Learning from Latin America: Debt crises, debt rescues and when and why they work

20 February 2012

The Argentine Foreign Debt Default and Restructuring[1]

Roberto Frenkel[2]

For almost three decades, Argentina's foreign debt was one of the main concerns of economic policy in the country. Despite this, both the record amount of the defaulted debt and the novel characteristics of its restructuring surprised many observers. We have analyzed the Argentine foreign debt problem, the default of part of the public debt in 2001 and the restructuring process in a number of papers, particularly in Damill, Frenkel and Rapetti (2010)[3]. In what follows we comment on some aspects of the issue that seem to be more relevant for present discussions. We start by briefly assessing three frequently mentioned arguments about the Argentine foreign debt and default and commenting on the role of the IMF.

Debt Intolerance

Let us first consider the argument that takes the Argentinean experience as an example of "debt intolerance." Some economists include Argentina in a grouping of countries that carry an "original sin" of being serial defaulters and consequently suffer from debt intolerance. The extraordinary emphasis that the debt intolerance approach puts on both the remote past and rigid institutional features takes the focus away from what is the most fruitful perspective in an international comparative analysis of the external debt problem: the different policies followed by the countries in their processes of financial integration into the global system. In our analyses of the Argentine foreign debt we have paid special attention to the economic policies that framed Argentina's external debt growth since the 1970s. We conclude that there is no supporting evidence for the "debt intolerance approach". We show that by the end of the seventies the country had built up an intolerable debt burden. The origin of the external debt problem was not a remote "original sin" but a more recent original policy mistake—essentially, the combination of capital account opening, a fixed nominal exchange rate and an appreciated real exchange rate. That original policy mistake was repeated again in the nineties.

Fiscal Profligacy

The second argument we criticize is the one that takes the Argentine case as an example of how uncontrolled public spending is the main cause of the crisis and default. This is probably the most common, yet false, image of the Argentine case. A detailed examination of the fiscal accounts shows that the cumulative effects of the interest rate rise, which followed the increase in the country risk premium due to contagion after the Asian and Russian crises, caused the adverse public debt dynamics

[1] Presentation at the Seminar 'Learning from Latin America: Debt crises, debt rescues and when and why they work', hosted by the Institute for the Study of the Americas, University of London, and sponsored by the Latin American Development Bank (CAF). London, February 20, 2012.
[2] Principal Research Associate at CEDES and Professor at the Buenos Aires and Torcuato Di Tella Universities.
[3] Damill, M., R. Frenkel and M. Rapetti "The Argentinean Debt: History, Default and Restructuring" in Herman, B., J. A. Ocampo and S. Spiegel (eds.) *Overcoming Developing Country Debt Crises*. Oxford University Press, Initiative for Policy Dialogue Series. 2010.

in the last quarter of the nineties. Interest rates on Argentine public debt rose more than in many other countries in the region. The interest payment item was the main factor explaining the increase in the fiscal deficit in the 1998-2001 period leading up to the default. Indeed, the fiscal deficit increased despite a significant rise in the surplus in the primary balance. In addition, the deficit of the pension system following the social security reform of 1994, partly privatizing the public system, also contributed to the increase in the fiscal deficit. The fall in the public pension system receipts also resulted from the recession and the employment contraction that started in mid-1998. In other words, the rise in the country risk premium and the interest rate can be associated with the fragile external accounts or, alternatively, with the evolution of public finances, or with both, as the investment fund analysts and the risk rating agencies actually wrote in their reports. However, even if the uncertainties regarding public debt sustainability weighed significantly in the investors' assessments, this should not overshadow the original source of the rise in public deficits and debt in the late nineties. The main source was not mistaken but exogenously chosen expenditure and tax policy, but rather the compounded effects of inherent fragility of the external accounts and their vulnerability to the contagion of crises of confidence elsewhere.

The Social Cost of the Default

We also question the view that the default was the main factor responsible for Argentina's deep economic crisis in the early part of the twenty first century and its high social cost. Our analyses show that the abrupt contraction in the activity and employment levels began, to a great extent, before the default, i.e., while the government subjected the country to big efforts to keep the debt servicing on track. The collapse of activity and employment was a consequence of the generalized rush to buy external assets and the resulting liquidity crunch. And then in the first quarter of 2002, the real devaluation owing to the sharp fall in the peso exchange rate added another contractionary effect. However, the default also turned out to be one of the conditions that enabled the recovery that took place soon after. This was not only due to the positive fiscal effect of the payments suspension, but also a consequence of having freed the economic policy from the need to continuously issue signals aimed at facilitating the rollover of the debt obligations. It allowed the implementation of a pragmatic macroeconomic policy, focused on the stabilization of the exchange market and the quick recovery of fiscal revenues, which became feasible when no further new private or multilateral external fresh funds were needed. The success of this policy provided the base for the recovery.

The Role of the IMF

It is striking that Argentina's crisis and the massive default took place in a country that for a long time was considered a Washington Consensus success. Almost until the end of the nineties, the IMF and most of the financial market analysts considered Argentina as one of the cases following macroeconomic policy and structural reforms appropriate for the era of financial globalization. In our view, the IMF's advice was actually not helpful. In fact, the IMF's commitment to the "convertibility regime" – particularly, the rescue package granted to the country at the end of 2000 and extended in 2001—generated criticisms and conflicts within the institution and motivated a special investigation of the convertibility regime period by the Fund's Independent Evaluation Office. The relationship between Argentina and the IMF was very different in the period following the default. The debt restructuring took place in the context of a conflictive relationship between the IMF and the country. The most unusual feature in this process was that the IMF did not participate in the design and management of the debt restructuring. Neither did the organization audit the government's financial projections that justified the call for very deep dept reduction to achieve sustainability. The importance of this novelty is highlighted both by the record amount of debt that was restructured and by the unprecedented haircut, one of the highest in the debt restructuring history of the recent globalization period.

The macroeconomic evolution in the nineties

The basic plot of the macroeconomic story of the late nineties was quite simple. The negative financial turnaround in the foreign environment experienced in 1997-1998, after the East Asian and Russian crises, found the Argentine economy with a significant and growing current account deficit, a considerably appreciated currency and a visible lack of policy instruments to deal with these problems, given the rigidities of the adopted macroeconomic policy rule. In these conditions the country-risk premium jumped upwards and the access to foreign funds became more and more problematic. The subsequently increased interest burden had a negative impact on all borrowers, including the public sector.

Because of the fixed exchange rate and dependence of monetary conditions on the balance of payments, fiscal policies had to bear the burden of the adjustment to the new situation. The government argued that furthering fiscal discipline would strengthen confidence, and consequently the risk premium would fall, bringing interest rates down. As a result, domestic expenditure would recover pushing the economy out of the recession. Lower interest rates and an increased GDP would, in turn, reestablish a balanced budget, thus closing a virtuous circle. Fernando de la Rúa's administration in 2000 borrowed this entire argument from Carlos Menem's administration which had preceded it, and the IMF gave its seal of approval. All of them failed.

The entire macroeconomic story of the late nineties is about this failure. Despite the strong adjustment in the primary balance of the public sector the virtuous circle was never attained. Even worse, the increases in taxes and the cuts in public expenditures reinforced the recessionary trend, thus feeding the negative expectations that prevented realizing the highly anticipated fall in the country-risk premium. Fiscal policy alone was impotent to compensate for the strong macroeconomic imbalances, which laid somewhere else, i.e., in the external sector of the economy. Under this self-destructive fiscal policy orientation, the economy got trapped into a vicious circle for several years, and suffered from the longest recession since the First World War.

The evolution of the fiscal accounts

In the eighties the average deficit in the overall public sector was about 7% of GDP. The deficit decreased to less than 1% of GDP in 1991-94. This was mainly due to an improvement of 6 percentage points of GDP in the national administration balance, 90% of which is explained by the shift in the primary balance.

In 1994 the social security reform created the Private Pension Funds. One of the consequences was a considerable loss in contributions to the public subsystem. At the same time, in 1995 the economy went through a recession associated with the contagion of the Mexican crisis. Both factors negatively affected the public finances. But, in spite of these negative effects, between 1995 and 1997 the average fiscal deficit was – 2.6% of GDP, only 2 percentage points of GDP higher than the early nineties deficit. The increment is almost equivalent to the increase in the public social security subsystem disequilibrium caused by the reform.

After 1997 the fiscal panorama changed significantly. The impact of the Russian and Brazilian crises in 1998 resulted in a new jump in country-risk premiums, which had already started rising in mid-1997, after the East Asian crisis. This negatively affected internal demand and triggered a new recessionary trend. On the other hand, it increased the financial vulnerability of debtors, including the public sector as well as many private agents that were in a net debtor position. The public sector's deficit increased significantly reaching about 6 percent of GDP in 2001, despite the many rounds of contractionary fiscal policies adopted to stop the trend.

The pro-cyclical fiscal policies implemented were not ineffective: they produced a substantial increase in the primary surplus (without including the public social security results) that averaged 1.4% of GDP, though that was not sufficient to compensate for the rises in the interest item and in the social security system disequilibrium.

The amount of tax revenue absorbed by interest payments took a fast upward trend. In 2000, that ratio was nearly 19%, doubling the ratio registered in the middle of the decade. This was in part due to the decrease in tax revenues caused by the recession, but it fundamentally originated in the rise in the average interest rate paid on the public debt. The average interest rate on total public debt went from 5.8% in 1996 to 9.4% in 2001. This is an average rate, the marginal rate raised considerably more.

The rising path of the interest rate is associated with the increasing country-risk premium. These rising trends are the main factors behind both the consolidated deficit trajectory and the explosive path taken by the public debt. Between 1997 and 2001, in only four years, the public debt/GDP ratio increased by more than 20 percentage points.

The Efforts to Prevent Default and Save the Currency Board Regime

In December 1999 a newly elected government took office. The new De la Rúa administration adhered to the belief that the main cause of the economic depression was not the exchange rate appreciation and the financial vulnerability to external shocks, but the fiscal mismanagement. This vision led the government to adopt a tight fiscal policy as a way to take the economy out of the recession. The failure of this policy orientation should not obscure the fact that huge efforts were made to balance the public accounts and to prevent the default of the government's financial obligations. Successive packages of tight fiscal measures were applied during 2000 and 2001.

A Fiscal Responsibility Law approved in late 1999 set a mandatory declining trend for the public deficit that would bring it to zero in a few years. Tax increases and expenditure cuts were adopted with that purpose. Later on, by mid 2001 when the credit constraint had strengthened, a "zero deficit" policy was approved determining that the public accounts had to be immediately balanced (so that total expenditures had to be adjusted to total cash receipts). The package also included a 13% across the board cut in public wages and pension benefits. It should be kept in mind that these measures were taken when the economy was already ending its third recession year. These decisions exemplify the huge efforts made to prevent a default on the public debt.

In any case, the expected positive "confidence shock" never materialized. With the economy suffering from a deep recession and caught in a debt trap, these rounds of contractionary fiscal policies only reinforced the deflationary scenario and the pessimistic expectations.

During 2000 and 2001 the government attempted to complement its fiscal measures with some initiatives on the financial front. It obtained foreign support and implemented important debt swaps aiming to convince the public that there was no risk of default. Thus, at the end of 2000 an important package of local and external support, for about 40 billion dollars, was announced: (the "*blindaje*", financial shield). The IMF led the operation with a 13.7 billion dollar extension of the stand-by credit in force since March 2000. Local agents including a group of banks and the private pension funds also had a significant participation. The beneficial effect of this action, however, was very short lived. Two months after its announcement, and following the outburst of a new crisis in Turkey, the country-risk premium started to climb again.

The withdrawals from local bank deposits picked up speed in October 2000 and international reserves begun to fall. In March 2001, after the ephemeral recovery that followed the announcement of the *blindaje*, this process became more intense. Beginning in December the government established hard restrictions on capital movements and on cash withdrawals from banks (the so called "corralito"). One of the purposes of these measures was to avoid either the generalized bankruptcy of the banks or the violation of the currency board monetary rule. But the main objective of the measures was to hold back the demand for foreign currency, preserve the stock of reserves and avoid the devaluation (i.e. the formal abandonment of the convertibility regime). It was also the last drastic attempt to prevent the default. Yet, the measures actually did represent the end of the regime.

The restrictive December financial measures contributed to a deepening of the already strong social and political tensions. After a few days of social unrest and political commotion the government resigned, followed by a series of ephemeral presidents. One of them announced to the Congress the decision to default on the public debt, only to resign a few days later. In the first days of 2002, with a new president, Argentina officially abandoned the currency board regime and the one-to-one parity of the peso to the US dollar.

The Bailout of the Financial System and the Evolution of the Debt after Default

The suspension of the service payments on a part of the public debt was declared on December 24, 2001. The measure initially affected 61.8 billion dollars in public bonds and another 8 billion dollars in diverse liabilities, out of a total debt of 144.5 billion dollars. The rest—mainly debt with multilateral organizations (32.4 billion dollars) and recently issued guaranteed loans (42.3 billion dollars)—remained as performing debt.

The devaluation of the peso that followed had a strong impact on the economy, given the important dollarization of contracts inherited from the convertibility period. The government interventions beginning in early 2002 aimed both to reduce the wealth transfer from debtors to creditors and avoid the collapse that would have resulted from being unable to fulfill domestic contracts set in US dollars. The official intervention intended to manage the "distribution of losses". In many cases the intervention meant that parts of the losses were absorbed by the State by issuing new debt.

The main source of the new indebtedness came from the intervention in the financial system, which involved a 14.4 billion dollar rise in public debt. In February 2002, the government decided to compel the conversion of all foreign-currency bank deposits into pesos at a rate of 1.4 pesos per dollar. Withdrawals from demand and saving deposits were restricted to 1,500 pesos per week. The rest of the deposit balances in the banks as of the end of 2001 was transformed into longer term deposits. This measure included both the deposits recently converted from dollars to pesos and those originally denominated in pesos. Bank credits denominated in foreign currency were converted into pesos at a rate of one peso per dollar. This measure was aimed at avoiding generalized bankruptcies in the private sector. The "asymmetric pesification" of credits and deposits caused a significant loss in banks' net worth that was compensated by the government.

Considering the different measures and effects derived from the management of the convertibility collapse and the declaration of default, between December 2001 and December 2003 the gross public debt stock increased by about 28.2 billion dollars (23% of 2003 GDP). By the end of 2003, Argentina's total public debt reached 179 billion dollars (146% of 2003 GDP).

The Public Debt Swap

In the second half of 2003 the first official steps for the restructuring of the defaulted debt were taken. In September, after reaching an agreement with the IMF, the government took advantage of the annual meeting of the IMF and the World Bank in Dubai to make public the main guidelines and the agenda of their restructuring proposal.

The "Dubai proposal" established that Argentina would offer uniform treatment to every holder of its bonds issued up to December 2001, while still fully servicing its multilateral debt and the guaranteed loans issued in 2001. The government thus recognized a defaulted stock of bonds of about 87 billion dollars. This amount left aside an important volume of past due interest. A 75% haircut was to be imposed on the bonds, according to which new bonds would issued in a swap that would leave the equivalent of a maximum amount of bonds of about 21.8 billion dollars. Three bonds, called Par, Quasi-Par and Discount, were announced. Although the detailed characteristics of the instruments were not published at the time, their outlines were clear. The Par would preserve the nominal value of the original debt but would have longer maturity and a lower interest rate than the other two. The other two bonds would entail nominal haircuts. The haircut corresponding to the Discount bond would be higher than the haircut of the Quasi-Par. The new bonds would also incorporate mechanisms—which would be specified later on—to reward the bondholders with a coupon tied to the economic rate of growth. The sustainability of the proposal was said to be consistent with a target for the primary surplus that had been recently agreed upon with the IMF (2.4% of GDP for the central government and 3% for the consolidated public sector). The government announced that it expected to maintain that target in the long run.

The voices of the financial market expressed strong disapproval. It was said that Argentina was in a position to make a much better offer—from the creditor perspective—by targeting a higher primary surplus. The IMF exerted pressure on the government in many ways and repeatedly called for signs of "good-faith".

In June 2004, a few months after the finance ministers of the Group of 7 manifested that Argentina should accelerate the restructuring process and issue "good faith" signals, the government made public a new proposal in Buenos Aires. It was a second offer that aimed to get closer to the creditors' positions. The eligible debt was the same as the one defined in Dubai, although it was now measured at 81.8 billion dollars. In exchange for that defaulted debt stock, new bonds would be issued for a total of 38.5 billion dollars, in case the level of acceptance of the swap was lower than 70%, and for 41.8 billion dollars in case the level of acceptance was higher than the 70% benchmark. This offer involved a substantial improvement if compared to the 21.8 billion dollars to be issued according to the Dubai proposal. The swap would comprise only the capital of the defaulted bonds while the past due interests would not be recognized; i.e. liabilities amounting to 81.8 billion dollars would be exchanged for new bonds amounting to 38.5 or 41.8 billion dollars, depending on the level of acceptance.

The three instruments announced in Dubai were maintained in the Buenos Aires proposal. It was established that the issuing date would be December 31, 2003 and that the bonds would accrue interest from then. The offer to include a coupon tied to GDP growth was also maintained. It was announced that the Par and Discount bonds could be issued in “CER-adjusted pesos,” US dollars, euros and yen. The Quasi-Par bond would be exclusively issued in CER-adjusted pesos.

The offer specified a Par bond issuance of 10 billion dollars if acceptance was not higher than 70% and of 15 billion dollars in the opposite case. This instrument would recognize the original nominal value of the defaulted bond, would have a 35-year maturity and would have fixed interest rates (in dollars) rising from 1.33% during the first 5 years to 5.25% in the last 10 years.

For the Discount bond, an issuance was announced of approximately 20.17 billion dollars in the low acceptance scenario and of about 19.87 billion dollars in the more optimistic one. The new bond would entail a 66.3% haircut on the original nominal debt value, would have a 30-year maturity and would yield an increasing fixed interest, part of which would be capitalized throughout the first 10 years.

The Quasi-Par bond was designed to take into account the local institutional holders’ needs—mainly the private pension funds—and involved a 30.1% haircut. The announced issuance amount was about 24.3 billion pesos (about 8.33 billion dollars) independent of the degree of acceptance. The instrument would have a 42-year maturity, yielding a fixed 3.31% interest rate in pesos, with capitalization of interest during the first 15 years.

The announcement made in June also specified the characteristics of the coupons tied to GDP growth. GDP-linked units would be issued in an amount equal to the amount of the bonds effectively swapped. The units could be separated from the bonds and quoted independently 6 months after the swap. Payments depended on the level of real GDP relative to a “base GDP,” which rises over time. The “base GDP” was defined as the GDP resulting from about a 3% average annual growth rate, using the GDP of 2004 as a starting point. The units would then pay a return if real GDP was above the base level and also grew more than 3% in the previous year. Payment to all units together would then be set at 5% of the amount by which GDP exceeded the base level and this amount converted into foreign exchange would be distributed to unit holders in corresponding proportions.

In comparison to the Dubai proposal, the Buenos Aires proposal involved a tighter path of fiscal policy in the future. Instead of the 2.4% of GDP target in Dubai, the government announced that in order to ensure the offer’s financial consistency, it was committed to maintaining a primary surplus target of 2.7% of GDP during the first 5 years—when the service of the debt issued post default was concentrated—and then stabilize the primary surplus at around 2.3% of GDP from 2014 on. With this program and a 3.3% annual average economic growth assumption, the projections indicated that the fiscal effort would finance the interest payments. However, it left aside a relevant proportion of the capital maturities, for which funding sources had to be obtained. If the multilateral organizations agreed to the refinancing of their debt amortizations, the government would still have to obtain annual funding for about 2% of GDP to face other principal payments coming due during the first 10 years after the swap.

The evidence that Argentina would continue supporting a heavy debt burden after the swap did not ease the creditors' demands. Immediately after the announcement in June, the bondholders' organizations rejected the proposal, claiming that the country should pay more than what was offered. The financial analyses showed that the new offer, including the coupons tied to GDP growth, was between 20 and 27 cents on the dollar. This signified a haircut of about 73% to 80%, which was considered unacceptable by the market participants. The calculation of the haircut compared the nominal value of the defaulted debt with the present value of the new bonds and thus the discount rate used in these latter calculations was crucial to the result. Most of the analysts considered it reasonable at the time to use the yield on assets of similar-risk emerging market countries, which at that moment was around 12-14%. Brazil's debt was commonly used as a benchmark. Its yield then oscillated around 12%. The debt of Ecuador, a country that had recently restructured its external liabilities, yielded a rate close to 14%. High yields were a consequence of the unfavorable funding conditions that the developing countries faced at that time. The JP Morgan EMBI+ index showed an average value of 502 basis points in May-June. In the same period Brazil's country risk-premium averaged 691 basis points.

By late 2004, however, the international capital markets evolution unexpectedly started to play in favor of the Argentinean offer. There was an increasing demand for emerging market debt and a reduction of the developing countries' risk premium. The EMBI+ index decreased to an average of 375 basis points in the last quarter of the year, whereas the Brazilian country risk-premium fell to 417 basis points. The yield of Brazilian debt was about 9-10% and the yield of Ecuador's bonds was about 11-12%. In this new context, the swap looked more attractive. The present value of the offered bonds calculated with the lower discount rate was between 30 and 35 cents per dollar. This present value represented a 65-70% haircut and was similar to the market price of the defaulted bonds.

The improvement in the financial environment did not stop the pressures for a better offer; but it did pave the way for the government to finally launch the swap, practically without introducing any change to the proposal announced in June 2004. To put pressure on the bondholders, the government mentioned that it would be satisfied with a 50% level of acceptance and warned the bondholders that there would be another offer.

The swap started on January 14, 2005. Six weeks later, the restructuring operation was closed. On May 3, 2005, the government announced that acceptance of its offer had reached 76.15% of the debt in default. This meant that 62.3 billion dollars of the old bonds would be exchanged for about 35.3 billion dollars of new instruments plus the corresponding GDP growth-linked coupons. The maximum amount of the issuing would be 15 billion dollars in the case of the Par bonds, 8.33 billion dollars in the case of the Quasi-Par bonds and about 11.9 billion dollars in the case of the Discount bonds.

The government expressed satisfaction at the swap's outcome. The operation signified the reduction in the public debt stock by about 67.3 billion dollars and attenuated the public finances' exposure to the exchange risk, since around 44% of the new bonds were denominated in local currency.

Macroeconomic Policy and Performance after Devaluation and Default

After three years of recession, economic activity had suffered from an additional abrupt decline in the second half of 2001. The massive flight to external assets that took place in the second semester precipitated the collapse of the convertibility regime and resulted in the devaluation of the peso and the default. There was a strong fall in reserves during that year, which rapidly shrank domestic liquidity. The payments chain collapsed after the *corralito* was established. Output and employment followed the abrupt contractive trajectory showed by reserves and liquidity. Social indicators such us the unemployment rate and the poverty and indigence indices—which had considerably worsened during the nineties—suffered from an additional deterioration, adding to the social tensions and the politic crisis that brought the government of the Alianza to an end.

The abrupt fall in output and employment continued after the end of the convertibility regime, but for only a very short period. Certainly, in opposition to most opinions and beliefs—including those of the IMF's officials—the traumatic episodes that brought the convertibility regime to an end were not followed by a deeper depression. Moreover, an extraordinary quick recovery started only one quarter after the devaluation and default. the GDP recovery started soon after the exchange rate depreciation (around three months later, as can be seen in the available monthly activity indicators).

The recovery was precisely triggered by the sudden change in the relative prices in favor of the tradable goods sectors. In the beginning of this phase the recovery was led by the local production of previously imported goods. Apart from the shift in relative prices, the quick economic recovery that followed the crisis was also a consequence of a set of policies that, still with flaws and ambiguities, aimed at recovering the basic macroeconomic equilibria.

Many of the policies that played important roles in this stage faced opposition from the IMF. Firstly, the imposition of exchange controls: this measure compelled the exporters to liquidate in the local market a considerable part of the international currency generated by their exports and also restricted capital outflows. Secondly, the establishment of taxes on exports (retentions): this absorbed part of the devaluation's favorable effect on the exporters' incomes and significantly contributed to the recovery of fiscal equilibrium; it also attenuated the impact of the devaluation on domestic prices and, consequently, on real wages. Thirdly, a flexible monetary policy:

this initially enabled assistance to banks in the crisis phase and afterwards contributed to the recovery of money demand, thus helping the recovery. Fourthly, when the foreign exchange market started to show an excess supply of international currency, exchange rate policy attempted to stop the peso from appreciating through the intervention of the Central Bank (and of the Treasury later on).

The IMF particularly insisted on a freely floating peso. For a short period the government adopted this regime. Once the exchange rate was free to float, however, the parity rose abruptly, reaching levels close to 4 pesos per dollar. Reintroduction of exchange controls followed, which was crucial to contain the exchange rate overshooting. The government managed to stabilize the nominal exchange rate by mid-2002 by compelling the exporters to liquidate the international currency in the local exchange market and by limiting the currency outflows.

Soon after, when the exchange rate was stabilized, the demand for pesos started to recover and the exchange market began to show an excess supply of dollars. The end of the exchange rate overshooting put a check on the rise in the domestic prices. The freezing of public utilities rates, as well as the high unemployment (which kept nominal wages from rising) also contributed to slow the rise in prices.

Another important point in the tense relations of the country with the IMF relates to the net flow of funds between Argentina and IMF and the other multilateral organizations. In this regard, a substantial change occurred after the end of the convertibility regime; i.e., in the post default phase the net funding from the IMF and the other multilateral organizations became negative. According to the Argentinean Minister of the Economy, the IMF passed from playing the role of "last-resort lender" to play the role of "privileged debt payment collector".

Whereas in the 1994-2001 period Argentina received from the multilateral organizations a net funding of more than 23 billion dollars (40% of which were concentrated in 2001), in the 2002-2005 phase the country made net payments amounting more than 14 billion dollars (including interest payments). In 2005 the government decided to prepay all outstanding liabilities still owed to the IMF, and that explains the significant size of the negative bar attributed to 2006 in the graph.

The GDP recovery that started in the first half of 2002 had a short first phase in which aggregate demand barely rose and in which every internal component of domestic expenditure (private consumption, public consumption, and investment) kept shrinking, as had also happened, though at a low pace, during the previous depression. Therefore, it was not growth of domestic demand that stopped the decline in activity level. The expansive factors were mainly the international trade variables: exports and the switching of expenditure from imports to import substitutes—most especially the latter, as local expenditure on local production started to provide an increasing proportion of aggregate demand. This import substitution particularly favored the manufacturing sector. After that short initial stage, the recovery of activity was led by an increase in domestic demand components, especially by investment, which grew at an annualized rate close to 40% between 2002 and 2004, and by private consumption.

It is frequently mentioned that a favorable external environment was an important element behind the economic recovery. In this view, the main part of the rebound is attributed to a set of positive “exogenous” factors. In those interpretations, the recovery would have taken place in spite of what is often considered an economic policy full of mistakes and omissions. Although the contribution of external factors to recovery has been undeniable (in particular some high commodity prices), the fact that a substantial part of the expansion’s dynamism derived from internal demand sources weakens that interpretation.

It should also be stressed that the consumption and investment recovery took place in a context of heightened credit rationing, both external and internal. The investment was apparently financed by higher profits retained by firms, although the “wealth effect” resulting from the significant external asset holdings of the private resident sector, surely contributed as well. These assets increased their value in pesos with the exchange rate depreciation, and also rose in relation to the prices of domestic assets such as real estate and land. This factor also fed the recovery of private consumption expenditure.

The adjustment experienced by the Argentinean external sector took place in part before the devaluation. However, the end of convertibility generated an important trade surplus. The trade balance exhibited a deficit higher than 3 billion dollars in 1998. It decreased from then on and turned into surplus, due to the reduction in the volume of imports. In 2002 the surplus was higher than 17 billion dollars, and remained over 16 billion in 2003 and over 12 billion in 2004. The trade surplus caused the change of sign in the current account balance.

A strong adjustment in the public accounts has also been taking place alongside the external adjustment process we have just mentioned.

The improvement in the consolidated public sector global balance that took place between 2001 and 2004 was equivalent to 10 percentage points of GDP. This result passed from a global deficit of 5.6% of GDP in 2001 to a 4.5% surplus in 2004.

Which factors explain the adjustment in the fiscal cash flow results? Forty percent of it derives from an improvement in the provinces balances. This improvement comes from the increase in tax collection facilitated by the recovery and the rise in nominal prices, together with the restraint in expenditure. Meanwhile, 60% of the six-points-adjustment in the national public sector’s budget is explained by the improvement in the primary balance (+3.7% of GDP). The contraction of interest payments, basically resulting from the default on the sovereign debt, accounts for the rest (-2.4% of GDP).

The rise in the national primary surplus is mainly explained by an improvement in tax revenues (+4.7% of GDP). It is interesting to observe that although the receipts from traditional taxes such as the VAT and the incomes tax rose significantly, they did not increase substantially when measured as a proportion of GDP. Between 2001 and 2004 they increased by 1.2% of GDP taken together. The tax on exports is the item that mostly explains the rise in tax revenues. The soy and derivatives industry generated almost one half of the taxes on exports.

Hence, the public sector absorbed part of the effect of the devaluation on the profitability of the tradable goods sector, and also benefited from the high prices reached by some of the exportable goods, such as soy and oil. The contribution made by the tax on financial operations established in 2001 was also very relevant. The increase in the collection of this tax explains 30% of the improvement in total tax receipts.

The interest payments on the public debt passed from representing almost 4% of GDP in 2001 to only 1.4% in 2004 (without taking into account the accrued interest on the debt in default).

However, the fiscal effects of the suspension of part of the debt service payments are significantly higher than what is shown in the mentioned account. It cannot be calculated with precision because a significant amount of new debt was issued after the suspension of debt payments. However it can be estimated that the amount of interest on the public debt—valued at the 2004 exchange rate—would have represented, in that year, between 9 and 11 percent of GDP. This is approximately equivalent to one half of the total tax collection of that year. Paying that amount would have certainly been incompatible with the economic recovery. As was pointed out above, a crucial aspect of the fiscal financial vulnerability derived from the extremely high proportion of debt in foreign currency, with the consequent exposure to the impact of exchange rate variation. The substantial exchange rate depreciation in 2002 would have had a harsh impact on the public sector's financial equilibrium. Taking this into account, it can be said that the payment suspension and the following debt restructuring enabled a considerable amount of fiscal savings—either measured in domestic currency or as a proportion of GDP.

However, the most important effect of the default and the end of the convertibility regime was regaining the instruments of macroeconomic policy. This was of crucial importance in moving the economy out of the abysmal situation generated by the agony and the final collapse of the convertibility regime.