

ABSTRACT

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Institutional Causes of Argentina's Unsustainable Public Debt and Economic Instability
Under the Direction of Dr. SANTANU CHATTERJEE

In the Nineties, Argentina implemented a series of neo-liberal policies and a currency board to end a period of hyperinflation and regain access to the international capital markets. The system collapsed in 2001 when Argentina sunk into a severe depression and economic crisis, which ended in the largest sovereign debt default in history. Three years later, the Argentine government renegotiated and offered bondholders a meager 30% of the original face-value of the bonds. Although in the years following the crisis Argentina experienced low inflation and high GDP growth, today Argentina faces double-digit inflation and public debt levels above 50 percent of GDP. In this paper I find that behind Argentina's economic problems lie institutional weaknesses, including severe corruption, the federal-provincial revenue-sharing system, and the absence of the rule of law. Argentina must first address these institutional problems before it can hope for sustained economic recovery and proper public debt management.

INDEX WORDS: Argentina, Debt, Default, 2001 Crisis, Coparticipación, Coparticipation, Institutions, Rule of Law, Corruption, Menem, Kirchner, Fernandez, Thesis, Honors Program, Capstone, The University of Georgia, Center for Undergraduate Research Opportunities

INSTITUTIONAL CAUSES OF ARGENTINA'S UNSUSTAINABLE
PUBLIC DEBT AND ECONOMIC INSTABILITY

by

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DEDICATION

I would like to dedicate this paper to my grandmother Marta Liernur, who has experienced first-hand Argentina's economic turmoil throughout her life and who represents all Argentine citizens who suffer the hardships caused by Argentina's public debt mismanagement.

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CHAPTER 1 INTRODUCTION

In 2001, Argentina, attempting to pull itself out of a deep recession which started in 1998, defaulted on \$130 billion dollars' worth of public debt, the largest of all sovereign defaults in history. Four years later, the Argentine government renegotiated its debt independently from the IMF and other international parties, offering bondholders a meager 30% of the original face value of the bonds. Despite having defaulted on its debt several times in the past, Argentina continues to amass unsustainable debt. One year after the restructuring, Argentina's public debt was already 64% of the nation's GDP (compared to the average public debt of 30% of GDP held by other developing nations). Unfortunately, solving Argentina's debt problems requires more than a simple change in economic policy. This paper finds that deeply rooted institutional deficiencies have led to Argentina's struggle with economic stability. In particular, corruption, absence of the rule of law, and the provincial-federal revenue-sharing system undermine any economic policies that may have proved successful in the absence of these institutional flaws. Without correcting these, Argentina will continue to experience crisis and amass unsustainable public debt.

Since the history of Argentina's debt problems highlights the inherent shortcomings of Argentina's system, which has undermined the nation's development, this paper is structured in a time-sequential manner. First, I consider Argentina's remote debt history, which puts into context the more recent struggle, and confirm the historical precedence of Argentina's struggles. Next, I review the corruption and debt mismanagement that occurred under President Menem,

considering how the deterioration of the fiscal accounts was affected by both the institutional flaws and the external shocks. Then I review the 2001 crisis, and address the institutional flaws in the economic and political structure. And finally, I examine Argentina's post-crisis recovery, the debt restructuring and the recent return of high inflation and debt growth. I finish by recommending that Argentina address its problems with the rule of law, property rights and fiscal discipline if it wishes to ensure economic growth and sustainable debt in the long run.

CHAPTER 2 HISTORY OF ARGENTINE DEBT

Argentina has struggled with debt management since before it was even a nation, defaulting on its debt with the City of London in 1828. Time has not improved Argentina's debt situation; rather, debt accumulation and default have been a part of its history. Although this paper will focus on the debt situation since the 1990s, this chapter will review earlier debt levels and defaults to put into perspective the 2001 crisis and default and emphasize the historical patterns in Argentine economic politics.

2.1 The Early Defaults and Crises

Much of the research on debt and default attempts to determine the role that past defaults have on current debt sustainability. The debt intolerance approach, presented by Carmen M. Reinhart, Kenneth S. Rogoff and Miguel A. Savastano, argues that defaults and debt crisis can be explained by a country's debt sustainability level or "debt tolerance" (2003, p. 1). Developing countries, they find, are especially subject to lower debt tolerance thresholds than developed countries. These thresholds are dependent on past default and inflation levels. According to Reinhart, Rogoff and Savastano, "Debt- intolerant countries tend to have weak fiscal structures and weak financial systems. Default often exacerbates these problems, making these same countries more prone to future default" (2003, p. 1).

Other literature, however, has argued that the past debt "sins" have little to no influence on the current risk of default. In their evaluation of the Argentine debt, Mario Damill, Roberto

Frenkel, and Martín Rapetti emphasize that the debt problem is not debt intolerance, but rather arises from a recent policy mistake, a mistake which may have been made before (2005, p. 33). Argentina, for example, should have had better risk valuation than other Latin-American debtors in the early Eighties, since it was the only country to fulfill all its financial obligations in the Thirties. However, Argentina defaulted in the early Eighties along with all the indebted Latin-American countries. In addition, Argentina was the only country to default in the Nineties. For this reason, Damill, Frenkel, and Rapetti argue that differences in the trade and financial integration paths led to the different vulnerabilities in each country. It is not the remote past defaults themselves that cause these vulnerabilities (2005, p. 32).

2.2 Debt Crises of the 19th Century

According to Eugenio A. Bruno, in 1824, the province of Buenos Aires took out large international loans from the City of London to finance its war for independence. Unable to maintain economic stability, the province defaulted on its debt just four years later, followed by the fall of the government.¹ Restructuring of the debt did not come until 1857, and immediately after, Argentina turned again to the international financial markets for loans. The debt incurred by these new loans quickly became excessive, and by 1873, after a fall in export demands, the nation was faced with another debt crisis. Although President Avellaneda evaded the pressure to default on the public debt with economic reform, the effects of the crisis were severe. Argentina turned to financing economic growth through debt again, in the 1880s, under Presidents Roca and Juarez Celman. Crisis ensued in 1890, and President Pelligrini, who preceded President

¹ The effects of the Latin-American defaults of this time had a devastating effect on the City of London, which was almost bankrupted as a result.

Juarez Celman after his fall during the crisis, was left to clean up the mess. Bruno furthermore finds that Argentina's inability to pay its obligations not only affected its economic stability but threatened the City of London. President Pelligrini avoided default, but further restructuring and adjustments were needed a couple years later to bring the debt down to sustainable levels (2006, pp. 362-363).

2.3 Debt Crises in the 20th Century

Argentina experienced relative debt stability in the years that followed the 1890s crisis, and met its financial obligations in the Thirties when other Latin-American countries defaulted. However, Argentina was far from having a thriving economy in the 20th century. In their review of Argentine debt, Rudiger Dornbusch and Juan Carlos de Pablo examine how Argentine performance rapidly declined in the 20th century. They consider that Argentina's standard of living, which was equal to that of the United States in 1900, was by 1950 only 41 percent of the U.S. standard of living, and by 1985 only 30 percent (1987, p. 3). Argentina's per capita income grew steadily from 1945 to 1975 at an annual rate of 1.7 percent, but fell from 1975 to 1985 at a rate of 1.7 percent. Inflation, moreover, did not fall below 100 percent at any time from 1970 to 1985, and rose past 1000 percent between 1975 and 1976 (1987, p. 4). Dornbusch and de Pablo furthermore note that total external debt did not fare better; under a military government, the debt steadily increased from 1970 on, reaching 19.0 billion dollars by 1979, up 240 percent from 1975 (1987, p. 5).

To its credit, the military government did not simply sit back and watch the worsening economic conditions. Martinez de Hoz, the finance minister from 1976 to 1981, implemented

financial reforms which aimed to open Argentina to the world capital market and liberalize capital markets. As a result, the black market premium, which by 1976 had reached 200 percent, fell to zero. When inflation failed to decline, de Hoz introduced a “tablita” in 1979, which announced the pre-fixed rate of exchange depreciation. This display of government commitment to disinflation was successful in reducing inflation below 100 percent by 1980, but the real exchange rate appreciated, leading to overvaluation. This overvaluation became so large by 1980 that financial markets began to expect depreciation, and lack of confidence in the government’s ability to continue with the current policy led to widespread capital flight. The capital flight which occurred 1979-80 furthermore created a situation where Argentina’s Central Bank, to sustain its exchange rate policy, borrowed dollars abroad, which were then bought by private speculators in Argentina and invested abroad. According to Dornbusch and de Pablo, this cycle created a system where foreign creditors lent the government money to finance capital flight which returned to the same creditors as deposits (1987, p. 9). Rudiger Dornbusch and Juan Carlos de Pablo identify the “mismanagement of exchange rate combined with an opening of capital account [as] the almost exclusive explanation for the massive debt accumulation” (1987, p. 9).

Argentina’s financial situation deteriorated in 1981 due to both the debt crisis abroad and the massive capital flight which occurred when the incoming administration failed to declare an exchange policy and depreciation seemed imminent. As Central Bank reserves declined and external debt increased, Martinez de Hoz was forced to abandon the “tablita” and depreciate the currency. Public debt, however, continued to rise in the following years. Damill, Frenkel and Rapetti believe that this debt increase was due to a rise in international interest rates, and the

absorption by the public sector of a large amount of private debt (2005, p. 42). Table 2.1 shows the debt growth from 1975 to 1985; during this time Argentina's debt to GDP ratio grew from 18.6 percent to 64.5 percent. Furthermore, the net debt to exports grew by 260 percent from 1975 to 1985. The largest increase in the net debt to exports ratio occurred between 1979 and 1982, growing by 420 percent, due largely in part to the 1981 crisis.

Table 2.1: Argentina's External Debt (1985 dollars , percent)

	1975	1978	1979	1982	1985
Total External Debt (USD)	7.9	12.5	19.0	43.6	48.3
Public	4.0	8.4	10.0	28.6	40.0
Reserves (USD)	0.6	5.8	10.1	3.0	6.0
Net Debt/Exports (%)	260	110	120	540	520
Debt/GDP (%)	18.6	23.9	30.2	60.3	64.5
Interest Payments/GDP (%)	0.7	1.4	1.4	2.4	5.7

Source: Dornbusch and de Pablo (1987, p. 5)

According to Damill, Frenkel, and Rapetti, no haircut to the debt was provided in the 1980s, and small relief to the public debt did not come until the Brady agreement in 1992-93. Argentina continued to amass debt in the years following the 1980s international credit contraction, due in part to a slowdown in output, but it did so at much slower rates (2005, p. 43). By the 1990s the debt began to grow again at a much faster rate. The following section considers how the economic policies of the Menem administration responded to this growth.

CHAPTER 3 SYSTEMS AND POLICIES: PRE-CRISIS

The Nineties marked a change in Argentina's economic policy and approach to economic stabilization. For the first time, Argentina showed a willingness to collaborate with the International Monetary Fund and implemented the so-called "Washington Consensus" reforms advocated by economists of the time. Unfortunately, the Menem administration's early accomplishments of curbing inflation and decreasing the public account deficit were short-lived. Hit by a series of external shocks, decreased export competitiveness and economic slowdown, Argentina's economy quickly spiraled into chaos and hit rock bottom in late 2001. The following section explores the institutional groundwork that led to the largest sovereign debt default in history.

3.1 Economic & Political Systems of the 1990s

When Carlos Menem became president in 1989, Argentina's economy was suffering from a decade of high inflation and stagnant growth. Early in his Presidency, Menem and his Minister of the Economy, Domingo Cavallo, implemented a series of economic reforms aimed at stabilizing the economy. These economic reforms consisted of two parts: exchange-rate stabilization and structural reform.

The first part of the economic reform was carried out by the Convertibility Plan in 1991, which hard-pegged the peso to the dollar at parity and required the Central Bank of the Republic of Argentina (BCRA) to back at least two-thirds of the monetary base with hard currency

reserves. In other words, for every peso on the street, the BCRA had approximately one dollar on reserve. Furthermore, the Convertibility Plan required Argentina to practice fiscal policy restraint. John Williamson explains how the Convertibility Plan, which set up the currency board, “stipulated a one-for-one parity between the Argentine peso and the US dollar and guaranteed the right to convert pesos at that rate, meaning that devaluation would require a new act to be passed by Congress” (Dhillon *et al.*, 2006, p. 379). In this type of system, the sovereign nation relinquishes control of its monetary policy in exchange for monetary stabilization. A hard peg also curbs inflation, as inflationary expectations are now tied to the foreign currency, in this case, the dollar. In addition, the nation can no longer finance its deficit by printing more money, and any budget deficit must be financed through more borrowing.

President Menem also reformed the Argentine economic structure through wide deregulation, trade liberalization, and privatization. Andres Gallo, Juan P. Stegmann and Jeffrey W. Steagall note that the widespread layoffs associated with privatization, and the fiscal restraint imposed by the currency board, created socio-economic hardships for most Argentines. However, the fear of a return to hyperinflation and the hope of economic recovery made them willing to temporarily bear the burdens (2006, p. 196). Improvements came early in the 1990s with a fall in inflation, GDP growth, and increased foreign investment. In addition, the Brady Plan, in 1992, brought the public debt down to manageable levels and opened up access to the capital markets once again.

The international community applauded President Menem for his stabilization program based on “Washington Consensus”-type reforms. Argentina was at this time the “poster-child” for IMF-style reforms, and received full support from the international community. This was

further encouraged when Argentina withstood the shock created by the Tequila effect and avoided devaluation. Despite the positive economic signs, however, behind President Menem's success lay the trail of corruption through which he had implemented his economic policies. Gallo, Stegman, and Steagall examine President Menem's threats to impeach Supreme Court Justices if they seemed likely to overturn his policies and his use of executive decrees to govern;

Menem could rely on an automatic majority whenever constitutionality of his economic policies was questioned, allowing him to implement unpopular measures. However, Menem's strong-arm tactics undermined the rule of law, a prerequisite to a well-functioning economy. This moved Argentina on to the fast track for political abuses that allowed the events of 2001 to occur (2006, p. 196).

This breakdown in the rule of law was further aggravated by the federal-provincial power struggle, which deteriorated Argentina's fiscal accounts and increased the public debt. The problem, unfortunately, lies in the structure of several of Argentina's institutions, and the federal-provincial relationship. To clearly understand this power struggle and how it affects Argentina's debt, one must also understand the revenue-sharing system.

As discussed by Kent Eaton, *coparticipación* (co-participation) was established in Argentina in 1934 when declining trade decreased the federal government's revenue, since it depended mostly on tariffs for its financing. This agreement between the provinces and federal government gave Congress the exclusive rights over certain taxes and promised the provinces a share of the collection (2001, p. 5). Eaton explains the weakness of the system as "something of a Faustian pact. Surrendering most tax authority to the federal government in exchange for a cut of the revenues it would collect undermined the autonomy and strength of the provinces" (2001,

p. 6). *Coparticipación* also weakened the connection between the provincial taxpayers and the government and left the provinces “fiscally dependent on the centre and therefore vulnerable to various sorts of manipulation” (2001, p. 6).

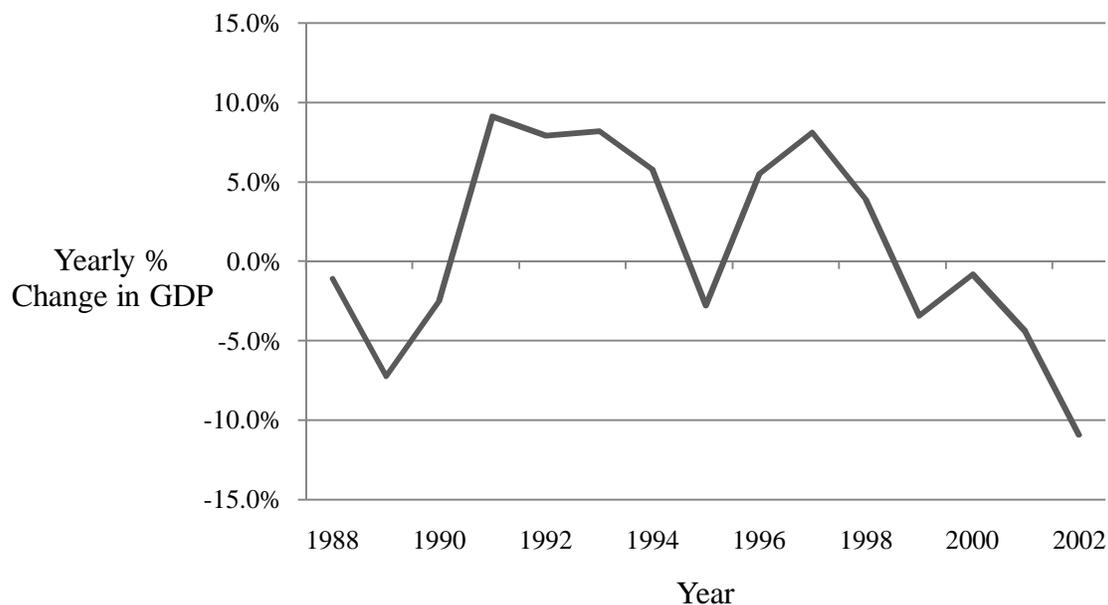
Because the Menem administration’s stabilization program required sufficient revenues to avoid budget deficits, it increased the need for the federal government to renegotiate the revenue shares promised to the provinces in the 1987 *Coparticipación* law. Eaton argues that this renegotiation proved possible thanks to Menem’s success in lowering inflation, and also the tax reforms which increased the size of the tax revenue pool (2001, p. 19). Menem could therefore increase the federal government’s revenue, but did so at the expense of the provincial budgets. In the following years, this worked to undermine the stabilization that the Menem administration worked hard to establish, as provinces were forced to borrow money to finance their spending. Although at first the Convertibility plan and the structural reforms seemed to indicate a turnaround in Argentina’s volatile economic history, it soon became clear that the foundations Menem laid down, with the IMF and the international market’s approval, were not very solid after all.

3.2 Argentina’s Economy in the 1990s

From 1991 to 1994 Menem’s economic policies were successful in balancing the public accounts, encouraging GDP growth, controlling inflation and opening access to the capital markets and foreign investment. In their review of Argentina’s debt, Damill, Frenkel and Rapetti distinguish three periods in the Nineties: 1991-94, 1995-97, and 1998-2001. During this first period they found that the average deficit decreased substantially from that of the Eighties, from

7 percent of GDP to less than 1 percent, “mainly due to an improvement of 6 points in the GDP in the national public sector balance result, from which 90% is explained by the primary balance result” (2005, p. 44). GDP also grew during the early nineties. Graph 3.1 shows the annual GDP percentage growth from 1988 to 2002. From 1991 to 1994 Argentina experienced GDP growth of 31 percent. In comparison to the 1989 negative GDP growth of 7.2 percent, GDP in the early nineties grew 9.1 percent in 1991, 7.9 percent in 1992 and 8.2 percent in 1993. Argentina’s banking sector gained credibility as well during this period. Lee Alston and Andrés Gallo argue that the increase of domestic deposits from 4 billion to 80 billion dollars, during the first half of the Nineties, indicates an increase in the banking sector’s credibility (Gallo, Stegmann, and Steagall, 2006, p. 196).

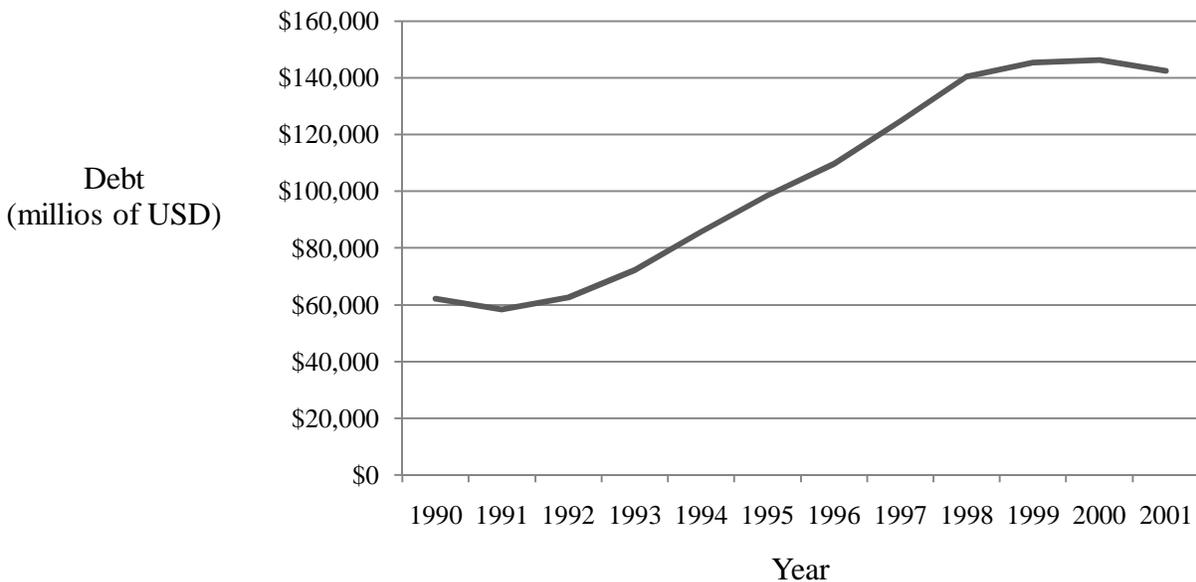
Graph 3.1: GDP Growth in Argentina 1988- 2002



Source: Banco Central de la República Argentina (BCRA)

The Brady Plan of 1993 opened Argentina’s doors once again to the foreign credit markets. According to Roque B. Fernández, et al., “Government liabilities with foreign banks that were in default were refinanced through guaranteed bonds...This agreement included extension of maturities, a reduction of interest rates, and a reduction of the principal” (2007, p. 14). Despite the Brady Plan’s restructuring of Argentina’s debt, Menem’s administration was not successful in controlling the level of public debt. Graph 3.2 shows the continual escalation of Argentina’s debt during the Nineties. From 1992 to 1997 the gross external debt almost doubled. Fernández et al. explain part of this increase by the social security reform of 1994, which switched from a pay-as-you-go pension system to a capitalization system, creating a growing need to finance the deficit through borrowing (2007, p. 15).

Graph 3.2: Argentina Gross Annual Debt 1990-2001



Source: Based on data from Gerardo F. Gambero (2003, p. 86)

Menem's reforms and the Convertibility Law were not long in place before they were put to the test by the external shock of the Mexican Crisis in 1995 and its "tequila effect." According to Domingo F. Cavallo and Jaocuin A. Cottani, Argentina's banking system lost 18 percent of its deposits in three months, resulting in a 4.4 percent reduction of output and an increase in unemployment (1997, p. 18). The tequila effect forced Argentina into a brief recession, but Argentina did not itself experience a crisis. Federico Sturzenegger and Jeromin Zettelmeyer note that after the tequila crisis, foreign direct investment in Argentina increased, creating high growth. However, they point out that "after a brief period of fiscal surpluses, budget deficits reemerged, mainly financed through debt" (2006, p. 168). Interestingly, Gallo says that Argentina's ability to avoid devaluation paved "the way for Menem's re-election in 1995" (2006, p. 196). According to Damill, Frenkle and Rapetti, Argentina also recovered from the recession mainly because of the IMF's financial aid package of approximately 11 billion dollars (2005, p. 46).

Over the next two years, the policy changes in 1994 further deteriorated the public finance. Damill, Frenkle, and Rapetti point to three main causes during this time. First, they argue that the pension reform contributed to considerable losses in the public subsystem. Second, they blame the recession associated with the tequila effect. And last, they find that the government's attempts to compensate for the negative effect of commercial opening and exchange rate appreciation, by lowering the tax burden on the tradable goods production sectors, further deteriorated the public finances (2005, p. 45). Confidence in the convertibility system continued at this time, however, at least among Argentine officials and the IMF. In 1997, for

example, Minister of the Economy Domingo Cavallo and Undersecretary of Finance Joaquin A. Cottani boasted in an article,

Today [May 1997], the Argentine economy is healthy again, recovering from last year's recession. GDP growth is expected to be 4 percent in 1996 and 6 percent in 1997, and inflation for the 12 months ending in November 1996 is practically zero. Having withstood the crisis, Argentina's monetary system looks much more solid and credible than before.

While unemployment is a problem, the Menem administration is determined to fight it the "old-fashioned way" (i.e., by introducing greater flexibility in labor markets) (1997, p. 18).

Despite the government's expectations of continued success, Argentina's economy soon showed weakness when it was hit by the external shocks of the Russian Crisis and South East Asian Crisis in 1997 and 1998. Moreover, Damill, Frenkle, and Rapetti argue that Argentina's financial condition was not very stable even before these shocks:

In spite of the rise in the current deficit and the disequilibrium in the social security system, the standard debt indicators did not suggest fiscal sustainability risk towards 1997, before the beginning of the depression. However, the debt ratio measured with the PPP exchange rate had already reach 60% of GDP" (2005, p. 46).

Argentina, in fact, was by no means prepared to handle the external shocks created by the Russian and South East Asian Crisis. These external shocks interrupted capital inflow and increased country risk, bringing Argentina once again into a recession.

Conditions further worsened with the Brazil crisis, as the devaluation of the *Real* hurt Argentina's export competitiveness. Falling GDP growth (see Graph 3.1) also deteriorated Argentina's public accounts. Table 3.1 shows that the debt to GDP ratio increased steadily from

1996, reaching 51.3 percent in 1999. The debt to export ratio also rose during the 1998-99 crisis, due partly to the fall in exports at this time, but also due to the continuing rise of external debt. In their study, Damill, Frenkel, and Rapetti calculated the public debt to GDP ratio using PPP exchange rates and found even more alarming rates of growth. In 1993, the debt to GDP ratio was 50 percent using the PPP exchange rate, rose to above 70 percent in 1999, and hit 80 percent by 2000 (2005, p. 44). By the time Fernando de la Rúa entered the presidency in 1999, Argentina's economy was on the brink of collapse due to the decade's combination of rigid monetary policy, deteriorated fiscal situation, and several external shocks. In just two years, Argentina went through several presidents, a currency and bank run, a too late devaluation, and the largest sovereign default in history.

Table 3.1: Debt Indicators 1996-2003

	1996	1997	1998	1999	2000	2001	2002	2003
Total External Debt (billions of USD)	111.4	128.4	141.5	145.3	145.9	136.7	132.3	142.5
Current Account Balance (billions of USD)	-6.9	-12.3	-14.6	-12.0	-9.0	-3.9	9.1	7.8
Debt/GDP (%)	40.9	43.8	47.3	51.3	51.3	50.9	129.7	110.0
Debt/Export (%)	467.9	485.8	535.1	623.4	554.8	515.8	514.8	481.4

Source: Economist Intelligence Unit

My analysis of the Argentine debt situation has thus far consisted of reviewing some of the political undercurrents and the economic policies that caused the debt crises in the remote past and set the groundwork for the recent crisis. The next chapter will focus on the specific

government reactions and policies transpiring during the 2001 crisis and how those affected Argentina's debt sustainability and the likelihood of long-term recovery.

CHAPTER 4 THE CRISIS OF 2001

It is unnecessary to argue the importance of Argentina's 2001 crisis; the enormous size of the default alone would be enough to justify interest. Add to that the global community's expectations of success of Argentina's Convertibility Plan and endorsements of its neo-liberal policies, and the crisis becomes a favorite subject of research. Much of that research is focused on explaining why the crisis occurred and then also explaining the default situation. In the previous chapter, I recounted the policies and events that brought Argentina's debt to unsustainable levels. These unsustainable debt levels, as well as the other economic factors involved, such as lack of economic growth, currency overvaluation and external shocks, are the most common and most reasonable explanation for the crisis. Since I have briefly reviewed the background, this chapter focuses on the government's role during the crisis, especially its instability and misconduct, to gain an understanding for the systems that affect Argentina's debt management.

4.1 Infringements on Property Rights and the Rule of Law

Argentina's 2001 crisis serves as a clear example of what occurs in a nation that does not have the strong institutional structure prepared to handle economic crises. The continual debt mismanagement and fiscal indiscipline of the Nineties, as well as the monetary restriction imposed by the Convertibility Law, created a situation which limited Argentina's policy toolset

and left it unable to deal with the external shocks and the recession. The worsening fiscal situation aggravated the situation, as it became evident that Argentina's debt levels were unsustainable.

At the beginning of his term, President de La Rúa passed the Fiscal Responsibility Law, promising to end corruption and bring the economy out of the recession while maintaining the currency board and Menem policies. Despite his early efforts to reduce the fiscal deficit and impose fiscal restraints, the worsening recession and the increase of the country risk due to falling credibility furthered the fiscal imbalances. De La Rúa and Minister of the Economy José Luis Machinea launched another program in December 2000 known as the "blindaje" (shield). According to Federico Sturzenegger and Jeromin Zettelmeyer, this program relaxed the limits of the Fiscal Responsibility Law and included substantial line of credit from multilaterals, bringing relief in the short run with a fall of country risk (2006, p. 170). This program, however, was unsuccessful in slowing down Argentina's deteriorating economic situation, and Argentina furthermore failed to meet the IMF-imposed fiscal targets in 2001.

Machinea resigned and was succeeded by Ricardo López Murphy, who took his own shot at resolving the fiscal imbalances. His approach was a modest \$2 billion expenditure cut, which would have been sufficient to ensure IMF support, according to Sturzenegger and Zettelmeyer, but was so politically opposed that Murphy was forced to resign after two weeks (2006, p. 171). Former Minister of the Economy Domingo Cavallo replaced him and set out to solve Argentina's problems through growth stimulation. Despite the special powers he received from Congress to implement the reforms for his growth stimulation plan, he was unable to achieve consensus for the fiscal adjustments.

De La Rúa's failure in bringing around economic recovery and preventing the crisis could be compared to trying to stop an avalanche from occurring after the necessary bombs are in place and ready to go off. As it was, de La Rúa and his various finance ministers were unable to ensure the necessary change and popular confidence needed to prevent at least some of the destruction of the economy. Before President de La Rúa's resignation at the end of 2001, Cavallo took several measures that would both anger the IMF and add to the popular discord that speeded up their exile.

The first of these acts was the "megacanje" (mega-swap), which extended the maturity dates of almost \$30 billion worth of government bonds. Andrew F. Cooper and Bessma Momani point out that this measure acted to erode investor confidence because Argentina never consulted with the IMF about this plan. The authors further explain the complexity of the situation, amid rumors that President de la Rúa might resign, domestic investor confidence dipped along with stock exchange prices and international credit agencies lowered Argentina's credit rating. IMF-Argentinean relations soured during this time as the Fund watched Argentina continue to announce policies that the IMF deemed 'misguided', although these initiatives were overtly approved out of fear of systemic collapse (2005, p. 308).

Argentina began experiencing a bank crisis in March 2001, as expectations of a devaluation and falling credibility of the Convertibility caused a bank run, which, according to Gallo, Stegmann and Steagall, "eroded 10% of deposits" (2006, p. 198). Fear of a mass bank run did not come until later, however, after Cavallo's attempt to promote growth and bring the debt to manageable levels was deemed impossible when the IMF and other international creditors refused to continue financing Argentina's debt.

With the beginning of a mass bank run in early December and the probable currency crisis that was to follow, the government froze all bank accounts in a program known as the *Corralito* (playpen). It is clear that this act trespassed on property rights, as depositors were unable to withdraw cash from their bank accounts. The IMF strongly disapproved of this measure, and especially disapproved of Argentina's continued refusal to cooperate with the Fund. But ultimately, it was the popular discontent and mass protests of the Argentine people that forced President de La Rúa and Minister Domingo Cavallo to resign.

Political turbulence continued as the interim President Rodríguez Saá lasted only enough to default on debt and declare the end of a neo-liberal economy, before being ousted for expressing his desire to block elections. Two one-day presidents were up next, followed by Eduardo Duhalde, who was appointed by Congress to finish de La Rúa's term. Duhalde, upon becoming President in January 2002, ended the currency board with the long-awaited devaluation of the peso.

4.2 Pesification and Social Welfare

Despite the default and devaluation, Argentina was still facing problems caused by the *Corralito*. To solve this banking sector problem, President Duhalde and Congress passed a decree which mandated the asymmetric *pesification* (peso-fication) of dollar-denominated assets and liabilities in the financial sector. Under this decree, all dollar deposits and loans to the public sector would be pesified at a rate of 1 dollar to 1.4 pesos, and all loans to the private sector at 1 dollar to 1 peso.

Since the fall of the devaluation and the currency board changed the official exchange rate, the peso was now worth around .33 dollars. *Pesification* thus hurt depositors, as every dollar deposit in an Argentine bank was now worth one peso, and likewise every dollar loan was now also worth one peso. For example, with the exchange rate of 3 pesos per dollar, this now meant that a depositor who had worked and saved 10,000 dollars now had 14,000 pesos in his or her bank account, the equivalent of approximately 4,666 dollars. Conversely, the *pesification* was beneficial to all debtors. Someone with a 30,000 dollar mortgage, for example, now owed only 30,000 pesos, or 10,000 dollars.

Gallo, Stegmann and Steagall explain, “The favoring of borrowers benefited the government, which had been highly indebted in the banking system. That is, the government bailed itself out” (2006, p. 201). Furthermore, they note that the government debt was 20.8 billion dollars and 1 billion pesos in December 2001, and after *pesification* in December 2002 was only 0.2 billion dollars plus 29.9 billion pesos (2006, p. 201). Table 4.1 shows the favorable change in current account balance from a negative 3,780 million dollars to a positive 8,720 million dollars. As GDP fell from 268,831 million dollars in 2001 to \$102,042 million in 2002, the surplus in the current account balance can best be explained by the default and decreased expenditures in social services. An overview of other economic indicators during the crisis can be found in Table 4.1. Table 4.2, likewise, gives an overview of the social situation before and after the crisis, (the complete tables from 1988 to 2007 can be found in the Appendix).

Table 4.1: Selected Economic Indicators: Argentina 1998-2003

	1998	1999	2000	2001	2002	2003
Total GDP (millions of USD)	299,098	283,665	284,346	268,831	102,042	129,596
GDP measured at PPP	340,100	333,557	337,936	330,908	299,981	333,253
Real GDP Growth (% growth)	3.9	-3.4	-0.8	-4.4	-10.9	8.8
Trade Balance (millions of USD)	-4,944	-2,200	1,061	6,223	16,660	15,732
Exports	26,434	23,309	26,341	26,543	25,650	29,566
Imports	31,377	25,508	25,280	20,320	8,990	13,834
Annual Rates of Inflation (%)	0.9	-1.2	-0.9	-1.1	25.9	13.4
Budget Balance (millions of USD)	-4,150	-8,130	-6,821	-8,744	-1,131	154
Current Account Balance						
(millions of USD)	-14465	-11910	-8955	-3780	8720	8065
(% of total GDP)	-4.8	-4.2	-3.1	-1.4	8.5	6.2
Unemployment (in thousands)	1,950	2,207	2,420	2,879	3,375	2,687
Foreign Direct Investment						
Inflows (millions of USD)	7,291	23,988	10,418	2,166	2,149	1,652
Outflows (millions of USD)	2,326	1,730	901	161	-627	774

Source: Data from Global Market Information Database

Table 4.2: Selected Social Welfare Indicators: Argentina 1998-2003

	1998	1999	2000	2001	2002	2003
Gross Annual Income per capita (USD)	2,210	2,047	2,012	1,877	1,976	2,404
Population living on less than \$2 a day (%)	10.4	-	-	14.3	-	23.0
Population living on less than \$1 a day (%)	-	2.0	-	-	3.3	-
Economically Active Population (in thousands)	15,269	15,726	16,131	16,624	17,192	17,538
Employed Population (in thousands)	13,320	13,519	13,712	13,745	13,817	14,851
Unemployed Population (in thousands)	1,950	2,207	2,420	2,879	3,375	2,687
Government Expenditures (millions of USD)						
on general public services	11,443	13,449	14,228	14,469	7,839	9,457
on social security and welfare	23,178	23,292	23,381	22,020	7,661	9,533
on other community/social services	132	115	100	65	36	51
on economic services	3,106	2,807	2,266	2,173	1,031	1,994

Source: Data from Global Market Information Database

Thus far, this paper has concentrated on the state of the Argentine economy without giving much thought to the people who were most affected by it. The effect of the crisis on the socio-economic welfare of Argentine citizens, however, cannot be overlooked with the same indifference. As Table 4.2 shows, 23 percent of the Argentine population was living under the international poverty line of 2 dollars a day, double the percentage of poverty in 1998. The crisis also increased the unemployed population, though the number of employed population slightly increased from 2001 to 2002. The most likely explanation is that the loss of the head of the household's job forced other family members to enter the workforce, thus increasing the number of people desiring work. Additionally, there was a drop in the gross annual income per capita in 2001 and 2002, which was recovered by 2003. It should be noted that in this case, the increase of the gross annual income did not signify an increase in the overall socio-economic welfare of Argentines; the increase in the poverty rate clearly suggests otherwise.

The default itself created losses to Argentines, according to Sturzenegger and Zettlemeyer, as about 60 percent of the defaulted debt was held by Argentine citizens (2006, p. 182). Still, Congress celebrated the default as a victory. Further losses by Argentines include the losses due to the double-digit inflation in 2002, the reduced government expenditures and the loss of savings. Inflation, which had dropped dramatically during the Nineties, reached 25.9 percent in 2002, and stayed in the double digits in 2003 (Table 4.1). Also, in 2002, government expenditures on public services, social security, community services and economic services were cut by more than half. Despite the severe negative effect the crisis had on most Argentines, others, including the government itself, actually benefited from some of the policies of the crisis.

The government gained directly from the *pesification* and default, in three ways. First, the asymmetric *pesification* reduced the amount the government owed. Second, the default stopped all foreign transfers and freed up revenue for internal use. Finally, Gallo, Stegmann, and Steagall argue that default also facilitated the accumulation of reserves in the Central Bank, as they were not used to pay for debt service (2006, p. 202).

Others gained during the crisis also, including exporters, as well as middle- and upper-class debtors. Exporters gained from the increased competitiveness of their products in the foreign markets due to the devalued peso. By 2003, exports had recovered the losses from the late Nineties and were steadily increasing. Moreover, the negative trade balance of the Nineties contrasts with the high positive trade which began in 1999, reaching its height of 16,660 million dollars in 2002, and remaining positive since then. However, this peak was mostly due to a sudden drop in imports, due to the devaluation, and not to any extraordinary increase in exports that year. Nevertheless, since the devaluation, exports have been increasing steadily (see Table 4.2, and the Appendix). Likewise, the middle- and upper-class debtors gained from the *pesification*, as many had savings outside the Argentine banks and were able to benefit from the *pesification* of their debts. I follow with an example of how an individual may have gained directly as a result of the *pesification* policies.

For illustrative purposes, I will invent a fictional Argentine citizen called Juan, based on Carlos Escude's example (2004, p. 2). Like most upper-middle-class Argentines, Juan knew the risk of saving money in a local bank, and therefore kept most of his dollar savings in a safe, and the rest abroad in a Swiss bank. In December 2001, he still owed a mortgage on his apartment in Buenos Aires, of 43,200 dollars and credit card debt from his shopping trip to Miami of 3,000

dollars. Notice how Juan benefits when the asymmetric *pesification* occurs. Juan can now take some of his dollar savings from his safe, convert 3,000 of those dollars to 4,200 pesos (at the official exchange rate of 1.4 pesos per dollar), pay off the credit card and pocket the remaining 1,200 pesos. A few months later, Juan notices that the dollar is now worth 3.60 pesos in the market. So again, he takes 12,000 dollars from his savings, maybe withdrawing from his Swiss account, which still has the value of the dollar amount he deposited, converts the dollars into 43,200 pesos and pays off his entire mortgage. The 43,200 dollars he owed before the crisis were 43,200 pesos after the crisis or approximately 12,000 dollars. Note that Juan's pure gain was paid for by an equivalent loss by the bank and the credit card company.

The analysis of the Argentina's *pesification* and the social distress of the crisis would not be complete without further examining the losses incurred during the crisis. The lower class and lower middle class suffered heavily during this crisis, as they faced political uncertainty, a fall in the real value of wages, high inflation, loss of savings and unemployment. In addition, they could expect little relief from the overwhelmed government or from foreign relief, as the IMF and others stopped supporting Argentina in 2001. During this time emerged what are called the *cartoneros* or cardboard collectors. These working-class people were forced into poverty in the crisis and turned to collecting scraps from the Buenos Aires streets for survival. This class, unfortunately, still exists today. The population outside Buenos Aires likewise suffered deteriorating conditions, especially as the provincial government struggled to pay wages during the crisis and emitted several quasi-monies.

The asymmetric *pesification* not only affected the general population but also deteriorated the books of the local banks and creditors. According to Jose M. Fanelli, in 2003

banks were claiming 12 billion dollars as compensation for the *pesification* that had created a gap between the value of their assets and their liabilities (2003, p. 61). Eventually, Sturzenegger and Zettlemeyer note, the banks which decided not to litigate were compensated with approximately 9 billion dollars of government bonds. Investors who lost in the *pesification*, in contrast, took legal action against the government. According to the authors, loan holders of about 3.65 billion dollars returned to the defaulted foreign currency bonds. In contrast, investors holding about 16.3 billion dollars of “pesified loans,” who took legal action against the government, saw the loans “redollarized” in 2003 (2006, p. 183).

In his analysis of what he calls the parasitic state, Carlos Escudé explores the phenomenon of recurring corruption patterns. He explores Argentina’s political and economic history and compares Argentina’s debt to that of India, and Argentina’s foreign relations, especially the IMF, to those of Russia. Escudé argues in this manner that Argentina is a parasitic state which feeds off the wealth of others, and is ruled by a “delinquent political class.” According to Escudé, the asymmetric *pesification* was meant to benefit companies that were heavily indebted with the banks in Argentina, and not the middle-class debtors (2004, p. 3). Furthermore, he compares this to the absorption of private debt which occurred both under the military government of Domingo Cavallo and during the democratic government of Raul Alfonsín. This example suggests that Argentina’s struggle with economic stability and debt management stems from inherent institutional flaws.

A thorough review of Argentina’s crisis has revealed the infringements on property rights and the rule of law that occurred during this time. The next chapter will explore the

government's involvement in bringing around economic recovery, the debt restructuring and also the debt growth.

CHAPTER 5 RENEWED DEBT GROWTH: POST-DEFAULT

Deep as the Argentine economy fell during the 2001 crisis, the devaluation and the stalled debt service payments allowed the economy to recover quickly. In May 2003, Nestor Kirchner, supported by the incumbent President Duahde, was elected president. Early in his tenure he was strongly supported by Argentines for his internally focused agenda and his defiance of international creditors. Furthermore, his approach in dealing with private creditors allowed the economy to rebound quickly, and ensured his wife's election as president in 2007. This chapter will review the post-crisis and default situation considering the likelihood of long-term growth and economic health through an inspection of Argentina's current institutions, the debt restructuring and the debt growth.

5.1 Economic Recovery

Soon after the devaluation and the default, Argentina's situation began to look more promising. Table 5.1 shows the positive turn of the current account balance in 2002 and the continuation of a positive balance in the following years. GDP grew significantly after the crisis, increasing by 8.8 percent in 2003, up from the negative 10.9 percent of 2002. Growth remained fairly consistent until 2007, reaching a height of 9.2 percent GDP growth in 2005. In addition, in the immediate years following the crisis, inflation fell to the single digits. During 2002, inflation reached its highest point since 1991, at 25.9 percent, but fell to 4.4 percent and 9.6 percent in

2004 and 2005 respectively. With the subsequent rise of inflation in 2006, however, the Argentine government simply changed the methodology for calculating inflation, instead of adjusting any monetary policies (see section 5.5).

Table 5.1: GDP Growth, Inflation and Current Account Balance

	2001	2002	2003	2004	2005	2006	2007
Real GDP growth (% growth)	-4.4	-10.9	8.8	9	9.2	8.5	8.7
Annual rates of inflation (% growth)	-1.1	25.9	13.4	4.4	9.6	10.9	8.8
Current Account Balance(% of total GDP)	-1.4	8.5	6.2	2.1	2	2.5	1.1

Source: Data from Global Market Information Database

Argentina was able to recover from the crisis for several reasons. First, the devaluation allowed an increase of the exports and also benefited the import competing industries, helping to balance the current account. Second, according to Gallo, Stegmann, and Steagall, Kirchner contained inflationary pressures by freezing utility tariffs (2006, p. 207). The debt restructuring likewise ensured economic recovery, as the public obligations were significantly reduced. Sturzenegger and Zettlemeyer note that the low interest rates during the restructuring were due to the extremely favorable international liquidity environment and allowed the very large reduction of Argentina’s public debt (2006, p. 196). Another factor which allowed Argentina to recover was that commodity prices increased and world and regional growth resumed, allowing very favorable trade conditions, as noted by Sturzenegger and Zettlemeyer. These authors moreover note that “inflation stabilized at low values in 2003 and 2004. The more stable macroeconomic environment stimulated a strong recovery of economic activity” (2006, pp. 196-197). Though Argentina did recover quickly from the crisis, several trespasses on the rule of law threaten the future sustainability of this recovery. These will be reviewed in the subsequent sections.

5.2 Manipulation of the Supreme Court

As often happens when private interests are hurt, those who lost due to the policies of the crisis turned to the judicial system to set wrongs right. Among these was a claim against the government relating to the deposit freeze of the *Corralito*. According to Sturzenegger and Zettlemeier, in January 2002, the Supreme Court gave its decision of the *Smith v. Poder Ejecutivo* case, finding that the transitory suspension of property rights was justified during an “economic emergency” but that the arbitrary or permanent denial of those rights was unconstitutional. This ruling gave a legal basis for depositors to withdraw dollar-denominated deposits at the market rate instead of the *pesification* rate of 1.4 pesos per dollar. The deposits withdrawn as a result of this ruling caused liquidity problems which forced the BCRA to give banks liquidity and increase the interest rates on the peso (2006, pp. 185-186). Congress therefore decided to solve this problem in a way that severely threatened the rule of law. Gallo, Stegmann, and Steagall explain that the government was so outraged by the Court ruling that they threatened to impeach the Justices. In addition, Congress passed a law which stopped the withdrawal of the banks’ funds. As a consequence, the Court overturned its ruling of the unconstitutionality of the *Corralito*. Despite this flagrant corruption, only one Justice resigned (2006, p. 202).

As was briefly mentioned in Chapter 3, Menem interfered in the Supreme Court and placed Justices loyal to him to guarantee an automatic majority of the court. Kirchner, likewise, adjusted the Supreme Court to his liking. His government was able to end Menem’s majority in the Court in 2004 by impeaching two Justices and forcing two others to resign. This effectively ended the debate about the constitutionality of the *Corralito* and *pesification*. According to

Gallo, Stegmann, and Steagall, “The resultant perception of a less independent Supreme Court has increased uncertainty over whether the rule of law can protect investors” (2006, p. 202). Furthermore, they note that “the new court has supported the government’s resolutions of issues such as the *Corralito*, the renegotiation of existing privatization contracts with owners, the measures of necessity and urgency that prohibited evictions and protected debtors, etc.” (2006, p. 208). Unfortunately, manipulation of the Supreme Court is not the only tactic the Kirchner administration has used to achieve its political ends. The federal-provincial relationship similarly demonstrates the political problems that have long undermined Argentina’s economic growth and stability.

5.3 *Coparticipación: The Federal and Provincial Revenue-Sharing System*

The federal provincial revenue-sharing system, *coparticipación*, which was introduced in Chapter 2, is central to the discussion of fiscal mismanagement. Mainly it is the instability of the *coparticipación* terms, which the federal government changes as it pleases, which affects Argentina’s ability to practice fiscal discipline. *Coparticipación* has caused two major problems in Argentina, of which only the second will be discussed in depth. The first problem is the dependence of the provinces on the federal government for any revenue, which allows political manipulation. And the second problem is the imbalance in provincial budgets, due to the varying terms of the *coparticipación* system and revenue uncertainty in the provinces. The provinces have turned to other funding during the crisis, for example, including emitting quasi-currencies and also provincial bonds. Though these measures solved provincial deficits in the short term, they have contributed to the growth of the total public debt in Argentina.

The political struggle between the provinces and the federal government played a large role in delaying action and the implementation of programs that may have lessened the severity of the crisis. According to Gallo, Stegmann and Steagall, the political confrontation between the two governments worked to accelerate the crisis; they argue that “this political disunity was the main reason for the government’s continuing mismanagement of the economy and its inability to impose fiscal restraint in the immediate aftermath of the crisis” (2006, pp. 200-201). During the crisis this disunity affected the public accounts severely, as the government could not reduce its spending. Sturzenegger and Zettlemeyer explain that the provinces financed their increasing deficits through bank loans and bonds backed by a tax guaranteed. However, by July 2001, the debt consumed most of the provinces’ residual resources (2006, pp. 174-175). Moreover, in 2002, the provinces were no longer able to pay wages and turned to emitting quasi-currencies to meet their financial obligations. These quasi-currencies, which amounted to 25 percent of the total monetary base, reflect the problems between the federal and provincial governments, according to Gallo, Stegmann, and Steagall. They also point out that these problems were worsened by the lack of any long-term agreement on tax sharing. Gallo, Stegmann and Steagall further emphasize that “there are still no rules governing revenue- or responsibility-sharing between the federal governments and the provinces” (2006, p. 201).

The result of the lack of coordination, or lack of cooperation, between the provincial and federal governments, contributed greatly to Argentina’s debt problems and its economic stability. In fact, Gallo, Stegmann and Steagall argue that the currency emissions contributed to the fall of the peso’s value in March 2002 to 4 pesos per dollar (2006, pp. 201-202). Eventually the federal government was forced to deal with the provinces’ debt and according to Damill, Frenkel, and

Rapetti, absorbed 9.7 billion dollars of bank debts from the provinces. The federal government also assumed 2.4 billion dollars in losses from the quasi-currencies. However, this bailout came with a cost, as these notes were exchanged for the provincial bonds, and the rescue from the currencies was absorbed by the federal government in exchange for a proportion of the future flow of national tax resources to the provinces (2006, pp. 67-68). In other words, the government absorbed the provincial losses, but reduced their future share of tax revenue.

Unfortunately, in the years since the crisis, provinces continue to accrue debt. According to *Calling the Shots*, Argentina's largest province, the province of Buenos Aires, which accounts for 32 percent of Argentina's GDP and 40 percent of its population, offered its bondholders a restructuring deal in 2005 following the national government's restructuring offer (2005).

Despite the restructuring, the province of Buenos Aires still holds the largest amount of provincial debt. According to Chloe Hayward, this may be because Buenos Aires collects 40 percent of the total tax revenue, but receives only 22 percent of the funds through *coparticipación* (2007). Another province which has seen a growth in debt is Córdoba. In fact, *Desafíos Fiscales* notes that Córdoba experienced a growth of more than 745 percent of its debt between 1998 and 2006, and a per capita debt of 2,478 pesos as of December 2006 (2007). Furthermore, *Desafíos Fiscales* points out that Córdoba's debt service was 13.6 percent of the province's current revenue in 2007, compared to the 8.3 percent in 1999 (2007).

Since this year, the Kirchners have shown no attempt to improve the provincial fiscal situation. According to *El Presupuesto 2009*, the provinces will be receiving only 24.8 percent of the total revenues in 2009. Furthermore, this share size is the smallest of the last 50 years' shares and down 10 percent from the last agreement. *El Presupuesto 2009* furthermore argues that this

low revenue received by the provinces will make them even more dependent on the national government. Moreover, the federal government often transfers additional funds to the provinces for specific programs, such as education; however, these transfers are ruled by no law and are completely given at the discretion of the federal government (2008).

The instability of the federal and provincial government relationship and of the *coparticipación* system has had a significant part in aggravating the Argentine debt problem. Despite this, there have been no moves to improve either coordination or commitment between the two governments.

5.4 Debt Restructuring and Multilateral Debt Repayments

A couple months after entering the Presidency, Kirchner began renegotiating with the IMF on its defaulted loans. The IMF agreed to roll over the debt during the next three years but gave no additional funds to Argentina at this time. A couple months later, in September 2003, Argentina delineated a debt restructuring proposal known as the “Dubai guidelines” which would impose a 75 percent haircut on the defaulted debt. In addition, the restructuring under this proposal would not pay past due interest. Creditors strongly opposed Argentina’s preliminary proposal based on Argentina’s capacity to present a better offer. Sturzenegger and Zettlemeier note that the proposal stimulated an increase of litigation against Argentina; however, the enforcements of the judgments against Argentina were unsuccessful due to the difficulty of finding attachable assets (2006, p. 187).

Over the next few months, the government adjusted the Dubai proposal and presented a new restructuring proposal that was meant to be more attractive to creditors. According to

Damill, Frenkel, and Rapetti, the eligible debt under the new “Buenos Aires proposal” totaled 81.8 billion dollars and would be exchanged for new bonds totaling 38.5 billion dollars if the acceptance of the swap was lower than 70 percent, or the new bonds would total 41.8 billion dollars if the acceptance rate was higher than 70 percent. Like the Dubai agreement, this exchange would not recognize past due interest (2005, p. 71). The outstanding bonds were to be exchanged for three different types of bonds: par bonds, discount bonds and quasi-par bonds. Each bond had a different write-off value and coupon rate, but all three bonds would begin paying interest at the formal issue date of December 31, 2003. In addition, each bond carried with it a GDP growth-linked coupon. These unities would begin distributing 5 percent of any GDP growth, above a 3 percent GDP growth base, in 2006. According to Sturzenegger and Zettlemeyer, this “kicker” was initially valued at two cents on the dollar, but as the economy recovered and discount rates decreased, the net present value estimates increased to above eight cents on the dollar by 2006 (2006, p. 190). The falling international discount rates worked in favor of Argentina’s offer in late 2004, and increased the net present value of the new bonds, Damill, Frenkle, and Rapetti argue. The authors note the initial calculation of the bond value was 20 to 27 cents on the dollar, and later the bond value rose to 30 and 35 cents on the dollar (2005, p. 73). The bonds also seemed more favorable due to several contractual features, including the “most favored creditor” clause, which allowed participating creditors to participate in any future exchange offers and ensured that holdouts would not receive a better offer, and collective action clauses.

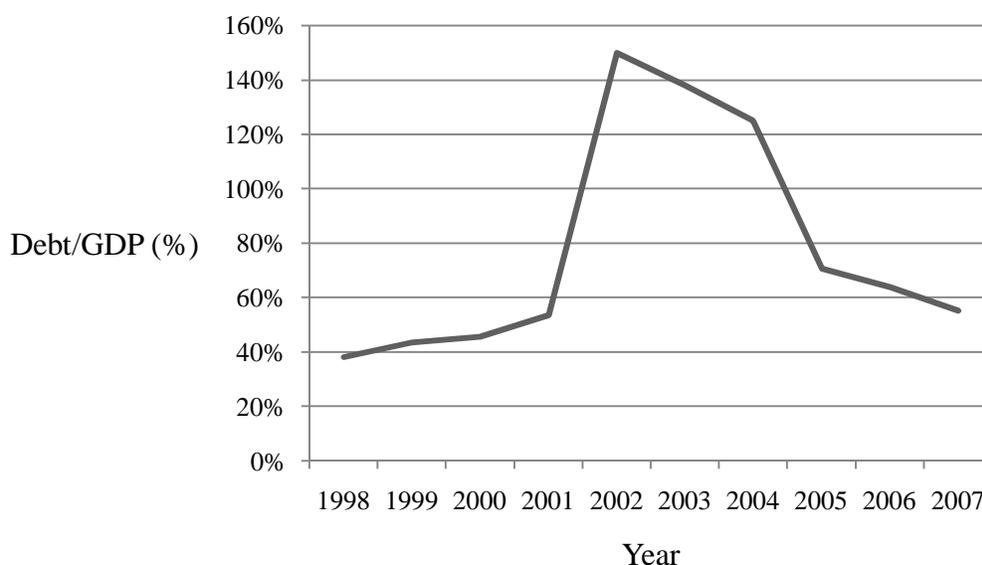
The large haircut that the bonds entailed put in question the acceptance rate of the restructuring deal. Despite the numerous lawsuits against Argentina, and Argentina’s

unwillingness to cooperate either with private creditors or with multilateral creditors like the IMF, Kirchner did in the end successfully restructure Argentina's public debt. Several things worked in Argentina's favor. In their analysis of the debt swap, for example, Dhillon et al. find that the length of time that the debt restructuring took was beneficial to Argentina's position. The time lapse allowed creditors to see improvements in the economic condition for settlement, increasing the size of the pie that they would share. But it also allowed Argentina the first-mover advantage, as creditors realized that any counter-proposals would signify an even longer delay in settlement, according to Dhillon *et al.* (2006, pp. 384-389). Argentina also took care to cover up a legal loophole in the "most favored creditor" clause, according to Sturzenegger and Zettlemeyer, which prevented the government from entering into any agreements with holdouts in the future, whether judicial, extrajudicial or private, and boosted participation among foreigners (2006, pp. 192-193). These authors also note that before the offer opened, the Argentine government reached a deal with eleven local pension funds. These pension funds traded 16.2 billion dollars in bonds and dropped their lawsuits against the government in exchange for slightly better terms than offered to other creditors and permission to value the new bonds at face value, thus protecting them from sharp accounting losses. The deal with the pension funds also gave the government a 20 percent head start in the restructuring participation (2006, p. 191). On November 1, 2004, Argentina presented its final offer, which opened on January 12, 2005, and closed on February 25.

Kirchner's restructuring was indeed successful. The acceptance rate reached 76.15 percent, meaning that 62.3 billion dollars of bonds were exchanged for 35.3 billion in new debt. Sturzenegger and Zettlemeyer find that there was "two-thirds participation outside Argentina

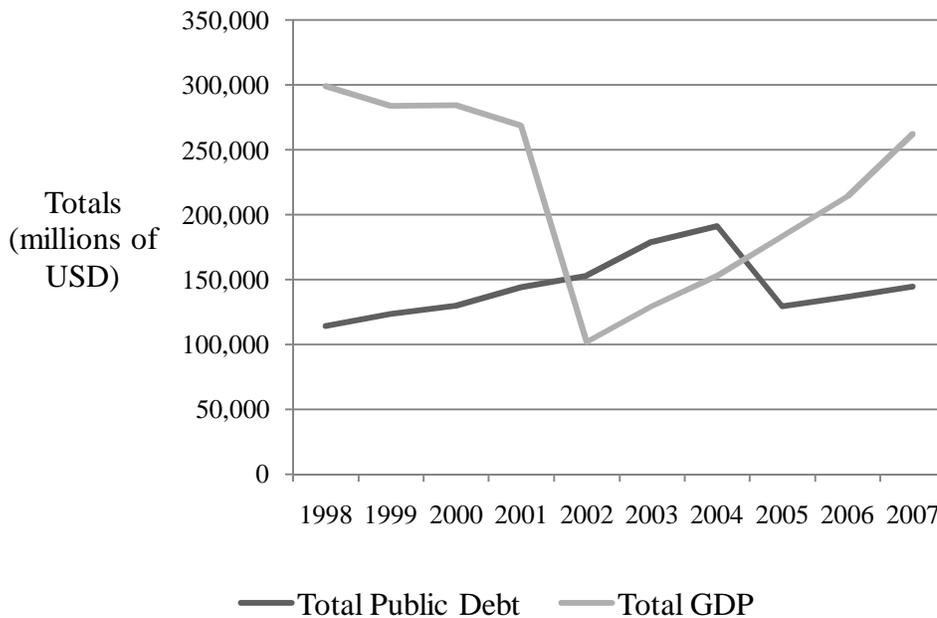
(with estimated participation of about 63 percent among foreigners and 90 percent among Argentine citizens) and 98 percent inside Argentina (100 percent for pension funds, banks, and other institutional investors, and about 91 percent for retail bondholders)” (2006, p. 192). These authors furthermore note that the average haircuts of the bonds were about 71 to 75 percent of the face value (2006, p. 193). Finally, Damill, Frenkel, and Rapetti argue that the restructuring reduced the public debt stock by 67.3 billion dollars and “attenuated the public finances’ exposure to currency risk, since around 44% of the new bonds are denominated in local currency” (2005, p. 74). The restructuring entailed quite a relief on Argentina’s public debt; however, it did not eliminate Argentina’s large debt burden. Graph 5.1 shows that Argentina’s debt to GDP ratio reached 150 percent in 2002 before falling significantly in the following years, and reaching 50 percent in 2007. Total debt levels, as can be seen in Graph 5.2, fell with the restructuring efforts in 2005 to pre-crisis levels, but increased in both 2006 and 2007.

Graph 5.1 : Debt to GDP Ratio: 1998-2007



Source: Data from BCRA

Graph 5.2: Total Debt and GDP: 1998-2007



Source: Data from BCRA

In January 2006, Argentina finally canceled its outstanding debt with the IMF of 9.8 billion dollars, following a similar move from Brazil. The article *Néstor Unbound*, argues that this move saved Argentina interest payments and also ended the IMF's freedom to meddle in Argentina's policies. However, the article pointed out that Argentina would likely have to issue bonds at higher interest rates to compensate for the payment (2005). In fact, Gustavo Stok notes that Argentina would still need 2.3 billion dollars in 2006 after cancelling its commitment with the IMF to compensate for the deficit (2006, p. 47). For financing, President Kirchner turned to Venezuela's president Hugo Chavez, who bought 4.7 billion dollars of Argentine bonds paying interest of almost 11 percent and resold them immediately. Gustavo Stok points out the way in which the IMF debt was repaid. To withdraw the reserves to pay off the debt, Kirchner modified the restrictions on the Central Bank reserve withdrawals through a decree (2006, p. 47). This

displays a lack of independence from the Central Bank and further attests to the weakness of the rule of law in Argentina.

5.5 Number Tampering and the Paris Club

By 2007, President Nestor Kirchner had pulled Argentina out of the crisis and had successfully restructured the public debt. However, inflation, which had remained at low levels since the crisis, began to rise at this time. With elections looming, the government took a rather corrupt approach to reducing inflation numbers. Instead of changing any economic policies to control inflation, it simply manipulated the inflation numbers. January 2007, the government replaced the head of the consumer-prices section of the National Statistics and Census Institute (INDEC) with Beatriz Paglieri. According to *Cooking the Books*, Ms. Paglieri changed the INDEC's methodology for calculating the inflation index. It dropped prepaid health-insurance policies, whose average cost rose 22% that year, from the index and changed the sample of tourism companies. These measures reduced the inflation rate of January 2007 by 0.8 of a percentage point. The article furthermore notes that if the government wished to reduce the real inflationary rate, it would have to curb public spending and allow interest rates to rise and the peso to appreciate (8 Feb 2007).

Later that year, Kirchner's wife, Cristina Fernández de Kirchner, ran for the Presidency in his stead. By promising the continuation of Argentina's growth and with no real opponents running for the position, she won the election with a large majority. Though she has kept most of the policies of her husband, Argentina is far from having the prospering economy that existed under him. The article *Cristina in the Land of Make-Believe* points out that unofficial inflation

estimates in May 2008 had reached 25 percent, while the INDEC claims 9 percent inflation. Furthermore, independent estimates calculated that the poverty rate was 27 percent in 2006 and 30 percent in 2007, with 1.3 million Argentines descending into poverty in 2007 (2008). *Cristina in the Land* also points out that there are no longer any official calculations of the poverty rate, as the INDEC stopped releasing poverty figures in 2006 (2008). President Fernández also contributed to the manipulation of the inflation numbers. According to *Hocus-Pocus*, the INDEC's methodology was changed in June 2008 and required the removal from the index of any product whose price rose too quickly, with the reasoning that consumers would no longer be buying that product (2008). In addition, the article notes that the inflation number manipulation saved the government around 500 million dollars in 2007 on its inflation-protected bonds but angered foreign investors (2008).

In September 2008, President Fernández announced that Argentina would finally cancel its debt of 6.7 billion dollars, which it had defaulted on, with a group of western creditor nations known as the "Club of Paris." According to Jude Webber, that same month Argentina also began negotiations for a new offer from Barclays Capital, Citibank and Deutsche Bank that would allow Argentina to enter the capital markets again, for the first time since the default (12 October 2008). With heavy debt servicing becoming due in 2009, President Fernández had an incentive to befriend foreign creditors. However, a month later, when the global financial crisis was well underway, Argentina decided to delay the debt repayment. President Fernández will most likely wait until the global financial situation promises opportunities for further financing before it cancels any of its outstanding debt.

5.6 Nationalization of the Private Pension Funds

By October 2008, President Cristina Fernández's plan to repay the Club of Paris and renegotiate outstanding debt was long forgotten and replaced by worries about heavy upcoming debt payments in an electoral year. According to Joaquín Morales Solá, 5 billion dollars of Argentina's debt would be due in the following 18 months; however, neither Néstor Kirchner nor other ministers expressed any inclination to reduce public spending. To compensate for the upcoming cash shortages, the Kirchner administration began to refinance guaranteed loans and increased tariffs on Brazilian and Chilean products (2008). Despite these measures, Argentina was still likely to face financing difficulties during the global credit crisis. To prevent possible default in the future, President Fernández proposed a bill in late October that would nationalize the private pension fund (Administradora de Fondos de Jubilaciones y Pensiones or AFJP), with the justification that this action protected those funds from market uncertainty. According to Matt Moffett, the private pension funds, valued at around 30 billion dollars with future contributions of 4 to 5 billion dollars a year, would bring much needed cash into state hands (2008).

The AFJP system allowed workers to contribute to their retirement in individual capital funds and would receive these savings and their earnings upon retirement. Unlike the public social security, these private pension funds would be payable to the contributor's family, in the case that the worker died before retirement. Ramón Indart and Germán Angeli argue that the nationalization of the private pension fund conflicts severely with private property rights and is based on false arguments. First, they reason that since the private funds are returned to the same workers that contributed to the funds, they are private property, unlike the public funds which are

pooled together and then paid out to the current retirees (2008). Indart and Angeli also discuss Legislator Patricia Bullrich's argument that the hereditary nature of the private pension funds makes these funds private property. In addition, constitutionalist lawyer Gregorio Badeni's view that the Kirchner's pension plan violates the rights acquired by workers with the capitalization system because the funds are individual. Since the funds are individual, pooling them with the public funds is evidently infringing on personal property (Indart and Angeli, 2008).

Despite the blatant infringement on personal property rights that the nationalization of the AFJP private pension funds entails, the conversion is likely to occur soon. It is then only a matter of time before President Fernández and her husband Néstor Kirchner access those funds to maintain their current level of spending and splurge in the 2009 elections. Unfortunately, the easy cash from the private pension funds will contribute to the increasing disincentives that exist in Argentina for hard workers. In addition, the tariffs imposed to raise revenue and other measures are likely to result in retaliation from Argentina's trading partners and in the deterioration of those relationships.

CHAPTER 6 RECOMMENDATIONS

Argentina's turbulent economic history and the mismanagement of the economy and the public debt can be explained by corruption, the federal-provincial relationship and the general absence of the rule of law. The slowdown in Argentina's miraculous economic recovery furthermore highlights the inherent flaws of Argentina's institutional system. These flaws can be characterized as three main problems: failure in the rule of law, violation of property rights, and fiscal indiscipline. Without ensuring the establishment of a rule of law, guaranteeing property rights, and practicing fiscal discipline, Argentina will continue to struggle with its debt management. By addressing these flaws, Argentina can establish credibility, allowing the nation to regain access to the capital markets in the long run and ensuring the stability necessary for the proper management of its debt.

6.1 Restoring the Rule of Law

Violations against the rule of law have occurred throughout Argentina's history. This paper has in particular pointed out the absence of rule of law under Menem, during the crisis and most recently under the Kirchner administrations. In particular, Argentina seems to be missing a balance of power that ensures that private interests do not take precedence over public ones. The manipulation of the Supreme Court, which occurred both under Menem and Kirchner, is an example of the Presidency's dismissal of the rule of law. Carlos Escudé argues that in Argentina, the judicial power is in fact a puppet of the executive power (2004, p. 29). Argentina must

therefore reinstate the autonomy of the Supreme Court to ensure a rule of law in the future. In the same manner, Gallo, Stegmann and Steagall emphasize the continuation of the rule of law, “so that citizens and international investors believe that the days of impeachment and forced resignation of Supreme Court Justices in favor of pro-government replacements are over” (2006, p. 209).

Likewise, the autonomy of the Central Bank, with which it was established, must be restored so that the Central Bank may independently pursue its objective of preserving the value of the peso. The independence of the Central Bank is jeopardized when the President can, through a decree, simply change the laws concerning withdrawal limits. Such actions by the executive power should in the future be blocked, unless the nation is in a state of emergency. Argentina was in no emergency, for example, when Kirchner withdrew reserves from the Central Bank to repay the IMF debt.

Finally, institutions like the National Statistics and Census Institute (INDEC) should not be manipulated by the federal government. The goal of Argentina’s government should be to improve the economy through policy, not simply to make it appear that the economy is doing well. Statistical manipulation furthermore undermines Argentina’s credibility and interferes with the rule of law, which damages its relationship with creditors. This in turn increased Argentina’s country risk and the interest paid on its debt.

6.2 Protection of Property Rights

Property rights must also be strongly established if Argentina wishes to promote economic growth and investment. The suspension of property rights that occurred during the

crisis with the *Corralito* and the asymmetric *pesification* not only damaged the banking sector and the depositor moral, it also resulted in a series of litigation against the government. Here the rule of law was also undermined, as Congress forced the Courts to rescind the declaration that the *Corralito* was unconstitutional, thus ending any legal ground for litigation. By observing the rule of law and ensuring property rights, the government can avoid costly litigation and promote investment and savings. Moreover, this would allow the government to focus on developing more efficient economic and social policies, ensuring better debt management and advancing economic growth.

6.3 Fiscal Discipline

The review of Argentina's debt mismanagement would not be complete without restating the importance of fiscal discipline to economic stability and debt management. Fiscal discipline is critical to the success of any monetary policy and likewise to the sustainability of public debt. According to Osvaldo H. Schenone, the fall of the Convertibility plan and the default occurred because of Argentina's fiscal deficit. He furthermore emphasizes that any exchange regime is compatible with fiscal discipline, whereas no exchange regime is compatible with fiscal indiscipline (2003, p. 771).

In Argentina, it is clear that one of the problems in achieving fiscal discipline lies in the revenue-sharing system. The lack of established rules for the *coparticipación* undermines fiscal discipline, as the provinces cannot be certain of their income. Argentina should therefore firmly establish equitable rules for the revenue-sharing system. For example, the system might determine a formula used to distribute the revenue among the provinces. This formula might take

into account the state's individual revenue and its population size. *Coparticipación* should also delineate how the provincial and the federal shares of the revenues are decided. Currently, Argentina's provinces simply negotiate with the federal government to establish these figures, making the provinces dependent on the federal government and leaving room for all types of corruption. Furthermore, the *coparticipación* system should also include restrictions to the provinces use of financial tools. Provinces should never follow independent monetary policies nor emit their own currency. In addition, there should be limits to the amount of debt the provinces can incur. With a commitment of fiscal discipline established both in the provincial and the federal government, Argentina can safely follow its chosen monetary policy and determine likewise the adequate level of debt to incur.

Selected Economic Indicators: Argentina 1988-2007

	1988	1989	1990	1991	1992	1993	1994	1995	1996
Total GDP (millions of USD)	126,890	76,630	141,353	189,709	228,990	236,755	257,696	258,097	272,242
GDP measured at PPP	111,062	180,224	182,334	208,648	235,563	255,681	276,520	274,210	294,854
Real GDP growth (% growth)	-2	-7	-1.3	10.5	10.3	6.3	5.8	-2.8	5.5
Trade Balance (millions of USD)	3,813	5,375	8,275	3,860	-2,637	-3,666	-5,751	842	49
Exports	9,135	9,579	12,353	11,978	12,235	13,118	15,839	20,963	23,811
Imports	5,322	4,204	4,078	8,118	14,872	16,784	21,590	20,122	23,762
Annual rates of inflation (%)	343	3079.8	2314	171.7	24.9	10.6	4.2	3.4	0.2
Budget Balance (millions of USD)	-1,699	-507	-464	-1,010	-74	-1,576	-1,888	-1,426	-5,235
Current Account Balance									
(millions of USD)	-1572	1095	4665	-429	-6468	-8043	-10981	-5104	-6755
(% of total GDP)	-1.2	1.4	3.3	-0.2	-2.8	-3.4	-4.3	-2	-2.5
Unemployment (in thousands)	729	914	932	770	914	1,420	1,729	2,695	2,526
Foreign direct investment									
Inflows (millions of USD)	1,147	1,028	1,836	2,439	4,431	2,793	3,635	5,609	6,949
Outflows (millions of USD)	-23	64	35	49	1,166	705	1,013	1,497	1,601

Source: Data from Global Market Information Database

APPENDIX

Selected Economic Indicators: Continued

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total GDP (millions of USD)	293,006	299,098	283,665	284,346	268,831	102,042	129,596	153,129	183,196	214,267	262,327
GDP measured at PPP	323,959	340,100	333,557	337,936	330,908	299,981	333,253	373,036	419,510	469,468	523,580
Real GDP growth (% growth)	8.1	3.9	-3.4	-0.8	-4.4	-10.9	8.8	9	9.2	8.5	8.7
Trade Balance (millions of USD)	-4,019	-4,944	-2,200	1,061	6,223	16,660	15,732	12,131	11,664	12,411	11,072
Exports	26,431	26,434	23,309	26,341	26,543	25,650	29,566	34,576	40,351	46,569	55,779
Imports	30,450	31,377	25,508	25,280	20,320	8,990	13,834	22,445	28,688	34,158	44,707
Annual rates of inflation (%)	0.5	0.9	-1.2	-0.9	-1.1	25.9	13.4	4.4	9.6	10.9	8.8
Budget Balance (millions of USD)	-4,360	-4,150	-8,130	-6,821	-8,744	-1,131	154	3,224	3,744	3,993	3,850
Current Account Balance											
(millions of USD)	-12116	-14465	-11910	-8955	-3780	8720	8065	3158	3686	5413	2812
(% of total GDP)	-4.1	-4.8	-4.2	-3.1	-1.4	8.5	6.2	2.1	2	2.5	1.1
Unemployment (in thousands)	2,220	1,950	2,207	2,420	2,879	3,375	2,687	2,239	1,920	1,760	1,618
Foreign direct investment											
Inflows (millions of USD)	9,160	7,291	23,988	10,418	2,166	2,149	1,652	4,584	5,008	4,809	5,720
Outflows (millions of USD)	3,653	2,326	1,730	901	161	-627	774	442	1,151	2,008	1,196

Source: Data from Global Market Information Database

Selected Social Welfare Indicators: Argentina 1988-2007

	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Annual rates of inflation (% growth)	343	3079.8	2314	171.7	24.9	10.6	4.2	3.4	0.2	0.5	0.9
Population living on less than \$2 a day (%)	-	-	-	-	5.8	-	-	-	9.8	-	10.4
Population living on less than \$1 a day (%)	-	-	-	-	-	2	-	-	-	2	-
Economically active population (in thousands)	12308	12569	12763	13322	13809	14122	14337	14473	14745	14973	15,269
Employed population (in thousands)	11579	11655	11831	12551	12894	12702	12608	11778	12219	12753	13,320
Unemployed population (in thousands)	729	914	932	770	914	1420	1729	2695	2526	2220	1,950
Tax and social security contributions (% of gross income)	-	-	6.4	3	1.6	5.7	11.2	8.6	11.2	15.8	13.5
Government Expenditures (millions of USD)											
on general public services	-	1110	2460	4115	4877	5287	6638	7692	8867	10041	11,443
on social security and welfare	-	2820	6848	9615	13957	18206	21093	21865	22347	23404	23,178
on other community/social services	-	59	60	65	103	118	155	178	148	170	132
on economic services	-	1155	1895	2428	3252	4069	3587	2836	2631	2976	3,106

Source: Data from Global Market Information Database

Selected Social Welfare Indicators: Continued

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Annual rates of inflation (% growth)	-1.2	-0.9	-1.1	25.9	13.4	4.4	9.6	10.9	8.8
Population living on less than \$2 a day (%)	-	-	14.3	-	23	17.4	-	-	-
Population living on less than \$1 a day (%)	2	-	-	3.3	-	7.3	6.6	-	-
Economically active population (in thousands)	15,726	16,131	16,624	17,192	17,538	17,815	18,216	18,621	19,027
Employed population (in thousands)	13,519	13,712	13,745	13,817	14,851	15,576	16,296	16,861	17,410
Unemployed population (in thousands)	2,207	2,420	2,879	3,375	2,687	2,239	1,920	1,760	1,618
Tax and social security contributions (% of gross income)	8.5	7.8	7.9	8.1	7.9	7.9	8	8	8
Government Expenditures (millions of USD)									
on general public services	13,449	14,228	14,469	7,839	9,457	9,325	10,001	10,505	12,247
on social security and welfare	23,292	23,381	22,020	7,661	9,533	11,406	13,654	16,502	22,308
on other community/social services	115	100	65	36	51	53	62	70	88
on economic services	2,807	2,266	2,173	1,031	1,994	2,048	2,588	2,851	3,530

Source: Data from Global Market Information Database

Argentina's Public Debt (millions of USD, percent)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total Public Debt	114,134	123,366	129,750	144,222	152,974	178,768	191,296	129,227	136,725	144,729
Total GDP	299,098	283,665	284,346	268,831	102,042	129,596	153,129	183,196	214,267	262,327
Debt/GDP ratio	38%	43%	46%	54%	150%	138%	125%	71%	64%	55%

Source: Data from BCRA

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