

Hard Money's Soft Underbelly: Understanding the Argentine Crisis

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Abstract

Argentina's crisis did not take people by surprise, yet it proved impossible to avoid. Hausmann and Velasco argue that a simple fiscal explanation is inadequate. They attempt to understand the Argentine crisis by focusing on the interactions between two factors: the misaligned real exchange rate and the country's capacity to borrow abroad. In this framework, export prospects determine the access of financially constrained countries to external resources. Starting in 1999, expectations of future export growth declined sharply: expected returns to capital in this sector fell, alongside low export prices and an appreciating real multilateral exchange rate. The drastic tightening of the financing constraint explains the onset of Argentina's investment decline and recession. Thereafter negative factors fed on each other: higher risk premia and smaller capital flows meant less demand for domestic investment, which in turn depressed aggregate demand and output, further curtailing creditworthiness and the ability to borrow. Moreover, because Argentina was dollarized, relative prices could not adjust quickly (deflation did its painful job, but very slowly), so quantities had to do so instead. In this sense, Argentina's financial crisis was a growth crisis.

In this situation, policymakers were faced with tough choices. Standard fiscal contraction ran the risk of further contracting the economy, while having a highly uncertain impact on expectations, investment and future growth. Using the exchange rate was no easier. Argentina clearly suffered from exchange rate overvaluation. But given the large stock of dollar-denominated debt, devaluation by itself would have most likely made matters worse. Arguably, a devaluation accompanied by a symmetric pesification of financial claims might have resolved the overvaluation, while minimizing the negative balance sheet effect.