WHICH FACTORS WERE THE MOST IMPORTANT IN CAUSING ARGENTINA’S 2001 SOVEREIGN DEBT CRISIS?

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Introduction

Sovereign debt crises in developing countries have become increasingly frequent in the past 30 years and tend to affect certain countries, especially within Latin America (Catão and Sutton, 2002). Argentina has repeatedly required international assistance, however, due to a lack of consensus in this area, the suggested reforms have not prevented debt crises. This paper explores the causes of Argentina’s 2001 default, and finds short-term borrowing in foreign currency, and a fixed exchange rate regime as two significant economic factors. However, this paper concludes that the single most important cause was Argentina’s constitutional and electoral system. This devolved power to provincial governors, gave pressure groups undue influence and facilitated short-term policies such as those two.

In the wider context, this chain of events gives an insight into why policies to reform defaulting countries tend to fail. This research paper also gives context to the effectiveness of policies that could be applied today as Argentina’s crises continue.

This paper is organised as follows: section 2 describes the methodology; section 3 evaluates the composition of Argentina’s debt, its fixed exchange rate and the political institutions in causing the default; section 4 concludes that weak institutions was the most important as it led to the ineffective policies of short-term external debt and a fixed exchange rate.
Methodology

Argentina was more severely affected following the 1997 East Asian Crisis compared to the other Latin American countries, and this paper aims to highlight factors that were specific and unique to Argentina as opposed to factors common across the continent. Therefore, data from three of the largest Latin American economies is used as a comparison: Brazil, Mexico and Colombia.

Established papers focus mostly on the economic fundamentals, but this paper will amalgamate both economic and political economy papers to establish a chain of events leading to Argentina’s default. The majority of the cited literature in this paper are empirical in order to understand whether the causal relationship between the factor being analysed significantly increased the probability of a debt crisis, and attempts to use papers which have included Argentina and other Latin American countries in their dataset. This has been complemented with papers from the political economy field which offers a more descriptive analysis of Argentina’s institutional structure. There is also a lack of literature in explaining sovereign debt crises compared to currency and banking crises, which has led to the use of older literature.
Results

1) The Composition of Argentina’s Public Debt

This paper argues that the composition of debt is far more important to analyse than the total amount of debt. This explains why developed countries such as the USA have a sustainable government debt of 106% of GDP, and at the extreme Japan at 238% (IMF, 2018). Figure 1 shows how much more Argentina was affected following the East Asian and Russian crises, as compared to the other major Latin American economies using GDP growth as a measurement, and this can be partially explained by external debt.

![GDP Annual Growth Rate](image)

Figure 1: GDP annual growth rate of selected countries (World Bank, 2018)

The theory behind a high level of public debt causing a default is highly flawed. The argument stands that higher interest payments leads to a vicious cycle of higher payments and higher interest rates, as evidenced by Paesani et al (2006).

Although Paesani et al (2006) reaches a plausible conclusion that more debt leads to temporarily higher long-term rates when applied to the datasets of the USA, Germany and Italy, the argument is less applicable to Argentina. Argentina’s economy is small and the domestic interest rate is more affected by the world interest rate. This is important as the effect of Argentina’s debt on long-term rates may be less substantive than the changes in the world
interest rate. The issue of endogeneity also makes it difficult to isolate fiscal policies from other factors affecting interest rates, and different econometric models counter the claim by Paesani et al (2006).

A stronger argument states that there is no boundary at which point economic growth simply falls, and that reverse causation is likely when regressing high public debt levels with GDP growth (Herndon et al, 2014). Moreover, figure 2 below shows that prior to the 2001 crisis, Argentina’s public debt remained broadly in line with Colombia and Mexico, and well below the level of Brazil. The initial argument of high public debt is therefore weak both empirically and also in the wider Latin American context.

![Debt as % of GDP](image)

**Figure 2: Debt as a % of GDP (IMF, Fiscal Affairs Departmental Data, 2018)**

In terms of composition, Argentina’s public debt comprised mostly of foreign debt as compared to the other Latin American economies, as evident in figure 3. Secondly, the debt was issued with short maturities.
Prior to the default, Argentina’s economy had grown into a much more dollarised economy. The banking system had built up a large amount of short-term liabilities in dollars (Kiguel, 2011).

Empirical research into the causality of foreign debt increasing the probability of a debt crisis further strengthens this theory. Different papers establish different thresholds, but hold the same prevailing view. One paper suggests countries with an external debt that is higher than 50% of GDP have a significantly higher probability of default (Manasse et al, 2003). The paper reaches this conclusion by logit and binary recursive tree analysis to find the most important macroeconomic variables that can predict debt crises, using panel data of 47 developing countries. Argentina’s external debt stood at 59% prior to the crisis. Mallucci (2015) provides a more useful insight as he calibrated his model to Argentina from 1980 – 2001.

The second aspect of Argentina’s debt composition was its short-term maturities but, whilst important, this was not a factor unique to Argentina. There is a consensus across empirical research that short-term debt is a significant cause of debt crises. Rodrik and Velasco (1999) used evidence from a much larger sample of 32 emerging countries and across a longer period between 1988 – 1998, found the same conclusion. It used a short-term debt to reserves ratio and found it to be a robust predictor of crises.
However, multiple countries held a majority of debt in foreign currency, but did not face a default (Gopinath, 2005). The composition argument must therefore be taken together with the fixed exchange rate to explain the default.

2) Argentina’s Fixed Exchange Rate

This paper argues that the fixed exchange rate first led to a currency and liquidity crisis, and in turn led to a sovereign debt crisis.

This series of events in Argentina’s case is explained best by Dreher et al (2006): a negative aggregate demand shock (caused by the East Asian Crisis) placed market pressure for the currency to devalue. Due to the fixed exchange rate, the central bank was forced to sell international reserves. Speculators realised the incentives for the government to devalue and in anticipation of this, continued to withdraw capital and apply devaluation pressures. Argentina continued to borrow to counter the devaluation pressure, despite a strengthening dollar.

Research has shown the causal relation between a fixed exchange rate and a currency crisis. The size of global capital markets today, using hedge funds as a proxy, has meant that the successful maintenance of a fixed exchange rate without capital-market restrictions is extremely rare (Obstfeld and Rogoff, 1995). Competing government objectives place a limit on how much central banks are willing to spend on maintaining the fixed rate, and further lowers the credibility of the peg.

Secondly, the relationship of a currency crisis as the cause of a debt crisis is explored by Dreher et al (2006) which concludes an ‘internal contagion’ hypothesis where a currency crisis significantly increases the risk of a contemporaneous debt crisis, using panel data from 80 non-industrialized countries from 1975-2000. In the case of Argentina, this argument is strengthened by the high level of borrowing to maintain the peg (Perry and Servén, 2003).

However, to understand why Argentina could not give credibility to a fixed exchange rate, and why it pursued sub-optimal policy choices to accumulate short-term external debt, Argentina’s institutions must be discussed.
3) Argentina’s Political Institutions

This paper will argue that political factors were the most important as it led to sub-optimal economic policies, and identifies Argentina’s constitutional and electoral system in causing the weak institutions.

The theory stands that an effective political institution is one that is capable, accountable and transparent. In the case of a democratic state model as Argentina, the emphasis is on accountability and transparency to effectively provide public goods, economic institutions and economic policy. Demands from society act as checks and balances to the government, and meritocratic public bureaucracies form.

However, these features tend not to resonate across emerging markets where their fiscal, financial and monetary institutions are described as “weak” (Calvo and Mishkin, 2003). Calvo and Mishkin (2003) further argue that when looking at successful emerging economies, the exact exchange rate regime is unimportant compared to strong political institutions. For an unaccountable government, the fixed exchange rate made borrowing foreign funds easier, which led to excessive borrowing and created structural weaknesses as a result. These arguments highlight how Argentina’s institutions led to the sup-optimal economic policies of foreign debt.

Argentina’s constitution consisted of a Presidential, Bicameral and Federal structure, and combined with the electoral system led to provincial governors holding significant power in policymaking (Spiller and Tommasi, 2003). The involvement of many institutional actors, lack of judicial constraints and highly decentralised bureaucracies led to Argentina’s policies being myopic and more likely to be reversed after an election. This led to Argentina’s institutions having the issue of being too volatile over some policies and too rigid over others (Spiller and Tommasi, 2003). One reason for this could be due to powerful groups influencing central government policies (Qian, 2012). These groups act in self-interest and polarise government policy which leads to an inefficient equilibrium where the demands from society do not act as checks and balance.

The electoral system gave significant strength to voters in shaping policy decisions. Under certain conditions, democracies can be more likely to default as non-compliance can increase private welfare (Tomz, 2002). His paper analyses election poll results, newspaper headlines and Gallup surveys in Argentina between 1999 and 2002 to conclude that the default was
agreed due to a change in voter preferences. This led to a new president who immediately suspended debt payments.

The institutional weakness of Argentina in the global world, appears to be the most important factor in causing the default. It meant Argentina could not credibly borrow in its own currency or at a longer maturity, and did not give the belief to speculators in its fixed exchange rate policy. The combination of which led to the default.
Conclusion

This paper concludes that the combination of a high external debt and a fixed exchange rate that was not credible was sufficient to cause Argentina’s 2001 default. Short-term debt was less important as it was common across the continent. The key insight being that path dependency created a highly decentralised constitutional structure that led to these economic policies.

Understanding these issues gives a historical perspective into the recent crisis Argentina has been facing since August 2018, and why certain reforms such as budget constraints and loans prescribed by the IMF may not work as they only further increase Argentina’s external debt. This paper is limited as sovereign debt crises, compared to other crises, are less researched and there is scope for further analysis in this field, such as the link between currency and debt crises. Whilst Argentina’s institutional problems stem from path dependency, further research into the political reforms to escape serial crises would also be insightful, but unlikely to be practical to implement. One country in Latin America, Chile, has escaped from serial crises and a comparative analysis could highlight more practical economic reforms.
References


