including projects in the private sector as well as international energy cooperation agreements with Bolivia and Venezuela. So far, losses in GDP due to energy shortages have been very small; but the government's efforts to expand energy production may have to bear fruit over the next few years in order to avoid more significant problems.

It is also worth noting that the Argentine economy does not face any fiscal or current account imbalances that put the current recovery in jeopardy. As can be seen in **Table 2,** spending has increased quite substantially over the last two years, by 4.6 percentage points of GDP; this rate of increase in spending is not sustainable, but the public sector is still running a small surplus. The current account is also in surplus (2.3 percent of GDP), and the central bank holds $42.5 billion, or 17.3 percent of GDP, in international reserves.

The Role of the IMF

The IMF is often considered to be an international lender of last resort, analogous to the role that a central bank plays in a national economy. In the United States, for example, the Federal Reserve stands ready in some circumstances to lend money to a bank that is subject to a sudden rush of withdrawals by depositors, in order to prevent such a "run" on the bank from spreading to other financial institutions. However, when the Argentine banking system was subject to such a run and was collapsing in December 2001 – January 2002, the Fund did not provide any financial support. In fact, it did not provide any net funds at all in the ensuing year (2002). This was a time during which aid from the IMF could have been of great assistance in stabilizing Argentina's financial system, but it was not forthcoming. On the contrary, the IMF together with the World Bank and other IFI's drained a net $4 billion, or about 4 percent of GDP out of the economy, with most of that going to the IMF. This was in sharp contrast to the tens of billions of dollars of loans that the IMF arranged – e.g. the $40 billion loan in December of 2000 – prior to the collapse, when the IMF was more sympathetic to the Argentine government.

[14] The World Bank, for example, estimates that private participation in energy projects in Argentina was an average $638 million for the 2001-2005 period compared to an average of $2.8 billion for the 1992-2000 period (Private Participation in Infrastructure (PPI) Project Database, World Bank. [Online at: http://ppi.worldbank.org/]).

The Fund did, however, try to influence government policy during this crucial first year of the recovery. In keeping with its analysis that fiscal policy was the root cause of the crisis, the IMF pushed for spending cuts, as well as a tighter monetary policy including inflation targeting.[15] The IMF also wanted Argentina to change its bankruptcy law. According to press reports, the IMF's main objections were to a section of the law that provided those filing for bankruptcy with protection from creditors for 180 days, and another article allowing creditors a 360-day period to request a rescheduling of debt.[16] Anoop Singh, then Director of Special Operations for the IMF, stated publicly that "the international community could not be expected to support Argentina without the early adoption of a framework that provides an appropriate balance between creditor and debtor interests."[17] IMF negotiators also demanded the repeal of an "economic subversion" law under which the government could investigate acts by firms, banks, or individuals that damage the economy or cause harm to large sectors of the population.
During this time, it appeared that the Fund was playing the opposite role of a lender of last resort: helping to ensure the denial of credit, as much as possible, until an overall agreement with defaulted creditors could be reached. Even loans targeted for assistance to social programs, such as a $700 million loan that had been approved from the World Bank – were withheld pending an agreement with the IMF.[18] Many private lenders, as well as European governments, were also waiting for IMF approval before extending credit.[19] The lack of agreement with the Fund appears also to have held up some export credits.[20]

In January 2003, a year after the collapse, the Fund finally signed an agreement with the government of Argentina. This agreement simply enabled the government to roll over its debts to the IFI's, and provided no new net credit. Since the agreement was only for a year, the IMF continued to use its leverage pending the next agreement to push for more policy changes.

The Fund lobbied for the government of Argentina to offer a better deal to the defaulted foreign creditors. It invoked a little-known internal policy which provides that the IMF should not "lend into arrears" – that is, lend to a government that has fallen behind on its debt payments unless "the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors."[21] This effort on behalf of the creditors would continue into 2004.[22]

[15] The IMF's Anoop Singh called for the central bank to "strictly limit the growth of its own credit and to move toward establishing "a full-fledged inflation-targeting regime – such as that adopted by other countries, including Brazil after its own difficulties in 1999" (Anoop Singh (2002), *op. cit.*).

[16] See "Time is running out, Argentina admits," by Mark Mulligan, *Financial Times*, May 9, 2002, and "Para dejar tranquilo a Singh," by Cledis Candelaresi, Página/12, April 19, 2002.

[17] Anoop Singh (2002), *op. cit.*

[18] "Argentina: World Bank Continues Support," World Bank Press Release, Washington, July 19, 2002 [Online at: http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20055157~menuPK:34466~pagePK:34370~piPK:34424~theSitePK:4607,00.html].

[19] See "No Argentina/EU aid talks until deal signed with IMF—Ruckauf," AFX News, May 22, 2002.

[20] The head of the Argentine Chamber of Exports, Enrique Mantilla, signaled a disruption in the terms by which normal credit relations function; Foreign Minister Carlos Ruckauf and other Argentine government officials 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, pledged money for trade financing in its promises of aid, but only once an IMF agreement went through (See "Argentina Gets $100 Million World Bank Emergency Aid," by Mark Drajem, Bloomberg, March 8, 2002).

[21] "IMF Policy on Lending into Arrears to Private Creditors," IMF, 1999.
[Online at: http://www.imf.org/external/pubs/ft/privcred/lending.pdf]

The IMF also pushed for higher primary budget surpluses than the government was willing to accept, including a 4.5 percent budget surplus for 2004 and even higher surpluses for the next two years. Although the government ended up running large primary surpluses in these years, that was only because of higher than expected growth – the planned surpluses advocated by the IMF were significantly higher than what the government wanted to target. The higher primary surpluses demanded by the IMF would enable more money to be paid to the private creditors.

The IMF also pressured the government to get rid of the emergency protection for homeowners from mortgage foreclosure. Legislation passed in 2002 delayed foreclosures on mortgages for homes that were a family's "sole and permanent residence." According to Argentine government officials in 2003, the Fund insisted that this freeze on mortgage foreclosures had to go, if there were to be a new agreement with the IMF.[23] As a result of the economic collapse and the devaluation -- many homeowners had mortgages owed in dollars -- millions of Argentine home owners were behind in their payments.

Finally, the Fund also played a negative role in the recovery by continually forecasting growth far below what actually transpired. While there is no evidence that this was done deliberately, the effect of such forecasts was to cast doubt on the sustainability of the recovery as it transpired. **Table 4** (bottom half) shows the IMF's forecasts in the Fall of the prior year, for the years 2003, 2004, 2005, and 2006. As can be seen in the table, the Fund's projections were consistently low by 7.8, 5.0, 5.2, and 4.3 percentage points for these four years, respectively. These are huge and remarkably consistent forecast errors. They also contrast sharply with the large and consistent forecast errors in the other direction – overestimating growth – in the prior three years, before the collapse of the convertibility system. These are shown in the top half of **Table 4**.

TABLE 4
IMF Projected GDP Growth for Argentina and Actual Growth

Year of Fall WEO	Projected Growth for Following Year	Actual Growth in Following Year	Error in Forecast (Percentage Points)
1999	1.5	-0.8	+2.3
2000	3.7	-4.4	+8.1
2001	2.6	-10.9	+13.5
Default and Devaluation			
2002	1.0	8.8	-7.8
2003	4.0	9.0	-5.0
2004	4.0	9.2	-5.2
2005	4.2	8.5	-4.3

Sources: Rosnick and Weisbrot (2007), Table 1, p. 4.[24]

[22] See, e.g., "Argentina pays Dollars 3.1bn IMF bill," by Adam Thompson, *Financial Times*, March 10, 2004.

[23] See, "The Homes of Argentines Are at Risk in I.M.F. Talks, " by Larry Rohter, *The New York Times*, June 23, 2003, p.A6.

[24] Rosnick, David and Mark Weisbrot (2007), "Political Forecasting? The IMF's Flawed Growth Projections for Argentina and Venezuela," CEPR.
[Online at: http://www.cepr.net/documents/publications/imf_forecasting_2007_04.pdf]

Conclusion: Lessons from Argentina's Recovery

It is difficult to make generalizations about economic policy based on any particular economic recovery. All business cycles are different, having different drivers of expansion and different causes of their cessation, even in the same national economy. Nonetheless, there are some observations about Argentina's recovery that are worth noting, because they appear to contradict the conventional wisdom.

First, certain unorthodox economic policies seem to have played an important role in the recovery. As discussed above, the central bank's targeting of a stable and competitive exchange rate is one. This is something that may be applicable to other countries that are looking for macroeconomic policies that would promote more effective development strategies. For example, as the government moves to lower inflation over the next year, it is unlikely to abandon its policy of having the central bank target a competitive real exchange rate. In so doing, it is deciding that this policy is important enough so that the exchange rate should not be generally used as a tool in managing inflation.[25]

The government's willingness to accept double-digit inflation as a tradeoff for rapid growth is also a major departure from established orthodoxy, but one that appears to have paid off for Argentina. This may also have implications for other developing countries. Latin America over the last 26 years has experienced its worst long-term growth performance in more than a century, with only about 14 percent per capita growth from 1980-2006, as compared with 82 percent growth from 1960-1980.[26] In fact, the vast majority of low- and middle-income countries have experienced a sharp growth slowdown during the last quarter-century.[27] It is likely that overly tight monetary and perhaps fiscal policy, in a tradeoff that sacrifices too much growth in order to maintain very low inflation levels, is part of the cause of this slowdown. Of course, if inflation were to spiral out of control in the next few years, there may be second thoughts about the government's policy; but, assuming it does not, it would appear that accepting higher inflation for the rapid growth of the economy was a good choice.

As we have seen, Argentina's recovery was not driven by exports and high commodity prices, but rather – except for the first six months – primarily by domestic demand. It also was not hindered by low and declining levels of foreign direct investment – 1.4 percent of GDP for the years 2003 – 2007 – which in policy and media circles is often considered to be the central building block of a growth strategy for low and middle-income countries.

Perhaps most importantly, the government was very firm in negotiating the restructuring of its defaulted external debt. This was important in terms of both enabling pro-growth policies to be implemented, and avoiding the drain of resources and other negative consequences on the investment climate, of a larger debt burden. While default is not an option that most countries would want to consider, the costs of Argentina's default turned out to be vastly less than commonly

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[25] In many developing countries, the main mechanism through which monetary policy affects the rate of economic growth is through the exchange rate: e.g., higher interest rates raise the value of the currency and reduce net exports.

[26] Author's calculations using data from Alan Heston, Robert Summers and Bettina Aten, Penn World Table Version 6.2, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania, September 2006 and World Economic Outlook Database, International Monetary Fund.

[27] See: Weisbrot, Mark, Dean Baker and David Rosnick (2005), "Scorecard on Development: 25 Years of Diminished Progress," Center for Economic and Policy Research (CEPR).
[Online at: http://www.cepr.net/documents/publications/development_2005_09.pdf]

believed at the time. Similarly, Argentina's recovery does not seem to have been hindered by its greatly reduced access to international credit markets, something which goes against the standard arguments in policy circles, where a country's sovereign credit rating is considered to be a very important determinant of its prospects for economic growth. In hindsight, it seems clear that the government made the right decision in deciding to prioritize its immediate economic recovery over satisfying foreign creditors and international credit markets.

This is also something that may have implications for other developing countries, including low income as well as middle-income countries. There are many countries that remain saddled with large debt burdens, and are borrowing internationally – generally from official creditors – only to make debt service payments. Their international borrowing is therefore not financing their economic development, but only debt service. At the same time, they are often subject to policy conditions attached to borrowing from the IFI's, as Argentina was prior to its default, that may prevent them from achieving rapid and sustained growth and development. Of course, poorer countries are often more vulnerable and dependent on foreign financing than a middle income country such as Argentina. But Argentina was able to assert its independence from the IMF and its policy recommendations primarily because it was running a large trade surplus, and therefore did not need foreign financing other than to service its foreign debt. There are other developing countries that are similarly situated, and they may have more bargaining power than is currently recognized with respect to the IMF and other IFIs and bilateral lenders that are their major creditors.

This is particularly important in light of the enormous changes that have taken place in the international financial system in recent years. Prior to a few years ago, the IMF was able to exert considerable influence over economic policy in most developing countries because of its "gatekeeper" role for loans from official creditors. In other words, borrowing countries would very often not be able to access credit from the World Bank, other IFI's or G-7 governments – and sometimes even the private sector – without first reaching an agreement with the IMF. This relationship has broken down for most middle-income countries.[28] Indeed, Argentina's successful standoff with the Fund was part of the process that ended this historic relationship. When Argentina temporarily defaulted to the IMF in September 2003, it was entering uncharted territory. Such a default carried the risk of a cutoff of almost all international credits, and because the potential punishment was so severe, the only countries that had really defaulted to the IMF were failed or "pariah" states: Afghanistan, Congo, Iraq, Liberia, Somalia, and Sudan. As it turned out, the IMF backed down and rolled over Argentina's debt to the Fund, thus avoiding a real default. More recently, Argentina has received major loans from the World Bank ($1.76 billion in 2007) and the Inter-American Development Bank ($2.16 billion in 2007). These large loans from these two IFI's who work closely from the IMF, given Argentina's very antagonistic relationship to the Fund, would never have happened a few years ago, and are another indication of this drastic change in the international financial system.

Thus, while default or a forced restructuring is not a decision that any debtor would want to take lightly, there are situations – as in Argentina's case five and a half years ago – where it is the best alternative. It may also be important, as it was in the case of Argentina's showdown with the IMF, to have default to official creditors as a viable option – in order to have the bargaining power to reject harmful economic policy conditions. Even in the case of middle-income countries whose debt is

[28] For more on this change in the international financial system, see Weisbrot, Mark (2007), "Ten Years After: The Lasting Impact of the Asian Financial Crisis," CEPR [Online at: http://www.cepr.net/documents/publications/asia_crisis_2007_08.pdf].

primarily held not by official creditors but by private creditors – both domestic and international – a debt restructuring could be the preferred option, if the demands of the financial markets (e.g. excessively high interest rates for many years on end) are incompatible with economic growth.

As more countries become more independent of the IMF and allied IFI's and governments, the "policy space" for different and potentially more successful macroeconomic and other economic policies will expand. In Argentina's case, as we have seen, the IMF was opposed to most of the major economic policies that contributed to the country's rapid economic recovery. Argentina's break with the Fund was therefore one of its most important decisions, and one that may prove to have lessons for other developing countries as well.