Argentina's 2001 Economic and Financial Crisis: Lessons for Europe

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The 2001 Argentine economic and financial crisis has many parallels with the problems that some European countries are facing today. Prior to the crisis, Argentina was suffering a deep recession, large levels of debt, twin deficits in the fiscal and current accounts, and the country had an overvalued currency but devaluation was not an option.

Argentina tried in vain to restore its competitiveness through domestic deflation and improving its solvency by increasing its fiscal accounts in the midst of a recession. The country also tried to avoid a default first by resorting to a large financial package from the multilateral institutions (the so called shield or *blindaje*) and then by implementing a debt mega-swap that helped to refinance most of the debt with private banks. In the end, none of these efforts worked and Argentina faced its worst economic and financial crisis ever.

There were two issues that complicated the policy response to the crisis in Argentina, which to different degrees are important in Europe today. First, Argentina was unable to devalue its currency—without breaking the convertibility law—to restore competitiveness when the external conditions deteriorated. The strategy of trying to achieve a real depreciation through deflation did not work because there was not enough downward flexibility in nominal prices and wages.

Second, there was a large degree of financial dollarization in the economy, as the banking system functioned mainly in dollars. In this environment, the banking system had short-term liabilities in dollars but lacked a lender of last resort, as the stock of dollar assets—namely liquidity held by banks and international reserves—was not enough to cover the financial liabilities of the consolidated financial system. This was a major source of vulnerability, especially because there is ample evidence that an economy without a lender of last resort is inherently unstable and subject to bank runs. This is not a pressing issue in Europe, where the European Central Bank can provide liquidity to banks.

The trigger for the crisis in Argentina was a run on the banking system as people realized that there were not enough dollars in the system to cover all the deposits. As the run intensified, the Argentine government was forced to introduce a so-called "fence" to control the outflow of deposits. Under this system, people could only transfer funds within the banking system but they were not allowed to get cash, except in small amounts. This measure resulted in a monetary crunch and led to a collapse of economic activity—especially in the informal sector which mainly works on cash—and to widespread social unrest.

In the end, the fixed exchange rate regime collapsed and the country declared what until now has been the largest sovereign default in history ($85 billion). Argentina suffered its worst economic and financial crisis ever. The currency depreciated from one to more than three pesos per U.S. dollar in a matter of weeks, GDP per capita fell by around 20 percent during the whole period, while unemployment increased to 25 percent of the labor force and poverty levels reached 55 percent of the population.

While the crisis was extremely painful, the economy recovered relatively quickly. Since the crisis, Argentina has enjoyed sustained high rates of growth (a median of around 8 percent per year), which only suffered a pause during the 2008 global financial crisis. What factors explain the Argentine recovery? There is certainly no consensus on this issue. Some analysts give most of the credit to the default on the debt, others to the depreciation of the currency combined with policies that reduced macroeconomic vulnerability, while others argue that the key factor was the improvement in the external environment.

Although the default is often seen as the most important policy decision, it is not obvious that Argentina had a solvency problem at that time even though it definitely had a liquidity one. In 2001, the debt-to-GDP ratio was 55 percent, although the figure increased to 150 percent after the depreciation since most of the debt was denominated in foreign currency. The default was helpful in dealing with the refinancing problems because it provided significant relief to the liquidity problems. But in itself it did not help to restore competitiveness or confidence to resume growth.

The depreciation of the currency was probably more important, as it helped to improve competitiveness and to generate the twin surpluses. It was particularly effective in eroding the real value of wages and public sector expenditures (especially pensions), where there had been significant resistance to accept nominal reductions. It provided the flexibility in real wages that was not possible to achieve through reductions in nominal wages. The fact that the economy was suffering a severe recession and high rates of unemployment minimized the inflationary effects of the devaluation, which previously had been a problem.

The devaluation was also critical in reducing government expenditures in real terms and in improving the fiscal accounts. It was also instrumental in allowing the government to run large fiscal surpluses for more than five years.

While the sharp depreciation of the currency succeeded in changing relative prices, it did have substantially negative balance sheet effects, as firms and individuals had most of their debts denominated in dollars. To address this problem, the government adopted a forceful conversion of most financial assets and liabilities that were denominated in dollars into pesos at the old parity—this is now widely known as "pesification".

This policy was very disruptive and was a source of social unrest, especially among small depositors who found that their savings had lost purchasing power. It definitely affected property rights; the exchange rate that was used to convert the assets and liabilities was arbitrary and implied excessively large transfers of wealth from creditors to debtors, but it also avoided widespread bankruptcies.

In the case of the Europe, this would only become a problem if one of the countries were to abandon the euro. This may not have severe balance sheets effects if in the end the euro depreciates against other currencies. The opposite may happen, however. On balance, it would appear that an exit from the euro could be full of huge risks for any country in the eurozone.

The greater competitiveness of the economy in the aftermath of the devaluation was helped by a better external environment, especially the improvement in export prices and the stronger demand from Brazil, China and other emerging markets.

In addition, the de-dollarization of the banking system, while traumatic, did reduce the financial vulnerability of Argentina, as the central bank could again act as lender of last resort. The government also reduced its currency miss-match as a large part of public debt was also "pesified", which implied that it could service the debt using its tax revenues that were mainly in pesos.

Four years after announcing the default, Argentina finally restructured 72 percent of its debt and it managed to negotiate long maturities and a 65 percent haircut in net present value. Most of the outstanding debt that remained in default after the first offer was restructured in 2010—nine years after the default—under similar financial terms.

Is the Argentine default and subsequent restructuring an example to follow for Europe? There is no clear cut answer to this question, as the Argentina case had mixed outcomes. True, Argentina has enjoyed high growth since the crisis, but it could be argued that this took place thanks to the depreciation and the improvement in the external environment, and at the cost of allowing inflation to rise to almost 25 percent per year. Argentina took a large haircut that over time has led to a reduction in the net debt burden to around 25 percent of GDP. However, as this reduction was obtained by what the market perceived as an "excessive" initial haircut and by eroding the peso-indexed debt through the under-reporting of inflation, Argentina has not been able to regain fluid access to financial markets and credit spreads have been the second highest among emerging countries—only surpassed by Venezuela.

With the benefit of hindsight, it seems that Argentina could have done a few things differently. The market understood and accepted a restructuring of its debt and a large haircut as part of the process to restore solvency and access to financial markets. But it penalized the country thereafter mainly because Argentina imposed tougher terms than the market had expected. In addition, once Argentina finished the restructuring, it once again affected the property rights of the creditors, making what some economists have termed a "technical default" on the peso-indexed bonds.

The lessons for Europe are important. A default is doable, the market can accept it and it can work to restore fiscal solvency. However, in and of itself, a default is not enough to restore growth. In Argentina, the real depreciation of the currency and luck—the rise in soybean prices—were critical to sustaining a strong recovery.