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Pathways Through Financial Crisis: Argentina

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By the end of 2001, Argentina faced economic recession, a collapse in its banking system, and an external sovereign debt crisis. While preemptive action earlier in the year might have made one or more of these crises less severe, preemption was a political orphan at home and abroad. The country's long-standing relationship with the International Monetary Fund brought with it a mutual dependence: the IMF had come to embrace Argentina as a symbol of the success of its policy advice, and Argentina had come to rely on the IMF's endorsement and occasional financial support to navigate the choppy international markets. That relationship deepened along with Argentina's growing difficulties in the run-up to default. IMF support was used to put off a correction of the overvalued currency and to postpone a major debt restructuring. A new Argentine policy regime—and a new, more adversarial relationship with the IMF—emerged only after devaluation and default. KEYWORDS: Argentina, financial crises, banking crises, debt restructuring, International Monetary Fund.

Argentina's relationship with the International Monetary Fund (IMF) has been remarkably long-standing and intense. For fourteen of the twenty years preceding Argentina's crisis in 2000, its economic policy operated within an IMF program. Even after the initial success of its currency board arrangement and debt restructuring in the early 1990s, Argentina relied on the IMF's endorsement and occasional financing to navigate choppy international markets. As the IMF came under criticism for its handling of Asia's financial crisis, it set aside early doubts about Argentina's currency board arrangement and embraced the country as a symbol of the success of IMF policy advice. When external shocks left the Argentine peso overvalued at the end of the 1990s, neither Argentina's political system nor its relationship with the IMF could adjust successfully to a financial crisis that proved far deeper than either Argentina's elite or the IMF had recognized.

Between 1999 and 2001, Argentina's economic slump transformed into a deep financial crisis. Two theories for Argentina's malaise dominated the policy debate. One held that Argentina was suffering from a crisis of confidence. Another held that the crisis was mostly fiscal. Both theories were

too simplistic. They ignored the central importance of an overvalued currency and the heavy use of the dollar in domestic financial contracts. They also failed to recognize the extent to which the "convertibility" system (Argentina's currency board arrangement) had become an organizing device for Argentina's politics—not just an anchor for monetary policy—and how access to external financing had provided the critical glue that held together the political economy of "convertibility."[1] Argentina's political system was unwilling to act preemptively to reduce the scale of what in many ways was an unavoidable crisis. At no time was there a political consensus to incur the costs of exiting convertibility immediately to avoid a bigger, deeper, and more costly exit later. Neither was there a consensus to shrink Argentina's economy and drive down wages and prices to abide by the constraints of a currency board, particularly once those constraints started to bite in the face of reduced capital inflows. Argentina's leaders preferred to hope that its difficulties were temporary: they drew on IMF financing, spent reserves, and then resorted to increasingly desperate attempts at financial engineering to postpone a payments crisis.

Default and devaluation did not immediately bring political consensus on how to allocate financial pain. A desire to avoid probable losses transformed into an inability to allocate losses already incurred and demands for compensation from all sides. All the major players initially hoped that someone else would get stuck with the bill. The denouement of Argentina's crisis turned out to be as protracted as its buildup. External bondholders eventually agreed to a large "haircut"—effectively helping to finance compensation to the domestic financial system. Yet by early 2006, five years after the default, only some domestic interests had received compensation—and the fate of key sectors, notably Argentina's regulated utilities, remained unresolved.

President Kirchner's popularity suggests that Argentines endorsed the policies that followed devaluation and debt default. Growth remained brisk, at over 9 percent for 2005. Inflation rose in 2005 to just above 10 percent, in part because Argentina's central bank has resisted pressure for the peso to appreciate. Argentina is managing inflation partly through price agreements with key industry groups. But it avoided the bout of hyperinflation many predicted would follow the initial devaluation. Its budget remained in balance, with interest payments financed out of tax revenues. International investors were keen to buy Argentina's inflation-indexed domestic debt despite ongoing litigation over the US$20 billion in external bonds that did not participate in its 2005 debt exchange. In 2005, President Kirchner replaced the finance minister and central bank governor with close political allies and repaid the IMF in full, signaling confidence that his policy course no longer needed technocratic validation.

This article is organized into four sections. The first section traces the evolution of Argentina's crisis. The second looks at the key decisions that defined how the crisis unfolded, paying particular attention to internal political forces that made alternative policy directions unattractive during the initial stages of Argentina's crisis, and to the decision to resolve Argentina's domestic debt crisis through pesification and compensation. The third section looks at who has borne the costs of Argentina's crisis. The conclusion examines the constraints Argentina's political institutions imposed on its approach toward crisis management.

The Dynamics of the Crisis

Argentina experienced three conceptually different crises:

- *An economic crisis.* Argentina was pushed into recession in 1999 by reduced market access following Russia's default, the competitive challenge from Brazil after its devaluation, and the slump in soybean prices. Output stalled in 2000, fell sharply in 2001, then collapsed in early 2002 after devaluation and default. The country did not emerge from this recession until late 2002.
- *An external sovereign debt crisis.* As Argentina's economy cooled, external investors lost interest in its government bonds. The government then turned to domestic banks, domestic pension funds, and the IMF for financing. After exhausting these sources, the government unilaterally restructured its domestic debts and defaulted on its external bonds at the end of 2001.
- *A domestic banking crisis.* Argentina experienced a series of domestic bank runs in 2001. After default and devaluation, the banking system was in shambles and required extensive restructuring.

Argentina's three crises were tightly interlinked. The series of shocks that led to the economic slump called for a real depreciation of the peso, yet the dollar's rise at that time led the peso to appreciate in real terms.[2] Breaking the dollar peg institutionalized in convertibility would have allowed the exchange rate to adjust—but at the cost of bankrupting many firms and the government, since the peso value of their dollar debts would balloon. The alternative was slow deflation, which strangled growth, reduced tax revenues, and risked the same outcome: bankruptcies throughout the private sector and perhaps the government as well.[3] With no growth and no market access, the government sought financing from the banking system, increasing the risk of a banking crisis (see Table 1).

Table 1 Access to Domestic and External Financing (in US$ billions)

Year	Net Private External Financing	Net Financing from the Bonds Market	Net Financing from the IMF and MDBs	Increase in Bank Deposits
1995	13.2	2.4	3.8	–2.9
1996	11.5	10.0	1.1	8.9
1997	14.5	8.4	0.4	13.1
1998	16.8	11.6	2.3	8.9
1999	3.4	2.8	1.3	5.5
2000	1.3	–0.8	1.4	3.7
2001	–6.4	–9.2	10.6	–19.8
1996–1998 (fat years)	42.8	30	3.8	30.9
1999–2001 (lean years)	–1.7	–7.2	13.3	–10.6

Source: Government of Argentina, external debt statistics; and BCRA.

Growing Difficulties Raising New External Financing

A steadily shrinking real economy contributed to persistent political tension, and both combined to lead successive groups of creditors to lose confidence.[4] Argentina's initial difficulties accessing international capital markets came at a politically inopportune time: in 1999, Argentine president Carlos Menem and Buenos Aires governor Eduardo Duhalde were competing for the Justicialist (Peronist) Party presidential nomination.[5] As the economy slowed and bond markets closed, neither cut back on spending. Rather, both sought credit from domestic banks. In the end, both lost to the Radical Party candidate, Fernando de la Rúa.

Between 1998 and 2000, the IMF swallowed its own doubts about the consistency of Argentina's fiscal policy with its exchange rate regime and backed a precautionary program that briefly helped reassure the markets. Argentina's ability to tap unsophisticated retail investors in Europe[6] initially made up for the shortfall of institutional investors willing to buy new Argentine bonds.[7] However, by the end of 2000, Argentina was losing access to the retail market as well. After a political scandal forced the vice-president to resign, Argentina needed more than the IMF's seal of approval. It needed IMF emergency financing.

The IMF responded with a $15 billion program—dubbed *blindage* (shield)—which, unusually, deferred fiscal consolidation until after 2001. However, it soon became clear that Argentina would have trouble meeting even these relatively loose fiscal targets, since the ongoing slump reduced government revenues. In the spring of 2001, President de la Rúa chose orthodox economist Ricardo López-Murphy as economy minister but failed to back his demands for budget-cutting authority. López-Murphy resigned, prompting

significant withdrawals from the banking system even as the IMF program implicitly relied on the banking system for additional financing.

The return of Domingo Cavallo, architect of Argentina's 1991 Convertibility Plan, stopped the bank run. When he took over the finance ministry, Cavallo rejected calls for severe fiscal tightening, arguing that technical changes in the operation of convertibility could provide a monetary easing and jumpstart growth.[8] Central bank president Pedro Pou resisted Cavallo's efforts to loosen reserve requirements for banks; he was forced out. López-Murphy had failed to win control over the spending ministries; Cavallo succeeded in winning control of the central bank.

In June 2001, Cavallo also initiated an ambitious $29.5 billion voluntary government debt swap (the *mega canje*) to push out maturities. Creditor participation in the swap exceeded expectations, but the operation also increased the net present value of Argentina's debt by $9.5 billion.[9] The government's willingness to pay so much to defer payments signaled desperation to the markets.[10] Both local and international markets turned for the worse. A failed Treasury bill auction led Cavallo to reverse fiscal policy course; the government announced that it had lost access to credit and therefore had to run a zero-deficit policy. The ensuing deposit run concentrated rationally on the banks most actively involved in financing the government: two state banks and one Argentine-owned private bank.[11]

Cavallo played his last card, audaciously announcing that the IMF would speed up and augment its next disbursement, even though he had yet to secure commitment from Fund management or its shareholders.[12] The bluff worked—the announcement helped to stem the run, and Argentina got more money. The $15 billion IMF program was increased to $23 billion, with $6 billion made available immediately to supply emergency financing to the banking system in what became the IMF's last disbursement before default. The augmentation alone was more than four times the $1.9 billion in net financing Argentina received from the IMF in 1995, after Mexico's Tequila crisis spawned a bank run. Net disbursements from the IMF in 2001 totaled $9 billion.

However, the economy continued to contract, government revenues continued to fall, and the pace of deposit withdrawals picked up again after Peronist opposition won congressional and provincial elections in October.[13] In November, Argentina converted domestically held international bonds into loans. Although the loans were issued under Argentine law and carried a lower interest rate, they were backed, at least in theory, by revenues from the financial transactions tax.[14] But efforts to cut spending, including interest spending, lagged falling revenues. Many provinces resorted to paying their workers with IOUs marketed as quasi-currencies. The federal government itself started issuing a quasi-currency, Lecops, to cover shortfalls in revenue transfers to the provinces. McDonald's started selling Lecopburgers.

In December, growing pressures on the banks led the government to restrict access to sight deposits (*corralito*), and then to time deposits (*corralón*). Financial standstill quickly turned into a full-blown political crisis. Riots followed the bank holiday, resulting in several deaths. De la Rúa and Cavallo resigned, and de la Rúa's successor declared default on Argentina's external debt. Days later yet another government, led by Duhalde, formally devalued the peso, introduced exchange controls, and issued a decree that converted domestic financial contracts from dollars into pesos.

Financial Stabilization and Economic Recovery

Argentina's crisis reached its nadir in the spring of 2002. Economic activity plummeted, poverty rates surged, the financial system remained frozen, and the peso briefly fell to four to a dollar. Duhalde's new government—and a new economic team led first by Jorge Remes Lenicov and then by Roberto Lavagna—eventually managed to achieve a degree of financial stabilization without the IMF. Central bank intervention to the tune of $3 billion, capital and exchange controls, and, above all, responsible fiscal policy combined to stop the peso's free fall. Government revenues were plunging, but the government generally spent only what it took in, refusing to print money.[15]

The real economy started to rebound in mid-2002; stabilizing the banking system took more time. The deposit freeze was never watertight: frozen deposits could, for example, be used to pay peso debts, and the courts ordered additional deposits to be released from the freeze. However, once both the peso and the economy had stabilized, the government was able to lift the freeze in stages without triggering a renewed run. By the end of 2002, all sight deposits had been freed.

This started a new phase of Argentina's crisis—a phase marked on the one hand by a strong domestic recovery and the steady improvement in domestic financial conditions, and on the other hand by deliberations on allocating enormous financial losses from the crisis among domestic and external constituencies. The phase ended when Argentina restructured its external debt and repaid the IMF in full, ahead of schedule. However, nearly five years after the crisis, Argentina's restructuring remains incomplete. Holders of nearly $20 billion in bonds refused the exchange; many have sued. The standoff continues between the government and foreign investors over utility tariffs. Investor complaints against Argentina still dominate the World Bank's arbitral tribunal.

Managing the Crisis

Argentina made three key decisions during the course of its crisis. The first was to seek IMF assistance in the fall of 2000 to support the currency board

and a relatively accommodative fiscal policy. The second decision, made by Cavallo in the summer of 2001, was to seek more money and push out bond maturities instead of exiting convertibility and seeking debt relief. The third key decision, made after the IMF left the scene, was to restructure public and private domestic debts through pesification.

Seeking IMF Financing

Neither Argentina's decision to seek IMF financing in late 2000 nor the IMF's decision to support Argentina came as a surprise. The IMF had a long and close relationship with Argentina. IMF financing supported the initial reform package that launched convertibility and helped Argentina through the bank run that accompanied the 1995 Tequila crisis. Another IMF program followed in 1996–1998, and a nondisbursing "precautionary" program was in place from 1998 until the crisis (see Table 2).

While IMF programs are often viewed as a major constraint on a country's macroeconomic freedom, the opposite became true in Argentina as the 1990s wore on. Private foreign investors flocked to Argentina after the success of its initial stabilization. Market access allowed Argentina to exit from the cycle of IMF programs and debt reschedulings of the 1980s. Private external financing also helped loosen the constraints that otherwise would accompany a strict currency board. However, during market disruptions—

Table 2 History of Lending Arrangements, 1 May 1984–31 May 1996 (in thousands of SDRs[a])

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Agreed	Amount Drawn	Amount Outstanding
Standby arrangement	20 Sept. 2003	5 Jan. 2006	8,981,000	4,171,000	0
Standby arrangement	24 Jan. 2003	31 Aug. 2003	2,174,500	2,174,500	0
Standby arrangement of which Supplemental	10 Mar. 2000	23 Jan. 2003	16,936,800	9,756,310	0
Reserve Facility	12 Jan. 2001	11 Jan. 2002	6,086,660	5,874,950	0
Extended Fund Facility	04 Feb. 1998	10 Mar. 2000	2,080,000	0	0
Standby arrangement	12 Apr. 1996	11 Jan. 1998	720,000	613,000	0
Extended Fund Facility	31 Mar. 1992	30 Mar. 1996	4,020,250	4,020,250	0
Standby arrangement	29 July 1991	30 Mar. 1992	780,000	438,750	0
Standby arrangement	10 Nov. 1989	31 Mar. 1991	736,000	506,000	0
Standby arrangement	23 July 1987	30 Sept. 1988	947,500	616,500	0
Standby arrangement	28 Dec. 1984	30 June 1986	1,182,500	1,182,500	0
Total			38,558,550	23,478,810	0

Source: International Monetary Fund, available at www.imf.org/external/np/tre/tad/extarr2.cfm?memberKey1=30&date1key=2006%2D05%2D31.

Note: a. Special drawing rights is a unit of account in the IMF, whose value is based on a basket of key international currencies. As at 18 August 2006, 1 SDR was worth $1.48672.

notably in 1995—the IMF stepped in to offset a fall in private funding and, above all, to bolster domestic and external confidence in Argentina's policies. Particularly after Asia's crisis, both parties believed that they gained from this relationship: Argentina's success showed the value of IMF advice, and IMF endorsement helped Argentina secure financing in increasingly difficult market conditions.

Argentina's federal authorities have long struggled to bridge the gap between their limited ability to raise money and the demands for government spending, notably for transfers to Argentina's politically powerful provinces.[16] In the 1980s, the federal government closed the gap by borrowing from the central bank, which led to hyperinflation.[17] "Convertibility," along with the Brady debt restructuring, anchored a classic "liberalize, privatize, and stabilize" package that sought to break this political and economic constellation. A currency board, at least in principle, required that all pesos be backed one to one by hard currency reserves and thus precluded central bank financing of the government—though, in practice, Argentina designed convertibility in a way that gave the government room to maneuver.[18]

Stabilization brought an economic boom. An expanding economy meant growing revenues; privatization added substantial onetime gains. The apparent success of the reform project and changes in global markets combined to open new sources of market financing to the government. These early gains allowed the government to reward supporters and to buy off opponents to its other promarket reforms—a general pattern that Dani Rodrik has emphasized.[19] But after the first gains from ending inflation had been spent, Argentina's government came to rely more and more on access to external capital markets to generate the resources to lubricate Argentina's political system.[20]

The institutional power of the economy ministry in particular hinged in no small part on its ability to deliver external financing. This meant a delicate balancing act: to tap the markets, the economy ministry needed to sell Argentina as a model of financial prudence, even though the financing obtained on the back of such promises was needed to pay for the spending ministries' priorities. External financing delivered yet another benefit: external inflows meant that the current account deficits associated with rapid growth never triggered the currency board's automatic adjustment mechanism.

At the end of the decade, de la Rúa may well have needed access to external financing even more than Menem. Commenting on the politics of the Menem era, the head of emerging markets research for JP Morgan observed:

> Menem's authority was very much influenced by his ability to provide goods in exchange for favours. Once privatisation proceeds were exhausted, the power of the executive branch was severely weakened. By

> the time De la Rúa took office, there was relatively little in the way of goods to distribute to political leaders. Menem was in the position to "give and splurge" while De la Rúa was left with the task of attempting to "take back and save."[21]

The ability "to provide goods in exchange for favours" became more important, not less, when different parties controlled different parts of the government. Market commentary at the time often criticized de la Rúa's political weakness, without observing that the structural basis of strong executive leadership disappeared along with access to external financing when the Peronists won control of the legislature and the provinces.

When IMF-endorsed policies no longer generated the market financing Argentina needed to avoid deflationary adjustment, it was eminently logical for Argentina to seek financing from the IMF itself. IMF financing specifically made fiscal easing a policy option for de la Rúa where it would not have been available otherwise.

Before turning to the IMF, de la Rúa had backed tax hikes to curb a deficit that was rising on the back of falling revenues and rising interest payments (see Table 3). The Peronists promptly blamed the hikes for Argentina's inability to grow.[22] The Peronist legislators had no desire to provide political cover for unpopular spending cuts, but imposing cuts by decree would have threatened de la Rúa's political position further: most constituencies, including the provincial governors, wanted protection from a deflating economy, not a program of shared sacrifice.[23] Since IMF financing allowed de la Rúa to make one last effort to "grow" out of the crisis, the political costs of asking the IMF to finance the status quo were smaller than the costs of the alternatives.

The IMF's willingness to finance a program that, at least initially, supported a slight short-term loosening of fiscal policy is more surprising than Argentina's desire for IMF support.[24] However, at the end of 2000, IMF staff and management—and for that matter the G7 and most market participants—were torn between two competing analyses of Argentina's troubles. Some believed the core problem was with Argentina's profligate public finances and dysfunctional relations between the provinces and the center. Others saw the problem as a temporary disruption in market access attributable to Russia's default and a self-fulfilling loss of confidence brought about by the economic slump that followed fiscal tightening.[25] The split within the IMF, Argentina's reputation as a bastion of IMF-backed market reforms, and widespread criticism of the IMF's tight fiscal conditionality during Asia's crisis certainly strengthened the hand of Argentina's negotiators.[26] The credibility of the Fund's traditional policy prescription—fiscal tightening—was nearly exhausted. The IMF was loath to be seen as the constant enemy of growth.

Table 3 Fiscal and Public Debt Indicators

	Interest Payments on Debt (% of GDP)	Implicit Interest Rate (% of GDP)	Primary Balance	Debt to GDP (%)	RER Adjusted Debt to GDP (%)
1991	2.8	8.6	–0.4	28	28
1992	1.6	6.2	1.4	24	24
1993	1.4	5.0	1.2	28	28
1994	1.6	5.1	–0.1	29	29
1995	1.9	5.4	–1.0	32	32
1996	2.1	5.6	–1.3	35	35
1997	2.3	6.1	0.2	38	39
1998	2.6	6.4	0.6	41	46
1999	3.4	7.1	–1.6	48	63
2000	4.1	8.0	0.3	51	71
2001	5.4	8.7	–1.4	62	95
2002	2.4		0.9	151	
2003	2.4		2.4	149	

Source: From G. Perry and L. Serven, *Argentina: What Went Wrong* (Washington, DC: World Bank, May 2003); International Monetary Fund, *Argentina: Request for a Standby Arrangement and Request for an Extension of Repurchase Expectations* (Washington, DC: IMF, September 2003).

Argentina's close relationship with the IMF, its reputation in the markets, and intellectual currents that favored "corner" exchange rate regimes after the collapse of various intermediate "pegs" in the late 1990s all weighed against another policy option: moving away from convertibility. Some prominent economists, notably Paul Krugman, argued that Argentina's real problem was that its exchange rate regime had, after the dollar's appreciation against the euro and the Brazilian real, become inconsistent with growth. Some US policymakers had sympathy for this view. However, President Clinton's last treasury secretary, Larry Summers, was a lame duck when Argentina's crisis broke. A truly bold course—like pushing Argentina off its chosen exchange rate regime or making debt restructuring a condition for IMF financing—would have reverberated throughout the region. Such policy (or, for that matter, giving Argentina a Mexico-style megabailout) would have required the sort of sustained US leadership that Summers could not put on the table. In many ways, the late-2000 program was a placeholder with relatively modest upfront financial commitments that deferred hard decisions. But even if Summers had had more political capital, Argentine policymakers likely would have refused to abandon convertibility before exhausting other options.

Turning to Cavallo and Yet More IMF Financing

The IMF's failure to lend Argentina yet more money in November 2001 to give convertibility yet another chance is not surprising. Michael Mussa and

Paul Blustein describe how staff and management scepticism of Argentina's policy mix deepened during the course of 2001.[27] The puzzle is why Argentina's authorities refused to discuss alternatives to convertibility and voluntary debt reschedulings as economic, financial, and social conditions progressively deteriorated. For all the attention to Cavallo's deviations from economic orthodoxy—introducing special import tariffs and a financial transactions tax, and talking abut pegging to both the euro and the dollar—he continued the core policies of his predecessors. Cavallo has suggested that Argentina should have moved off convertibility in the late 1990s, before it came under pressure.[28] But in office, he remained committed to it, refused to seek debt reduction, and eventually resorted to orthodox fiscal tightening.[29] Cavallo's core accomplishment was to draw on his considerable reputation to secure a series of additional injections of IMF liquidity to finance what turned out to be a classic gamble for resurrection.

Argentina's failure to meet the program's fiscal targets provided an obvious point for all parties to reassess their strategy, as did Argentina's request for yet more financing in the summer of 2001. But no one was willing to take the risk of changing course.

Even as popular support for sacrifice waned, no alternative to convertibility commanded widespread support. Some wanted to float, others wanted to dollarize, yet others wanted to devalue and dollarize. In the face of a deteriorating economy, the only consensus inside Argentina was to seek more IMF financing and to spend its remaining reserves to defend the status quo. Blustein reports that convertibility was the one subject Cavallo would not even discuss at a meeting with the IMF on 7 December 2001—when Argentina had no real option other than to exit.

This had a cost. N. Roubini and B. Setser have argued that the odds that Argentina could have abandoned its peg and restructured its external debts without freezing the banking system fell during the course of 2001. Early in 2001, Argentina still had substantial reserves and credit with the IMF to provide additional backing to the banking system.[30] Yet any major change of course—including a policy based on abandoning the peg and seeking a comprehensive debt restructuring (the "Uruguay option")—also risked bringing about the complete collapse of domestic confidence and extreme overshooting in the exchange rate. The case for preemptive action hinged on the argument that it was less risky than waiting—not that it guaranteed an easy path to recovery.

Continued support for the status quo reflected a key economic reality: all other policy options carried higher short-term costs than trying to muddle through. Seeking meaningful debt relief meant losing access to domestic and external credit and immediately moving into fiscal and external balance. About half of Argentina's $90 billion in bonds were held domestically; reducing the value of the government's debt would reduce the financial

wealth of those Argentines who had invested in the debt—banks and pension funds as well as wealthy Argentines with offshore accounts.[31] A deep restructuring was not an alterative to adjustment; rather, it traded more short-term pain for potential long-term gains.[32]

Abandoning convertibility and letting the peso float also held few short-term political rewards. A wide swath of the Argentine society, including the big winners from the 1990s reforms who dominated Argentine politics, had extensive dollar-denominated debts and thus a financial stake in dollar parity. This may explain why, in Argentina, the noisy opposition to fiscal consolidation was not matched by an open political debate about the costs of convertibility. Political analysts argue that support for currency stability traditionally comes with trade integration, as exporters and importers demand a stable—though not necessarily strong—currency to facilitate commerce.[33] But Argentina's overall trade was limited, and its trade with the dollar zone was particularly small. Demand for a stable exchange rate came from the nontradables sector, which, ironically, was heavily foreign owned. Firms and households in this sector had borrowed in dollars during the early convertibility boom and wanted a stable and strong peso to facilitate access to new dollar financing or to facilitate repayment of existing dollar debts.[34] Argentina's eventual solution to the domestic dollar debt dilemma—converting domestic loans into pesos, issuing compensation bonds to the banks, and servicing these new bonds ahead of defaulted external debt—was too radical for the government, or the IMF, to contemplate until the crisis really bit.

Why Did Argentina Get More Money in the Summer of 2001?

Many in the IMF and the G7 finance community had serious doubts about providing additional financing to Argentina in the summer of 2001. Blustein reports that at an internal staff discussion, the optimists in the IMF thought the augmentation had a less than 20 percent chance of succeeding. IMF management nonetheless supported Argentina's request.[35]

One explanation rests on the IMF's institutional aversion to forcing a change in its member's currency regime. The IMF likes to define its role as advising members on the policies needed to make their own choice of exchange rate regimes work. Telling a country that it had to let its currency fall and suffer the consequences of a disruptive default was more than the Fund could bear. But it was also willing to go the extra mile and provide Argentina with extra financing largely because it hoped that the money would help inoculate it from blame for Argentina's collapse. The IMF's leadership calculated that its reputation would suffer less if Argentina got one last chance and then failed to live up to a demanding adjustment program. When

Cavallo refused to discuss options for exiting from convertibility, the IMF did not press—in part because, as Blustein writes, "If IMF officials explicitly urged a devaluation, Cavallo could hold them accountable for the outcome."[36]

The IMF's major shareholders also bear responsibility for the decision to disburse. After blessing an unprecedented bailout for Turkey (a critical strategic ally in a critically important region) in the spring of 2001, the new Bush administration had a clear opportunity in Argentina to break from the "jumbo" packages of the Clinton era that many administration officials had criticized[37] and show that fear of contagion would not drive policy. The head of the National Economic Council, Lawrence Lindsey, and Treasury Secretary Paul O'Neill both had indicated that they opposed IMF bailouts that had little chance of working. However, the Bush administration was not monolithic. The foreign policy team did not want to create the impression that the administration was turning its back on Latin America. Eric Helleiner suggests that, among other things, the White House saw Argentina as central to its efforts to create a hemisphere-wide free trade zone.[38] And it is plausible that the president himself did not share his economic team's aversion to bailouts: as governor of Texas, George W. Bush had backed the Clinton administration's bailout of Mexico.

However, chances were slim for a Mexico-style success. Argentina's government debt to GDP ratio, its external debt to GDP ratio, its external debt to export ratio, and its level of "liability dollarization" were all far higher than in Mexico.[39] No one in the new administration stepped up with a comprehensive, workable plan and insisted that the international community and the crisis country coalesce around this plan, as Rubin and Summers had done in Mexico. Rather, US policy coalesced around a fleeting compromise among different parts of the administration: Argentina got a $5 billion augmentation along with the scheduled $1 billion under the original program to stem the bank run but, at O'Neill's insistence, also received $3 billion to back a market operation to improve debt sustainability. O'Neill's own staff, the IMF, the US Council of Economic Advisers, and market participants involved in the short-lived discussions of the operation all came away convinced that $3 billion was patently insufficient to catalyze a $100 billion restructuring.[40] Argentina never put forward its own proposal.[41] Bush treasury officials never pressed the Fund to push Argentina to consider alternatives to convertibility, perhaps because key officials did not agree among themselves on an alternative. Treasury Secretary O'Neill publicly suggested that Argentina needed to let its exchange rate float. Yet, after Argentina floated, O'Neill's chief deputy for international affairs, John Taylor, testified in Congress that he believed that Argentina should have dollarized—but that it was not his place to tell this to the Argentines.[42]

Neither did the rest of the G7 press. Many economic and financial policymakers, led by the Bank of England, believed that Argentina could not

be saved; however, European political leaders were reluctant to block a multilateral support package that had US backing.

Key Decisions in 2002: Pesification

By the end of 2001, Argentina could not avoid devaluing the peso and defaulting on its external debt. A bank holiday was no longer avoidable: the banking system lacked dollars, and the government did not have nearly enough dollar reserves—even after breaking convertibility—to back all dollar deposits.[43] But Argentina did not have to pesify, or to convert deposits and loans into pesos at different rates (asymmetrically), or to index interest payments on loans to increases in peso wages, and the consumer price index and interest payments on deposits to increases in the consumer price index. After considerable pressure and litigation, the government eventually issued new low-coupon bonds to compensate banks for the 40 percent difference in conversion rates.

The final outcome reflected political limits on the scale of losses that a democratic government could impose on depositors; it also reflected economic constraints on the scale of the losses the government could impose on banks. The political imperative to help depositors regain access to their frozen deposits is not hard to understand. Citizens wanted their money back. The economic constraints are harder to grasp. The populist policy of asymmetric pesification initially pushed enormous paper losses onto the banks' owners. But there is no way to force a bank's owners to lose more money than they had put up in capital. It soon became clear that the government would either have to pick up some of the tab, or, in the words of one policymaker, take the keys to every bank in Argentina—a politically untenable outcome.

Despite its myriad of detractors, pesification has proved to be a qualified success: it instantly restructured domestic contacts and restored payment flows; it made it possible to unfreeze deposits relatively rapidly; and, by resolving the internal payments crisis, it helped lay the basis for Argentina's current recovery.

No bankruptcy regime is designed to function effectively when insolvency is the norm rather than the exception. After the devaluation, almost all firms, households, and individuals with dollar debts were effectively bankrupt.[44] Some form of across-the-board solution was needed: the banks neither had the capacity to assume control over all technically insolvent firms nor the ability to monitor the behavior of this many debtors.[45] Keeping deposits frozen while restructuring banks on a case-by-case basis was neither politically nor economically viable. Across-the-board reduction in the debts of small firms and households had another virtue: it allowed scarce workout resources to be devoted to the biggest and most important cases.

Nonetheless, pesification has many flaws. The government lacked the capacity to convince firms, banks, and markets that the measure was a legitimate response to the unprecedented difficulties from ending convertibility rather than a populist attack on the banking sector.[46] Initial decisions on conversion rates and indexation were arbitrary. Those who benefited most from the initial pesification decision paid down their pesified debts quickly; those who lost sought and often obtained compensation.

It is reasonable to ask if domestic debtors should have picked up more of the cost of the crisis, leaving less to be borne by other stakeholders. One-to-one pesification and indexation effectively kept the real debt burden constant for domestic firms without export revenues. That was broadly right. On the one hand, given the scale of economic contraction, any solution that was substantially less favorable to debtors without export revenues risked leading to more nonperforming loans—and the deadweight losses associated with more widespread bankruptcy.[47] On the other hand, influential dollar debtors lobbied hard to extend a solution initially meant to cover only mortgages and other small loans to cover Argentina's biggest firms.[48] It might have been possible to do something that offered less relief to the firms with more capacity to weather the crisis.[49]

The Consequences of the Crisis

In 2001, Argentina used its substantial reserves and IMF funds to buy time in the hope that its troubles would pass. In the process, it dug itself into a deeper hole and, in our view, increased the scale of the resulting crisis.[50] Clearly, no strategy would have avoided large losses. Correcting the real overvaluation of the peso required a fall in the real income of most Argentines. Most domestic financial assets were dollar-denominated claims on borrowers who had no way of earning enough dollars to pay their debts in full. The resulting restructuring had to reduce the real value of many domestic financial assets.

But even if delay increased losses overall, some benefited from it. The domestic depositors who moved their funds ($16 billion) abroad in 2001 were the biggest beneficiaries of delay. The real domestic value of assets moved offshore increased substantially after the devaluation. The banks' short-term external creditors who cut their exposure by $8 billion also benefited, as did those holding the $6.5 billion in bonds that came due in 2001. Investment bankers earned large fees on Argentina's megaswap.

Big losers include all private creditors who provided additional financing to Argentina in 2001. Argentines with accounts in Argentine pension funds and Argentines who kept money in the banking system bore the bulk of domestic losses—though the restructuring ultimately protected the real

domestic value of their investments, limiting the domestic political fallout. The IMF, which provided roughly $10 billion in net new financing in 2001, recently got repaid in full ahead of schedule: lending to Argentina damaged the IMF's reputation, but not its financial health.

Clear winners from Argentina's decisions to abandon convertibility, to default, and to pesify include Argentina's exporters and import-competing industries, which gained both from the devaluation and from pesification if they had borrowed locally in dollars. Farmers did particularly well: their dollar debts were pesified just before the harvest brought in an influx of dollar revenue. Indeed, relative to most alternative scenarios, those who borrowed dollars under Argentine law won: the compensation bonds issued to cover the costs of asymmetric pesification were a subsidy that Argentine taxpayers granted to bank borrowers as well as to bank depositors.

The clear losers are Argentina's external bondholders. They had to wait over three years for a restructuring offer, and the terms of the final restructuring were far less generous than in other sovereign restructurings. Those who accepted reduced the face value of their claims by about 50 percent in the aggregate and had to accept relatively low coupon payments for a long time. Using market discount rates, the new bonds issued in the exchange were worth about 32 cents on the original dollar.[51] External creditors ended up subsidizing Argentina's domestic bank compensation scheme. Argentine taxpayers are another likely loser—they will be paying off the domestic debts from the crisis for a long time.[52]

One of the more salient factors of the postrestructuring period is that many of the groups that benefited the most from convertibility—external bondholders, private banks, the owners of privatized utilities—have been among the biggest losers, while some groups who lost out before the crisis have emerged as the biggest beneficiaries of the new policy regime.

However, the impact of many decisions remains ambiguous five years after the default. Although domestic bank depositors believe they are among the losers, since they did not get paid in full, they in fact did better in the restructuring than Argentina's other creditors.[53] Domestic bank owners decry asymmetric pesification and court injunctions (*amparos*). But compensation bonds and, for local banks, the regulatory leeway to value compensation bonds at par helped. Foreign banks may have benefited from pesification (particularly after compensation) as compared to the alternative of foreclosure on scores of dollar-denominated mortgages after the devaluation. Regulated utilities gained from the pesification of their domestic debts even as they were hurt by Argentina's price freeze. Spanish-owned Telefónica did not come out badly: most of its debts were pesified, and its declining costs reduced the impact of the price freeze. French-owned Télécom did worse, because more of its debt was foreign law (and thus not pesified). Domestic energy firms were hit especially hard, because their prices remained frozen

while world energy prices rose. The large number of ongoing challenges to the emergency measures from foreign-owned utilities makes any final assessment of their losses premature.

Argentina's urban poverty rose steadily during the recession, reaching 38 percent just before the devaluation. It peaked at 58 percent in October 2002 and fell back to just under 34 percent in the second half of 2005.[54] Devaluation likely brought forward the increase in poverty that was bound to accompany Argentina's external adjustment, which required a fall in Argentina's real income. The poor also suffered from rising unemployment and the increase in the price of basic necessities. The peso price of food—a tradable good priced in dollars—soared after the devaluation. In this context, using the proceeds from the export tax to pay a subsidy to the poor (the "heads of household" program) can be viewed as a way of redistributing gains from the devaluation to help those hurt the most.

Default affected the poor indirectly. Those who were poor before 2001 generally did not own government bonds and had little savings in the banking system. However, both before and after default, the government's perilous finances constrained its ability to ease the suffering of Argentina's vulnerable population with large transfer payments. In 2001, Argentina's ability to help the poor was constrained by its large and growing interest bill. After 2001, the government initially lacked access to credit and had to finance all spending out of tax revenues. Printing money would have led to inflation, which disproportionately hurts the poor. Government spending on the poor increased after default and devaluation, but the rise did not keep pace with growing poverty, so spending per poor person fell.

Conclusion

No easy path was open to Argentina in 2001. Nonetheless, the IMF got both the economics and politics wrong by continuing to support Argentina's attempts to cling to its peg and avoid a restructuring through 2001. In 2001, the IMF bet that continued support for convertibility would be less risky politically, even if the economics did not work. However, the IMF underestimated the extent to which it would be blamed for backing a failed system. Conversely, in early 2002, the IMF refused to lend to Argentina and effectively bet that Argentina's attempt to stabilize the peso, the domestic banking system, and the government's finances would fail. It did not. By the summer of 2002, the relationship between the IMF and Argentina had changed for good: Argentina's policymakers now looked at the IMF as just another creditor to be satisfied at the lowest possible cost.

Yet Argentina's leaders would be hard pressed to attribute the policy mistakes of 2001 to pressure from the IMF or its shareholders. Argentina opted

to use all its potential sources of flexibility going into 2001—the banking system's liquid reserves, the pension system's free cash flow, Argentina's capacity to borrow from the IMF, Argentina's relationship with the US government—not to develop a way out of its economic and political trap, but rather to mount an extended, painful, and ultimately futile defense of convertibility.

Argentina's political establishment, not the IMF, set Argentina's 2001 policy course. However, access to IMF financing opened up policy options that otherwise would have been unavailable to Argentina's establishment. De la Rúa got the financing to defer fiscal tightening in the face of a recession in late 2000. Cavallo got the financing to try to loosen the constraints of covertibility without abandoning it—and yet more financing to avoid shutting down the banking system. But IMF financing also allowed successive Argentine governments to avoid the really hard choices needed to put Argentina on a clear pathway out of its crisis. Argentina did not seek debt reduction until after it lost access to IMF funding. From that point on, Argentina's government charted its own course, going so far as to walk away from a Fund review in 2004 with great fanfare in the name of preserving its negotiating independence.

In 2001, though, no one in Argentina wanted to "own" the painful steps it had to take to escape from the trap created by extensive dollar debts and an overvalued exchange rate. The IMF, the United States, and the other G7 countries were equally reluctant to push Argentina toward developing a workable exit plan. The US administration neither wanted to be perceived as turning away from Argentina, a promarket Latin friend in need, nor wanted the responsibility for foisting a potentially costly solution on reluctant Argentines. And the IMF seemed more eager to avoid responsibility for the messy decisions Argentina would have to take than to help Argentina develop a workable Plan B. 🌐

Notes

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1. Convertability generally refers to the ability to convert the national currency into foreign currency without restriction. In the Argentine context, "convertability" became short-hand for Argentina's currency broad arrangement—a policy that pegged the peso to the dollar at a 1:1 rate and required Argentina's central bank to back pesos in circulation with hard currency reserves as well as guaranteeing the free convertability of the national currency.

2. G. Perry and L. Serven, *Argentina: What Went Wrong* (Washington, DC: World Bank, May 2003). The World Bank estimates that the peso was overvalued by roughly 40 percent, with about half the overvaluation explained by the dollar's appreciation. See also Independent Evaluation Office, "The IMF and Argentina, 1991–2001" (Washington, DC: International Monetary Fund, 30 September 2004); and Mario Blejer, "Managing the Financial Crisis in Argentina," powerpoint presentation at the World Bank's "Practitioners of Development" seminar series, Washington, DC, 22 October 2003.

3. N. Roubini, "Should Argentina Dollarize or Float? The Pros and Cons of Alternative Exchange Rate Regimes and Their Implications for Domestic and Foreign Debt Restructuring/Reduction," New York University (manuscript, 2 December 2001), available at www.stern.nyu.edu/~nroubini/asia/argentinadollarization.doc. Roubini emphasizes that the real exchange rate adjustment brought about by deflation increases the real burden of foreign currency–denominated debts in the same way as a nominal depreciation.

4. Javier Fronti, Marcus Miller, and Lei Zhang, "Sovereign Default by Argentina: 'Slow-Motion Train Crash' or Self-Fulfilling Crisis?" CEPR Discussion Paper No. 3399 (London: Centre for Economic Policy Research, May 2002), available at www.cepr.org.

5. The year 1999 was the only year nominal noninterest spending sharply increased.

6. *Wall Street Journal,* 13 January 2004.

7. See, among others, A. Ades, *Emerging Market FX and Bond Views,* Goldman Sachs, 30 October 2003.

8. Cavallo reduced mandatory reserve requirements to free up bank credit, allowed the banks to reduce the quality of their remaining reserves by encouraging the banks to sell US treasuries to buy a new government bond (generating a capital inflow of $2 billion), introduced a set of tax subsidies to help firms facing competition from Brazil, and signaled his intent to change the currency board from a pure dollar peg to a dollar-euro peg.

9. Republic of Argentina, prospectus supplement dated 10 January 2005, and prospectus dated 27 December 2004, filed pursuant to Rule 424(b)(5) under the US Securities Act of 1933, Registration No. 333-117111 (Washington, DC: United States Securities and Exchange Commission), p. 165, available at www.sec.gov (accessed 12 June 2006).

10. The swap did not cover euro-denominated bonds, yet these bonds accounted for a large share of Argentina's near-term external debt payments. For more, see N. Roubini and B. Setser, *Bailouts or Bail-Ins* (Washington, DC: Institute for International Economics, 2004); and M. Mussa, *Argentina and the Fund: From Triumph to Tragedy,* Policy Analyses in International Economics No. 67 (Washington, DC: Institute for International Economics, March 2002).

11. V. Miles, "Argentine Banks. Why Deposits Hold the Key," JP Morgan, 23 July 2001.

12. See Mussa, *Argentina and the Fund,* pp. 40–46.

13. Short-term lines fell from $28 billion to $20 billion during the course of 2001. See World Bank, *Global Development Finance* (Washington, DC: World Bank, 2003).

14. The government continued to tap local banks for financing, particularly those local banks that depended on support from the central bank.

15. Primary expenditures fell from 18.6 percent to 17.2 percent of GDP. Argentina's fiscal stabilization did not come just from ending interest payments.

16. The provinces' enduring independence is in stark contrast to the power of the Argentine presidency over the legislature and even the judiciary. Most presidents have had a working majority in the legislature as well as the ability to use decree power to shift the power balance between the executive and the legislature. See L. A. Romero, *A History of Argentina in the Twentieth Century,* trans. J. P. Brennan (University Park: Pennsylvania State University Press, 2002).

17. Mussa, *Argentina and the Fund.*

18. Argentina allowed some of the monetary base to be backed by the government's own dollar-denominated bonds rather than true reserve assets. It also kept more reserves on hand than required just to back the pesos in circulation. See Kurt Schuler, "Ignorance and Influence: U.S. Economists on Argentina's Depression of 1998–2002," *Econ Journal Watch* 2, no. 2 (August 2005).

19. D. Rodrik, "Understanding Economic Policy Reform," *Journal of Economic Literature* 34, no. 1 (1996), argues that the "liberalize, stabilize, privatize" policy package typical of many "reform" programs of the early 1990s used the large, broad-based gains from ending hyperinflation to help compensate the losers from other reforms, which often had ambiguous or negative distributional effects.

20. Pamela K. Starr, "Government Coalitions and the Viability of Currency Boards: Argentina Under the Cavallo Plan," *Journal of InterAmerican Studies and World Affairs* 39, no. 2 (Summer 1997).

21. Joyce Chang, "Comments and Discussion on the Argentine Papers," *Brookings Trade Forum 2002* (Washington, DC: Brookings Institution Press, 2002).

22. The 2001 IMF program assumed that Argentina would retain access to captive domestic sources.

23. The point can be extended even further. Many of Argentina's privatized utilities had the right to index their prices to the US dollar and to increase their prices in line with US inflation even as other prices in Argentina were falling. Neither the utilities nor Argentina's labor unions were volunteering to give up their hard-fought privileges.

24. International Monetary Fund, *Argentina: Second Review Under the Stand-by Arrangement and Request for Augmentation—Staff Report,* IMF Country Report 01/26 (Washington, DC: IMF, 2001). See also International Monetary Fund, "Lessons from the Crisis in Latin America" (Washington, DC: IMF, 9 October 2003).

25. M. Gavin, "Argentina Update: Drowning in a Cup of Water," UBS Warburg, 29 October 2000.

26. The Argentine and Asian crises, however, were not analogous. Several Asian governments had little government debt going into their crisis, though they had large contingent liabilities as a result of weak banking systems.

27. Mussa, *Argentina and the Fund;* Paul Blustein, *And the Money Kept Rolling In (and Out): Wall Street, the IMF and the Bankrupting of Argentina* (New York: Public Affairs, 2005).

28. Domingo Cavallo, "Argentina and the IMF During the Two Bush Administrations," *International Finance* 7, no. 1 (2004). Cavallo wanted Argentina to peg to a currency basket that more closely reflected Argentina's trade mix.

29. Cavallo's own statement in 2004 that a currency basket should have replaced the dollar peg is consistent with his efforts to modify "convertibility" in ways that made it less restrictive in the first part of 2001. Cavallo may have hoped to use the credibility he gained as the father of convertibility to change it in ways others could not, without being accused of abandoning the arrangement. He was, however, unwilling to go further. See Cavallo, "Argentina and the IMF," and Fronti, Miller, and Zhang, "Sovereign Default by Argentina."

30. At the end of 2000, Argentina had $27 billion in reserves, and the banking system held an additional $7 billion in cash and mandatory liquidity reserves in an offshore account. Argentina might have supplemented this $34 billion pool of reserves with a $15 billion loan from the IMF. The parent firms of foreign-owned banks might have been willing to contribute to help back their local operations. Argentine banks had only $49 billion in dollar deposits at the time, along with $18 billion in short-term external liabilities and around 35 billion in peso-denominated deposits. See International Monetary Fund, "Debt-Related Vulnerabilities and Financial Crises: An Application of the Balance Sheet Approach to Emerging Market Countries" (Washington, DC: IMF, 1 July 2004); Roubini and Setser, *Bailouts or Bail-Ins;* and Blustein, *And the Money Kept Rolling In (and Out).*

31. Giselle Datz, "Pension Privatization and the Politics of Sovereign Default," Rutgers University (manuscript, 2006).

32. The political difficulty of selling a restructuring was compounded by the technical challenges to a preemptive restructuring created by the size and complexity of Argentina's external debt. Uruguay's bonded debt was roughly one-twentieth the size of Argentina's, with a considerably less diverse range of holders and instruments.

33. Argentina's currency board never fit entirely comfortably with either economic or political models that seek to explain exchange rate preferences. Economically, it was clearly not an optimal currency area with the United States. Nor was it the small open economy that political theorists suggest favor a fixed currency to meet the demands of commercial interests. See Jeffrey Frieden, "The Political Economy of Dollarization: Domestic and International Factors," in *Dollarization: Debates and Policy Alternatives,* Eduardo Levy-Yeyati and Federico Sturnzenegger (eds.) (Cambridge, MA: MIT Press, 2001); and Jeffrey Frieden and Ernesto Stein, "The Political Economy of Exchange Rate Policy in Latin America: An Analytical Overview," in *The Currency Game: Exchange Rate Politics in Latin America,* Jeffrey Frieden and Ernesto Stein, eds. (Baltimore: John Hopkins University Press, 2002).

34. Liliana Rojas-Suárez has noted that Argentina's banking system was in far worse health than most believed because of its extensive dollar lending to firms that lacked export revenues. See Liliana Rojas-Suárez, "Comments and Discussion on the Argentine Papers," *Brookings Trade Forum 2002* (Washington, DC: Brookings Institution Press, 2003).

35. Blustein, *And the Money Kept Rolling In (and Out),* pp. 155–156, 183–184.

36. Ibid., p. 184. Blustein writes: "As an institution, the IMF would not muster sufficient gumption to proactively impel the Argentines to change course in a fundamental way before disaster struck. Nor would the U.S. Treasury, which could have intervened directly (as the Clintonites had in previous crises) but would instead defer to the Fund."

37. Ron Suskind, *The Price of Loyalty: George W. Bush, the White House, and the Education of Paul O'Neill* (New York: Simon & Schuster, 2004).

38. Eric Helleiner, "The Strange Story of Bush and the Argentine Debt Crisis," *Third World Quarterly* 26, no. 6 (2005).

39. Both Robert Rubin and Larry Summers believed Mexico's exit from its peg was central to the success of the rescue package. See Robert E. Rubin and Jacob Weisberg, *In an Uncertain World: Tough Choices from Wall Street to Washington* (New York: Random House, 2003).

40. For more, see Blustein, *And the Money Kept Rolling In (and Out).*

41. At the discount rates Argentine debt traded at in the fall of 2001, any market-based exchange would have been prohibitively expensive. Three billion dollars allowed Argentina to buy back $4 billion in short-term debt or $6 billion in longer-term debt—a drop in the bucket for a country with $90 billion in debt. To get around this proposal, most investment bank proposals made at the time assumed a far larger commitment of official funds—say $20 billion—to back an exchange.

42. John Taylor, Senate testimony, 2002.

43. In August, it might have been economically possible to have closed down some locally owned banks without triggering a run on foreign-owned banks, so long as it was clear the foreign owners of foreign-owned local banks were willing to back their local operations. By December, this option was clearly no longer economically viable. It was never politically viable. Closing Galicia—the largest Argentine-owned private bank—without closing Nación or Provincia—the large publicly owned banks—would have been hard to justify financially, yet closing Nación and Provincia was politically impossible. Nación was the only bank in many smaller communities; Provincia was tightly linked with the governor of the province of Buenos Aires. Moreover, at the time, Argentina relied heavily on these banks for emergency financing, sometimes involving rather questionable transactions.

44. The prospect that a firm's equity investors would lose control of the firm in the bankruptcy process is the key incentive for payment.

45. Anna Gelpern, "Systemic Bank and Corporate Distress from Asia to Argentina: What Have We Learned?" *International Finance* 7, no. 1 (2004): 151–168.

46. Randall S. Kroszner, "Is It Better to Forgive Than to Receive? An Empirical Analysis of the Impact of Debt Repudiation," Graduate School of Business, University of Chicago, 2003; Randall S. Kroszner, "Is It Better to Forgive Than to Receive? History Lessons Guide Policy Choices," Capital Ideas: Selected Papers from the Stigler Center for the Study of the Economy and the State, University of Chicago Graduate School of Business, February 2006, available at www.chicagogsb.edu/capideas/feb06/4.aspx; Marcus Miller, Javier García-Fronti, and Lei Zhang, "Contractionary Devaluation and Credit Crunch: Analysing Argentina," 2005, unpublished manuscript, available at www.bde.es/doctrab/seminar/sie0519.pdf ; and Gelpern, "Systemic Bank and Corporate Distress."

47. Kroszner, "Debt Repudiation."

48. See Mario Blejer, "An interview with Mario Blejer," *Central Banking* 13, no. 1 (August 2002).

49. Most large firms had external as well as domestic debts and were not able to avoid bankruptcy in any case.

50. For a similar view, see Ricardo Hausmann and Andres Velasco, "Hard Money's Soft Underbelly: Understanding the Argentine Crisis," *Brookings Trade Forum 2002* (Washington, DC: Brookings Institution Press, 2003).

51. Government of Argentina, "Argentina Announces Results of Successful Exchange Offer," Secretariat of Finance, Ministry of Economy and Production, Buenos Aires, 18 March 2005, www.mecon.ar; Republic of Argentina, "Recent Restructuring Developments," SEC form 18-K/A, Secretariat of Finance, Ministry of Economy and Production, Buenos Aires, September 2004, www.mecon.ar; Mario Damill, Roberto

Frenkel, and Martin Rapetti, "The Argentine Debt: History, Default and Restructuring," CEDES, Buenos Aires, August 2005 revision.

52. Cooper and Bessma and Miller and Fronti describe Argentina's successful efforts to play creditor constituencies against one another. See Andrew F. Cooper and Momani Bessma, "Negotiating Out of Argentina's Financial Crisis: Segmenting the International Creditors," *New Political Economy* 10, no. 3 (September 2005); and Marcus Miller and Javier García Fronti, "Case Study: Restructuring Argentine Debt: A Renegotiation Game?" University of Warwick and CEPR, September 2005, available at www2.warwick.ac.uk/fac/soc/csgr/research/keytopic/global/csgr28febversion.pdf.

53. Anna Gelpern and Brad Setser, "Domestic and External Debt: The Doomed Quest for Equal Treatment," *Georgetown Journal of International Law* 795 (Summer 2004): 35.

54. World Bank, "Country Assistance Strategy for the Argentine Republic 2006–2008," annex F: Poverty and Social Development (Washington, DC: World Bank, 6 June 2006).

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