Round Up the Usual Suspects: The Latest Latin American Debt Crisis

by Stephen A. Schuker

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The Mexican peso crisis of December 1994 seemed to mark a turning point in the Latin America's fortunes. Perhaps the long and sorry tale of improvident borrowing, squandered opportunities, hyperinflation, and debt default would end happily at last. The U.S. Treasury provided massive financing to stop a financial meltdown south of the border. Lo and behold, Mexico restored financial equilibrium, paid back its debts, and—against the weight of history—initiated a virtuous circle of transformation and modernization that continues to this day.

The financial community rejoiced. Sebastian Edwards, chief Latin American economist for the World Bank, discerned a continent moving from despair to optimism:

> The economic history of Latin America has been compared to Gabriel García Márquez's classic novel, *One Hundred Years of Solitude*. Events seem to repeat themselves endlessly, following irregular and magical cycles of sorrow and frustration. The recent reforms that engulfed the region are beginning to break this melancholic circularity. After decades of timid performance and spiraling inequalities, and in spite of the Mexican crisis, there are rays of hope.[1]

In summer 2003, storm clouds lower once more over those sunlit uplands, most acutely in the Southern Cone. Argentina, the poster-child for forward-looking reform in the 1990s, has defaulted on its debt and turned again to the printing press. Brazil has elected a radical populist president, and no one can foretell whether he will continue to heed the counsels of moderation. Adjoining Uruguay, allied with both of them in the Mercosur common market, cannot survive upheaval in both unscathed. Paraguay, sandwiched between the two, also appears poised on the precipice of default. To the north, Venezuela's Hugo Chávez has broken a middle-class general strike, arrested

[1] *Crisis and Reform in Latin America: From Despair to Hope* (New York: Oxford University Press for the World Bank, 1995), p. 314. Edwards invokes Gabriel García Márquez, *One Hundred Years of Solitude* (New York: Harper & Row, 1970).

business leaders, hobbled trade with currency controls, and bids fair to divert the country's oil riches for a Castro-style social revolution. The state of public order in neighboring Colombia has likewise deteriorated. Fashionable academics habitually dismiss the endemic kidnapping and ransom operations in Colombia as a form of rural entrepreneurship. But lately the guerrillas have branched into urban terrorism and narcotics trafficking, making it harder to maintain such equanimity.[2] Will the reform process in Latin America again become unglued? Will García Márquez's gloomy cycle continue to shape the continent's future as it has the past? If so, where lies the fault? Argentina seemed to have broken free of old populist shibboleths in the 1990s. The hopeful rise and sensational fall of free-market policies there provides a model to ponder for the rest of the continent.

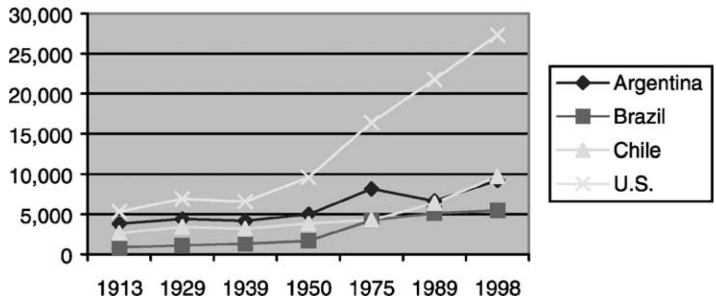
From the defaults of the 1930s through the debt crisis of the early 1980s, Latin American development followed a single dominant paradigm. The received dogma rested economically on import-substituting industrialization and politically on a stew of home-grown populism flavored with sentimental Marxism, xenophobic nationalism, and traditional clientism. The classic form of the doctrine, articulated by Raúl Prebisch and his UN Economic Commission for Latin America (ECLA) in the early postwar period, held—through faulty extrapolation from limited data—that the terms of trade moved inexorably against the primary producers of foodstuffs and minerals. The solution, according to the theorists of underdevelopment, lay in the state's seizing the commanding heights of the economy and subduing the export elites. The state would promote development through planning. It would hot-house home-grown industry, impose prohibitive tariffs to keep out competitive goods from the North, cap the illegitimate profits of foreign direct investment, and distribute the putative benefits through an expansive monetary policy and enough currency depreciation to accommodate that expansion.[3]

Some scholars argue that the collapse of agricultural commodity and mineral prices in the Great Depression of the 1930s forced Latin American countries into default and autarchy. Hard times, they maintain, mandated hypertrophy of the state sector. The figures suggest otherwise. After an initial shock, the 1930s figured as a growth era for Latin American economies. Most countries in the region did comparatively well through their quasi-voluntary

[2] Herbert Braun, *Our Guerrillas, Our Sidewalks: A Journey into the Violence of Colombia* (Niwot, Colo.: University of Colorado Press, 1994); *El rescate: diario de una negociación con la guerrilla* (Bogotá: Grupo Editorial Norma, 1998). On the exploding narcotics business of the FARC guerrilla movement, see Rensselaer W. Lee, "Perverse Effects of Andean Counter-narcotics Policy," *Orbis*, Summer 2002, pp. 537–54.

[3] Raúl Prebisch, *Towards a Dynamic Development Policy for Latin America* (New York: United Nations, 1963); for Marxist embellishment by underdevelopment theorist André Gunder Frank, see his *Latin American Underdevelopment or Revolution: Essays on the Development of Underdevelopment and the Immediate Enemy* (New York: Monthly Review Press, 1970), and James D. Cockcroft, André Gunder Frank, and Dale L. Johnson, *Dependence and Underdevelopment: Latin America's Political Economy* (Garden City: Anchor Books, 1972).

Figure 1
Per Capita GDP (*in 1990 U.S. Dollars*).



debt defaults and beggar-thy-neighbor regimes of unmanaged exchange-rate flexibility. Between 1929 and 1939, aggregate real output rose 16.7 percent in Argentina and 51.7 percent in Brazil, compared with 6.3 percent in the United States. Owing to import substitution policies, the industrial sectors of the Latin countries registered even more impressive gains: industrial production rose 35.2 percent in Argentina and 86.2 percent in Brazil, compared with a loss of 1.7 percent in the United States.[4]

In the long run, however, those inward-looking policies, for which Perón's Argentina serves as the extreme model, led to disaster. In 1929, following a three-decade growth spurt based largely on beef and wheat exports and averaging 4.6 percent annually, Argentina could boast one of the highest per-capita incomes in the world. Only the populations of the United States, Britain and the Dominions, and three West European countries (Switzerland, France, and Belgium) lived better. Argentines enjoyed higher average incomes than Germans and almost half again as much as Italians. Sixty years later, after a catastrophic decade of −3.1 percent negative growth, Argentina had sunk to 40th per capita, or, by the alarmist calculations of President Carlos Saúl Menem, 85th. Even in the lagging Western Hemisphere, it fell below Trinidad and Tobago, Brazil, Uruguay, Venezuela, and Mexico. (For selected international growth comparisons, see Figure 1.) Argentina had suffered no catastrophic wars or foreign occupations. Its dismal economic performance largely reflected its stubborn adherence to the strategy promoted by the underdevelopment ideologues at ECLA.

Of course, countries on the periphery often had no alternative to import substitution when foreign investment became unavailable before and during World War II. Private capital flows from the first world to the third resumed on an impressive scale only in the 1960s. At that time the bankers and

[4] Carlos F. Díaz Alejandro, "Stories of the 1930s for the 1980s," in Pedro Aspe Armella, Rudiger Dornbusch, and Maurice Obstfeld, eds., *Financial Policies and the World Capital Market: The Problem of Latin American Countries* (Chicago: University of Chicago Press, 1983), pp. 5–40, Tables 1.2 and 1.3.

investors who had been burned by debtor ill-will in the 1930s finally retired. Their successors not only perceived objective opportunity abroad, but also adhered to a portfolio theory that mandated wide diversification. Owing to its prevailing closed-economy model, however, Latin America lagged in the resumption of "globalization." The holders of capital saw greater opportunity for direct and portfolio investment in the newly industrialized countries of East Asia. It took another debt crisis in the early 1980s to shake the import-substitution faith in the Southern Hemisphere. Economically literate Latin Americans, who had watched the newly industrialized countries shoot ahead of their own nations in productivity and living standards, finally began to promote radical reform.

Latin technocrats, many with Ph.D.'s from Chicago and other American universities, closed the book on Marx and Prebisch and belatedly discovered Adam Smith. New thinking first emerged in Chile under Pinochet's military regime. The Chilean example instructed others. The modernizing technocrats aimed at macroeconomic reconstruction through the freeing of market forces and promotion of the open economy. They proposed to liberalize trade and investment, shrink the state, privatize money-losing state-owned enterprises, and deregulate the domestic markets that had protected special interests (both business and labor) at the expense of economic growth. Creating a functioning market economy necessitated honest money as a store of value and a medium of exchange. This involved considerable risk in Latin American cultures. Taming chronic inflation required the state to limit budget deficits and fiat money creation. That in turn meant curbing the social programs and other payoffs that had traditionally kept the peace in societies plagued by marked income inequality.[5]

This complex of free-market policies became known as the "Washington Consensus" because American banks were not prepared to write down the existing indebtedness that had piled up in the 1970s without promises of such reform. Trusting naively in their computer models, the money-center banks had earlier followed Walter Wriston's dictum that sovereign borrowers do not go bankrupt. Having learned wisdom in a hard school, they declined to be hornswoggled again.

At the same time, forward-looking Latins elaborated a more uplifting vision. In 1986 Bela Belassa, Gerardo Bueno, Pedro-Pablo Kuczynski, and Mario-Henrique Simonsen, all high-profile business or political figures as well as distinguished economists, published the movement's most influential text, *Toward Renewed Economic Growth in Latin America*.[6] Belassa and his

[5] Sebastian Edwards and Alejandra Cox-Edwards, *Monetarism and Liberalization: The Chilean Experiment* (Cambridge, Mass.: Ballinger, 1987); Juan Gabriel Valdés, *Pinochet's Economists: The Chicago Boys in Chile* (Cambridge: Cambridge University Press, 1995).

[6] Bela Belassa, Gerardo Bueno, Pedro-Pablo Kuczynski, and Mario-Henrique Simonsen, *Toward Renewed Growth in Latin America* (Mexico City, Rio de Janeiro, Washington, D.C.: El Colegio de Mexico, Fundação Getúlio Vargas, Institute of International Economics, 1986).

colleagues advocated political democracy as well as a revolution in attitudes to promote entrepreneurship, raise the domestic savings rate, and limit the state to the provision of basic services and the rule of law. These reformers, seeking to fashion an authentic culture of economic growth, were certainly right in theory. Economic historians have come around in recent years to the view that culture and institutions matter at least as much as capital and labor inputs in promoting prosperity. In Peter Temin's aphorism, it is indeed "kosher to talk about culture."[7] But breaking through the rigidities of populist politics and cultural predilections would prove exceedingly difficult in practice. The course of the Argentine economy in the 1990s would demonstrate precisely how difficult.

Up until 1930 Argentina boasted economic advantages vouchsafed to no other Latin nation. It had a predominantly European workforce with more education and a higher average skill level than any neighbor save for Uruguay. It could boast more foreign investment per capita (railroads, port facilities, internal improvements, etc.) than any other Latin land (excepting the special case of Cuba). On the negative side of the ledger, Argentina remained dependent on the British business cycle, and the trade disruptions of World War I led to unrest. The 1916 election brought a first burst of populism—a victory for the Radical Civic Union, a middle- and working-class alliance that opposed the export oligarchy of railroad and stockyard owners, bankers, shippers, and insurers who had traditionally dominated the country. Still, the export economy returned more or less to normal in the 1920s. One-third of the infant industries that had grown up during the war went out of business. As late as 1933, the Roca-Runciman Treaty provided for preferential treatment of Argentine beef and British manufactures in each other's markets.[8]

Military-dominated Argentine juntas evaded Roca-Runciman later in the 1930s. But radical change came with a vengeance when the populist Juan Perón took power in 1943. North Americans have often viewed the Perón regime as a type of left-wing fascism. In fact, Perón represented a home-grown alliance of organized urban and rural labor, domestic-oriented business, state employees, and the nationalist, anti-American middle class. Between 1943 and 1950 Perón increased state ownership from 11 percent to 35 percent of the economy. Boasting a "third way" between capitalism and communism (much like that of European Social Democrats after the war), he articulated an explicit

[7] Peter Temin, "Is it Kosher to Talk about Culture?" *Journal of Economic History*, June 1997, pp. 267–87; see also David S. Landes, *The Wealth and Poverty of Nations: Why Some are so Rich and Some so Poor* (New York: Norton, 1998), and Lawrence E. Harrison and Samuel P. Huntington, eds., *Culture Matters: How Values Shape Human Progress* (New York: Basic Books, 2000).

[8] For a good summary and guide to the existing historical literature, see Luis Alberto Romero, *A History of Argentina in the Twentieth Century*, trans. James B. Brennan (University Park, Pa.: Pennsylvania State University Press, 2002); comparative analysis in Eul-Soo Pang, *The International Political Economy of Transformation in Argentina, Brazil, and Chile since 1960* (Houndmills, Eng.: Palgrave Macmillan, 2002).

import-substitution strategy through his 1947 Act of National Independence. He nationalized or bought out railroads, public utilities, harbor facilities, oil and gas companies, and meat-packing plants. Strictly controlling foreign exchange, he banned capital-goods imports, imposed national-content rules on other manufactures, and restricted profit expatriation. In short, the Perón regime became the archetype for import-substituting industrialization.[9]

By 1955 the budget deficits required to finance Perón's lavish state-building had ignited a predictable hyperinflation. The military sent him packing. Still, owing to post-Perón distortions in the economy, Argentina largely missed out on the subsequent renewal of direct investment by American multinationals in Latin America. Such investment was favored by the U.S. tax code (which exempted non-repatriated profits from tax) after 1962. But as late as 1970 Argentina's major trading partner remained the USSR. Faced with an urban guerrilla insurrection that it could not master, the military called Perón back from exile in 1973. Another three years of populist economics followed, with the usual sequelae of outsized budget deficits to satisfy diverse subsets of labor and business interests, hyperinflation, and ultimately economic chaos. As Guido di Tella, who would later become one of President Menem's economic advisers, put it: "The price mechanism was the principal battleground for the distribution of income, and . . . this was at the root of the inflationary process."[10] This legacy of cyclical "structural hyperinflation" forms a background to the expectations of all economic actors in later periods.

In 1976 the military intervened again—for the seventh time in the twentieth century. The new junta appointed a conservative businessman and former aide to David Rockefeller in order to restore monetary stability, liberalize the economy, and attract foreign investment. But, intent on fighting a war against Great Britain over the Falklands while at the same time buying labor quiescence, the armed forces eventually multiplied the budget deficit by 25 times to pay for guns and butter. Following the familiar pattern, such reckless spending brought yet another burst of hyperinflation and government collapse.

When Raúl Alfonsín, an opposition center-left Radical, inherited the mess in 1983, the country had 707 state-owned enterprises, most money-losing sinks of corruption. Even the state-owned oil company, uniquely in an OPEC-dominated world economy, managed to lose billions! What's more, import substitution still ruled; Argentina ranked 117th on the World Bank's "country openness" index—sharing pride of place with the USSR, Iran, and Iraq. Alfonsín began with good intentions. He even accepted, at some political cost, an IMF-supervised austerity program in 1984. In order to build democracy, however,

[9] Rudiger Dornbusch and Sebastian Edwards, eds., *The Macroeconomics of Populism in Latin America* (Chicago: University of Chicago Press, 1991).

[10] Guido di Tella, "The Economic Policies of Argentina's Labour-based Government (1973–1976)," in Rosemary Thorp and Laurence Whitehead, eds., *Inflation and Stabilization in Latin America* (New York: Holmes and Meier, 1979), pp. 181–226; quotation on p. 184.

he sought to satisfy everybody, and to accomplish that he skipped from plan to plan with ever more creative accounting. By mid-1985, inflation reached 6,500 percent. The economy contracted for the entire period 1981–91 by an average of 3.1 percent annually. Michael Mussa, long-time director of research at the IMF, describes the prevailing Argentine monetary culture this way: "The Argentine government is like a chronic alcoholic—once it starts to imbibe the political pleasures of deficit spending, it keeps on going until it reaches the economic equivalent of falling-down drunk."[11]

This was the situation when an almost unknown Peronist, Carlos Saúl Menem, became president in 1989. A Syrian immigrant's son from the western foothills province of La Rioja, Menem had a charisma on the campaign trail that reminded voters of Perón. During the campaign Menem assumed a vaguely populist position and criticized Alfonsín for pussyfooting with the IMF. Yet, after covering his tracks with a public relations offensive for "development with justice" (*desarollo con justicia*), Menem turned to big business for advice. He instituted an orthodox liberal program: suspending subsidies, abolishing price controls, reducing the budget deficit, forcing conversion of the domestic debt, and acquiescing in de-facto dollarization.[12] Inflation fell back in 1990 from 20,000 percent to 1,200 percent. This marked progress, albeit not enough to break inflationary expectations.

Unfortunately, Menem revealed himself as a somewhat unsavory character in the Peronist mold. His wife had an entourage of corrupt Arab arms dealers, drug traffickers, and labor bosses on the take. His vice president, Eduardo Duhalde, retained known drug lords on his staff. And Menem's early privatization of state-owned enterprises opened new avenues for corruption, verging on a post-Soviet scale of largesse. Until he finally cleaned house in 1994, Menem's main merit consisted in allowing his economics minister, Domingo Cavallo, to take the lead in reform.[13]

Cavallo was an ambitious, squeaky-clean technocrat of modest provincial origins. He had risen from provincial budget officer to president of the Central Bank and then to foreign minister. With a Ph.D. from Harvard, he had anti-monetarist leanings; before his appointment to the Economics portfolio he was mostly known for his pro-American foreign policy and his advocacy of U.S.-led globalization. Cavallo's main objective after 1991 was to restore business confidence so that the demon of hyperinflation would not reappear. His means to that end lay in opening the economy. Cavallo based

[11] Michael Mussa, *Argentina and the Fund: From Triumph to Tragedy* (Washington, D.C.: Institute for International Economics, 2002), p. 10.

[12] For a sharply critical view of this turnaround as "socially regressive," see William C. Smith, "State, Market, and Neoliberalism in Post-Transition Argentina: The Menem Experiment," *Journal of Interamerican Studies and World Affairs*, Winter 1991, pp. 45–82.

[13] Pang, *International Political Economy*, pp. 95–122; see also Judith A. Teichman, *The Politics of Freeing Markets in Latin America: Chile, Argentina, and Mexico* (Chapel Hill: University of North Carolina Press, 2001), pp. 97–128.

his strategy on a Convertibility Law, which pegged the austral (later the peso) to the dollar. He strengthened this hard peg by ensuring the independence of the Central Bank and reinforcing the banking system with high capital and reserve requirements on the American model.

Prof. Joseph Stiglitz of Columbia University, formerly of the World Bank, argues that fixed exchange rates have never worked and that Cavallo's Currency Board was "doomed to failure."[14] Cavallo believed, however, that using a monetary-growth target instead would not accommodate demand shocks in an economy such as his own.[15] Admittedly, it would have minimized risk for Argentina to adopt a crawling peg or to stabilize against a basket of currencies representing its various trade partners rather than the dollar alone. But those options did not seem practicable for technical reasons. Even the otherwise critical Martin Feldstein concedes that, within its own terms, the Argentine Currency Board system was cleverly and parsimoniously conceived. The dollars in the Central Bank covered only pesos in circulation, and not demand deposits. In practice, the Bank could raise the interest rate on peso deposits high enough to cause prices and wages to fall and make holding pesos attractive again.[16] In its first test, the system worked. Pedro Pou, head of the Central Bank, notes with pride that the banking and currency system withstood the run on deposits during the early 1995 "Tequila crisis" with aplomb.[17]

In the meantime, the reduction of inflation to 20 percent for all of 1992 permitted Cavallo to proceed with complementary reforms. Import duties were reduced. Cavallo negotiated a customs union of four Southern Cone countries (Mercosur) that would go into effect in 1995. He also reformed the tax collection system in a land where many people habitually ignored taxes, and revenue jumped by 43 percent in one year. Taking advantage of the U.S. Treasury's Brady Plan, Cavallo renegotiated the $50 billion existing foreign debt on highly favorable terms. The creditors allowed him to write off 35 percent of the debt and to fund most of the rest for thirty years at 4 percent, backed by U.S. Treasury zero-coupon bonds. Meanwhile, an Economics Ministry team tackled the problem of the scandal-ridden state-owned enterprises (SOEs), whose annual losses, amazingly, equaled the total service cost of the foreign debt. To suggest the magnitude of the problem, under Alfonsín the SOEs had expended 18 percent of GNP and consumed 21 percent of all investment, even though they produced only 7 percent of GDP.

[14] Joseph Stiglitz, "Why the Nation that followed the Rules fell to Pieces," *Washington Post*, May 12, 2002. For Stiglitz's full-bore attack on neoliberal economics, see his *Globalization and Its Discontents* (New York: Norton, 2002).

[15] Domingo F. Cavallo and Joaquin A. Cottani, "Argentina's Convertibility Plan and the IMF," *American Economic Review*, May 1997, pp. 17–22.

[16] Martin S. Feldstein, "Argentina's Fall," *Foreign Affairs*, March/April 2002, pp. 8–10.

[17] Pedro Pou, "Argentina's Structural Reform in the 1990s," *Finance and Development*, March 2000, pp. 13–15.

The telephone and electric utilities labored under a cost structure four times greater than world levels; a third of the electricity was stolen. Winding down the Russian-style giveaways, Cavallo brought in American-trained investment bankers to carry out privatization efficiently. For the moment, the proceeds to the Treasury kept the usual fiscal deficit limited.

All this made for a record of solid accomplishment—indeed by Argentine standards unprecedented success. By 1996 inflation fell to 1 percent, below the North American level. With a stable currency and deregulated economy, foreign investment poured in, not merely from North America, but from East Asia and Europe as well. Foreign reserves sextupled from 1992 through 1998. So, what went wrong? The issue has drawn close attention from development economists. Michael Mussa, former director of research at the IMF, has produced a remarkable insider's study. The issues were also aired in spring 2002 by leading economists and U.S. Treasury officials before the House Committee on Financial Services.[18]

Yet no clear consensus has emerged. Orthodox opinion, as voiced by Fred Bergsten of the Institute for International Economics, holds that a currency board may work for a while in a country desperately needing an external anchor, but that a nation adopting one requires an "exit strategy." It either has to proceed to full dollarization, or it must at some point return to a flexible exchange rate in order to avoid overvaluation. A common currency accompanying broad economic integration may well function effectively, as contrary to common prognostications the euro now promises to do. But full dollarization would have caused major distortions in an economy like Argentina's, where the relative cost structure differs fundamentally from that of the United States. On the other hand, the preferred orthodox alternative of "inflation targeting" with flexible exchange rates forms a mighty thin reed given the strongly imprinted inflationary expectations among the Argentines.[19]

The main point, sometimes obscured by the technical debate, is that the Washington consensus model—privatization, deregulation, and liberalization—promotes rapid growth wherever it receives a fair trial. Indeed, that prescription, which reflects the preferences of the IMF when sheltered from political pressures, often works with stunning effectiveness even in an economy previously subject to dreadful mismanagement over several decades. What failed in Argentina is that the process stopped short of completion. Official labor markets remained so inflexible that the informal

[18] *Argentina and the Fund: From Triumph to Tragedy;* also *Argentina's Economic Meltdown: Causes and Remedies*, Hearings before the Subcommittee on International Monetary Policy and Trade, House of Representatives, 107 Cong., 2 Sess., Feb. 6–Mar. 5, 2002 (Washington, D.C.: GPO, 2002).

[19] See the conflicting testimony of Under Secretary of the Treasury John B. Taylor, Fred Bergsten, Steve H. Hanke, Allan Meltzer, and others at the Congressional hearings, *Argentina's Economic Meltdown*, esp. pp. 6–29, 38–51.

sector of the economy could not be reduced; the real fiscal deficit continued and was only temporarily masked by the revenues from privatization. And the provinces, which benefited from mandatory revenue-sharing, refused to curb clientist overmanning or to trim their own chronic overborrowing. In some provinces up to half of able-bodied adults found a place on the government payroll. In those difficult circumstances, one could plausibly maintain, Cavallo's hard peg went on too long. Since Argentine labor had resisted every effort to improve productivity, a series of unexpected shocks resulted in peso overvaluation. The Asian financial crisis of 1997–98 pushed the dollar upward relative to the euro and the yen. Then the devaluation of the Brazilian currency by roughly 30 percent in 1999 priced Argentine goods out of Mercosur markets.

Meanwhile, in August 1997, Menem had "dropped the pilot." After public disagreements, Cavallo resigned. Angling for reform of the electoral law and a possible third term, Menem shied away from tackling corruption in the provinces. Unemployment remained, at least in the official economy, over 14 percent, and Menem came under pressure from traditional Peronist labor circles to relax austerity. Did the reforms of the 1990s really increase "poverty," however that contested term is defined? The evidence appears mixed.

The most careful scholarly study currently available suggests that the number of Argentine households with unsatisfied basic needs declined secularly some 20 percent during the 1980s; and surely the boom of the 1990s must have produced a faster decline. Officially measured poverty fell from 24 percent to 14 percent of households in greater Buenos Aires between late 1988 and late 1991 alone.[20] However, the distinction between the structurally poor and those temporarily pauperized proves difficult to draw in a society beset by hyperinflation followed by sudden disinflation. The figures may not fully measure dislocation in the underground economy. What's more, as the U.S. "war on poverty" in the 1960s made clear, figures are one thing, perceptions quite another. Neither Menem nor Cavallo put the war on poverty in the center of their public rhetoric, and Argentines, having once enjoyed a first-world standard of living, felt entitled to enjoy it forever, whatever the relative productivity tables. Argentine labor unions proved unusually resistant to downward pressure on real wages no matter what the competitive circumstances.

Third-world interest groups that resist the adjustments required by stabilization programs know that they can count on sympathy from the socially-minded in lender countries on political grounds. That support, deriving from liberal guilt as well as pragmatic calculation, strengthens their position. In the Argentine Congressional hearings, Rep. Barney Frank (D-MA) of the House Committee on Financial Services voiced the typical position of

[20] Nancy Powers, "The Politics of Poverty in Argentina in the 1990s," *Journal of Interamerican Studies and World Affairs*, Winter 1995, pp. 89–137.

the American Left about austerity policies, especially when they come with the imprimatur of the dreaded IMF:

> We are often in the position of advising countries to do things . . . that most of us would not vote for. We are telling them to impose on their own people restrictive policies, increases in . . . regressive taxation, cutbacks in various levels of benefits. . . . We run the risk . . . of undermining democracy. . . . One of the victims so far in the Argentine crisis is the respect the Argentine people have for the democratic process.[21]

After Cavallo's departure in 1997, fiscal profligacy and corruption crept back into the Argentine body politic. Within eighteen months, contagion from the East Asian liquidity crisis and the Brazilian devaluation produced a recession. Unemployment shot up to 18 percent. Public sentiment shifted. The center-left Radical opposition swept the elections of 1999. The new president, Fernando de la Rúa, abandoned his election rhetoric and initially accepted the existing IMF targets with no more than routine grumbling. But pensioners and the unemployed fell deeper into poverty. Although Argentina spent 18 percent of GDP on social programs throughout the 1980s, more seemed called for in a recession, and the provinces eagerly complied. The provincial budgets, which under law are subsidized by the central government, spiraled totally out of control. After prolonged indecision, de la Rúa turned to an orthodox economist of the Chicago school, Ricardo López Murphy, who tried to force through tough spending cuts. Rioting erupted in the capital, however, and Congress indignantly rejected additional fiscal discipline.[22]

In March 2001 de la Rúa ventured a last desperate throw of the dice. He brought Domingo Cavallo, the presumed miracle man, back to the Economics Ministry. Renouncing spending restraint as politically impossible, Cavallo sought instead to raise revenue, not enough really to bite, but perhaps enough, with a wink and a nod, to demonstrate good will for the IMF. Meanwhile, a "voluntary debt swap" would take immediate pressure off the budget at the expense of higher payments starting five years down the road. Did this frenzied maneuvering mean that it was now too late to save the Convertibility Plan? World capital markets grew increasingly skeptical. Traders noted that the interest spread (over U.S. Treasuries) on Argentine sovereign debt remained below the Emerging Market bond index until spring 2001, and then suddenly rose above it.[23] Despite the increasing cost of funds, Argentina continued to borrow. Counting refinancing, it now required some $22 billion a year into the

[21] *Argentina's Economic Meltdown*, pp. 36–37. The *Wall Street Journal* has repeatedly denounced Frank and like-minded Congressional "Sandalistas" for favoring authoritarian South American governments of the left (e.g., "New Yankee Imperialists," editorial, Dec. 31, 2002). All the same, this Capitol Hill junta enjoys broad support in one wing of the Democratic party as well as among academic specialists on Latin America.

[22] The following paragraphs draw heavily on Mussa, *Argentina and the Fund*, pp. 9–65; Pang, *International Political Economy of Transformation*, pp. 117–22; and periodic reports in the *Economist*.

[23] Mussa, *Argentina and the Fund*, p. 34 (Figure 3.1).

indefinite future—about one-fifth of all available emerging market flotations—to balance its external accounts.

In December 2000, Argentina had asked the IMF to acuate a three-year standby credit and to bail the country out. The Fund had agreed. The Fund could have forced an involuntary private debt restructuring as the price of emergency assistance. But that would have forced the suspension of convertibility and a de facto sovereign default, with all its domestic consequences and implications about the prospects of help for other countries in crisis. According to the formula used by the IMF to calculate whether a given ratio of foreign debt to GDP is sustainable, Cavallo might just have pulled a rabbit out of his hat up to late spring 2001, but not thereafter. Once the cost of foreign borrowing exceeded a certain point, the Convertibility Plan became unsustainable.[24]

In August 2001, nevertheless, Cavallo sought to coerce the IMF into granting one more concessionary loan, through vigorous lobbying in Washington and announcement of a zero-deficit plan that had zero chance of coming into effect. Eventually the Fund management, operating on the three-monkeys principle—hear no evil, see no evil, speak no evil—supplied another $9 billion. Stanley Fischer, second-in-command at the IMF, expressed open panic about possible contagion from Argentina to Brazil, Colombia, Peru, Turkey, and Indonesia, all of which had taken on a debt burden close to unsustainable levels by conventional measures. Not all policymakers agreed with his analysis. Secretary of the Treasury Paul O'Neill, who would later lose his job for loquacity beyond the call of duty, failed to detect the sheep "all running for the cliffs." The Argentines had been "off and on in trouble for 70 years or more," he equably opined. "They don't have any export industry to speak of. And they like it that way. Nobody forced them to be what they are."[25] Finance professionals bristled at such uninhibited language. Yet in retrospect Fund officials realized that they had poured their money down a rathole. At best it would serve to help Argentine investors retrieve some funds before the inevitable collapse. As with the Russian loan package of July 1998, the IMF pretended to believe in "reform" because of perceived pressure from member countries to preserve global political stability.[26]

[24] The IMF begins with a straightforward formula to calculate fiscal sustainability: primary budget surplus/GDP $\geq$ debt/GDP $\times$ (government debt interest rate minus the economic growth rate). It can put a political thumb on the scales, but only in marginal cases. By traditional measures, Argentine debt became unsustainable in late June 2001, when the spread over medium-term U.S. Treasuries reached 1,000 basis points. Bond traders responded rapidly, and by August 2001 the spread had jumped to 1,600 basis points.

[25] "How the Bug Can Spread," *Economist*, July 21, 2001.

[26] The debate about the advisability of the Russian bailout still waxes acrimoniously. See Janine Wedel, "Tainted Transactions: Harvard, the Chubais Clan, and Russia's Ruin," *The National Interest*, Spring 2000, pp. 23–34; and replies by the economists concerned, "Tainted Transactions: An Exchange," *The National Interest*, Summer 2000, pp. 98–110.

The end in Buenos Aires was not long in coming. The Peronists won the parliamentary elections in October 2001, and the legislature predictably rejected all further austerity. This time the IMF refused to provide a handout. Within weeks, a bank run began. The stabilization plan collapsed. Argentina defaulted on most of its $140 billion public debt. First Cavallo and then de la Rúa resigned. Riots broke out in Buenos Aires. After three temporary presidents within a week, the Peronist Congress elected the old party warhorse Eduardo Duhalde to that office, and the familiar fun and games of Argentine public finance resumed.

Duhalde's henchmen did more than freeze bank deposits, depreciate the peso, and then let it float (it has depreciated over the intervening period roughly to three to the dollar). Those measures were arguably unavoidable in the circumstances. Duhalde also deliberately, some would say cynically, decapitalized the banks by forcing conversion of bank deposits into pesos at a rate considerably above the conversion rate for bank liabilities. To top things off, he sent armored cars in the middle of the night to relieve the banks of their hard currency. He also undertook the disguised confiscation of private direct investment, for example by freezing peso utility rates while the currency continued to depreciate. The IMF asked, as the price of lending into arrears, that investors be treated "fairly" when the time comes for renegotiating external claims. But what is "fair" when the claims of "welfare" and "stability" effectively take precedence over property rights? The second-ranking figure at the Buenos Aires Finance Ministry proclaimed that utility investors had "made a currency mismatch" and would have to take their lumps.[27]

Taken together, all these confidence-eroding measures wreaked havoc on the Argentine economy. Output tumbled 12 percent in the first year under the new dispensation and continues to contract. Although the Argentine Supreme Court eventually ruled that holders of dollar bank deposits were entitled to compensation, it is hard to imagine a practical way to achieve that objective without another dose of fiat inflation.[28] Predictably, Argentine officials found it politically useful to blame the IMF and foreign investors for the mess. Duhalde's economy minister, Robert Lavagna, charged that the multilateral organizations had exhibited "a certain blindness" by pushing an economic model that had led to "indebtedness, unemployment, poverty, and finally, financial collapse."[29] Summoning the IMF to lend into arrears, Lavagna coolly informed that body that on-budget federal expenditures would rise by 40 percent in the subsequent fiscal year. "If they are asking us for more taxes,

[27] Secretary of Finance Guillermo Nielsen visit to *Wall Street Journal* editorial board, reported in Mary Anastasia O'Grady, "Why Would Anyone Trust Argentina?" *Wall Street Journal*, Jan. 17, 2003.

[28] "A Property-Rights Lesson," editorial, *Wall Street Journal*, Mar. 7, 2003; Steve H. Hanke, "Argentine 'Bank Robbery,'" *ibid*., Mar. 21, 2003; follow-up articles in *Wall Street Journal,* March 6, 10, April 4; and *New York Times*, Mar. 6 and 29, 2003.

[29] *Financial Times*, Sept. 25, 2002.

more belt-tightening or throwing people out into the streets, then there is nothing to talk about," proclaimed José Manuel de la Sota, governor of Cordoba Province and a prominent Peronist spokesman. "These recipes have brought us to this crisis, which is killing children."[30] While Lavagna lobbied the IMF in Washington, the mood in Buenos Aires turned ugly. Graffiti defaced the Citibank office in the capital: "Thieves, returns [sic] our dollars!"[31]

It appeared in early fall 2002 that the IMF might finally stand firm and turn off the financial spigot if Argentina did not at least pretend to reform. "It wouldn't be the end of the world" if Argentina defaulted, insisted deputy managing director Anne Krueger.[32] Yet the tune in Washington changed when, despite ample reserves in the Central Bank, Argentina actually defaulted on a World Bank loan and threatened to do the same to the Inter-American Development Bank. Within a few days the IMF rolled over a crucial $6 billion loan. The Inter-American Development Bank offered another $2.5 billion to improve the efficiency of anti-poverty programs. With war looming in Iraq and nuclear troubles in Korea, no one in Washington dared to rock the boat in the Southern cone before the May 2003 presidential election there.[*] "Given the upcoming election and the difficulty in getting major structural measures adopted, this seemed a pragmatic approach," explained an IMF spokesman lamely. "Creole slickness" (*viveza criolla*), as the Argentines call it, had bested the *gringo* again.[33]

The IMF is often criticized—in the *Wall Street Journal* as well as on the left—for using "conditionality" to force unnecessary austerity on economies suffering from simple liquidity problems. The criticism does not lack validity with reference to the East Asian crisis of 1998, but the faultfinders have tended to generalize.[34] Obviously the Fund must maintain a difficult balancing act between its roles as "social worker" and "cop." Argentine developments suggest that frequently, in the face of political pressures, conditionality is not tough enough or, rather, does not produce comprehensive reform over a long-enough period to be effective.[35] The chattering classes spend a lot of time worrying about "moral hazard," by which they

[30] Larry Rohter, "Argentina Defaults on Big Payment to World Bank," *New York Times*, Nov. 15, 2002.

[31] Nicholas Kristof, "If Saddam Were Only Brazilian," op-ed, *New York Times*, Dec. 12, 2002.

[32] *International Herald Tribune*, Sept. 27, 2002.

[*] As expected, the hypernationalist Néstor Kirchner won the May election.

[33] Quotations from O'Grady, "Why Would Anyone Trust Argentina?" and the "Americas" column, both in *Wall Street Journal*, Jan. 17. Argentine officialdom made clear that no generous deed goes unpunished. President Duhalde insisted that the Fund had been "hostile" and had "failed to help us during the worst time in our history," *New York Times*, Feb. 11, 2003.

[34] Stiglitz, *Globalization and Its Discontents,* presents an elegant but polemical indictment.

[35] Deepak Lal, *The Poverty of 'Development Economics'* (London: Institute of Economic Affairs, 2002), pp. 102–24.

mean the tendency of institutional investors to take undue risk in the expectation that the international agencies will bail them out. This, in light of historical experience, does not figure as a major problem. Given the present cultural climate, the Fund will rarely do favors for foreign investors unless the contributing creditor governments insist. On the other hand, properly diversified investors were handsomely compensated for the volatility of emerging market debt in the 1990s, in sharp contrast to their experience during the 1980s.[36] That generous return, of course, may redound to the general benefit because it keeps capital flowing in the presence of heightened risk.

The successive payment disturbances since 1998—in Russia and East Asia as well as Argentina—have led many international economists to investigate ways to improve the world financial architecture. Three main schools have emerged. The first maintains that no institutional redesign is necessary, aside from greater resolve by existing multilateral institutions not to bail out incautious lenders or insolvent debtors that have followed imprudent policies. On that view, markets themselves can sort out most debt problems. The second school, with which Stanley Fischer and George Soros are associated, believes that either the IMF itself or the G-7 central banks should act reliably as lenders of last resort. If central banks, in Bagehot's apothegmatic formulation, "lend freely at a penalty rate against good collateral," then debtors could always work their way out of unforeseen liquidity problems. The third school, for which Anne Krueger of the IMF serves as champion, calls for a formal, mandatory process of debt restructuring analogous to a domestic bankruptcy court. According to Krueger's mechanism, a majority of creditors (presumably money-center banks and multilateral institutions) would gain the power to impose a Standstill or a debt-restructuring scheme on a dissenting minority.[37]

Most variants of the second and third schemes for refining the payments architecture assume that crises arise from sudden panics or liquidity traps. Sometimes they do. And in those cases, better mechanisms can smooth the path to adjustment. But more frequently the breakdown, as in the current Argentine case, has deep-rooted political causes. That proved the case in the Great Depression, and it remains the case today.[38] As Anna J. Schwartz of the National Bureau of Economic Research has observed, "experts" on the international debt problem, particularly if they come from academia, tend to be

[36] The J. P. Morgan Emerging Market Bond Index registered a total pretax return of 340% in the period 1991–2002, compared with a return (including interest or dividends) of 322% for the Dow Jones Industrial Average and 200% for a representative portfolio of U.S. corporate bonds. See *Wall Street Journal*, Sept. 18, 2002.

[37] See Barry Eichengreen, *Financial Crises and What to Do about Them* (New York: Oxford University Press, 2002), esp. pp. 51–100, 135–56, for a limpid exegesis of these schemes and their variants.

[38] Stephen A. Schuker, *American 'Reparations' to Germany, 1919–33: Implications for the Third-World Debt Crisis* (Princeton: Princeton Studies in International Finance, 1988).

debtor-country sympathizers. They instinctively consider it "high-minded" to bail out the disfavored. In addition, money-center banks have proven notoriously bad at evaluating political risk. Troubled debtors have usually misallocated borrowed resources and adopted flawed domestic policies on political grounds. Finally, multilateral agencies rarely amass the clout to enforce conditionality over time.[39] It would be sensible to conclude that debtor nations must first help themselves through sound economic policies as a precondition for accommodation. In the meantime, political-risk premiums for third-world lending should rise. Such an approach, however, cannot expect to win plaudits from the development community.

So far, the Argentine financial meltdown has not produced much contagion beyond Uruguay and Paraguay.[40] Yet neighboring Brazil has developed problems of its own. The growing disequilibrium in the Brazilian economy illustrates again the moral hazard that occurs when borrowing countries pursue risky policies because they do not think the investment community will apply effective sanctions against their doing so. After the end of the Brazilian military regime in 1985, successive civilian presidents began to dismantle the state-capitalist institutions of the populist era. Especially under the leadership of a thoughtful social democratic sociologist, Fernando Henrique Cardoso, Brazil followed a successful stabilization and growth policy for much of the 1990s. Cardoso eliminated self-defeating prohibitive tariffs, loosened the grip of corrupt state-owned monopolies, and ingeniously stabilized the *real*. After a lost decade, economic growth resumed, though fresh problems arose after the 1998 East Asian crisis that compelled devaluation of the *real*.[41] Contrary to received wisdom, the voters in a democracy do not always perceive what is good for them. As a goodbye present to Cardoso, the electorate, in a landslide, chose the perennial Workers Party candidate, Luiz Inácio Lula da Silva, as its next president. When Lula assumed office in January 2003, Brazil already faced a credit crunch. Net public debt had ballooned 16 percent within three years, largely because of uncontrolled spending by the states. During the same period, foreign portfolio

[39] Anna J. Schwartz, "International Debts: What's Fact and What's Fiction," Presidential Address to the Western Economic Association, in *Economic Inquiry*, Jan. 1989, pp. 1–6.

[40] In March 2003, Uruguay formally asked its foreign creditors for a debt-swap, and Fitch Ratings promptly downgraded the country's debt to triple-C (below investment grade). See "Americas" column, *Wall Street Journal*, Mar. 13, 2003. In Paraguay the smuggling trade, a mainstay of the economy, has collapsed: Larry Rohter, "Troubles Push Paraguay close to Bankruptcy," *New York Times*, Nov. 29, 2002.

[41] Susan Kaufman Purcell and Riordan Roett, eds., *Brazil under Cardoso* (Boulder, Colo.: Lynne Rienner, 1997); Peter Kingstone and Timothy J. Power, eds., *Democratic Brazil: Actors, Institutions, and Processes* (Pittsburgh: University of Pittsburgh Press, 2000); Pang, *International Political Economy*, pp. 123–45. Fernando Henrique Cardozo has articulated his own views: see Mauricio A. Font, ed. *Charting a New Course: The Politics of Globalization and Social Transformation* (Lanham, Md.: Roman & Littlefield, 2000).

investment in Brazil fell by two-thirds, and direct investment turned negative. Several foreign banks interpreted Lula's election as a signal to lower their profile or leave the Brazilian market altogether.[42]

Lula figures as a characteristic throwback to the populist era. Having left school at the age of 12 and risen to prominence in the metalworkers' union, Lula sees himself as an eclectic thinker of the independent left. As a young man, he declined to join his older brother in the Communist Party. And his Workers Party is not strictly speaking a Marxist party at all, but rather a heterogeneous grouping of such diverse interests as rural landless militants, Trotskyites, socially-minded Catholic priests and laymen, and left intellectuals with a partiality to dependency theory. In two past runs for the presidency, Lula had called for a debt moratorium and land invasions, and described George W. Bush's proposed 34-nation Free Trade Area of the Americas (FTAA) as tantamount to U.S. "annexation." During the most recent campaign, he criticized foreign investors as "economic terrorists" seeking immoral profits at Brazil's expense.

Nonetheless, after winning office, Lula took care to reposition himself as a Social Democrat who would keep all commitments to the IMF. The *New York Times* accepted him at his word: "His election is a tribute to the triumphant consolidation of democracy in South America's largest nation."[43] Still, those who delved deeper than the press handouts noted that some of the president's entourage had a controversial past. For example, Lula's top lieutenant in the legislature, José Dirceu, had an earlier incarnation as a pistol-packing student leader who served a term in prison for kidnapping the American ambassador. After some years of exile in Cuba, where he underwent plastic surgery and took guerrilla training, Dirceu had infiltrated back to Brazil under an assumed name and entered democratic politics. "We won't be a government of economists," Dirceu assured a post-election rally. "Ours will be a government of producers."[44]

In his first months in office, Lula steered a precarious middle course between his clamorous legislative supporters and the watchful international banking community. Mindful that he did not enjoy a Congressional majority, Lula guilefully balanced his appointments. He named the market-friendly Antônio Palocci to the Finance Ministry and designated a well-known banker, Henrique Meirelles, as Central Bank governor. On the other hand, Tarso Genro, a self-described disciple of Antonio Gramcsi, became minister of social development, and Olívio Dutra, a "post-Marxist democrat," took the

[42] Michael M. Phillips and Jonathan Karp, "A Global Journal Report: In Brazil, a No-Fault Default?" *Wall Street Journal*, Oct. 25, 2002, reproduces figures from the Banco BBA Creditanstalt; "Americas" column, *Wall Street Journal,* Jan. 14, 2003, reports the decision of foreign banks to reduce their exposure.

[43] Editorial, *New York Times*, Oct. 30, 2002.

[44] Jonathan Karp and Miriam Jordan, "The Changing Face of Brazil's Leftists," *Wall Street Journal*, Oct. 29, 2002.

urban affairs portfolio. As Lula could not forget, the IMF had granted its latest $30.7 billion loan contingent on fiscal performance. At least starting off, he raised the target for the primary budget surplus (excluding debt service). He likewise defended the Fiscal Responsibility Law that supposedly caps state-government payroll spending. With inflation already running at 13 percent, the Central Bank nudged up interest rates while raising the alleged inflation target from 4 percent to 8.5 percent. Hyperinflation may wait in the wings, but has not yet appeared on the stage. Finally, Lula has squeezed foreign-owned utilities with dollar-denominated liabilities by blocking retail price increases that would cover their costs, but so far has not proposed renationalization.[45]

In the rhetorical realm, however, Lula has rehearsed a hoary populist tune. Addressing the World Social Forum in front of a banner reading "No to imperialism!," he pleased the crowd with a rousing speech calling for "a new world economic order that distributes wealth more fairly."[46] And at the inaugural festivities in Brasília, the familiar icons of the Latin American left—including Fidel Castro of Cuba, Hugo Chávez of Venezuela, and Colonel Lucio Guitterez of Ecuador—gathered to rejoice. Chávez spoke boldly of constructing an "alternative to neo-liberalism."[47]

Eventually Lula will have to meet the hyperbolic expectations of his supporters somehow. Indeed, Fábio Konder Comparato, the chief Workers Party theorist, has already accused him of "putting bankers ahead of people."[48] At this writing, it seems hazardous to predict whether Lula will seek to beggar his North American neighbor on the trade side or the finance side. He knows that the Bush administration cannot succeed in creating the FTAA without full cooperation from the most populous Latin country. In an early visit to Washington, Lula signaled that he would be "very tough" in seeking U.S. trade concessions, particularly for his citrus, sugar, steel, and apparel industries.[49] Brazil nurtures an old tradition, dating back to the Getúlio Vargas dictatorship in the 1930s, of extracting outsized trade and

[45] Jonathan Karp, "Brazil Gets Tough on Unruly States: New President Moves to Keep Spending Controls," *Wall Street Journal*, Jan. 9, 2003; "Brazil Raises Its Inflation Targets Sharply," *Wall Street Journal*, Jan. 22, 2003; "Party of Brazil's da Silva Grumbles over Policies," *Wall Street Journal*, Feb. 10, 2003; Jonathan Karp, "Debt-Saddled Power Firm Creates Test for Brazil's Leftist Government," *Wall Street Journal*, Feb. 25, 2003; Larry Rohter, "Antiglobalization Forum to Return to a Changed Brazil," *New York Times*, Jan. 20, 2003; Tony Smith, "Brazilian Government's Mixed Signals," *New York Times*, Feb. 26, 2003, and "Power Company Stresses its Commitment to Brazil," *New York Times*, April 11, 2003.

[46] Tony Smith, "Brazilian Leader Vows He Will Plead for the Poor in Davos," *New York Times*, Jan. 25, 2003.

[47] Juan Forero, "Latin America's Political Compass Veers Toward the Left," *New York Times*, Jan. 19, 2003.

[48] Larry Rohter, "Brazil's Leader Angers His Old Allies," *New York Times*, Mar. 23, 2003.

[49] Michael Phillips, "Free Trade Discord Looms for Americas," *Wall Street Journal*, Dec. 31, 2002.

monetary concessions from the Northern colossus in return for foreign-policy support.[50] Will George W. Bush yield to the temptation, as Franklin D. Roosevelt did sixty years ago, of sacrificing the banks and bondholders to domestic export and labor interests? The da Silva government will almost surely insist on some linkage between its trade stance and the treatment of its foreign debt.

The next chapter of the Latin American debt saga remains to be written. It may be too soon to say whether the burgeoning "axis of populism" will become an "axis of malversation." In any event, the continent's most recent flirtation with dependency theory, perfervid nationalism, and quasi-voluntary default is unlikely to be its last.

[50] Stanley E. Hilton, Brazil and the Great Powers, 1930–1939: The Politics of Trade Rivalry (Austin: University of Texas Press, 1975).