

DEPARTMENT OF ECONOMICS AND FINANCE

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Chair in Financial Markets and Intermediaries

**Dollarization, IMF, Kirchnerism, "Vulture" funds and other
illnesses.**

The case of Argentina from 1990 to 2015.

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Chapter 1. Introduction, Background and Purpose

1.1 Introduction¹

This dissertation analyses the political and economic history of Argentina. We will see an excursus from late 1990 up to the most recent developments in 2015. We will then make a comparison between the default in 2001 and the one in 2014.

Argentina poses a big contradiction: On the one hand, it has a great potential in terms of natural and human resources, but on the other side, it is characterized by high political and monetary instability, which are detrimental to the economic growth, and which lead it to chronically operate under potential.

This research is multifocal, in the sense that it analyses all the potential reasons behind Argentina's problems. We cannot find just only one cause, Argentina is a so complex country that many and even contradictory reasons were brought trying to explain the ambiguity of its path. The idea is to clarify by how much each variable contributed to the general dip of the country.

Before starting an analysis, we should have clear in mind what exactly we are going to do and which are the aspects we are interested in. Therefore, the first chapter sets the background for the analysis, giving the definitions for what we intend with the wording "crisis", and how usually we arrive at such a situation.

We will also develop the idea that a crisis is not a stand-alone phenomenon, but usually what affects one "market" has also effect on everything else that is in contact with that market. In a interconnected world we cannot abstract from the effects of globalisation, and the final part of the chapter will be intended to go more in details about this phenomenon, and to show how past foreign crisis had effect also on Argentina.

After seeing the globalisation effect, our analysis will then focus on Argentina and on its specific background. We will discuss how political instability had a negative impact on financial markets; how the nominal anchor to the dollar was realised and with what negative effects it ended up; and the great potential of Argentina, which in theory seems to be a rich country, and how the bad management of its resources made it become a defaulting country.

Therefore, we will see the role of the IMF in the happening. This institution not always has found the best solution, and from a certain point of view, we can even consider it as one the causes that contributed to deepen even further Argentina's situation. Some argue that the IMF is a last resort and therefore it is necessary to follow through and through its instructions in order to get the necessary help, this in the view that as an external of the situation it can see with less involvement the situation and find an unbiased solution. On the other side, we can also say that Argentinians know better how to deal with problems in Argentina, and then the final decision should be theirs.

¹ This section is based on the overall material required for the writing of the dissertation. They can be found at the end of the document, in the Bibliography and the Websites of reference sections.

Lastly, we will look at the years that followed the crisis, at which reforms were chosen and how they were implemented. Many things has changed since 2001 in Argentina, in particular regarding the government and the legal situation: we will explain how the socio-economic background of today is different from the one of 15 years ago, and how that led to the current situation of default and in particular we will analyse the case of the “vulture funds”.

1.2 The roots of past financial crises

Financial markets and intermediaries are at the centre of our everyday life, from the simple operations we make every day, to the most important and famous ones like agreements between institutions and governments. What makes finance so important are the functions it performs. At its very essence, the functions of finance is to connect lenders and borrowers. Therefore, it improves **economic efficiency** reducing transaction cost, in the sense of providing a guarantee against moral hazard and adverse selection. This is not always the case with individual negotiations. In addition, it act as an engine of growth, financing the best ideas.

Finance can also have negative aspects. The presence of bubbles (price of assets different from their fundamentals, not reflecting real information but just people's beliefs that others are valuing it at a high price) and **market failures** (all the concrete risks that prevent the efficient allocation of resources), generate inequalities, unemployment and debt.

For this reason, one should balance what is useful and what is destructive about finance.

Since "History is a good place to look for answers", we will see the historical roots of the mainstream financial concepts we adopt nowadays.^{2,3}

First state support

Alexander Hamilton, the first Treasury secretary of the United States, wanted to shape the financial terms of US like those of Britain: to create a common federal debt for all the states, to trade new bonds on the open market and grant the government access to cheap borrowing. In order to do this, he created the BUS, the first bank of the United States, in 1791. The new-born bank faced two risks very soon: William Duer's speculative activities, trying to put up the prices of the bonds of the BUS; and the bank's itself problems, that is the massive amount of loans it made in the first two months, due to investor's speculative fever.

Those two effects combined drove US's markets into plunge. Hamilton set a bailout programme in order to restore investors' confidence, and it had great results. Thanks to this, he built a precedent, and in all following crisis in the financial system there were the expectation of having the **state support**.²

The use of joint-stock organisation as guarantee against bank runs

In 1820s, Latin American countries became independent from Spain. Trades with Britain became more frequent, since it was a supporter of the freedom of the colonies, and in this sense "enemy" of Spain. Therefore, expectations were set up on the reliance of Latin American countries upon Britain in case of problems in their financial markets.

Latin American bonds paid 6% while the British gilts 3%, adding the expected support of Britain for financial backing, the decision regarding which one to buy it was simple. (For the same risk, prefer the higher return).

Information from Latin America were delayed since to get there it took several months. As time passed by, more information were available about the living conditions of Latin countries, and

² The Economist - <http://www.economist.com/news/essays/21600451-finance-not-merely-prone-crises-it-shaped-them-five-historical-crises-show-how-aspects-today-s-fina>

³ Financial Markets and Intermediaries – Federico Nucera - <http://docenti.luiss.it/nucera/teaching-3/financial-markets-and-intermediaries/materiali-didattici/>

European countries were scared of investing their money there.

Furthermore, the reliance on Britain resulted just an illusion, because when investors took a step backward, Britain did not intervene in any way to rescue the Latins.

On the contrary, the British banks were affected too, and there occurred many bank runs. What Britain did afterwards changed the successive frame of finance: the chiefs' opinion was that the fault was not on investor's overreliance, but on the banks. The blunder was that they were too small (only six partners could supply the equity. If they were larger, they would have been able to get through that situation, and avoid bank runs. About investors' trust in Latin America however, nothing more could have been done.

On the Scotland's example, banking shifted to a **joint-stock** organisation, to spread risk and possibly increase the capital funds. The negative implication was in setting the basis for the current "megabanks", and the relative problems regarding systemic risk.²

The rise of non-banks financial institutions...

In 1850 the American countries borrowed large amount of capital from Britain, to finance their spending.

In this environment of high capital demand, there was the fertile ground for the growth of a new financial intermediary: the **discount house**. They were money dealer, having also government's assets, connecting investors and lenders, just like a bank, but without the "bank" title.

In the discount house, who deposited money received a rate equal to that of the Bank of England, less one percentage point. The Discount Houses had just one percentage point with which it could play, because they were "followers" of the Bank of England's actions.

The decision they made was then to reduce the reserves, secure that they could borrow from Bank of England in case of risk of bank run. They showed already the problem of nowadays financial institutions: overreliance on the official institution, and risk-lover behaviour.²

... and their excessive risk taking

One lesson we can draw from the crisis of 1857 is that "Financial safety net can create excessive **risk taking**" (The Economist, 2014). Bank of England was displeased of the overreliance of the Discount Houses on itself as a "magic solution" in case of big problems; therefore, in 1858 to stop this process it changed the approach, by forbidding the Discount House on borrowing as wish. It also asked them to keep their own reserves and to think in advance about how to solve problems of excessive withdrawal.

Some thought that Bank of England was not making a credible threat, because it was not possible to let such entities to fail without consequences. They were proven wrong since in 1866 the Bank of England actually refused to rescue Overend & Gurney, a big lender in need of money. Thereafter the on-a-ten-years-basis crisis in Britain stopped, and the financial situation was calm for the next 50 years.²

First global crisis

In 1857, in America, the Ohio Life Insurance Company, had huge monetary problems due to the speculative activity of its owner Edwin Ludlow. All merchants dealing with this American firm

started to fall as domino pieces, and the contagion arrived even to the Bank of England. The presence of the Discount Houses made the situation even worse, since investors started to guess what was going on: those entities had inside very risky loans and very high leverage ratios (entities' resources founded by debt, instead of equity). This caused many bankruptcies inside England, that soon, even owing to tensions and panic, spread to all Europe. The crisis was **global**.²

Lenders of last resort can solve any situation

America had a reversed view to Britain: they thought that banks were autonomous and self-sustaining. People could obtain money from local banks, the state, or from Trust companies. The last ones are the equivalent of the Discount Houses in Britain: once more, they connected investors and lenders, just like a bank, but without the name of "bank". From the second decade of 1800 to 1907, everything was growing and the financial situation was stable.

All this was not enough for Augustus Heinze and Charles Morse that decided to create a pool of money to increase and corner the shares of United Copper, but the United Copper shares unfortunately decreased. To stop up the situation, they decided to take away money from the banks they ran, and involved it in the process a Trust company: Knickerbocker. When the news came up, depositors panicked and started to withdraw their savings owing to the financial contagion.

When the depositors run begin, one rich man, John Pierpont Morgan, organized pools of cash to contain the situation. He even arrived to lock the New York banking community to make them agree on a solution of bailout fund.

By 1909, America was growing again, but the National Monetary Commission met to discuss how to redesign the banking system, since the situation pointed out the need of a **lender of last resort**. The result was the creation in 1913 of the Federal Reserve, with the Federal Reserve Act.^{2,4,4}

When the Lender of last resort fails: create deposit insurance; prevent commercial bank from going into speculative actions.

In the 1920 the financial situation was glowing, markets were expanding, and new technologies were more and more widespread. Investors put faith in the trend, and expected the situation to go on in the same manner. To avoid the creation of bubbles, the Fed increased the interest rates, to discourage over-optimistic investor, however the increase was too small to arrest the climbing market. Furthermore, the industrial production decreased, and in the meanwhile, the London Stock Exchange collapsed. Because of all those factors, in 1929, the Dow Jones crashed, and in turn took several banks with him, which went bankrupt. The lender of last resort, the Fed, missed its purpose and it refused to lend.

Clearly a reform was claimed, and the Glass-Steagall act was introduced (removed in 1999)⁴ to separate stock market operations and the common lending, allowing in this way the Fed to regulate also banks used for investment.⁴ In addition, in 1933 after massive waves of bank panic, it was created a **deposit insurance**: the Federal Deposit Insurance Commission (FDIC), designed with the idea of performing three functions: deposits pay-out, supervision, resolution.

⁴ The repeal of Glass-Steagall, who voted against it? – Charles – <http://m.dailykos.com/story/2010/04/29/861900/-The-repeal-of-Glass-Steagall-who-voted-against-it>

The Federal Reserve does not supervise it. It provides high safety and trust, but on the other side it can weak market discipline and encourage moral hazard.³ After its introduction, bank runs did not occur for the next 70 years.²

Environment and historical events are better than any human plan, in shaping the markets.

Hamilton's idea at the end it was reversed: now the systems are based on states that ensure financial stability, with the burden put on the **taxpayers**, and not the financial system that makes governments more stable. The bailouts were anyway a good solution, because without them the effect could have been even worse.

Alternative solutions indicate that the risk should be restored to the **private sector**; however, this will require removing the benefits that banks enjoy and make their leverage more expensive; in turn, the equity owners will lose dividends and the cost of credit will increase.²

Current problems have their roots in historical assumptions

Nowadays we individuate a problem in the financial markets back to their origin, we contest the basis of finance directly from the assumptions they are made on. Since its origins, economics assumes efficient financial markets, where prices are fair and reflect all the available information, and nothing impedes the reaching of an equilibrium point. Namely, we assume perfect competition, perfect information, rationality – people can fully understand all the options available and the consequences of their actions, and no externalities – one's action do not affect anyone else except of himself.⁵ However, the most recent crisis proved all these **assumptions to be wrong**, people do not mechanically calculate costs and benefits in making a decision, but also rely on many other factors that cannot be quantified: they behave sentimentally rather than rationally. That that once was called "bounded rationality", and almost ignored from an economic point of view, is now at the centre of new analysis, since economics must explain reality and cannot disregard a part of it just because it cannot be measured easily.

People behave according to the incentives they are given. However not always it is the case that they are incentivised to behave in a proper and economically efficient manner. Therefore, the question is " Do people have incentives to behave badly? " And the answer is yes. Those incentives come from the structure we created in the past, which now are self-reinforcing and drive people to take excessive risk.

We have seen the rise of excessive reliance on state's support, and the origins of megabanks, in the previous pages. Megabanks are too big to fail, in the sense that if one takes a risk and the following situation it is favourable, then he can enjoy his profits. However if one ventures, and the outcomes are negative, then the government will gather his losses. From here, it comes the incentive to speculate and to take excessive risk, in a system of "dynamic instability", oriented toward a more and more distorted situation.

In this economic system, the Megabanks can easily get access to capital in order to lower their interest rate. Again, if the situation has a positive outcome everything is acceptable. On the other side, those who lend money say that there is not risk, because if there whether it will be a mistake, the government will bail it out.

⁵ Financial crisis as market failure - Joseph Stiglitz https://www.youtube.com/watch?v=g_W9SsstO9Y

As a result, the bank will become bigger and bigger, and in an instable system as the one presented, it will take down with him many other actors in case of default. This general euphoria it led to think that in the business cycle there are only fluctuations, but not externalities. However, macroeconomic consequences exist. There is a contradiction in terms: on the one side we admit that "too big to fail" is based on "someone will save the situation", allowing in this sense the existence of interactions and so of externalities. On the other side regulators, deny their existence, assuming that megabank's activities come at no risk. So even the vocabulary used recognises the existence of macroeconomic result, whereas the economic agents using this vocabulary pretend it means nothing. (Stiglitz, 2015)⁵.

1.3 Financial globalisation

We have seen the most important concepts about financial markets and intermediaries; we have looked at some examples of past crisis, mainly at the first ones of their kind.

An important concept that it has come out is how connected countries are among them. Therefore, we will turn now our attention to the idea of globalisation.

Financial globalisation is defined as “Global linkages through cross-border financial flows” (Yeyati & Williams, 2011). It is a “Process rather than a state of nature” (Gudmundsson, 2007). We can define a fully integrated market as one governed by a single set of rules, where there is common knowledge about them, with no barriers to entry and exit, and equally significant players. In case of frictions, they occur symmetrically, in the sense that they affect each agent at the same level. In other words, the law of one price holds. After those assumptions we define financial integrations as “The process by which financial markets and institutions become more tightly interlinked and move closer to full integration” (Gudmundsson, 2007). From here, we see that financial globalisation is nothing but **cross-border financial integration**.⁶

Benefits

1. The risk of “credit crunch” is reduced, because the access to sources of capital is increased.
2. The allocation of capital becomes more efficient, since all the adjustments in risk are immediately incorporated into asset prices.
3. Diversification happens more easily, as there is more room for negotiation in an enlarged market, and so both borrowers and lenders can obtain better conditions on their contracts.⁷

Drawbacks

1. The instability of markets increases, with negative effects on the financial stability.
2. The significance of risk can be difficult to measure adequately, because of the increased diversification and risk trading, which in turn makes it difficult to establish potential weaknesses.
3. The increased degree of integration rises the probability of having contagion effects. The weakly regulated countries are the most exposed to vulnerabilities, however their stability can affect also richer countries that are currently trading with it, arriving at stages of bad financial systems as a whole.⁷

⁶ Financial Globalisation – Gudmundsson - <http://www.bis.org/publ/bppdf/bispap39c.pdf>

⁷ The Globalisation of Finance - Gerd Hausler (IMF) - <http://www.imf.org/external/pubs/ft/fandd/2002/03/hausler.htm>

The Four drivers of globalisation.

1. *Advance in information and computer technologies*
IT permitted to improve the process of collection and diffusion of data; the better measurement and monitoring of risk; and the development of new and complex financial instruments.
2. *The globalisation of national economies*
Globalisation raised since the production process is dispersed over different regions, with the idea of exploiting the lower costs and the competitive advantages of each country. It is nowadays common to have final products sold in different markets, and that are also designed in one region and then assembled in another one. In this environment, it was settled the ground for the rise of big multinational companies, born thanks to mergers and acquisition, but also to expansion and settlement in previously inaccessible areas.
3. *Liberalisation of national financial and capital markets*
The request for mechanisms of intermediation of the cross-border flows and the easier access to the financial markets thanks to the reduction of the entry barriers, equally determined the need for liberalisation. This in turn permitted more growth thanks to investments.
4. *Competition among the providers of intermediary services*
The regulations in many countries were changed in order to permit the integration of financial institutions other from the traditional banks, which as we have seen, were just like a bank, but without the name of "bank". Apart from the Trust Companies and the Discount Houses we mentioned, nowadays we have a wide range of such institutions, for instance: mutual funds, insurance companies, hedge funds and investment banks.⁷

Measurements of financial integration

Once we have analysed the cost and benefit of financial globalisation, let us be more specific regarding the **measures** of its process. If the implications mentioned at the beginning of this paragraph hold (law of one price holding, risk sharing among investors...) we can define some trends that are present in a situation where the cross-border financial integration is widespread.

1. *Soft legal limitations*
Low level of restrictions on capital flow, taxation and monetary policies.
2. "Price-based measures"
Covered interest parity to holds;
Asset returns moving together.
3. "Quantity based measures"
High levels of cross-border assets;
Big amount of liabilities and capital movements;
Low correlations between investment and saving (thanks to the availability of foreign funds for investments) and between consumption and GDP.

Some clarification about specific measurements

- With **Covered interest parity** we mean that it is a good test for cross-border financial integration when the interest rate differential is equal to the difference forward-spot exchange rates, in percentage terms. This is the case when restrictions on capital movement are softened.

- The **Co-movements** of assets instead, presents some problems when using it as a measure of financial integration. The first range of problems it is in the measurement. One main obstacle can be that those co-movements are not generated by financial integration, but by other variables like common stock, or also by a situation where there is high volatility that characterizes the entire financial world.

In conclusion, the increase in co-movement it is not for sure caused by a rise in cross-border financial integration. However, the opposite is always true, if financial integration increase, then we will see the co-movements increase as well.⁶

Reasons behind the need for new measurements

Thanks to integration and globalisation, there are changes in capital market.

Rather than on loans and deposits, banks are going through a process of disintermediation, focusing on investment activities and on placing securities. Therefore, banks are shifting the credit risk from their balance sheets to the securities markets.

In addition, banks have new sources of funding, like underwriting corporate bonds, or they can raise funds for their own activities on the Over-The-Counter derivatives market.

This in turn allowed to adjust the portfolios and to better diversify for risk, enhancing the international portfolios. The multinational companies also can benefit from this framework, and finance their activities with cross-board funds, having access to pools of capital in an international environment.⁷

New measurements

1. Financial globalisation as market size

The conventional view is based on the measure of financial globalisation as "The average of cross border assets and liabilities over GDP – FG-to-GDP ratios" (Yeyati & Williams, 2011). However, a better proxy could be by host market size. This latter solution presents a more constant pattern in financial growth.

2. Consumption smoothing

About it we have different views. Artis and Hoffmann (2006) argue that financial globalisation improves risk sharing, therefore they suggest its introduction among the measurements.

Bai and Zhang (2005) have an opposite view: even if financial globalisation grew in the past, they say that there is no evidence about the improvement in international risk sharing.

3. Stability and growth

Financial globalisation and financial stability are related. At a first glance there it seems to be a positive correlation between globalisation and growth collapses, from a more

deep view we can see that in a scenario of global deleveraging, the effect is in a vast part captured by the negative influence of external debt. Additionally there is a link with dollarization, and it shows that deposit declines are due to the errors in valuation, raised from the real appreciation of dollar.⁸

Some specification about particular of the measurements

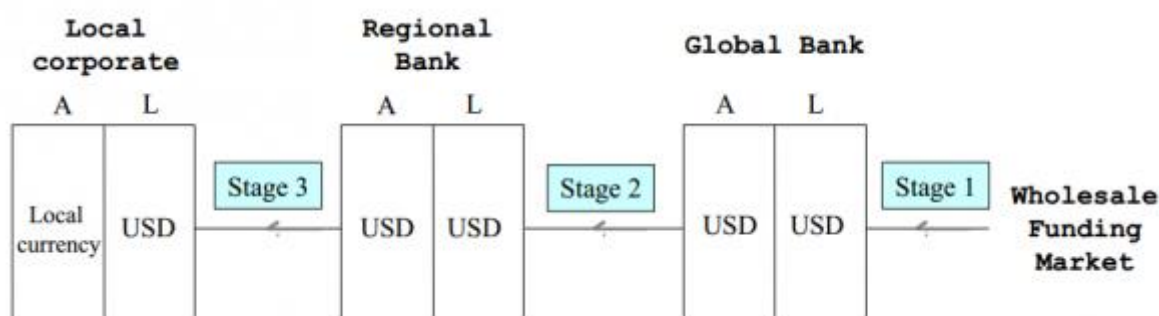
- Stability and growth through dollarization.

Bruno and Shin on their “Cross-Border Banking and Global Liquidity” (2014) say that “Bank leverage cycle is the determinant of the transmission of financial conditions across borders through banking sector capital flows [...] local currency appreciation is associated with higher leverage of the banking sector, thereby providing a conceptual bridge between exchange rates and financial stability”.

The starting observation is that decisions are taken adjusting risk periodically. When volatility is low, borrowers are better off and is easier for them to grow at the expenses of shorter and shorter maturities. The dollar is historically a stable currency, and pegging a currency against it, it means decrease in volatility.

Dollarization can also increase the likelihood of entering into a crisis. In this perspective, Bruno and Shin add to the model also borrowing in foreign currencies: Intermediaries can take advantage of interest rate differentials in order to lower their cost, when exchange rates are stable. The situation is graphically showed in the figure.⁹

Figure 1. 1: Wholesale Funding Market, according Bruno and Shin – from Princeton; Bruno and Shin¹⁰



“A distinctive feature of our model is the link between local currency appreciation and

⁸ Financial Globalisation in Emerging Economies: Much Ado About Nothing? – Yeyati and Williams - http://www.brookings.edu/~media/research/files/papers/2011/6/02-financial-globalization-yeyati/0603_financial_globalization_yeyati.pdf

⁹ Financial globalisation not so great, says BIS – Matthew C Klein - <http://ftalphaville.ft.com/2014/09/03/1953401/financial-globalisation-not-so-great-says-the-bis>

¹⁰ Cross-Border Banking and Global Liquidity - Bruno and Shin - http://www.princeton.edu/~hsshin/www/capital_flows_global_liquidity.pdf

loosening of financial conditions through the build-up of leverage in the banking sector” (Bruno & Shin, 2014). Banks who lend to local borrowers, in case of dollarization, face credit risk because of the possibility of currency mismatch. If local currency (say Peso) appreciates, the borrowers are better off (with the same one Peso now they can obtain more dollars). Their capacity to repay liabilities is also increased and therefore the credit risk is reduced. The bank is now more willing to lend money. However the risk is reduced due to the appreciation, not due to conditions related to borrowers, and so on the other hand, in this sense banks become more risk taking.

When it is the dollar to appreciate (One Peso is no longer sufficient to buy a certain amount of dollars, which previously it could) it results in narrow financial conditions. This highlights that financial crises are related to dollar dearth.

From here, we have two implications:

1.
 - An inadequate monetary policy can have higher impacts outside the country.⁹ If dollar fluctuations do not drastically change the financial situation on US, they can still have a huge impact on dollarized countries; therefore, it is a great responsibility for US to consider all possible variables, in taking economic policy decisions.
2.
 - It is significant to focus more on the capital account than on the current account because the latter gives less information about financing, and about the role a country has on the international scenario. While it is the former that captures the movements on the net resource flows and on the impact that cash flows can have in the domestic financial conditions.⁹

1.4 Crises during eighties and nineties

The crises of 1990, as we will see, unearthed the urgency for safeguarding methods of the financial stability. The main pillars of defence are robust financial institutions, efficient financial markets (that we already said do not exist in practice), and market discipline. Financial stability is also a "Global public good", so there is also the need for supervisors.

1.4.1 Mexico

The Mexican crisis occurred during the years 1994-1995. In the preceding years, the country appeared to perform well, and positive expectations led to an increase in consumption. In order to promote financial integration the barriers to foreign trade were cut down, also there was a need to attract foreign investors and therefore the legislations were enhanced. In 1989, there was a restructuration on external debt that the country had since the eighties. In addition, in 1994 with the aiming to achieving stability of the domestic currency, there was granted autonomy to the central bank.

Some policies actuated before, revealed to be crucial during the crisis. The exchange rate regime was fixed, and it stimulated short-term borrowing. The result was problematic for the current account, because of a misalignment of the real exchange rate. In addition, the government imposed a ceiling for open market operation, since the interest rate was inflexible. The deposit insurance was fragile, due to weak financial regulations. There was an increase in consumption thanks to the easy access to credit, that in the end resulted in an asset price bubble.

In 1994, the domestic economy faced some shock from the external. The Federal Reserve imposed its target rate at 6%, increasing it by 3 percentage points. The current account deficit increased sharply.

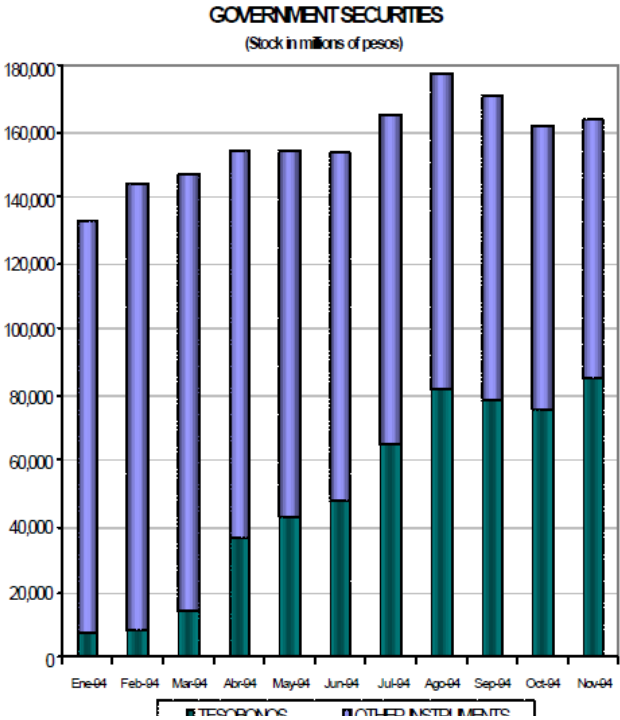


Figure 1. 2: see 11

Those event, and the political tension in the country during 1994 (election year) led the authority to a strict commitment to the exchange rate regime. The government massively issued Tesobonos (dollar-dominated securities) that accounted for more than 50% of outstanding securities, but the response of the interest rate was not as good as expected. The authorities considered those shocks temporary, and for this reason they issued Tesobonos instead of letting the interest rate free.

At the end of the year in investors' eyes there was the perception of an

unstable situation, and no confidence in the government, therefore risk increased. However, that that seemed a liquidity problem, in reality was a solvency problem. As a result, the authorities had to solve many issues.

To refinance the dollar denominated debt it was clear that the simple intervention of the government would have not been enough, then they negotiated a support package with the U.S., the IMF, the BIS and the World Bank.

Then to restore the stability there was needed a contraction in domestic aggregate demand, and the intent was to do it via a real exchange rate depreciation, so the exchange rate was turned into a floating one. In order to reduce the volatility of the exchange rate however, a restrictive monetary policy was applied. The interest rate determination was left to the market, while the requirements on reserves became very strict.

To avoid bank runs they worked on three fronts. First, in order to avoid bank runs on the dollar denominated liabilities it was created a dollar liquidity facility, loans were granted a high interest rate and the protection of the Central Bank. Then because the capitalization ratios fell down, the banks were required to issue debt convertible into equity, which was purchased by the government. The last point was giving an incentive to banks to continue to stay healthy, and the government acquiring part of their portfolios did it.¹¹

The main lesson we can learn from the Mexican crisis is that fixed and **pegged exchange rates** are problematic when there are free capital movements. It is a useful tool to control inflation but it presents many drawbacks. For instance, the residual inflation leads to an increase in the exchange rate that is damaging to the competitiveness of the country. It also exposes the country to the risk of overvaluation and presents a margin for speculative activities. In addition, it worsen agents' balance sheets: they are convinced that the exchange rate is fixed and immutable; therefore, they do not adequately hedge the exposure to the currency peg. When the interest rate is higher on domestic currency than on foreign, domestic agents are highly exposed to foreign exchange risk. Having a strong peg could avoid speculative attacks; however, the authorities must be ready to accept and the fact the interest rate increase that will follow.

Another lesson is that there is a **need for a strong financial system**. Authorities should liberalise the financial system and encourage prudent macroeconomic supervision. This in turn will attract foreign agents to operate and acquire capital in the domestic market. (As was did during Argentine crisis). The idea is to import the high standard from abroad in the domestic financial market; however, this process can be actuated only when there is a lender of last resort. In case of lack of liquidity the authority can no longer print money to meet the foreign obligations (especially not without affecting the exchange rate), so it can only help the domestic banks only in case they have big reserves.

The Mexican crisis arrived as a surprise, in response the IMF asked its member to ensure good macroeconomic data and to follow some **standards**. In facts during the Argentine crisis, no one

¹¹ Crisis Management Mexico, 1994-1995 – World Bank - http://www1.worldbank.org/finance/assets/images/Crisis_Man.pdf

was taken by surprise.¹²

On the other hand, it is also true that there is not a precise indicator of when a crisis will occur: some countries default with a debt that is 60% of their GDP like Argentina, some other, like Japan, even when it is 197% are still a healthy country. ^{13 ; 14}

¹²Some Lessons from the Argentine Crisis: (Mishkin & Eakins, 2011) View – Mark Allen (2002) - <http://www.fondad.org/uploaded/Argentina/Fondad-Argentina-Chapter8.pdf>

¹³Use the Debt-to-GDP Ratio to Predict Which Country Will Default Next – Kimberly Amadeo - <http://useconomy.about.com/od/glossary/g/Debt-to-GDP-Ratio.htm>

¹⁴ Crescita e debito dopo il QE: l'Italia vista dall'estero, dai mercati, dalla politica – Workshop: Edigi; Panizza; Morelli; Taddei; Manzocchi. - <http://ricerca.economiaefinanza.luiss.it/news/2015/02/17/crescita-e-debito-dopo-il-qe-l%E2%80%99italia-vista-dall%E2%80%99estero-dai-mercati-dalla-politica>

1.4.2 Asian Tigers

The Asian crisis in 1997, was originated by the collapse of the Thai baht. There are two main schools of thought about the reason for this. The first one says that the high increase in capital inflows made the Asian countries exposed to financial panic. The second one views the origins inside, in the Asian financial system: there were not sufficient guarantees from the government, and therefore an inefficient management of risk.

The background was of high levels of saving and investment, sufficient growth and gentle inflation. During eighties the growth was followed by an increase in asset values, and therefore in an increase of short-term foreign borrowing. During nineties then, the devaluation of the Chinese and Japanese currencies affected also the other Asian economies, with a decline in assets prices.

The most affected one was Thailand, where investors put into place tests to assess the health of the financial system in the region. The result was a currency depreciation that ended up in the collapse of the Thai peg and the subsequent decline in the overall currencies in the region. It followed many bankruptcies and the short-term economic activities decreased.

Asian financial liabilities toward foreign countries were not sufficiently liquid, exposing in this manner the financial system to panic. In fact, the Asian economic shocks are also called “runs” because of the simplicity with which the financial panic spread. It also involved some healthy agents, because when depositors decide to withdraw their money, even if the capital is not at risk, the lack of liquidity in the investors’ eyes signals the opposite situation.

The crisis did not affect all countries equally, but hurt most badly those where investors’ confidence was less strong, and where the tests on the peg showed a more vulnerable situation. Thailand as we have seen was the most hurt, as well as Indonesia and South Korea. Singapore, the most robust financially, was also the less damaged.

Two main characteristics are common to all those countries: “Financial intermediaries were not always free to use business criteria in allocating credit” (Moreno, 1998) resulting in some good borrowers that could not access credit, and some bad firms that instead obtained credit anyway. “Financial intermediaries or their owners were not expected to bear the full costs of failure” (Moreno, 1998) having the protection of government some firms had a guarantee on their potential losses, and gaining everything themselves in case of favourable conditions.

There are many reasons at the origins of the crisis. First of all the initial growth obscured the risk in lending, allowing for firms’ guarantees by the governments. Secondly, the technological innovations opened the door to the integration in foreign markets, but also exposed the Asian region to more vulnerability than it had when it was a closed economy. This vulnerability was further increased by the implicit assumption that peg meant stability. For this reason, borrowers did not feel the need to hedge for foreign currency risk. However, the final result was mispricing of the foreign credit, and excessive capital inflow.

The key black takeaway from the Asian crises is that weakness in the financial system contributes extensively to crises. The inability of lenders to use appropriate **standards in evaluating the risk** is expressed through these weaknesses.¹⁵

¹⁵ What caused East Asia financial crisis? - Ramon Moreno - <http://www.frbsf.org/economic-research/publications/economic-letter/1998/august/what-caused-east-asia-financial-crisis/>

When the banking sector is integrated correctly in the international financial system, investors are given the guarantee of the same standards applied to both domestic agents and foreign ones. The IMF and the World Banks implemented this lesson after this crisis, launching an initiative of transparency and of international standards. They created three categories of adherence: those related to macroeconomic transparency, to the financial sector, and to the corporate sector.¹²

1.4.3 Russia

Russia default in 1998 happened for many reasons, not only because the debt level was too high, but also due to problems of stability in the regime, the end of the war, political corruption, dollar denominated debt and reduction in productivity. After the collapse of the USSR in 1991, the country was divided in many smaller regions. Russia inherited the bigger one, with the related problems: foreign debt to be repaid and establishment of a new stable government. The process of transition took long and it was not easy.¹⁶ The 1996 - 1997 was a year of optimism, the government rescheduled the repayment of foreign debt, and there was a balance between export and imports, inflation decreased and output started to increase. In addition, the price of oil, the main export of Russia, increased sharply. Due to those favourable conditions the prediction about Russia's future were good, and the country was allowed to borrow at lower interests, and also to joined the London and the Paris clubs (group of private creditors operating at the international level). However, in 1997, there were the first symptoms of a crisis, the foreign liabilities increased by 17% with respect to the three previous years, and the Asian crises also led to a decrease in Russia's growth; in addition, the price of oil began to fall.¹⁷

Another key issue of the crisis was the tax collection, because the regional and the federal government shared those revenues, and there was competition between them. This kind of sharing gave an incentive to the regional to reduce the burden of taxes on firms, in order to obtain some return from the firms in exchange. This behaviour has consequently a sharp increase of the debt.¹⁶ During 1998, the country also faced political instability, mainly during the elections period. In March, the president Yeltsin changed completely the government and appointed Kiriyenko, a banking man owning an oil company, to substitute him. Investors became to consider a possibility of the devaluation of the ruble. Investors' confidence decreased even more when Kiriyenko refused to have a meeting with the America analyst Lawrence. Due to the increased perceived risk, the banks had less money in circulation; in addition, the government wanted to collect more taxes in cash, worsening banks' position. In August the stock, bond, and currency markets defaulted, because of the investors' lost confidence in the government, which they expected to devalue the ruble and default on the country's debt.¹⁷

Therefore, the Russian crisis was not simply caused by a monetary phenomenon, but by a phenomenon in an already weak environment: after the end of a war, a regime change and an unsustainable foreign debt.¹⁶ The government capability to repay the cost of its debt was inferior to the magnitude of the debt itself. Because of the administrative constraints on the tax system, the debt shifted toward shorter maturities, which in turn had the interest premium to increase, or in other words the cost of the debt increased. Since the government was not able to sustain this situation alone, it asked the intervention of the IMF. The combined effort however was not sufficient and Russia had to default. We can then conclude that the **solvency**

¹⁶ The Russian Default - what happened? – Cullen Roche - <http://www.pragcap.com/the-russian-default-what-happened>

¹⁷ A case study of currency crisis: the Russian default of 1998 – Chiodo and Owyang - http://www.fightthebias.com/Resources/Rec_Read/Study_of_a_Currency_Crisis.pdf

of the sovereigns was the main feature of this crisis.¹²

The peculiarity of the Russian crisis is not in its nature, but on its size. The country's inexperience, the resistance, and the contagion from the external was all equally important factors. However, what made of the Russian crisis such a great disaster was the bigness of the country. We can see that even small errors can have a great impact, if accounted for a whole region. In particular the mistake of Russia was the non-implementation of strict controls, and a weak and corrupted legal environment.¹⁸

¹⁸ Lessons from the Russian Meltdown: The economics of soft legal constraints – Enrico Perotti – www.onlinelibrary.wiley.com/doi/10.1111/1468-2368.00101/abstract

Chapter 2. The Argentine crisis of 2001-2002

2.1 Causes”

After considering the main crisis in the emerging markets during the nineties, that influenced each one in its own way the performance of Argentina, as well as the international scene as a whole, we will analyse the complicated scenario of Argentina itself. We will start from an historical perspective of the situation. We will then turn our attention to all the possible factors that led to the default of the country in 2001-2002.

“As is usual after a debacle of such a magnitude, fingers have been pointed at enough culprits to explain the Argentine crash many times over. The Argentine “political class” was too short-sighted to reach a compromise on fiscal policy. The currency board system was too rigid to allow Argentine exporters to regain their competitiveness [...] Cavallo was too sure of himself and went [too far]. Foreign creditors were too fickle and should not have reversed course so dramatically after their rush into Argentina in the early 1990s. The IMF should have pulled the plug much sooner. The IMF should not have pulled the plug.” (Rodrik, 2002). However, the reason it not only one, but a mix of causes. They are all important, even if they did not contribute in equal parts. Often they are also correlated among them.

2.1.1 Historical background

Historically Argentina was a rich country, one of the richest in the world, and its GDP was even higher of those of the best performing European countries. However, Argentina’s greatness started to decline after the Second World War. This was due to the deterioration of terms of trade and the stalemate of the political situation. The situation went even worse during the seventies, because of the crises of the Latin American regions¹⁹. Than main problems in Argentina were the increase in the oil price and the workers’ movements.

The government of Isabel Peron lasted from 1974 to 1976. She succeeded to her husband, the general Peron, that was a filo-Nazi colonel during the war, and maintained his anti-American perspective, also as president. Her government was characterized by the huge influence that the army had on it, and by the succession of incapable ministers of the economy. This factors led to the un-governability of the country, and settled the basis for the *coup d’état* by the Military junta, and the the facto dictatorship of the president Jorge Rafael Videla.²⁰ The scenario that Videla faced was terrible: the economic situation was crumbling and full of corruption, the inflation was skyrocketing and the population was constantly under the armed attack of both wings terrorists. He suspended the Congress and gave the power to a military commission; he also put military personnel into the government. What he did to the part of the population that was his opponent, was even worse: hundreds of people were imprisoned, and just as many “disappeared” – were killed. From the economical point of view, he was favourable to a free market policy. He would have been successful in his plan, if it was not for the international community resistance, that (properly) didn’t want to engage in economic

¹⁹ The Argentine Crisis 2001/2002 - Iris van de Wiel -

<https://economics.rabobank.com/publications/2013/august/the-argentine-crisis-20012002-/>

²⁰ Analisi dell’economia Argentina dal 1974 al 1999 - Etchevés Miciolino Aldana (LUISS 2014)

activities with him due to its bad fame as a murderer dictator, especially after he started to execute also journalists, educators, and intellectuals.²¹

The return to democracy was in 1983 and it was characterised by high inflation (5103% in 1989)²² and political and economic uncertainty.²³ Therefore, the minister of the economy Domingo Cavallo settled a plan for the stabilisation. In 1991 he introduced the system of **peso convertibility**: it linked the peso to the dollar on a one-to-one basis. The inflation decreased to 84% that year, and the following was at 17.5%. In 1993, it went even lower, at 7.4%. Once they have seen the positive results, they decided to take more determined steps and radical reforms.²² "The reforms included the privatization of state owned enterprises, the deregulation of the economy, lower trade barriers and state reform." (Wiel, 2013) The result in international popularity was great, and Argentina became the "the most favourite emerging market" (Wiel, 2013), of the IMF, the USA and the international scene in general. Consequently, the country was able to borrow dollars at cheaper rates. If on the one hand there was the benefit of the increased **confidence** of investors, on the other hand Argentina became **dependent on the dollar**.

Thanks to the peg both the problems of inflation and bad reputation were solved, leading to the stabilisation of the exchange rate. People could freely decide whether to denominate their debts in peso or in dollars, and there was an increasing trend toward the latter. The whole situation allowed the country to growth, and it experienced increase in output from 1991 to 1997, if we make an exception for 1996, but this can be explained by the Mexican crisis influence.

Again in 1998 Argentina was hit by the crisis in international markets, namely by the ones in Asian regions and in Russia. Those damaged the conditions for all the emerging markets, therefore also for Argentina, reflecting the loss of confidence in the investors eyes in higher borrowing costs for the emerging markets themselves. It is important to mention, still in 1998, the impact that one close neighbour and trading partner, Brazil, had on Argentina. Brazil had also a peg to the US dollar, but it renounced to it in that year. Brazil depreciated its currency and it renounced to the peg to US, this fostered the economy for them, but for one who wins another one has to loose: Argentina. The latter maintained its peg hoping to maintain also the credibility, but it actually lost competitiveness and reduced the price of its exports, running therefore a current account deficit.

Another hit came from the beloved peg itself, in the sense that the dollar appreciated to its maximum point in the last 15 years. For Argentina was difficult to match this rise, and it was also left with no tools to deal with it: it could not respond with monetary or exchange rate policies exactly because they were already given in the hands of the US.¹⁹

²¹ Jorge Rafael Videla - The Editors of The Encyclopædia Britannica - <http://www.britannica.com/bps/user-profile/4419/the-editors-of-encyclopaedia-britannica>

²² Timeline: Argentina's road to ruin – The Washington Post staff; Paul Blustein - <http://www.washingtonpost.com/wp-srv/business/articles/argentinatimeline.html>

²³ Argentina in the Red: what can UK's Regional Economies Learn from the Argentinian Banking Crisis? – Molly Scott Cato - <https://ijccr.files.wordpress.com/2012/05/ijccr-vol-10-2006-5-scott-cato.pdf>

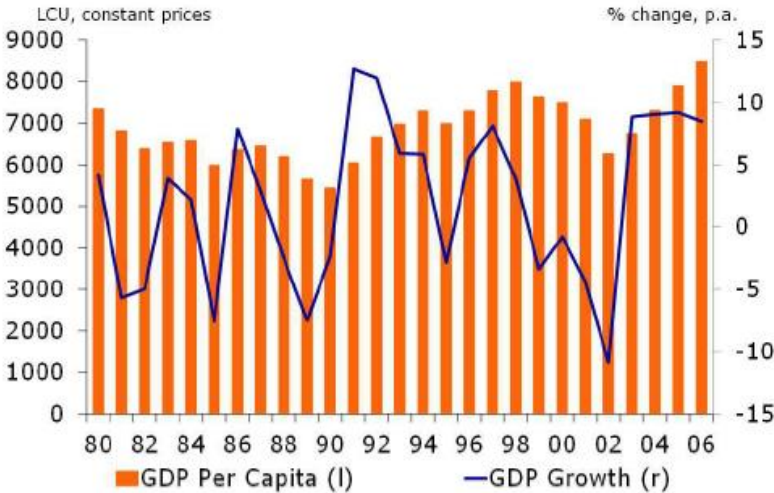
In 2000 the debt reached 50% of the GDP and the economist Calomiris suggested that the state had the necessity to restructure its debt. Later that year the IMF approved a rescue plan for 20 billion dollars, 14 of which directly came from the IMF.

In 2001, some more problems in international emerging markets suggested that Argentina could not be able to meet the IMF requirements. In May, it took place a “mega-swap” for 30 billion of bond exchange, with the intent of giving operating space to Argentina. However, a top bankers reunion in New York concluded one more time that a restructuring was needed. The Argentine government decided for a partial restructuring plan in November.²² Still in November the interest rate rose suddenly due to fears of peso devaluation.¹⁹ In December, in order to avoid bank runs and financial panics Cavallo imposed a deposit freeze named *Corallito*, impeding in practice the population to protect his saving. The population responded with demonstrations, and riots forced Cavallo and de la Rúa to resign. Meanwhile the IMF blocked the issuance of aids to Argentina, that was no longer considered trustworthy. The country lost this way its principal access to capital.

On the last days of December the president was then substituted, and the new charge was assigned to President Rodriguez Saá. The political tensions and the instability were more and more increasing, and his government did last just a few days.

In those hostile circumstances, the 1st of January 2002 Eduardo Duhalde became the new president. 5 days later it had no choice but to announce the **default** on the debt. He also decided for the Law of Public Emergency, the Reform of the Exchange Rate Regime, and the **end of the Convertibility** plan. At first the exchange peso-dollar became 1-to-1.4, but very soon it was allowed to fluctuate freely and the Peso devaluated even more.¹⁹

Figure 2. 1: GDP in Local Currency Unit – from Radobank; Iris van de Wie¹⁸



Source: World Bank

2.1.2 Openness to financial markets

There is a dynamic relation between the international financial markets and the countries which are part of that community. It is true that if a country has economic problem they will be reflected in the whole market (Asian crisis that brought to the overall increase in interest rate). And it is equally true that if it is the market to have problems, it is likely that even a safe country will experience some adverse conditions (Argentina affected by the lost confidence in emerging markets). On the first chapter, we have seen why financial markets exist, and how do they work. Now we will see how Argentina was granted access to them, and how this affected the performance of the country.

Argentina is a country very rich in terms of internal resources, even if it was not always able to exploit them successfully. Argentina is considered as an emerging market. This is mainly because of its inability to put in practice its talent, lacking the "know-how". However its potential is great and it has nothing to envy to the developed countries.

It occupied the 34th place in the UN's list of human development. Just Singapore and Korea (the less affected countries in the Asian crisis) preceded it, among the countries from the South. It also presented high rates in other development variables: the adult literacy was 96.8, which is more than what Portugal scored; the life expectancy was 73.4. A significantly cultivated and brilliant population characterized Argentina.²³ In fact "Argentina perceived itself as the **cultural leader** of the sub-continent" (Cato, 2003). Argentina has also a natural gift regarding the primary resources and raw materials.²⁵

It was enough a crisis to destroy the potential of Argentina, taking it from being the start of Latin American countries, to an average developing country.

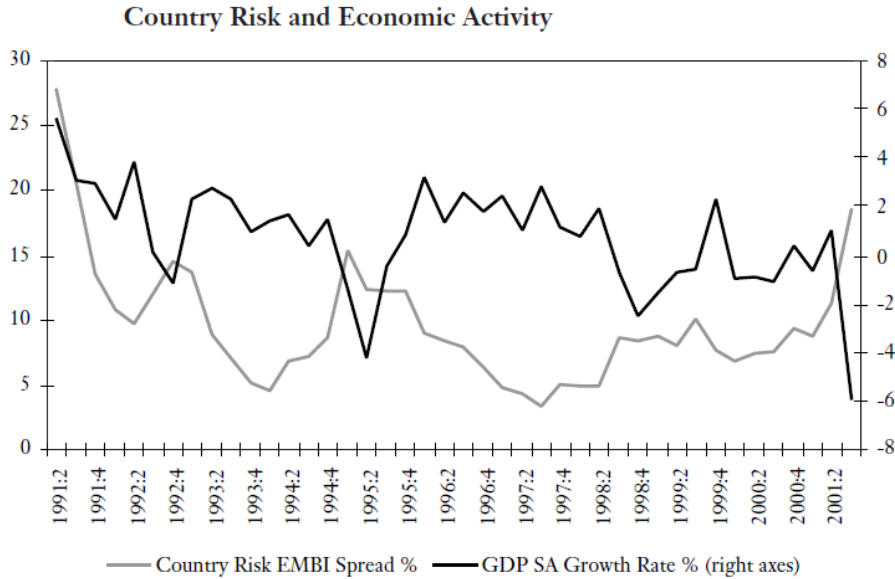
In general, we can describe the GDP per capita considering the accumulation of physical and human capital. For the case of Argentina, it is more difficult than that. In 2002, the GDP was inferior to the one in 1998 by 30-percentage point; however, the productive capacity was almost unvaried. It is reasonable therefore to ask how it is possible to obtain such results, if the basic condition of productivity did not change.

The explanation is that there was a lack of incentive to allocate the resources efficiently. The little degree of use is a result of the policy decisions taken during the crisis, and in particular of the lack of well-defined property rights. This came as a result for the Duhalde's abandon of the currency board, that led to the breakdown of the contractual infrastructure (see section 2.1.3) There was the need for policies that could improve the situation, and avoid the annihilation of Argentina's productive capacity, in order to prevent the increase in poverty and the sufferance of the population.²⁴ Before looking for corrective actions, it is useful to look at the starting point, and see how Argentina was related to foreign markets even before the crisis and why such destructive policies were chosen.

²⁴ Financial Stability and Development in Emerging Economies – Teunissens and Teunissen - <http://www.fondad.org/publications/stability> (Teunissen & Teunissen, 2003)

Typically, the developing countries are volatile in terms of country risk and GDP growth. Argentina is more volatile than what it should be. Since we cannot find the reason for this higher volatility in the shocks that affected Argentina (which were more or less the same as for any other developing country), we can infer that the source of volatility is in Argentina itself. Precisely the two determinant factors are: the asymmetrical way in which it was integrated in the international markets, and the rigid policies chosen to deal with the international environment itself.

Figure 2. 2: Country Risk and Economic Activity - from Fondan; Teunissens and Teunissen ²⁴



The integration can be defined **asymmetric** in the sense that the **real and the financial side** of the economy have opposite perspectives. Regarding the real part, intended as export and trade, the openness is very low, whereas for the financial side the degree of openness is much greater. Another point of asymmetry can be identified in the fact that the public sector is the one that contracted a huge amount of debt, while the private sector is the one that owns the higher amount of foreign assets. Furthermore, those assets are denominated in dollars, but the physical trade flows with the US are quite few.

Argentina has huge **problems in exporting** its products, and in facts among the Latin American countries, it has the lower coefficient of openness (ratio between exports and imports to GDP). Even if the country tried to open to new market (as we have seen mainly with Cavallo, but also Videl tried to do it), the response from the outside it is the main problem.

Agricultural products, commodities related to the primary sector, and low processed goods principally compose the export (see figure 2c). ²⁵ The trade partners of Argentina has protectionist policies regarding those sectors, therefore Argentina has problems in placing the output that can it can produce more efficiently. The foreign partners of Argentina in this sense can be defined irrational, because however on the financial side they lend enormous amount of

²⁵ Evolution of Argentine foreign trade over the last decade: origin, destination and composition – Daniel Berettoni - [http://www.cei.gov.ar/userfiles/CEI-REVISTA-19-MPK\(EN\).pdf](http://www.cei.gov.ar/userfiles/CEI-REVISTA-19-MPK(EN).pdf)

capital to a country whose products remain unsold. It is straightforward that a country that encounters protectionist policies will have problems in repaying its liabilities.²⁴

Another characteristics of Argentina's integration is the instability of flows, that are often under the attack of the **contagion** effects of the other countries' crises (as we have deeply discussed in chapter 1). It is complicated for Argentina to diversify its national risk, and under its imperfect market (it is anyway a still developing country) the choice of the agents was to demand foreign assets to protect themselves from the "bad state". Therefore we can see that the country is not highly indebted, but that the majority of foreign assets and uncovered position in Argentina are in the hands of the private sector, trying to hedge their risk. We can conclude that the debt problem of Argentina is then not on the financial side, but that is due to **problems of risk hedging and moral hazard of the firms**, relying to much on government's help in case of crisis. The currency risk, which comes from changes in value of one currency against another, slowly became credit risk, related to borrower's inability to repay his obligations. Therefore, one big problem that lead to the crisis was the **foreign flows that was not sufficiently balanced**.²⁴

Figure 2. 3: Main Argentine export sectors – from CEI; Daniel Berettoni ²⁵

Main Argentine export sectors
contribution to growth and evolution of export volumes

	Exports in millions of USD			Contribution to growth	Volume index (1993=100)		
	Average 98-00	Average 08-10	% Change		Average 98-00	Average 08-10	% Change
Residues and waste from the food industries	2,162	8,400	288	16.0	185	327	77
Road transport material	2,207	6,626	200	11.3	288	819	184
Fats and oils	2,320	5,576	140	8.4	206	262	27
Oil seeds and oleaginous fruits	980	4,068	315	7.9	159	341	114
Chemicals and by-products	1,377	4,125	200	7.1	316	794	152
Cereals	2,508	4,870	94	6.1	185	182	-2
Base metals and articles thereof	1,242	2,882	132	4.2	167	164	-2
Meat	817	2,128	160	3.4	138	217	58
Machinery and apparatus, electrical material	1,089	2,216	103	2.9	138	267	93
Plastic and artificial materials	423	1,340	217	2.4	342	864	153
Preparations of legumes, vegetables and fruits	323	973	201	1.7	177	461	161
Fresh fruits	456	1,099	141	1.7	188	327	74
Beverages, spirits and vinegar	217	783	260	1.5	241	417	73
Milling products	152	607	300	1.2	293	668	128
Dairy products	337	775	130	1.1	831	1,118	35
Paper, cardboard, printing and publishing	393	653	66	0.7	274	421	54
Unprocessed fish and shellfish	541	790	46	0.6	98	121	23
Unprocessed vegetables and legumes	314	520	66	0.5	188	188	0
Rubber and articles thereof	159	364	128	0.5	313	432	38
Sub-total	18,015	48,792	171	79.0			
Rest	7,471	15,672		21.0			
Total	25,486	64,464					

Source: CEI based on INDEC.

2.1.3 Credibility and Confidence

Now that we posed the basis for the Argentinian integration in international markets, we can look at another source of volatility and uncertainty: the policies chosen internally to deal with the changing environment, and the consequences that they brought in terms of credibility of the country and investors' confidence.

Sovereign risk is defined as the "likelihood that a government will be unwilling to service its foreign obligations even when it has the capacity to do so". (Rodrik, 2002) Sovereign risk matters because it is the key variable to achieve the convergence with the rich countries: investors must trust a country, and not perceive it as a risky place where to put their capital, in order to lend their capital and permit it to grow. Economic growth necessitates of capital to finance investments, and when the national saving are no longer enough, capital comes from abroad. However this is the case only if the borrowing country commits not to gamble with the received funds, but above all the commitment must be credible.

Argentina tried to be trustworthy by means of the currency peg. It was intended to signal to the financial world that also Argentina deserved to be integrated and to grow with foreign capital. Their hope was then to reduce the country risk via the Convertibility plan. Initially the plan worked well, however, shortly after something would have destroyed this feeble ambition of Argentina: the crisis in foreign markets and return of its minister Cavallo.²⁶

The Convertibility plan of Cavallo, despite the initial improvement in the economic conditions, meant also that the peg must follow the dollar in any case. The rigidity of the peg was clear once the dollar value increased in 1995. Exports became more expensive, since the peso had to rise just as the dollar did, while the competitors of Argentina, which did not have a peg, obtained an advantage. From 1997 to 1999 occurred the **regional crises** in Latin America and Asian regions, that signalled to the markets that the emerging countries were not able to meet their obligations in general, debasing the confidence in Argentina too.

Argentina's economic fundamentals were not bad, it followed also (unintentionally) the Maastricht standards for Europe, and in fact its debt/GDP ratio exceeded the 60% just in the year of the crisis. (see 2d)²³

²⁶ Reform in Argentina, Take Two. Trade Rout – Dani Rodrik _
<https://www.sss.ias.edu/files/pdfs/Rodrik/Commentary/Argentina-globalization-gone-too-far.pdf>

Figure 2. 4: Indicators of Health of Argentina's Economy, 1996-2001 - from Wordlerpress; Molly Scott Cato²³

Indicators of the Health of Argentina's Economy, 1996-2001						
Indicator (US\$bn.)	1996	1997	1998	1999	2000	2001
Exports (FOB)	23.81	26.43	26.44	23.33	26.41	26.68
Imports (CIF)	23.76	30.45	31.38	25.51	25.24	20.32
Trade balance	0.05	-4.02	-4.93	-2.17	1.17	6.36
International reserves	18.10	22.32	24.75	26.25	25.15	14.53
External debt	111.9	130.8	144.1	144.7	158.0	170.0
Debt/GDP ratio (%)	41.1	44.7	48.2	51.0	55.6	63.3

Source: Business Monitor International, *Argentina Quarterly Forecast Report*, Feb. 2003.

The fundamentals show that the perspective of the catastrophic ending of Argentina was exaggerated. However it was also a "self-fulfilling prophecy" because it was enough for investors to no longer trust Argentina, to see an increase in the interest applied, even when fundamentals were not so difficult from those of other (most reliable) countries. From this viewpoint, **the crisis seems to have been due to financial reasons** (and not based on fundamentals), via the pressure of the US and of the international scene in general, that deteriorated (unnecessarily) the investors' confidence in Argentina.²³

We have to say however, that associating the Argentinian crisis to the Maastricht parameters, in particular at the 60% ceiling of the debt/GDP ratio, is problematic. Those standards were designed for developed countries, not for emerging ones. The latter have problems in managing external capital flows, usually for unexpected changes in variables that they do not have under control. Just like Argentina and its foreign denominated liabilities, under the currency peg.

Even if it is true that Argentina observed the standards, it failed to conform the most important one regarding the public debt sustainability: "spread over public bond issued in domestic currency, compared with the lowest European country interest rates". This requirement admit a maximum spread of 150 basis points, but Argentina was three times more than that. The conclusion is that from this value it was already possible to see that at a certain point they would have loose the capability to manage their debt.²⁷

This does not mean however, that the pressure from the US played a central role in the crisis. We will restore to the influence that US and dollars had on Argentina in the next session, for a closer look at the dollarization (see 2.1.4.).

The return of Cavallo in 2001, that helped the country to restore credibility in the nineties, seemed to be the "deus ex machina" that could magically restore the situation one more time. This time however, nonetheless of his efforts, the policies that implemented were regarded with suspect from the international markets.²⁶

First of all, he proposed again an idea he had, but then rejected, in 1991: to peg the peso to a 50-50 basket. The currency chosen were the dollar and the euro. Then he announced a dual

²⁷ The Argentine Economic Crisis – Murphy, Artana and Navajas - <http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2003/5/cj23n1-3.pdf>

exchange rate, with a preferential one for the exports. This idea was viewed as in contrast with the original convertibility and with an orthodox currency board, that in fact has “one fixed exchange rate” as its first point. A mixed currency board, differently from a traditional one, is considered unstable, and Argentina was already in an unstable condition on its own. The proposal of Cavallo therefore just worsened the situation: because if once it was sufficient to confirm the commitment toward the peg to ensure stability again, with those mixed policies he not only altered the currency regime, he break with it definitively.²⁸

The result of the confidence lost was that the interest premium required on Argentina increased, in the anxiety that the country was close to the default. The things went the other way around, and in fact was the increase in interest rates that brought to the default: it was enough that there was a probability of default, for it to happen not long after.

The commitment of the government toward foreign creditors was adequately visible in the next step took by Cavallo: he decided to change the terms for the **contracts** for the Argentinians, in order to preserve a good (even if it was not so good) situation for the foreign creditors.²⁶

He also imposed a ceiling on the possibility of withdrawal from bank account, depriving the Argentinians of their savings. The population was mad about that, and protests became very frequent. The country did not gave a very safety image to the international scene.²⁸

Therefore ,it was not a matter of what the authorities were doing, but of how much the population could endure. When nothing else worked, Cavallo and de la Rúa decided for a very common resolution in times of crisis: austerity policy. If the funds were no longer coming from abroad, a (not so) brilliant solution could have been to cut on the salaries of the population, when the situation was already of just 1 over 5 of the workers actually having a job. Cavallo and de la Rúa became so hated by the **domestic and foreign opinions** that they were forced to resign in 2001, and the default was announced shortly after.²⁶

The lesson is that the requests of foreign creditors must come after the needs of the domestic population. The policies adopted inside the country project their shadows until the international markets. And even if from the economic point of view the government is still sound to its foreign creditors, this cannot be separated from the political point of view that regards the democracy inside the country. They necessarily go together, and therefore the population should be preferred, because, as in the case of Argentina, the foreign creditors can let you down anyway: “the market has only fair-weather friends” (Rodrik, 2002).

²⁸ Argentina’s current political-economic crisis – Steve Hanke - <http://www.cato.org/publications/congressional-testimony/argentinas-current-politicoeconomic-crisis>

2.1.4 Dollarization

Cavallo was the father of the Convertibility system, and his plan aided to come over the economic instability of the eighties. The initial reactions to the peg were positive and Argentina became the “favourite child” of the global capitalism, receiving high levels of international investments. However, this did not come at no price, and in turn the Convertibility system meant losing the capacity to manoeuvre the country’s monetary policy, delegating it to the US, and increasing the exposure to international capital markets’ risk.

Mainly external debt (60-70 %) rather than domestic composed the Argentinian debt in the last part of the nineties (figure 2e). The majority of the **domestic** Argentinian debt was contracted in dollars as well, with the intent of shielding against a devaluation of the peso. Thanks to this mechanism the government was not been able to repay its dollar liabilities in 2001.

The convertibility functioned this way: one peso was equivalent to one dollar, since the exchange rate fixed on a one-to-one basis. The government issued bonds denominated in dollars, and the buyers paid the respective amount in pesos. The government used pesos to repay it peso denominated liabilities, in practice, it reintroduced pesos in the domestic sector again. The local agents used pesos to buy government bonds denominated in dollars again. The procedure was possible thanks to a bi-monetary convertibility system, and dollars did not existed, resulting in a **virtual dollar creation**.

During this period, the **external** debt increased significantly, oppositely to the very slow GDP growth (figure 2.5). It grew by 61% if we take into account the time span 1991-1995, but it goes to 139% if we consider it until 2001. It happened regardless of a great income of funds considered “non-debt-incurring”, like the privatisation of traditionally state owned enterprises and FDI (Foreign Direct Investment).²⁹

Figure 2. 5: Evolution of Argentine Public Debt; 1997-2001 – Fondad; Bernardo Lischinsky 29

Evolution of Argentine Public Debt, 1997-2001

(by holder residence, in billions of dollars)

	1997	1998	1999	2000	2001 June	Sept.
Public Debt	101	112	122	128	132	141
External	73	81	82	81	79	87
Domestic	28	31	39	47	53	54

Source: “Quarterly Estimates of the 2000 and 2001 Balance of Payments and Foreign Assets and Liabilities”, Ministry of Economy, Argentina, March 2002.

²⁹ The Puzzle of Argentina’s debt problem: Virtual dollar creation? - Bernardo Lischinsky – <http://fondad.org/uploaded/Argentina/Fondad-Argentina-Chapter6.pdf>

Figure 2. 6: Growth of Argentina's GDP and External debt, 1980 – 2001 – Fondan; Bernardo Lischinsky 29

Growth of Argentina's GDP and External Debt, 1980-2001
(percentages)

	Debt	GDP
1980-1985	81.5	-1.4
1985-1990	26.1	0.0
1980-1990	129.1	-0.7
1991-1995	61	20
1996-2001	32	2.8
1991-2001	139	15

	Debt	GDP
1995	15	-2.9
1996	11.3	5.5
1997	13.6	8.0
1998	12.6	3.8
1999	3.4	-3.4
2000	0.6	-0.6
Sept 2001	17.5	-4.5

Source: ECLAC, December 2001 LC/G.2153-P/E, and Secretaria de Programación Económica (various issues), *Informe Económico*, Ministry of Economy, Argentina.

“One of the reasons the Argentine crisis was not avoided was that **nobody could provide a consistent and timely exit from the Convertibility regime**”. (Lischinsky, 2002-2003)

Despite the benefits for stabilisation, the Convertibility, through the bi-monetary system, permitted to the government to switch its pesos for dollars, and to increase its dollar debt. The government possibility of altering its monetary policy and provide liquidity was given away due to the Convertibility plan. The problem of creating liquidity was solved therefore issuing debt.²⁹

According to (Cato, 2003) “buying stability in the domestic currency was at the price of dependence on the US” and “the seeds of the monetary crisis were in the objectives set for its domestic currency”. She means that it was clearly stated that the roles of peso were of store of value and unit of account, but its function as a **mean of exchange** was overlooked. And she identifies in this, the reason for the lack of liquidity that triggered the financial crisis: while the macroeconomic fundamental were good, the inflexibility of the peso did not allow it to adjust for the appreciation of the dollar and the devaluation of the Mexican currency. The confidence in Argentina disappeared and everything resulted in a bank failure, and all due to the initial installation of the Convertibility plan.²³

(Vernengo, 2013) also is sceptical about the tie Argentina – US. He starts his critique even before the creation of the Convertibility plan, saying that not even the precondition for such a peg existed. He says that a logical currency union is implemented when the two countries are alike in terms in productivity growth and business cycles and shape of the labour market.

Argentina and US were not so similar in those terms.³⁰

Indeed they should have very similar approaches. Because once a country gives up its possibility to affect the domestic monetary policy, it must be sure that the decision taken by its delegate are not going in opposite directions. That what benefits one country is not detrimental to the other, or simply that one would not appreciate its currency letting the other unable to do the same in order to match.

The rising of the dollar value in facts came soon after, and this lead to an **overvaluation of the peso**.

Vernengo (2013) then agrees with Cato (2003) in saying that in the Argentinian situation the banking system deterioration played a central role, and that it was a consequence of the Convertibility system. Therefore he says that in order to remove the problems in the financial system, the elimination of the Convertibility is also required, since it is founded on mistaken assumptions.³⁰

Since the Convertibility became apparently a problem to overcome, some analysts suggested to abandon it, and proposed alternative views.

(Hausmann, 2001) proposed it in two steps. First, report **dollar denominated bonds** at their peso value in the internal sector of the debt. Then he proposed to change the **exchange rate from fixed to floating**. This last point was not intended as completely free to float, but linked to inflation targets. The idea was to help the country to grow again thanks to increased competitiveness, while avoiding problems in dollar liabilities in case of devaluation.

(Gaba, 2001) had three suggestion. The first was the same as Hausmann. The second was a partial devaluation (a 20%) combined with an increase in dollarization. The third one intended to keep the bi-monetary system while allowing the peso to devaluate and the exchange rate float.

He said highlighted the benefits of devaluation in terms of increased exports, that would result in an increase in the balance of payments as well, since the imports would reduce.²⁹

Probably he did not took into account that the export of Argentina were almost never a source of growth, since the country's comparative advantage was in a sector of minor interest from the international community.

It is furthermore important to notice that **devaluation** can also mean greater capital flight, and that even if the exports effect would have been present, the capital flight would have neutralize it. This kind of policy can be implemented only in countries that have well established directives of control over capital movements, and Argentina required the implementation of such policies at that moment.²⁹ The actually implemented solution, as we have previously seen, was an unorthodox exchange rate no longer fixed, and that the peso could devaluate.

The most enthusiastic author about the Convertibility plan is (Hanke, 2002) and also its final suggestion is different from those of the others. He says that the Convertibility system was unusual and that even if Argentinians understood it, it was difficult to comprehend by most economists and the IMF. He says that the Convertibility was the way to way to achieve stability,

³⁰ The limits to dollarization in Ecuador: lessons from Argentina – Matias Vernengo - http://www.jwsr.org/wp-content/uploads/2013/02/Vernengo_Bradbury-vol17n2.pdf

and that it was held responsible for the Argentinian crisis just from those who did not get the situation. He describes it as an unorthodox currency board, a “mixture of currency board and central banking features”. The reason is that in the Convertibility period the Banco Central de la Republica Argentina (BCRA) could lend to the government, regulate commercial banks and act as a lender of last resort. In particular, the bank obtained foreign reserves from IMF, and it lost them by lending to commercial banks, and therefore indirectly supporting the government bonds, that were used as collateral.

He identifies therefore a problem in the Convertibility system, and it is that due to its dualistic nature it can pursue two target, but since they are in conflict between them just one had to be choose. Those were the “exchange-rate target” and the “money-supply target”, and the government chose the second one. Under this solution, the BCRA conserved for itself the power to decide reserves ratios, acting as a lender of last resort. The critique that (Hanke, 2002) stances is that it was full of contradictions inside, and that an orthodox currency board would have been better. Therefore (Hanke, 2002) says that with the return of Cavallo, the situation became even worse because he proposed such different policies that were not only very different from an orthodox currency rate, but that was contrary also to the previously currency board that created Cavallo himself.

Hanke is not a supporter of the Convertibility plan as it used to be, just like the other authors cited, however he underlines its positive points. Those are the reduction in inflation and the great signal of stability that Argentina gave to the international scene, by being linked to the US. Therefore the solution proposed by Cavallo is both a step backward, to a more tighten connexion with the US and the dollar, and a step forward in the sense of going even beyond the original convertibility plan: he aspires at **full dollarization**. He says that this is possible because he noticed, unlike the others, that the Peso was never overvalued, but that in fact it always remained under its “fundamental equilibrium real exchange rate” of 6%.

He finds the reason of the crisis in the fact that the devaluation in Argentina resulted in the government stealing from its population, in the sense that the authorities confiscated dollars that were in the hands of the peso holders when Corallito was imposed.²⁸

This last point becomes less true if we admit that dollars in fact were not there waiting for the peso holders, under the virtual dollar creation hypothesis.

Hanke concludes then his point saying that full dollarization it would be beneficial to Argentinians. They would benefit from the fact that with full dollarization their government could not use the national currency as a mean to constrict the monetary conditions, and would also avoid increasing taxes during a recession. Also they will benefit in the eyes of the international financial system, increasing their credibility. Lastly a floating exchange rate usually meant a depreciating rate in Argentina. But even with this Argentina would not have good capital inflows levels, because of the poor rights about private property that signal to foreign investor that it is not a stable country.

He says that, Convertibility was the only thing that ensured economic growth in the nineties, nonetheless of all its problems. Combining the last two points, a solution comes automatically: full dollarization. People trust the dollar, which means to restore the ability of Argentina to borrow, and therefore to grow.²⁸

It is clear that the Convertibility system had its good days in the early nineties, while its

evolution was a disaster at the end of the decade. For sure, what Argentina needed before the crisis was more trust from the foreign investors, however other points, like the internal situation deterioration, required attention as well. Probably the proposal of Hausmann is the one that would have balance better everything. It is also true that taking decisions in that context was not easy for Cavallo, while it is easy to say ex post what should have been done.

2.2 The role of IMF

The IMF and Argentina have a close relation, since the Fund helped the country many times, and required to it many macroeconomic changes in order to give the necessary aid. They have a solid link, and so also the IMF was retained culpable for the crisis of 2001-2002.

This connection became tight during the eighties, when a huge number of programmes were taken into consideration. However, they were not implemented, due to the resistance of some members in the IMF's board and Argentina's not compliance with the requirements.

In 1982, Argentina occupied the Malvinas Island, which were under the UK's jurisdiction. Some political quarrels occurred between the two countries, and this resulted in a depreciation of the peso. Argentina asked the IMF for help. The IMF saw many problems in Argentina, such as its non-competitiveness, internal budget problems, and difficulties in the wage market. Therefore, programme failed. In 1983 Alfonsín became president, ending a military regime, and asked again for the IMF help, that was denied again. It was finally in 1984 that an agreement was made, but it failed soon after because of a deterioration in the wage market. In 1985 was decided the Austral Plan, that failed the next year again due to Argentina's nonconformity with the Fund's requirement, this time in terms of monetary policy. A new deal was made in 1987 that failed in 1988 because the IMF doubted of the Argentina's credibility.³¹

In 1988 parallel negotiation were made from Argentina with both IMF and World Bank. The second one provided loans to Argentina even before the end of the negotiation with the IMF. The Fund did not like the behaviour of both of them, and denied the help to Argentina because of its irresponsible policies.³² This was the situation when Menem became president in 1989, and Cavallo minister of the finance: problems on many levels, that the country was not able to solve not even when the IMF demanded to do it, and an "odi et amo" relation with the IMF itself.

In the moment of great development of Argentina, 1990-1994, the IMF did not have a big role, and in facts, Argentina decided and implemented the Convertibility system alone, it did not have directives from the IMF.²⁸

The IMF discouraged Argentina from this plan, in the same spirit of the view of Vernengo: Argentina did not met the criteria for the implementation of an optimal currency peg; its inflation level was very high, as opposed to the US; it required a more flexible labour market (goal that it was not able to achieve during the last decade); not corrupted institutions that respected always the law; and a strong fiscal policy in order to be protected against inflation.³¹

In 1996, the Argentinian need was to remain competitive at an international level, and in order to do it, it was necessary to maintain the investors' trust. The Fund supported Argentina even if it ostracized the currency peg that was implemented. It put emphasis on fiscal reform, privatization and again on labour market. It also decided to monitor the situation very meticulously, and this time even when Argentina did not respect the target it did not cut its support.

³¹ The Argentine Drama: a view from the IMF board - Onno de Beaufort Wijnholds – www.econbiz.de/Record/the-argentine-drama-a-view-from-the-imf-board-beaufort-wijnholds/10001816136

³² Silent Revolution, The International Monetary Fund 1979-1989 – James Boughton – www.imf.org/external/pubs/ft/history/2001/

Since the Convertibility was put into place, the Fund thought that a better idea could be abandoning it before the collapse of the situation, and this occasion according to the IMF could have been in 1997, even if this was not in the Fund's advices. The Fund actually complimented Argentina about its good reaction to the international crisis of the late nineties, though it said that the crises highlighted the weaknesses of Argentina as well.³³

It would be reductive to find in the **currency board** the only source of troubles for Argentina. In the programmes the IMF drew for Argentina it put too much emphasis on the "budget deficit" alone. It failed to include also "general government" and "external borrowing". Until the collapse of the economy both Argentina and the international institutions did not recognize that the problem was a combination of the currency board (that lacked even the conditions for its implementation) **and excessive external borrowing**, that very soon became unsustainable. In 1998, the main focus for the IMF became the current account deficit, that started to increase quickly. The Fund understood correctly that the international investors looked at the current account in order to verify the Argentina's vulnerability. The Fund also pointed out that the country traded often with Brazil, and that made Argentina vulnerable as well in case of problems in Brazil. The IMF believed that reducing taxes and improving the labour market was the right way to enhance competitiveness. In addition, it required to increase domestic saving to prevent exposing the vulnerability on the financial side.

In 1999 the economic conditions of Argentina deteriorated, and it entered into a recession. It was difficult at that moment to understand that the recession would have become unsustainable, and in fact the IMF's director Mussa predicted a 3% growth for the next year. His estimate was based on the improvement in the general conditions of the emerging markets, and therefore he concluded that also Argentina could have access to international capital. The history proved it wrong. The IMF was too optimistic, and also too permissive. Argentina neglected often the targets in fiscal policy, while the IMF should have been more rigid in imposing the respect of the target, considering the closeness of the Argentine economy and its faults in the tax collection.¹²

Too much optimism was put also on the side of the exchange rate. Since the peso was linked to the dollar on a one-to-one basis everyone assumed that Argentina had the capacity to get over a financial shock. However, without the investors' confidence a fixed exchange rate is much more difficult to be managed than a floating one.

Thus, Argentina continued to borrow large amount of capital when everyone had optimistic views about the country, and ended up with too much foreign liabilities when due to external shock it was no longer considered a safe country. Consequently, **the fixed exchange rate and the excessive borrowing** damaged Argentina's capability to maintain its peg, during adverse external conditions. At the end resulted in the abandon of the Currency board and the default in 2001.

Before the default, in the early 2001, the IMF came to rescue Argentina one more time. The aid was of 14 billion, which exceed Argentina's quota in the IMF by 500%, whereas usually the limit is at 300%. In addition, the World Bank contributed with 5 billion, and other 20 came from the

private sector.

The IMF was against a full dollarization solution, because even if it would have positive results in the long run, it could not have been sustainable in the long run. Or at least not without strict policies of austerity and the condemnation to a loss in competitiveness and high level of unemployment for many years on.

the default, Cavallo's plan to resolve the situation included cuts mainly in salaries and an increase in taxes. The IMF recognized that it was not realistic and it lent 8 more billion in order to save the country. This last move did not amaze the markets, that continued not trusting Argentina. Cavallo proposed then even more drastic solutions, like the rescheduling of the debt and the limit on deposit withdrawals. He ended up worsening the situation and was forced to resign.

The new president Duhalde in 2002 started new negotiations with the IMF. The regional government was afraid of losing their autonomy and thus the final agreement was postponed. In the end was clear that under that circumstances the country could not go on by itself and the arrangement was made.

From this story, both Argentina and the IMF can learn some lessons.

Argentina did not implemented the changes required by IMF while it asked for its help. However, neither the IMF acted as a watchdog, in order to ensure vigorous application of the requirement, while it continued providing support.

Political pressure from the outside cannot be ignore. In addition, a proper exchange rate must be applied, consistent with the environment in which the country operates.

Argentina has great potential in terms of natural and human resources, however this is not enough to ensure growth, but the markets' help is required. Argentina must restore the confidence it has lost, in order to interact efficiently with the international scene.

A closed country with low level of export, but high foreign capital inflows, it is a contradiction in itself, and eventually it will show its vulnerability. It is important therefore, to find a way to sustain the external debt situation.³¹

Chapter 3. Argentina today: the following 10 years and the default of 2014

3.1 After 2001: political changes and markets' response.

After the default it was clear that the country needed more commitment toward its policies, as well as to restore investor's confidence, and to promote growth through improvement in both the current account and the public spending. In this section we will see which policies was chosen to deal with the situation after the crisis, and how their implementation work. Then we will see how the country evolved during the last 15 years, and in which background the "default" of 2014 occurred. Therefore, default will be analysed in the second part of this chapter.

3.1.1 Subsequent scenario - 2002

The environments in which Argentina found itself after the default of 2001-2002, was of course not brilliant. Just after the crisis the GDP went down by 11%, the unemployment increased by 23% and bankruptcies were frequent. Analysts predicted that the nominal exchange rate will become uncontrollable, and that the recovery of the financial system was almost impossible.³⁴ As the situation developed, the economic conditions turned out to be not as bad as expected. However, this was due to short-term motives, not destined to last in the long run.

Even if it was a very uncertain situation (and in fact the loss in investors' confidence was one of the determinants of the crisis), the exchange rate and inflation increased, but not skyrocketed, as a result of export taxes. The money demand also increased, even more than predicted, thanks to a wage freeze. Trade surplus continued to stay positive by reason of reduced imports. Nonetheless, this last positive effect turned out to be somehow apparent: in the second semester of 2002 the trade balance weakened because it started to reflect the capital outflows. Those capital outflows were present even in the first part of the 2002, but were not included in the balance because of the noise created by the instability of the international reserve.

The good conditions were only present in a short-term point of view, whereas there also existed negative points, and they were meant to last. The country experienced an intensification in poverty, as a result of decrease in real wage (nonetheless their stabilisation in nominal value), a cut in the number of people employed and reduction in productivity.

The causes are to be found in the precedent crisis. Although, the way in which the afterward situation was managed can be viewed as an additional cause, since the indecisive measures adopted had the effect to prolong the poverty condition.

The relations with the banking sector was even more conflicting. The point of disagreement was in the devaluation. As a response to the decrease in the peso's value, after the abandonment of the Convertibility plan, the Central Banks postponed the regularisation of the payment system. Also the Courts were involved, and they decided to protect the interests of

³⁴ The Argentine Recovery: some features and challenges – Ruben Mercado - <http://lanic.utexas.edu/project/etext/llilas/vrp/mercado2.pdf>

the banks and their depositors. On the other side, the banks and firm learned quickly how to deal with the shortage of cash, and the number of bankruptcies decreased.³⁵

When the crash occurred, the country found itself without liquidity: who owned currency provided to send it abroad in the form of peso, while the IMF forbidden the government to print more money.

As a result, many alternative forms of “currency” were experimented by Argentina:

1. “Barter”; an exchange between two different goods, without the use of money;
2. Local Exchange and Trading Schemes (LETS); “ based on exchange of labour, but without the existence of paper currency”
3. Community Currencies; “organised on a local scale, supported by networks of trust and using paper tokens to facilitate complex exchanges”
4. Alternative Currencies; “complementary currencies that have some official status with either political or financial backing by a political authority” (Cato, 2003)

The first “barter club”, the Red Global de Trueque, was a LETS. It was established even before the default, when however the symptoms were already visible. Its aim was to allow people to trade freely, without the limitation that the use of currency comported. However, it soon became a Community Currency in order to be easier to understand and allow greater elasticity of use.

Similar currencies were developed locally in many provinces of the country. The regional governments were not fond of the limitations imposed by the central authority. For that reason, when they became aware of the alternative currencies, they decided to give their support. The support was intended both in form of providing currency, and in form of education and preparation. The first officialization of the state support occurred in December 2000, with the national Secretary of Small and Medium Industries.

Primavera criticized this link with the formal economy, saying that this way the Community Currency had lost its original purpose and ethics. In addition, she said: “A community currency no longer linked to a community is vulnerable to fraud and consequent lack of confidence”. In practice those Alternative Currencies filled in the gap that of the peso as a mean of exchange. The IMF considered negatively the affirmation of the local currencies, in the view that it could become detrimental to the repayment plans it had with the central government.

The regional governments however was of the view that the local currencies were beneficial to their populations, permitting them to address their basic needs, which had the precedence over those of foreign creditors.

The situation became even more extraordinary during the collapse of the economy. Some states begun to pay their employees via bond issues, promising the payment of the salary in the future plus a little interest rate.

In its most dramatic evolution, in 2002, the economy turned to Barter. Not only among people, but also its institutions. The building firm IRSA sold apartments in exchange of grain. Ford and GM accepted grain and cereals as well, in order to sell their machineries. Banks were ready to

³⁵ The mistaken assumptions of the IMF – José Ocampo – <http://fondad.org/uploaded/Argentina/Fondad-Argentina-Chapter3.pdf>

create loans repayable with grain, for those who wanted to buy trucks and agrochemicals. To resolve this situation the correct process is increasing the “Local multiplier”. Economies are not poor because they do not have money to use, and in facts as we have seen in this case desperate populations find extreme solution, and commerce anyway. Poor economies are so because when the money arrives, the government retains it for itself. In order to break this trend, the money should remain in circulation for a sufficiently long time, to permit the population to go on with its businesses and investments. Unfortunately, the IMF suggestions were in the opposite direction. Requiring the reduction in public spending, it just aggravated the situation.²³

3.1.2 The evolution of the situation: Kirchnerism - part 1 (2003-2006)

In 2003 the economic conditions of the country started to recover, even if slowly. That year, with only 23% of the votes, in a still unstable situation, Nestor Kirchner was elected president. Nestor followed the trend started at the end of the Convertibility, and let the peso devalue. Consequently, the wages were low in nominal terms, whereas for the industries it was a good move since it allowed them to be more competitive internationally.

The international context also changed, in a favourable manner for Argentina. The government of Kirchner was characterized by the lack of international shock (in facts we have to wait until the sub-prime crisis of 2008). The US did not keep the very strong dollar, appreciated in the previous years, and the interest rates turned to be negative in real terms. A New player arrived in the international scene, demanding for Argentina's products: China. Brazil set a floating exchange rate, which resulted in an enhancement of Argentina's trade balance.³⁶

A peculiarity in Argentina is that it has competitive advantage in the agricultural sector. Thus, the sector that contributes the most to the **exports** it is the same that feeds also the Argentinian labour force. This results in a conflict when we talk about the depreciation of the exchange rate. On one hand it is beneficial because it permits to increase profits thanks to and increase in export prices. On the other hand it increases also the domestic price for the product, and it deteriorates the real value of the wages in the sector.³⁴

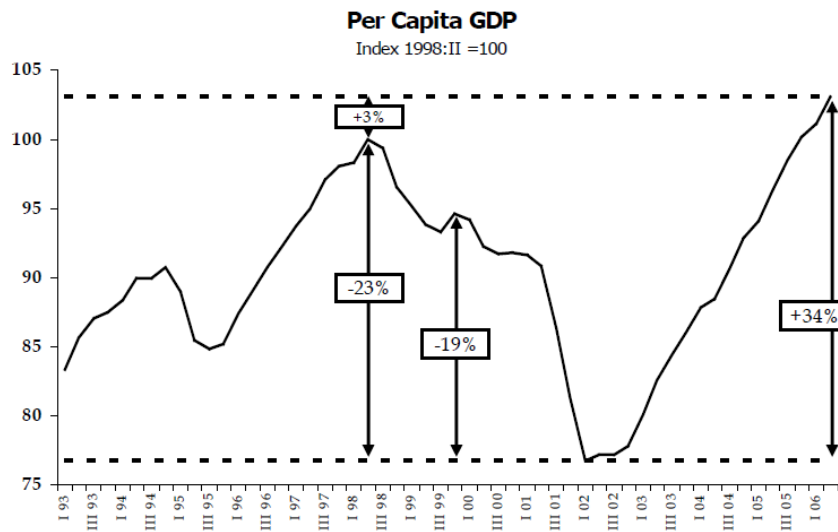
The government did not help to solve the situation, because in facts it exploited the exports sector by imposing a tax of 35% of their value.³⁶

Furthermore, the country would need structural improvements in order to enhance its competitive advantage: improvements in terms of human capital, in terms of quality of education, and technological and institutional frameworks, in terms of quality and transparency.³⁴

The **GDP** grew continuously and in 2007, at the end of Nestor's presidency, in total it increased by 34%. At first glance it may look like a boom as the one in the nineties. With a deeper analysis we can see that there is a reason, and we can find it in the evolution of the current account and fiscal surplus, that showed a "twin surplus", a very rare event for Argentina³⁴

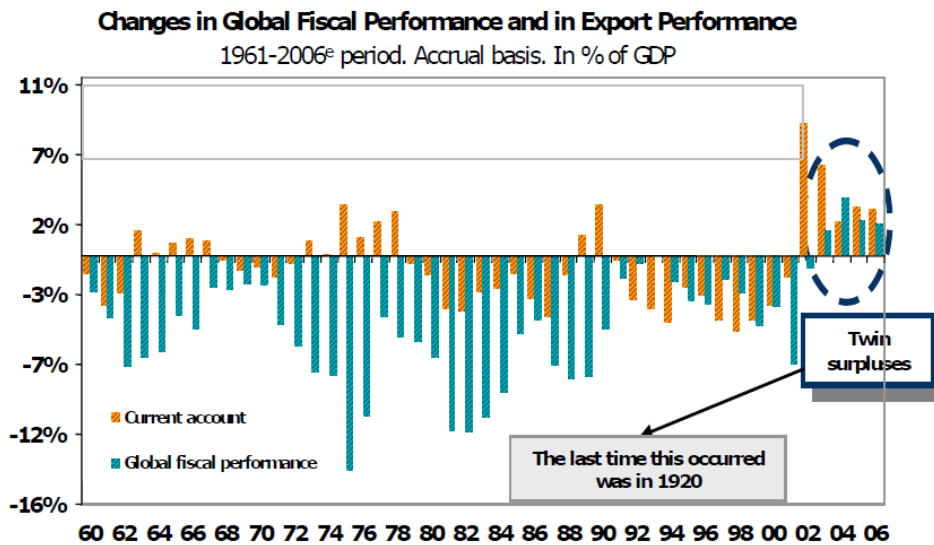
³⁶ The current unsustainable boom in the Argentine economy – Adrian Ravier - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2230520

Figure 3. 1: Per Capita GDP – from LLILAS; Mercado 34



Source: SSPE – Ministry of Economy

Figure 3. 2: Changes in Global Fiscal Performance and in Export Performance - from LLILAS; Mercado 34



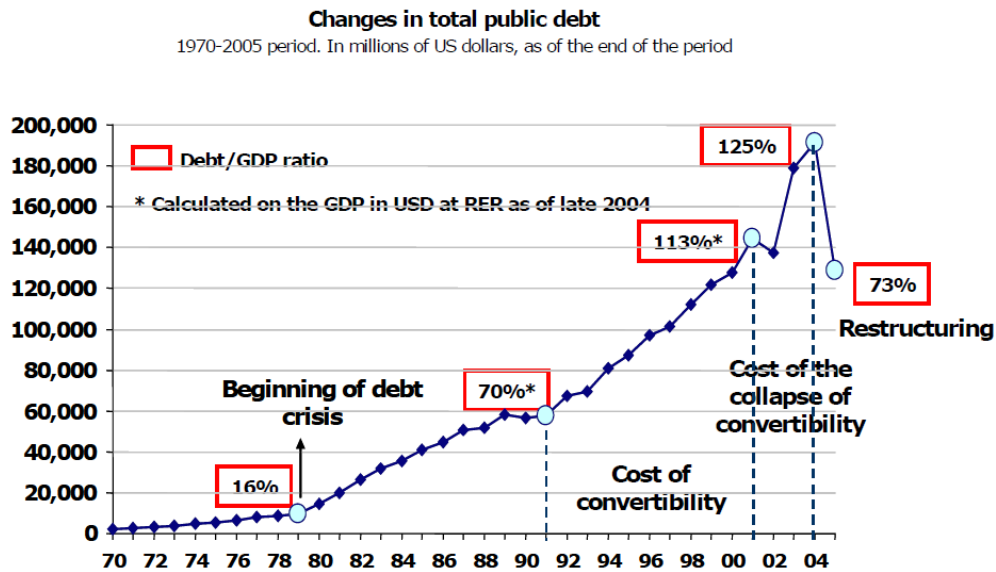
Source: SSPE – Ministry of Economy

In relation to the GDP, there was an improvement also in terms of total public debt. The **Debt/GDP ratio** decreased, because the country repaid its debt with the IMF. In particular, it extinguished it in 2006 with a payment of 10 billion dollar.³⁴

The relation with the IMF was not very intense since the default. The IMF wanted its debt repaid and did not lent anything else to the country, neither when it was in need for the recovery. The IMF still gave advices to the government, mainly on the side of favouring foreign creditors, in the view of a quick reduction of country's debt.³⁷

³⁷ Argentina's Economic Recovery Policy Choices and Implications – Weisbrot and Sandoval - http://www.cepr.net/documents/publications/argentina_recovery_2007_10.pdf

Figure 3. 3: Changes in total public debt - from LLILAS; Mercado 34



Source: Secretary of Finance – Ministry of Economy

Despite the good indicators, the government faced also some **challenges**. The high growth was compensated by a **depreciated real exchange rate**. As we have seen previously in this section, it was good for exports, but detrimental to the population. In fact it guaranteed protections to the industries, and in exchange the government was able to earn export taxes.

Another difficulty was keeping **inflation** under control. We previously mentioned that the price level went up, and in fact this was to be expected when the Convertibility system was cancelled. The wages increased as well. Together with an increase in domestic demand (via consumption and investment) all those factors contributed to an increase in the level of prices. The government thus, faced a conflict between the conservation of the depreciated exchange rate and the prevention of too much money supply.

In particular the fear of rising inflation was pointed out in 2006. The government's solution was a negotiation regarding prices with firms. Even if it worked, it is clear that this is not a sustainable answer over the long run.

Furthermore, another point on which the government still had to work was investor's confidence and country's **credibility**. For Argentina is very difficult properly adjust expectations over the long run trend. It was a country that had frequent structural changes for all its history, therefore it results complicated for both agents and the Government to understand what it is the potential level of the country. The only possible solution should be to renounce to the idea that a unique set of fixed rules exists, and learn by doing, how to deal with this problematic country.

3.1.3 The evolution of the situation: Kirchnerism - part 2 (2007-2010)

In the elections of 2007, Argentina had its first elected women president. With 45.3% of the votes Cristina Fernandez de Kirchner (CFK), the wife of Nestor Kirchner, succeeded her husband. The poor and the members of the unions principally composed her electorate.

She was of the same political view as Nestor, and she went on with liberalist policies. She wanted to nationalize the businesses that the ex-president Menem, in a corrupted process, privatized in nineties. She bought "Aerolineas Argentinas" (the state airline) in 2008, and the "Yacimientos Petroliferos Fiscales" acquirement will come during her second term in 2012.³⁸ Regarding the care of the poor, she created the "Patria Grande" plan: the Argentinian citizenship was granted to those immigrants that went to Argentina in order to work illegally, in low levels professions such as house cleaner or in constructions. She also went on with the legal proceedings against the crimes committed during the last military dictatorship.³⁶

In 2008 a difficult situation occurred in the field of exports. Argentina was the third world producer of soybean (even if this goal was achieved at the expenses of the environment, bringing problems such as the use of dangerous products, deforestation and desertification). The minister of Economics Lousteau wanted to increase the taxes on the exports, and principally on the country's first product: soybean. The production of soybean it was mainly concentrated on the hands of a small oligopoly (40% of the lands were owned by less than 4% of producers). The oligopoly prevented their workers to do their job for 129 days as a form of protest against Lousteau. Later this year CFK said that the soybean producers are "part of the country, not the owner of the country" and therefore proposed to solve the dispute in the congress. The decisive vote of the vice-president Cobos decided not to increase the tax. The result was a double defeat for the government, that did not have its tax, and also discovered that the Congress was not fond of the political agenda.³⁸

Another dispute occurred in 2009. CFK wanted to replace a law for media ownership that was still in place since the last military dictatorship. The Grupo Clarin, the group that owns the majority of the media in Argentina, opposed this initiative. The opposition was due, apart of the economic interests of Clarin in maintaining its advantage, due to personal disagreement between Ernestina Herrera de Noble and CFK. The two had a dispute about the children of Ernestina, that CFK doubted to be stolen children during the dictatorship, instead of legally adopted.³⁸

Between 2008 and 2009 the exports had a contraction, attributable to the decrease in the aggregate demand of the developed countries, due to the world crisis, that hit Argentina's main trade partners (US in particular). In particular is due to the income elasticity: the change in the demand of certain good in response to changes in the purchasing power.

The level of exports increased more in the first 10 years of 2000 than during the nineties. However if instead of on the values, we concentrate on the volume, the result its half as big. Therefore, we can conclude that the high increase we can observe, is largely due to an increase on the level of prices.²⁵

³⁸ Two hundred years of Argentina, seven years of Kirchnerism – CoHa - <http://www.coha.org/two-hundred-years-of-argentina-seven-years-of-kirchnerism/>

Figure 3. 4: World exports in Argentina, by value and volume – from CEI; Daniel Berettoni²⁵

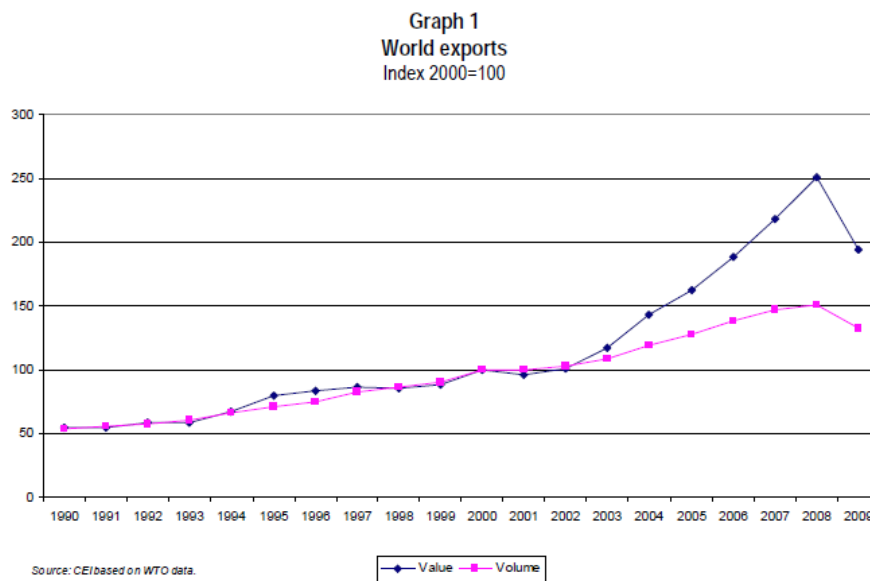


Figure 3. 5: Average annual growth rate in World exports in Argentina, by value and volume – from CEI; Daniel Berettoni²⁵

Table 1
World exports
Average annual growth rate (in %)

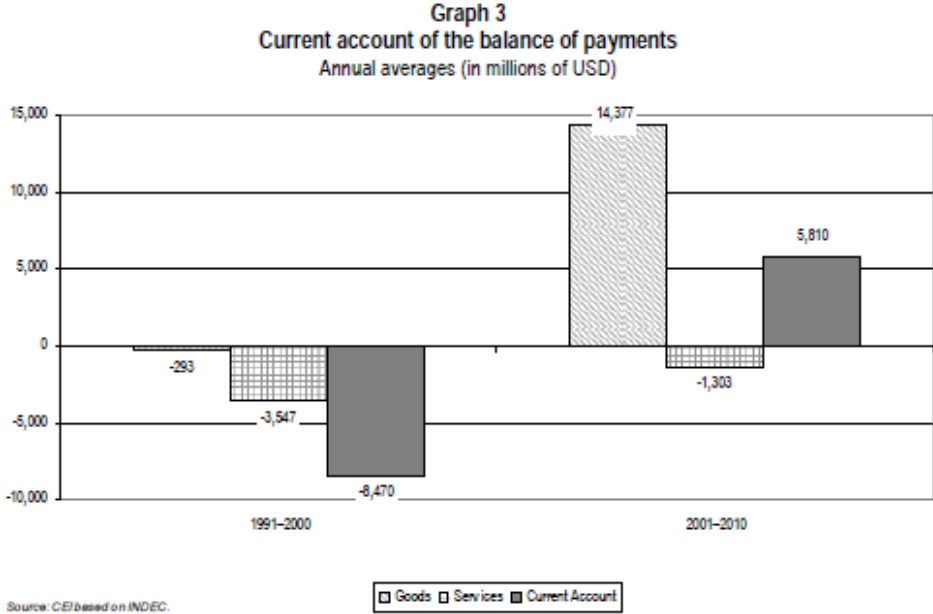
	Agricultural products	Fuels and products of extractive industries	Manufactures	Total
Value				
1991–2000	3.1	6.9	7.3	6.8
2000–2009	8.7	11.4	6.6	7.6
Volume				
1991–2000	4.0	3.8	7.6	6.8
2000–2009	3.2	2.2	3.4	3.2

Source: CEI based on WTO data.

In 2010 again a dispute occurred between CFK and a principal agent of her country. This time it was with the Central Banks. With the “Bicentennial Fund” plan CFK destroyed the independence of the “Banco Central de la República Argentina - BCRA”. She intended to repay the external debt using the reserves of the bank. The director, Redrado, was of the idea that the role of the BCRA was to maintain the “store of value” function of the currency, and not to use the reserves for commercial drives. Therefore, CFK fired him, because all other countries in the world had something similar to the “Bicentennial Fund” and she wanted it too.^{36; 38}

The current account is the difference between income and expenditure. In the nineties Argentina experienced a deficit, that means that the spending was higher than the income, and thus it was financed by external borrowing. In 2010 Argentina is repaying its debts. Thus, to maintain a surplus, Argentina needs to have surpluses from trade, to be able to repay its obligation without further lending. ²⁵

Figure 3. 6: Current account of the balance of payments volume – from CEI; Daniel Berettoni ²⁵



3.1.4 The evolution of the situation: Kirchnerism - part 3 (2011-2015)

In 2011 elections Cristina Fernandez de Kirchner won again, starting her second mandate as president, and continuing with the “Kirchnerism” policies that started together with Nestor Kirchner.

As anticipated, she went on with the liberal plan and the building of a strong state, as opposite to the privatisation era precedent to the Kirchnerism. Thus, in 2012 the Argentinian State re-acquired the “**Yacimientos Petroliferos Fiscales**” (YPF).

At its foundation in 1922 YPF was the first national oil company. Because of the high inflation and fiscal deficit the ex-president Menem decided to sell it, in 1993. In 1999 the Spanish firm Repsol bought YPF almost entirely, having a share of 98%. However in 2012 they decided to sell it, because of the reduction in investment. Therefore, in May of that year, CFK bought it back following the example of Venezuela. This way she increased the national production of crude oil, and the tax revenues via a tax on oil.³⁸

In 2012 however, the country imported oil. This did not happen since 17 years. CFK claimed that Repsol failed to invest in Argentinian production as a justification.

The oil import was made with dollars from the central bank. It resulted in the first pressure on the current account since 2001. US and Europe, therefore, foreseen a bad scenario for the energy sector in Argentina.

However, partners for YPF did not fail to arrive, and lately that year agreement were signed with state owned gas firms from Russia and China.

In 2013 YPS had also its first private foreign investor notable in size: Chevron. It followed many other deals, like with the billionaire Argentinian family Bulgheroni, the Chinese CNOOC, and the reinforcement of past deals with Exxon, Apache, Shell etc.³⁹

In May of 2014 Argentina made an agreement with the Paris Club (“An informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties”⁴⁰) experienced by debtor countries, interrupting its state of exile from the international markets. After the initial “hard-currency” payments, Argentina, in order to ensure the making of new one, will rely on the new investments it received by the **Paris Club** members. In making the deal with the club, Argentina demanded the help of the IMF, however the Fund did not want to offer any support. It is a peculiar situation, since part of the members of the Paris Club are also compositors of the IMF, and above all because the two institutions follow the same guide lines.

The question is not why the IMF do not trusts Argentina, which is reasonable considering all the times that they were not able to made an agreement, and how bad Argentina respected the impositions of the Fund. The odd point is why the Paris club decided to give a possibility to Argentina. The answer is not so complicated, and it is “oil”.

China and Russia have their own supply of energy, while the western countries not. The first two are free to invest how much they desire in their own state-owned energy firms, and

³⁹ Don't cry for Argentina-It's not 2001 again – Scott and Mitchell - www.tandfonline.com/doi/pdf/10.2753/0577-5132570605

⁴⁰ Paris Club - <http://www.clubdeparis.org/en/>

therefore acquire automatically an advantage over the Paris Club member that cannot follow a similar policy. Thus, in order not to lose power, they decide to invest in a state that has oil, but needs currency, and Argentina is the perfect candidate.

The situation is beneficial for Argentina too. Furthermore, frequent discoveries of shale oil were very common in Argentina during the last years, after the re-nationalisation of YPF: of course Argentina translated this into leverage in its negotiations, aiding of the situation even more.³⁹

An additional point of the last government of CFK was on the domestic side, rather than on the international one: finally, Argentina learnt how to collect **taxes**.

The IMF and the other international agencies look at the taxes on export as the main determinant of growth during 2003 – 2009. Nonetheless, the great development of the country came from a different kind of tax: the one on consumption. We can say that the moment of the tax on export, was also the moment of the tax on consumption, and we can see in the figure, the consumption tax was much higher.³⁹

Figure 3. 7: Tax revenues as percentage of GDP – from Scott and Mitchell (2001)³⁹

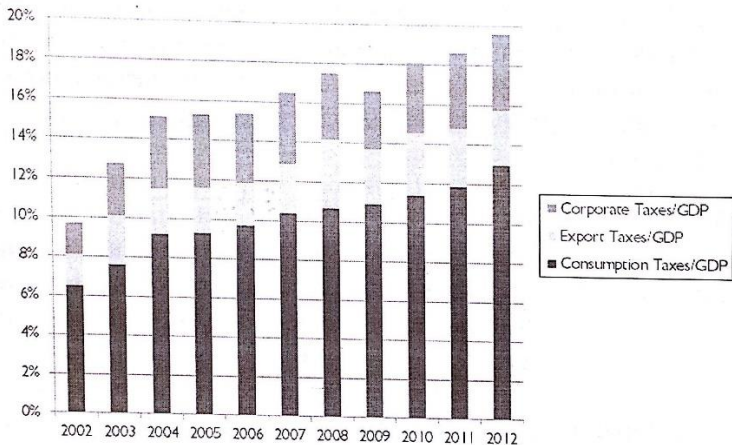


Figure 1. Argentine Tax Revenues as a Percentage of GDP

Source: OECD (2014).

The basis for the tax on consumption can be identified in the isolation in which Argentina found itself after 2001. When the funds from the outside of the country were cut, collecting taxes properly became a “life or death” question.

Already in 1997 the Central Bank required the payrolls to be attributed directly in employees’ bank account. Until 2002 there was not the need for a strict enforcement, even because a low level of taxation had to be preferred as well as labour flexibility, in order to assure competitiveness. Then after 2002 the enforcement became very strict, and the number of Argentinians that had a bank account passed from 41.7% in 2002 to 76.5 in 2013.

Having a bank account means two things: easier control on the monetary transactions, and higher access to capital for the population.

The implication of the first point for tax collection is straightforward: watching the whole thing makes much difficult the tax evasion. The implication of the second point are more profound.

When people started to use heavily bank accounts, the benefit were for both the banks and the citizens. With the use of bank account, there was also an increase of debit and credit card in circulation, in order to give the possibility to the owners of the accounts to manage properly their savings. (Credit cards increased by 478% from 2002 to 2013, while debit card by 175%)³⁹

Figure 3. 8: Growth in number of Credit and Debit Cards in circulation - from Scott and Mitchell (2001)³⁹

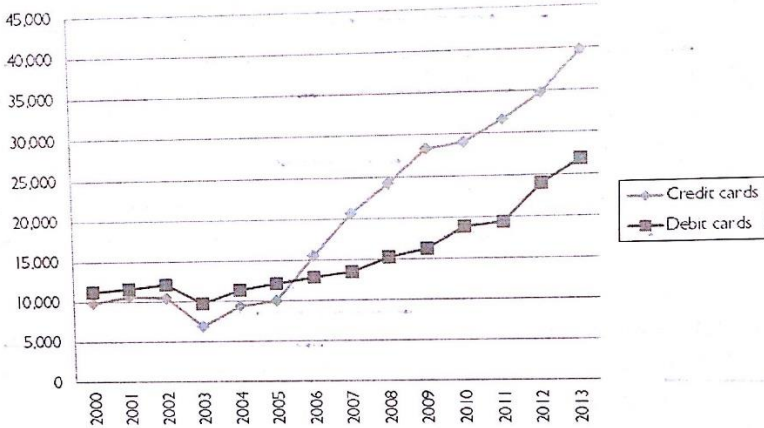


Figure 2. Growth in Number of Credit Cards and Debit Cards in Circulation (in thousands), 2000–2013

Source: Euromonitor International (2014).

The availability of the cards, increased the sources of spending for the population. In facts we can see a decrease in the Consumption as a percentage of GDP, even if between 2002 and 2013 GDP per person increased by 90% and unemployment decreased by 56.6%. The reason is exactly the availability of credit cards.

Using this kind of payment allows the population to buy something today, and repay it tomorrow at a lower price, in terms of purchasing power. The credit and debit cards became so popular, because they were used as a shield of inflation.

The banks as well gained from the situation, in terms of merchant fee from payments made directly with the card rather than with cash, and also profited from debtors, in terms of very high interest rates, much than 30%. (Even if with such high inflation, just 20% of the balances are not repaid in full at the end of the month).

And in the end, also the government benefited from a better tax collection in terms of reduced tax evasion and lower monitoring cost.³⁹

In numbers, the Kirchner government achieved very high growth. From 2002 to 2013 GDP per capita increased by 6 points every year, poverty went down from 54 % to 20% and unemployment decreased from 21% to 7%.

The Human development index sees Argentina in 2014 as the most developed country in Latin America, right after Chile. The debt-to-GDP ratio is a 45.6%, while Greece and Italy, two countries with which is compared often, are around 150%.³⁹

Even if the government puts emphasis on the high level of growth it achieved, there is still **criticism** about it. If we look at the evolution of GDP, we can see that indeed there was a growth in the last years, however it was just sufficient to restore the situation as just before the crisis, not to go further. There is also an explanation for this fact. It can be proved looking at GDP per capita and the capacity utilization.

GDP per capita in 2013 arrived just at his peak in 1998. On this point Carlos Hidalgo attacks who believes in the growth of Argentina saying that CFK reports false data, and that even The Economist has removed inflation figure from its indicators. Therefore, according to him all data has an upward bias, that do not respect the reality of the events. The fault is to be founded too high **inflation**, which for instance in 2011 was officially 9.7%, but private estimations gave it at 24.4%.

Regarding the **capacity utilisation**, it was at 60% in 2001 and then it went up to 80% until 2011. However, it is quite steady, and there is now little room to improvement. Therefore it is going to be difficult to grow even more than that.³⁶³⁹ FIGURE 5 and 6

Another controversy regards the public spending. Ravier says that such a high level of public spending cannot be achieved just by rising taxes, but that for sure it is financed via printing money, and collecting money from pension funds and the Central Bank.

To maintain this level of spending to conditions must be ensured, the first one is that China will remain one of the main partners of Argentina, and this is very likely; the second one is that the US will maintain a liquidity policy that will result in high commodities price in Argentina. This second option it is not very likely, since the interest rate is already almost 0 in the US.³⁶³⁹

However we have seen previously that Argentina improved the way in which taxes are collected from citizens, and that there were increases in tax on agricultural products, and from 2012 also on shale oil. In addition, the relations of CFK with the Congress and the Central Bank are not rosy; therefore if the suggestion of Ravier it is true, it must have been very difficult for her to convince them following her plan.

On the other hand it is true that inflation is a problem in Argentina, and that policies of "short-termism" prevail. The goal is to make good results in the short run, not ensure a durable growth. As Acemoglu says: "In Argentina institution-building has taken the form of very quick and clientelist redistribution"⁴¹

In conclusion there are two schools of thought about the Kirchnerism.

On the one hand there are those who hope for a radical change with the elections of 2015 (In which CFK herself cannot be elected anyway). This because they have view in this decade a positive growth for Argentina due to the lucky scenario in the international context, but a bad government that presents false data, let inflation skyrocket, and present an unsustainable level of public spending and growth.

On the other hand, there is who trust Argentina because they see in the reforms it

⁴¹ A century of decline – The Economist - <http://www.economist.com/news/briefing/21596582-one-hundred-years-ago-argentina-was-future-what-went-wrong-century-decline>

implemented a good justification for growth, and that there is even potential to further improvement. Krugman even arrived at suggesting to the Greece to behave like Argentina, devaluate its currency, and raise export, because he viewed the Argentinian model as a good working one.

3.2 The current situation: 2014 and 2015

The third Kirchner government will continue until 2015. Two of the three main points of CFK's second mandate were the agreement with the Paris Club and the re-nationalisation of shale oil in the country. Those points resulted fundamental dealing with the "vulture funds" in 2014. We will analyse the second "default" in the last 15 years of Argentina in the second part of this chapter, but before we have to clarify some other issue: we cannot describe the occurrence of a "default" without having clear in mind in which scenario it occurred.

Therefore, even if the long era of Kirchnerism was amply exposed in the first part of this chapter, it remain us to deal with the currency situation in 2015, and to see a brief inside in the legal points of the "vulture" funds controversy.

3.2.1 Currency situation

The monetary condition in Argentina is controversial. The inflation differs according to who it is reporting it, and official values are usually lower than the other estimations.

In addition, the exchange rate is "multi-coloured" because again it gives different values, accordingly to where the exchange is made.

The exchange rate is related to the purchasing power of the currency. In theory exchanges will be set at the point in which the purchasing power is adjusted. Therefore, saying that 8 pesos are equivalent to 1 dollar should mean that what one can buy with 8 pesos in Argentina it is the same as what one can pay with 1 dollar in the US.

It is easy to see how this concept is related to the change in price level in the counties. If inflation goes up the purchasing power will decrease within the country. Thus, also the exchange rate with currencies of other countries must be changed accordingly.

Inflation in Argentina is not a well-developed concept. In facts, they more or less ignore this value in official reports. The government has set the Statistical Office just as an ancillary sector of the Ministry of Economics, and it did not work on inflation until 2014. In February of that year, the minister Kicillof reported finally a number for the official inflation rate: 24%. Though, the opposite parties in the Congress made their own estimation, and the outcome was much higher. In facts, it resulted in switch in the numbers: almost 42%.

Such rates of inflation account for the excessive spending of the government, which cannot be covered entirely by tax collection, and in the long run is going to be unsustainable. But since we made this point before, regarding the implication of inflation for the government, it is better to look at how it affects the population.⁴²

In January 2015, the official rate peso-dollar was 8.50-to-1. Among Argentinians however, it is not a taboo to talk about the black market, or better, the blue markets. Because it is not only one and each one offers more or less favourable rates. In facts, are the Argentinians themselves, that call the official rate "white" and the alternative ones "blue". Borrowing the terminology from their national flag, to refer to the borrowing conditions in their country.

⁴² Don't cry for me Argentina – Schwartz - <http://www.econlib.org/library/Columns/y2015/Schwartzcry.html>

If one goes to a restaurant, or to a small shop, it can exchange one dollar for 11 pesos. The real estate business is done principally in dollars, so it has its own exchange rate, the azure one: 10.71. To obtain this rate however, a notary must confirm the real estate purpose of his client, in front of the bank.

Tourists paying with the credit card obtain the one of the highest rates, the gold one, at 11.56. It can go better than this in a particular moment of the year: Christmas. At that time the blue exchange rate was 12.87 in the shops. At the first place instead we find another particular exchange, this time related to location: Buenos Aires. In Buenos Aires there is the green rate, that is at 13.07. It is called green because the dealers have made their "roots" in Calle Florida, one well known street of the capital. They are also called, by the population, "Arbolitos", which means "Little trees".

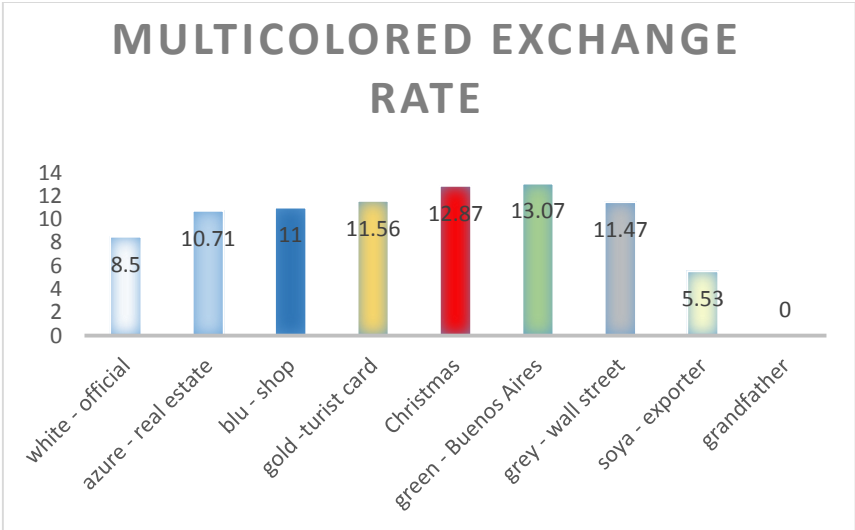
An almost equally good rate can be obtained in a more risky way: purchasing Argentinian bonds in peso, and then bringing them to the secondary market in Wall Street, where they will be sold for dollars. This exchange rate is grey at it is 11.47 ⁴²

In addition, it depends also on who is demanding currency. The worst exchange in facts is destined to Argentinians. For instance an exporter of soya can convert the money he made from his trade at a rate of only 5.53. The state somehow punishes his citizens that do not like their currency, who tries to sell goods for dollars, as a result of mistrust in peso.

Nonetheless, it can go even worse. There was examples of prevention of exchange for the population. The authorities allow entering the exchange market only people that they consider "a person of sufficient mean". In a television fireside we could have even observed a dispute between CFK and a Grandfather that brought the state to a court, because it was denied to him to acquire 10 dollars, that he wanted to give to his nephew. ⁴²

In contrast with her populist view toward her supporters (the poors), it seems that the CFK government puts the burden of inflation upon the citizens. It is forcing them to accept a highly devaluated peso, while the government is printing the money it need to conduct its transactions. Citizens try to avoid inflation as the best as they can: putting their savings in currencies that do not melt like ice, or, as we have seen, conducting their businesses via credit and debit cards. ⁴² The following chart summarizes all the possible exchange rates.

Figure 3. 9: Multicolored Echange rate - with data from Econlib; Schwartz ⁴²



3.2.2 Restructuring agreements

In 2002 Argentina began a process of debt renegotiation with the IMF. After three years, in **2005**, decided to go on by itself, since negotiations just led to conflicts between the IMF and the private creditors, that all claimed their priority in the accords.

It then decided, in accordance with the SEC (Security and Exchange Commission) to create a unilateral offer to the private creditors. As an enforcement, the Argentine legislature codified the **Ley Cerrojo**, which means Lock Law.

It *“prohibited the government from reopening the exchange or making any kind of future offer on better terms, and suspended any future payments on the untendered debt”*. (Hornbeck, 2013).

Argentina wanted to default in 81.8 billion dollars of debt, and 20.8 billion dollar on PDI (Past Due Interest – A repayment that has not been done until its deadline date). The latter was not addressed, while with regards to the first, 62.3 billion was exchanged for 35.2. Then the government could not settle the remaining 18.6 billion, and a dispute started with the IMF and the Paris Club. At the end a large part of the debt remained residual to the holdouts: 24% of the creditors.

Argentina therefore addressed the situation firstly in 2006, repaying in full its debt with the IMF with almost 10 billion in one payment. It also declared its financial independence and the will to remain self-financed via internal economic growth.

It promised twice, in 2008 and 2010 a repayment to the Paris Club, and it resisted the attempt of litigation of the holdouts.⁴³

In 2009 Argentina decided to renegotiate again its debt. The reason was that Argentina did not have access to capital market, and it managed to repay its obligations through monetizing the debt, selling bonds directly to the Venezuela’s government and by nationalizing the pension funds. However, it was no long enough, and CFK demanded the reserves of the central bank in order to repay the debts. Highly in need, Argentina found itself in a good scenario for restructuring the debt, since the interest rates in the markets were low and liquidity high. In addition, the country had a positive fiscal balance in the year.

Therefore, in that year the country restarted the negotiation with the SEC. The portion of the Ley Cerrojo impeding to open again the negotiation of the debt was cancelled by the Argentine legislature, in order to permit it.

In **2010** of the remaining 18.4 billion, 67.7%, which mean 12.4 billion, were exchanged. Considering the whole scenario since 2010, it resulted in a **participation rate of 91.3%** of total default debt. The remaining part continued to be problematic for Argentina, as holdout creditor (still having 11.2 billion) continue with attempts of litigation, and Argentina continued ignoring them. The remaining 6.3 billion were to the Paris Club.⁴³

⁴³ Argentina’s Defaulted Sovereign Debt: Dealing with the “Holdouts” – J.F. Hornbeck - <http://www.fas.org/sgp/crs/row/R41029.pdf>

3.2.3 “Buitre - vulture” funds: story and legal aspects.

Creditors strategies are different among them. Institutional funds usually tend to negotiate. Private investors resell their bonds in the secondary market, in order to gain something on the difference and not be involved in the difficult process of restructuring. Then there are the Hedge Funds specialised in distressed debt. Their strategy is to buy bonds of country in high difficulty for a very low price. Then to wait patiently for an opportune moment in which to sue for full repayment. For this behaviour CFK call them “Buitre” – “Vulture” funds.

The latter strategy is highly profitable in the long term, especially if they amount for a small part of the creditors. For a country, it is easier to accept their conditions, if they are just a few, while it would be difficult to deal with an army of creditors asking for full repayment, since the country could simply lack the means to satisfy them all.

Argentina’s response was the constant repayment to the creditors that accept one of the restructuring plan, whereas the Holdout remained unpaid.⁴³

The Buitres attracted the ire of Argentina, because of their evil actions, drove just by personal interest and speculation. This is the view of Argentina, considering that when the country defaulted in 2001 it issued bonds that are still existent and traded on the market, even if at very low values. Investors that in good faith acquired that bonds and are asking for repayment therefore do not compose the holdout creditors. Instead, they are agents trying to profit from the situation and to obtain a full repayment of the debt practically free. And this is confirmed by the fact that they did not accept the restructuring plan neither in 2005 nor in 2010.⁴⁴

On this ambivalent treatment, many holdouts sued Argentina saying that it does not respect the “**Pari Passu Clause**”:

“[1] The Securities will constitute ... direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank pari passu and without any preference among themselves.

[2] The payment obligation of the Republic under the Securities shall at all times rank at least equally with all is other present and future unsecured and unsubordinated External Indebtedness”.

In 2012, in the NML Capital, Ltd. et al., v. The Republic of Argentina (Docket No. 12-105(L)) (2d Circuit, October 26, 2012)⁴⁵, the plaintiffs went in front of the United States District Court for the Southern District of New York to determine Argentina’s breach of the contract. The judge Griesa was assigned to all cases regarding Argentina’s default of 2001.

Between 2011 and 2012 Griesa analysed many cases, and in the end he concluded that Argentina actually was guilty of not respecting the Pari Passu clause through the enactment of the Ley Cerrojo.

⁴⁴ The Gringo’s Guide to the Argentine Holdout Crisis - Samuel George - <http://semancha.com/2014/07/23/the-gringos-guide-to-the-argentine-holdout-crisis/>

⁴⁵ NML CAPITAL, LTD., Plaintiff, – against – REPUBLIC OF ARGENTINA, Defendants. - http://www.shearman.com/~/_media/Files/Old-Site-Files/Arg5Order112112.pdf

It therefore issued an injunction, demanding Argentina to pay the amount due to the plaintiffs, and forbidden Argentina from “*altering or amending the processes or specific transfer mechanisms by which it makes payments on the Exchange Bonds*”.

Argentina response was that it intended for more than 50 that the Pari Passu was against “discriminatory legal ranking” and the creation of unfavourable “legal priorities”, not that the meaning was repayments at the same time. However neither the judge Griesa nor the Second Circuit were convinced.⁴⁶

In 2014 Argentina appealed the decision of the court, but they refused to analyse the case. Griesa decided to set illegal for Argentina to repay the debt to everyone of its creditor if at the same time it was not repaying also the Holdouts. This resulted in a **technical default** for Argentina, the second in 13 years.

Technical meaning that Argentina repaid in time and in full amount the creditors that decided to sign the restructuring of the debt. Therefore, it could continue as it always did, and it had the means to continue paying. The impediment to the repayment was therefore just a legal issue imposed by Griesa, a technical issue, and not a complete default like in 2001.⁴⁴

Argentina had 30 days of time in June 2014 to decide on how to proceed. After the injunction by Judge Griesa, the next payment date for the restructured days was 30 days after. The country had basically two choices: accept the court decision, and repay in full the holdout, so as to have the possibility of repaying also the other 90% creditors; or refuse to act as Griesa told to and default.⁴⁶

Argentina refused to negotiate with holdout in the fear that the RUFO (Right Upon Future Offers – see Figure 3.10) clause would apply.

The RUFO clause, that ended in January 2015, says that Argentina cannot make a better deal to one of the creditors, without having to apply the same enhanced terms to everyone.

This means that Argentina could not negotiate with the Vulture, without avoiding future request of similar negotiations. In the end it would have resulted in an excessive and unsustainable demand, and therefore the country would not have been able to serve it.⁴⁷

⁴⁶ Don't Cry for Me Argentine Bondholders: the Second Circuit Decides NML Capital v Argentina – Sherman and Sterling LLP - [http://www.shearman.com/~/media/Files/NewsInsights/Publications/2012/10/Dont-Cry-for-Me-Argentine-Bondholders-the-Second_ /Files/View-full-memo-Dont-Cry-for-Me-Argentine-Bondhol_ /FileAttachment/DontCryforMeArgentineBondholdersSecondCircuitDec_.pdf](http://www.shearman.com/~/media/Files/NewsInsights/Publications/2012/10/Dont-Cry-for-Me-Argentine-Bondholders-the-Second- /Files/View-full-memo-Dont-Cry-for-Me-Argentine-Bondhol_ /FileAttachment/DontCryforMeArgentineBondholdersSecondCircuitDec_.pdf)

⁴⁷ Raising the RUFO in Argentine bonds – Joseph Cotterill - <http://ftalphaville.ft.com/2013/03/06/1411442/raising-the-rufo-in-argentine-bonds/>

Figure 3. 10: Right Upon Future Offers – RUFO – from FTAlphaville; Cotterill⁴⁷

Rights Upon Future Offers Under the terms of the Pars, Discounts and Quasi-pars, if following the expiration of the Offer until December 31, 2014, Argentina voluntarily makes an offer to purchase or exchange or solicits consents to amend any Eligible Securities not tendered or accepted pursuant to the Offer, Argentina has agreed that it will take all steps necessary so that each holder of Pars, Discounts or Quasi-pars will have the right, for a period of at least 30 calendar days following the announcement of such offer, to exchange any of such holder's Pars, Discounts or Quasi-pars for the consideration in cash or in kind received in connection with such purchase or exchange offer or securities having terms substantially the same as those resulting from such amendment process, in each case in accordance with the terms and conditions of such purchases, exchange offer or amendment process. The right of tendering holders to participate in any such transaction is subject to certain conditions described under "Description of the New Securities — Rights Upon Future Offers" below.

In August 2014 Argentina sued the US at the International Court of Justice, in the view that a judge of a district of another country cannot decide the rules for another country, namely Argentina. However the US must give its approval for the court to hear the case, and this is not very likely. In addition, it could be considered as a case of contract law, and not of international law, and therefore being rejected by the International Court.⁴⁸

In September 2014 a new restructuring was announced, and CFK called it an "Historic event". She also said "Argentina wants to pay, can pay and is going to pay all its debts to all bondholders". Therefore she invited all the creditors of Argentina that had agreement under the US legislation, to swap them to bonds under the Argentinian legislation. This way the injunction of Griesa could have been avoided.⁴⁹

In December 2014 the RUFO clause expired.⁴⁷

Between March and April 2015 Argentina found another way to repay its debtors, and this time through an intermediary: Citibank. Initially the bank found itself in trouble because the judge Griesa prohibited it to make payments in the name of Argentina, again claiming the *Pari Passu* clause. Therefore it could disappoint Argentina not paying, or judge Griesa going against the law, neither of which was a wise move.⁵⁰

However in April Judge Griesa decided to allow the payments of Citibank, but conditional on

⁴⁸ Argentina Sues U.S. in International Court of Justice Over Debt Dispute – Ken Parks - <http://www.wsj.com/articles/argentina-sues-u-s-in-international-court-of-justice-over-debt-dispute-1407431003>

⁴⁹ Argentina enacts law restructuring government debt – The Guardian - <http://www.theguardian.com/world/2014/sep/12/argentina-law-restructuring-government-debt-default>

⁵⁰ Now Argentina Can't Even Pay Bonds in Argentina – Matt Levine - <http://www.bloombergview.com/articles/2015-03-13/now-argentina-can-t-even-pay-bonds-in-argentina>

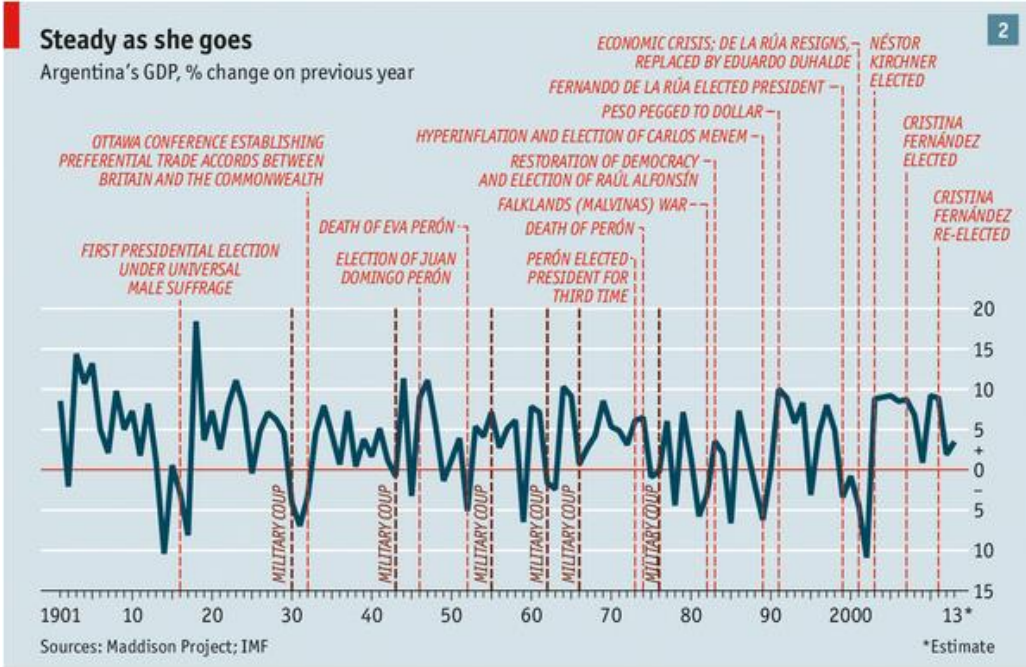
the Argentine law, and for the deadlines of March 31 and June 30.⁵¹ At the end of April, CFK announced the issue of the "BONAR 2024" bonds paying an interest rate of 8.75%, maturing in 2024.

On the 5 June 2015 the nightmare of the RUFO realised, even if in another form. Judge Griesa entitled many other creditors to join the holdouts, the so called "me-too" creditors. They have bonds similar to those of the Hegde Funds, therefore they must be treated under the same conditions. Now Argentina has to pay \$5.4 billion, and no longer the only \$1.6 billion.⁵²

At the end of the year, 2015, CFK reign will be over. The Pari-Passu-Saga, as the media calls it, it is just at the beginning.

If before 2014 the Kirchnerism had its opponents: believing that CFK cooked number and reported falls data to show an inexistent growth. It also had its supporters, having faith in the real recovery of the country. In this scenario, the successor of CFK would have had a difficult time assessing what is real and what not about all the Kirchnerism story and the government. In addition now, it would have to deal with the Vulture funds that are increasing in number, and with the international scene after a default, in order to restore credibility and attract funds. Permitted that Judge Griesa will allow it. Good Luck!

Figure 3. 11: Instability in Argentina’s GDP growth 1901 – 2013 – from The Economist ⁴¹



⁵¹ Sovereign Debt Update May-June 2015 – Mark G. Douglas - http://www.jonesday.com/Sovereign-Debt-Update-05-28-2015/?RSS=true?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original

⁵² A judge ruled Argentina owes \$5.4 billion, not \$1.7 billion — now here's the freakout everyone expected – Linette Lopez - <http://uk.businessinsider.com/argentina-freaks-out-over-me-too-bondholders-2015-6?r=US#ixzz3dLHgW7eD>

Conclusion

This dissertation analyses the economic and political conditions in Argentina. In particular, it examines the background in Argentina at the end of last century and the causes that led to the default of 2001-2002; the development of the situation in the following years; and how that conducted to the second default in 2014.

Argentina is a country characterized by great instability, in terms of economic development, that often operates under potential. It passed from being the "Star" of the Latin American countries, to a default, then back to its position as "Granary of the world", and again a default in the last 15 years.

The aim of the dissertation was, therefore, the analysis of all the causes that have been pointed at as responsible for the Argentina's behaviour. In such an unstable scenario, the possible reasons are many, but this dissertation's main focus was on those financial in nature. (Even if it cannot abstract from those social and political. In fact, eliminating them, would have been against the scope of economics itself, as described by Alfred Marshall: "It is on the one side, the study of wealth and on the other and more important side, a part of the study of man"⁵³).

The first chapter presents the instruments we had, in order to understand the nature of the problems that we encountered. We first had a look at the roots of past financial crisis, looking at how certain concepts developed: crisis that were no longer local, but global; the institution of lenders of last resort; the rise of non-banks financial institutions, etc. We argued that the complications that we encounter in present situations it is due to the financial assumptions made in less recent times.

We have then discussed the process of globalisation, its benefits in terms of efficiency, and its cost in terms in terms of complexity. On this point, we also viewed how to measure the degree of financial integration, which are the current measurements, and how they could be improved. At the end we described the main crises that occurred during the end of the last century, in the developing countries. We have seen the causes, the effects, and the lessons to be learned from the crises in Mexico, Asian Tigers and Russia. That in fact were the crises that influenced the performance of Argentina soon after.

With the second chapter, we go deeper in our analysis on Argentina.

We started from an historical perspective of the economy, how it used to be and what policies was introduced before the default. Argentina passed from the liberal government of Peron, to a military dictatorship, and then to democracy again with De la Rúa and its Economics minister Cavallo. Cavallo was the father of the Convertibility system, that linked the peso to the dollar, and that promoted stability and growth in Argentina during nineties.

However, he was also the author of more austere programmes just before the default, and due the malcontent of the population, he and De la Rúa were forced to resign.

Then we analysed the main determinates of the default.

Due to its instability and lack of experience, for Argentina was difficult to enter in the financial markets and to operate properly in an international context. In addition, as we have seen, the crises in other countries and the appreciation/ depreciation of their currency, underlined the

⁵³ Marshall, Alfred (1890 [1920]). *Principles of Political Economy*, v. 1, pp. 1–2 [8th ed.]. London: Macmillan.

stability of Argentina.

In addition, investors lost their confidence in the country. This can be because of the policies that Argentina implemented, and also because of its chronic instability .

We have seen then, that if from one hand the Convertibility system contributed to growth, it also deprived a country of the ability of using monetary and fiscal policies when needed. Therefore the peg to the dollar can be viewed both as a positive or as a negative factor in the Argentinian case.

Lastly, we have considered the role of the IMF in Argentina's history. We have seen all the plans that were discussed and went wrong because of the mistrust of IMF's directors in a country that often failed to comply with the requirements. We have then discussed how much the mistaken advices of IMF contributed to the crisis, along with all the other factos.

In the third chapter we have seen how the country performed after the default. Due to its isolation from the international scene, Argentina understood better how to deal with its problems alone, and in facts it showed positive growth until 2014. We have also seen the implementation of the Kirchnerism, the liberal policies actuated first by Nestor Kirchner, and then by Cristina Fernandez de Kirchner, the couple that ruled the country since 2002. Their approach was mainly based on re-nationalisation of private industries, that once used to belong to the state, an increase in taxation, increase in spending. We have also seen the critique to their governments, about "cooked" data, unsustainable inflation, and too much short-termism: policies aimed at showing growth in the short run indicators, without thinking about the long run effects.

We have then analysed the default of 2014, looking at the conditions under which occurred, and at which were the relation with the international financial markets. In particular are notable the full repayment of the debt with IMF, the new accords with the Paris Club group of creditors, and the restructuring of the debt in 2005 and 2015 (take together, 90% of the creditors accepted the new restructured terms).

A particular focus was on the legal aspect of the situation that occurred between the Judge Griesa and the "Vulture" funds, and the Argentinian country. Those who did not accept the restructuring terms are the holdout creditors, who principally bought the Argentine bonds on the secondary market at a low price, and then sued for full repayment. Cristina Fernandez de Kirchner called them, therefore, "Vultures". The Judge Griesa, from the state of New York, made an injunction for Argentina in which prohibited it from repaying any debt, without repaying the holdouts as well. The decision was taken considering Argentina's refusal to pay the holdouts as a breach of the "Pari Passu" clause, that guarantees equal treatment to all creditors. Argentina refused to negotiate with the "Vultures", and this resulted in a de facto default, even if until that date the repayment of the restructured debt has always been on time. We have then seen the evolution of the situation until June 2015, and the successive steps taken from both Argentina and Judge Griesa and the holdouts.

From this dissertation, we can learn that the easy way cannot be taken in analysing the causes of a crisis. This means that it is always a pool of causes, often connected among them, that lead to a final collapse of the situation, and not just one. Some look at one factor as the main cause, some others look at a different one but in the end they all exist and they are all important.

From both the defaults resulted the necessity of a harmonious integration with the international scene, since both its over-presence as its absence, are detrimental to a country that cannot emerge just by its own.

We have seen that prudent macro-economic policies, and a good system of monitoring the path, have significant impact on the growth of a country. Therefore, Argentina needs to improve even more its internal institutional framework. One cannot interact efficiently with others, if it is not even efficient in itself.

The way towards operating at full potential it is not easy, and cannot be done by Argentina alone. The international financial institutions should respond properly, even if it is not easy to restore investors' confidence in such an instable country. While trust is all: also a safe institution can collapse, as a result of panic in the sector, even more so Argentina.

With the the default in 2014, the future end of Kirchnerism, due to the elections at the end of 2015, and the still open litigations with Judge Griesa, the "Pari Passu Saga", as media calls it, is far from conclusion. Many questions remain open, whereas the most important points on which to work become clearer. The hope is on the new President.

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