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The Politics of Argentina's Meltdown

Javier Corrales

Argentina, the country that gave us the tango, Evita, the Falklands War, soccer and tennis legends, and some of the best red wines from the Southern Hemisphere, has also given us the first economic depression of the twenty-first century. What began in late 1998 as a mild recession by mid-2002 had become one of the most harrowing economic crises in Argentina's history.

The features of this depression are daunting: a default on government debts, a nearly 75 percent devaluation of the peso, an economic contraction that sent the GDP back to 1993 levels, an unemployment rate of 22 percent, the collapse of the banking system despite a freeze on bank deposits, and the creation of more than one and a half million new poor in just six months.

The toll on politics has been no less dramatic: between October 2000 and August 2002, there were five cabinet crises, two presidential resignations,[1] one Senate crisis,[2] and five ministers of the economy. The streets in downtown Buenos Aires are now full of abandoned retail stores and angry protesters. *¡Que se vayan todos!* (Kick everyone out!) reads the omnipresent graffiti.

The current crisis is perplexing to many Argentines (and scholars abroad) because, for the first time ever, Argentina in the 1990s seemed to have finally gotten its politics and economics right. On the economic front, Argentina introduced some of the most far-reaching market-oriented reforms in the world. In 1999, the Heritage Foundation, a conservative Washington think tank, ranked Argentina's economy as among the "freest" in the world. Politically, Argentina consolidated civilian control over the military and introduced stronger instruments of accountability, such as added powers for the legislature. Power was transferred peacefully, violent protests declined, and the leading parties negotiated a major pact to reform the constitution in 1994, ending a long period of interparty animosity. Consequently, Argentina between 1991 and 1998 achieved a long period of both political and economic stability not seen in the country since the early 1920s. As Harvard political scientist Steven Levitsky remarked, Argentina appeared to have turned toward "normalized" democratic politics.[3]

The stability of the 1990s was all the more remarkable given the tumult of the previous 60 years. Argentina at the beginning of the twentieth century was a country not unlike the United States. It had vast, rich agricultural lands, substantial foreign investment, and a relatively small population, which permitted the absorption of Europe's labor surpluses. But starting in the 1930s, Argentina succumbed to cycles of political instability that more or less followed a consistent pattern. A president would make crowd-pleasing promises on which he or she would fail to deliver. Protesters would take to the streets, scaring civilians and prompting the military to take power. Eventually, the generals would return power to civilians, in part because they would also have failed to contain the popular discontent. Argentina had 24 presidents between 1930 and 1958—one new president every two years or so, on average. This political instability hurt the economy. Periods of growth were typically followed by longer periods of spectacular collapses. During these same years, there were 58 ministers of the economy.

Just when Argentines were beginning to believe that they had left all of this behind them, the past came back with a vengeance. They had endured a decade of painful reforms, only to be cruelly rewarded with a brutal crash. This is why they now find their plight so disconcerting. It is also why the political climate in the country is so volatile. Today, Argentines exhibit a combination of ire, which has driven many of them to join the angry street protesters, and acute cynicism, which has driven many others to disengage from politics altogether.

A few years ago, Buenos Aires was a bustling city, famous for its vibrant nightlife. Nowadays, Buenos Aires's evenings are somber. People choose to stay home, not just because they cannot afford to go out, but because they want to avoid the "express kidnappings" (*secuestros exprés*) in which a victim is typically held for a few hours, until a ransom is paid. In many neighborhoods, the only people out at night are the new poor, who wander through the streets sifting through the garbage left outside for collection.

The question of what went wrong in Argentina has become the subject of debate. Most analysts look only at the economic picture for answers, blaming the crash on two factors: external shocks and fixed exchange rates. Yet this focus on economics overlooks what is perhaps the most important explanation for Argentina's collapse: political shocks. The Argentine depression is an example of the serious consequences of two types of political shocks to which all weak democracies, not just Argentina, are susceptible.

The first shock was caused by what I call the state-without-a-party condition. This occurs when the president of a given democracy is at odds with the leading members of the ruling party. Although it occurs infrequently, the state-without-a-party condition is not a rare political illness. And it almost always results in economic mismanagement. In the 1990s, this problem crippled the administrations of Carlos Andrés Pérez in Venezuela, Juan Carlos Wasmosy in Paraguay, René Préval in Haiti, and Ernesto Samper in Colombia, to name a few, and is causing problems today for Vicente Fox in Mexico.

The second political shock to which Argentina was subjected was caused by international actors: the technocrats who came to the U.S. Treasury Department and the International Monetary Fund (IMF) in the late 1990s with new ideas about how to deal with economic crises. These technocrats are hesitant to offer rescue packages for economies in trouble for fear of eliminating incentives for self-reform (the "moral hazard" problem). The best way to help governments facing an economic crisis, they believe, is to offer limited help, and only after these governments meet conditionalities that are deliberately made tougher the deeper the crisis gets. This toughen-as-you-sink approach is a policy fraught with risks, and it is particularly dangerous for weak democracies. It caused havoc in Argentina.

The combination of this international political shock with the domestic political shock of the state-without-a-party condition is the reason that Argentina's mild recession of 1999 turned into a depression in 2002. The lesson of the Argentine crisis is that no political or economic reform, however enlightened, can withstand such shocks. These shocks impaired the capacity of Argentine authorities to end the recession. Investors spent most of the 1999–2001 period sitting on their hands, waiting for signs of decisiveness from the government. However, without the support of its own ruling party, or from Washington, the government could not solve the credibility problem.

Economic Issues

The debate about the causes of Argentina's depression has mostly focused on two economic issues: the susceptibility of open economies to external shocks and the merits of different exchange rate regimes. The first issue is predicated on the idea that external vulnerability is the curse of globalized states.[4] Openness to trade and financial flows expose emerging markets to the "flus" of other countries.[5] Since the mid-1990s, there have been plenty of powerful economic viruses around the globe: the Mexican crisis of 1994–95, the Asian crisis of 1997, the Russian devaluation of 1998, the Brazilian devaluation of 1999, the rise of interest rates in the United States in 2000, the Turkish devaluation and the global recession of 2001, the drop in non-oil commodity prices between 1998 and 2001, the drying up of foreign direct investment in emerging markets after 1998. Sooner or later, it is argued, Argentina, with its open economy, was bound to be infected.[6]

The problem with the external-shock hypothesis is that it invokes a systemic variable to explain a singularity. External shocks should have hurt many countries, and yet only Argentina (and Indonesia) sank into a depression. Thus, something else must have made Argentina susceptible. This is where the debates about exchange rates apply.

Among the market reformers of the 1990s, Argentina adopted the most inflexible exchange rate possible under the Convertibility Law of 1991. While the use of inflexible exchange rates to stabilize prices is common, Argentina's approach was extreme. It obliged officials to uphold a fixed exchange rate vis-à-vis the U.S. dollar and banned the central government from printing money. This system came with two tradeoffs. First, it purchased credibility (the government would not play dirty tricks with the exchange rate, such as announcing surprise devaluations) at the expense of competitiveness (the price of Argentine goods would become expensive relative to the prices of Argentina's trading partners). Second, it injected predictable rules (a non-changing exchange rate) at the expense of flexibility in fiscal and monetary policy.[7] Most trade economists agreed that Argentina's economy, in terms of its size and trading structure, was not ideal for such a straitjacket. What justified its adoption in 1991 was Argentina's hyperinflation of 1989–91, which called for drastic measures.[8]

The debate about exchange rates centers on whether the currency regime should have been relaxed after stabilization.[9] Such well-known economists as Paul Krugman, and even some staff members of the IMF, insisted that the costs to competitiveness and flexibility were too onerous once inflation had been tamed.[10] Exports would stagnate, and faced with external shocks, authorities would be left without monetary policy tools—no gain, just pain. Some observers think that to stay afloat following the "sudden stop" of foreign capital after 1998, Argentina needed to depreciate its currency by as much as 46 percent.[11]

Others argue that in an economy with such a long history of arbitrary handling of the exchange rate and intense rent-seeking (when economic agents lobby the government for favors and protection), keeping the straitjacket on was necessary to avoid currency speculation.[12] Yet others say that the problem was political: once a fixed-exchange-rate regime in which people borrowed in dollars was established, it was hard to persuade politicians to change the system or to agree on an exit mechanism.[13]

As Argentina entered into a recession in 1998, two opposing trends developed. More and more economists began to turn against convertibility, whereas most Argentines become more and more in favor of keeping the dollar-peso peg as the only anchor in an otherwise erratic economy.

Now that the convertibility regime has crashed, critics of the fixed exchange rate feel vindicated. And yet, there are still some problems with blaming the exchange rate regime alone. First, the system worked prior to 1998. Argentina's exports almost doubled during the convertibility era (from $12.3 billion in 1990 to $23.8 billion in 1999), contradicting the argument that fixed exchange rates hamper exports. Furthermore, Argentina had weathered previous external shocks, surviving the European currency crisis of 1992, recovering from the Mexican peso crisis of 1995, and hardly feeling the effects of the Asian crisis of 1997. In addition, it is hard to imagine that the gains in competitiveness resulting from devaluation would have been significant given the small size of Argentina's trading sector (which accounted for less than 10 percent of GDP, and was a third of the size of Mexico's or Chile's). Increasing the competitiveness of this sector of the economy would not have constituted a sufficient boost to growth. This is why the 75 percent devaluation of the Argentine peso in the first half of 2002 has done nothing to spark a recovery.

The main problem with the convertibility regime was not that it was fixed, but that it was unaccompanied by sound macroeconomic management, especially after 1997. Fixed-exchange-rate regimes require impeccable fiscal accounts—very low deficits and low debt levels.[14] Starting in 1997, Argentina failed in this regard. Rather than take advantage of the economic boom of that year to pay down the national debt and lower deficits (as Mexico and Peru did), Argentina went on a spending and borrowing spree. The ratio of foreign debt to exports in Argentina surged from 385.5 percent in 1996 to 452 percent in 1998, whereas in Mexico and Peru, the ratios declined from 147 percent to 125 percent, and from 462 percent to 393 percent, respectively.[15]

And yet, blaming everything on macroeconomics (rather than on the exchange rate alone) is half the answer. Although the macroeconomic deterioration of 1997–98 was real, it was not particularly severe. Brazil was arguably in worse shape, and yet it survived its 1999 currency crisis. This raises a more fundamental question: why did the same administration that handled Argentina's macroeconomic problems and gained credibility with investors in the early 1990s fail on both counts in the late 1990s?

The answer is that since 1997 administrations have often been at loggerheads with their ruling parties. In 1997–99, the conflict resulted from the emergence of "imperious tendencies" on the part of the executive. In 1999–2001, it occurred because the new governing coalition was made up of parties that had failed to modernize. These two issues—imperious presidents and unadapted parties—are recurrent problems in weak democracies. In Argentina they became acute.

Imperious Presidents

Presidents in every kind of regime are often tempted to extend their stay in office indefinitely. In strong democracies, institutions deter them from doing so. But in weak democracies, institutions are not always powerful enough to act as deterrents. The result is that in weak democracies presidents often conclude that, with some clever political maneuvering and the use of public funds, they can manipulate institutions to their advantage. Weak democracies are thus susceptible to a clash between hard-to-restrain presidents and weak institutions that do the best they can to stop them. Such clashes can wreck an economy.

This is precisely what happened in Argentina in 1997. That year, President Carlos Saúl Menem (1989–99) decided to seek reelection to a third term, even though he had already modified the constitution in 1994 to be able to seek a second term in 1995. Until that point, Menem was still a relatively popular president, having won reelection in 1995 by a comfortable margin. Although his administration was marred by serious allegations of corruption, Argentines tolerated him because he was responsible for wiping out inflation and restoring economic growth, something no other president had accomplished. Furthermore, he had moderated the demagogic populism of his own Peronist Judicialist Party, or PJ, even if this meant fueling clientelism by distributing favors to political actors who went along with the reforms. Menem may not have given Argentines first-world politics, but he certainly gave them first-world economics, and many Argentines accepted this compromise.

But when Menem became obsessed with election to a constitutionally prohibited third term, he turned reckless, not just politically, but also economically, thus destroying his only remaining political capital. At first, Menem's bid for a third term seemed dead on arrival. There were formidable institutional and political obstacles: the 1994 constitution explicitly prohibited reelection beyond a second term, and the public was adamantly opposed to the idea (approximately 80 percent disapproved). Yet, Menem thought that if he could obtain the backing of his own party, he would generate sufficient political pressure to compel the Supreme Court to interpret the constitution in his favor (essentially, that his first term should not count), or to force a referendum.

Menem thought that with a good dose of populism—which meant increasing spending and slowing down reforms—he could manipulate political institutions to his advantage. But he was proven wrong. Institutions resisted, none more so than the ruling party itself. Many PJ leaders, especially provincial governors such as Eduardo Duhalde, Adolfo Rodríguez Saá, and Néstor Kirchner, objected to Menem's reelection drive because it blocked their own move up the party ladder. For the first time since 1991, Argentina had a president completely at odds with the majority in his party.

Menem's quest for reelection against all institutional odds unleashed a spending race between the president and the leading Peronist governors. With an executive in desperate need of allies, and a group of party leaders desperate to contain him, fiscal prudence went by the wayside. Everyone lost interest in fiscal austerity and in pushing for such needed reforms as revamping the tax bureaucracy, liberalizing labor markets, and reforming the revenue-sharing system between the federal government and the provinces. In a recent interview (with the author), a top-ranking officer in the Ministry of the Economy said: "Menem told us: 'I will not reject your proposals, but I will not promote them.'" This was in sharp contrast with Menem's unwavering support of his economic ministers before 1997.

The other side of this intra-party fight responded in kind. The governor of the province of Buenos Aires and today president of Argentina, Eduardo Duhalde, launched a massive public-spending campaign as a way to compete against Menem within the PJ. The province went from having a low, below-average fiscal deficit in 1996 (7 percent of current revenues) to a huge and significantly above-average deficit in 1999 (25 percent of current revenues). Most of these expenditures were related to increases in personnel to reward Dulhalde's political friends. The growth of spending and deficits in the most economically weighty province significantly undermined the country's overall economic performance.

Another economic consequence of these internal struggles within the PJ was the failure to contain the rising national debt. Economic officials recommended increasing taxes, decreasing expenditures, and using privatization proceeds to make payments on the rising debt. But no one at the top—neither the president nor his detractors within the PJ—cared. Rather than decrease spending, Menem actually proposed increases in his 1998 budget. In 1998, Congress rejected Minister of the Economy Roque Fernández's watered-down proposal to increase corporate taxes and expand the value-added tax to exempted sectors. The only recourse left to economic officials was to increase the already high levels of public debt and to delay payments to public-sector suppliers. This only served to restore the "credibility deficit" that had plagued the state in the 1980s. Once again, the government was in the business of cheating private agents, repeating its predatory behavior of the previous decade. When the aftershocks of the Russian financial crisis hit Argentina in mid-1998, the "concern" of skeptical business leaders turned into panic. Bank deposits declined, and Argentina entered into a recession.

Fortunately for Argentina's democracy, institutions prevailed in 1999. The resistance within the ruling party killed Menem's reelection drive, and Duhalde was chosen as its presidential candidate. But defending democracy against the political shock of presidential imperiousness was costly. The fight undid the reforms of the previous eight years, as well as the coalition of business leaders, regional PJ bosses, and the party's rank-and-file that Menem had skillfully built after 1991,[16] increasing the economy's vulnerability to the external shock of 1998.

The Nonadaptation of the Center-Left

The second source of the state-without-a-party problem in Argentina was the nonadaptation of the parties of the left. Eroding legitimacy, nontransparent finances, and platforms that promise but do not deliver are only some of the ills afflicting Argentine political parties. The non-Peronist parties are at another disadvantage because they control neither the major labor unions nor many of the provincial governments.[17] A less discussed problem, not just in Argentina, but in many new democracies, is the failure of political parties to renew their leadership and, more important, to incorporate specialized talent into the top echelons.[18] This problem became evident in Argentina during the truncated administration of President Fernando de la Rúa (1999–2001), creating a wedge between the president and his ruling coalition.

De la Rúa was elected by an alliance of two center-left parties, the old Radical Civic Union (UCR) and the new urban-based FREPASO. The Alianza was formed in 1997 for the explicit purpose of taking Argentina through "post-adjustment" politics—i.e., increasing transparency, fighting institutional corruption, investing resources in social sectors.[19] And yet, Menem's legacy was to throw Argentina back to a pre-adjustment stage. Alianza leaders had spent most of their time debating—and agreeing on—how to invest state resources, but not enough time debating what to do in the event of revenue shortfalls.

Programmatic adaptation was difficult in part because the UCR had a hard time retiring old leaders. The leader of the party in 2000 was the same as in the late 1970s—Raúl Alfonsín, who had also been president of Argentina from 1983 to 1989. The overextended political life of Alfonsín is all the more unjustifiable in light of his disastrous leadership: in 1989, he resigned as president because he could not prevent hyperinflation, and in the 1990s, he led the UCR through three catastrophic electoral defeats.

The Alianza was not only ideologically behind and partly hijacked by a strongman, it was also technocratically unprepared to govern. This reflects yet another problem of Latin American parties: their difficulty in incorporating people trained in public policy. Here, the UCR was in far worse shape than the PJ. At the beginning of the 1990s, 44 percent of UCR deputies in the lower chamber were lawyers; most PJ deputies at this time were either lawyers or labor representatives (17 percent and 25 percent, respectively). The presence of economists was marginal (2 percent in the UCR and 1 percent in the PJ). By 1997, the UCR remained undiversified: 50 percent of its deputies were lawyers, 3 percent were economists. The PJ, on the other hand, had become more diversified, and more important, open to technical experts: 12 percent of its deputies were economists.

The junior partner in the Alianza, FREPASO (Frente del País en Solidario), had similar problems. FREPASO was hastily formed in the 1990s to occupy the political space left vacant by the PJ's shift from the left to the center. Its founders, and its first presidential candidate in 1995, were dissident PJ leaders. But as the party continued to grow in the late 1990s, mostly in Buenos Aires, it remained driven by charisma rather than policy competence. Its two main leaders in 1999, Chacho Álvarez and Graciela Fernández Meijide were better known for their principled politics (they were advocates of corruption fighting and human rights) than for any real achievements in public administration. Thinking perhaps that governance was only a matter of participation, and not necessarily skill accumulation, FREPASO focused mostly on mobilizing grass-roots organizations rather than incorporating trained professionals.

The nonadaptation of the UCR and FREPASO, both programmatically and with respect to diversification at the top, was a major reason that the De la Rúa administration stumbled. When De la Rúa began to generate policy responses to the economic crisis, he shocked the members of his ruling coalition. The Alianza wanted more spending on social programs, but the exigencies of the situation (recession and high debt) meant the government could not deliver. Alianza leaders, both inside the cabinet and in the legislature, did not hesitate to voice their displeasure almost from day one. Alfonsín turned against the minister of the economy, José Luis Machinea, who had been central bank president in his own administration. In 2001, Alfonsín attacked Machinea for, among other things, defending convertibility, declaring it to be the "gravest episode in economic affairs of this century."[20] When De la Rúa replaced Machinea with the no-nonsense UCR economist Ricardo López Murphy in March 2001, the party was the first to demand that he be fired; two weeks later he was.[21] Until the last days of the De la Rúa administration, the most relentless critic of the government's economic policy was the ruling coalition itself.

The internal bickering between the government and the ruling coalition impaired the government's efforts to regain the trust of domestic investors that Menem had destroyed in 1998–99. The government basically had two policy choices to restore business confidence: produce a bold set of policies[22] or create a cohesive cabinet.[23] Both were impossible in the context of a state-without-a-party. Policies had to be watered down. The cabinet was fragmented because the president had to use the posts as bargaining chips to appease the various factions within the Alianza. Some ministries were even split in half, with the post of minister going to one faction, and the post of deputy minister going to another. When Machinea resigned in March 2001, he lamented, "I don't have any room left."[24]

The Rise of Imprudence-Fighting

The second major political shock to hit Argentina came from abroad. It consisted of a reversal in the priorities of the International Monetary Fund and U.S. Treasury officials, starting in February 2001. The IMF has traditionally seen itself as the world's economic "firefighter," ready to extinguish any financial crisis that might erupt.[25] In the 1990s, this goal became problematic. The fund began to confront a dilemma: how to act as a firefighter without creating incentives for reckless economic behavior (the moral hazard problem). In the words of IMF deputy managing director Anne O. Krueger, "Private institutions will be tempted to lend and invest *imprudently* if they believe that the Fund is standing by...."[26]

In the 1990s, the IMF and Treasury officials had privileged fire fighting over imprudence-fighting. They responded to the various capital account crises of the decade (stemming mostly from abrupt changes in capital flows rather than from the lack of funds to pay for imports, as in the past) by providing generous bailouts to Mexico in 1995, Asia in 1997, Brazil in 1998 and 1999, and even Argentina in 2000. Put the fire out first and worry about moral hazard later, was the mantra of the 1990s.

But in 2001, the Treasury and the IMF, under new management, reversed their priorities. The new secretary of the treasury, Paul O'Neill, the newly appointed managing director of the IMF, Horst Köhler, and his deputy, Anne Krueger, are strong believers in the paramount importance of imprudence-fighting. In this new thinking, so long as there are assurances that a particular fire will not spread, rather than provide quick relief the idea is to become tougher. Since the goal is to teach the target country and others a few lessons, aid comes with reprimands and harsh requirements.

This new policy began to be applied to Argentina gradually in 2001. The first sign of hard-line posturing came when Secretary of the Treasury O'Neill, shortly after taking office in 2001, chided Argentina publicly for getting in trouble because it never did its homework, essentially ignoring Argentina's reform record of the past decade and the role of external crises. By mid-year, the IMF and the Treasury had reached three conclusions. First, they had lent too much to Argentina. Second, the fire in Argentina would not spread, mostly because bondholders had protected themselves (more specifically, most major U.S. bondholders had already sold much of their Argentine debt). And third, based on the examples of Mexico, South Korea, and Brazil, which had recovered quickly from financial crises as soon as they switched to flexible exchange rates, the IMF and the Treasury became convinced that Argentina's fixed exchange rates had to go. Consequently, both the IMF and the Treasury began to openly express doubts about convertibility. O'Neill himself became even more disparaging of Argentina.[27] Both the IMF and the Treasury began to increase the degree of conditionality—disbursements would be contingent on Argentina delivering amazing, rather than just reasonable, fiscal results. Argentina became the ideal guinea pig for testing this toughen-as-you-sink policy.

In picking Argentina, incidentally, the Treasury was not geopolitically blind. If Argentina had been a NAFTA country (like Mexico), a NATO member (like Turkey), a major exporter to the United States (like South Korea), or an important military power (like Russia), then perhaps the Treasury might have found another test candidate. But Argentina is geopolitically innocuous—a country surrounded by penguins, as the Argentine ambassador to the United States is fond of saying—and hence, ideal for the experiment.

In order to meet these new expectations, Argentina came up with the most extreme fiscal measure imaginable: committing itself by law to zero deficits. Few countries in the region have ever delivered zero deficits consistently. Even in its best years, Argentina only achieved this once (in 1993). Furthermore, it is not clear that a zero-deficit prescription is good for a country in a recession. Yet, the IMF welcomed the passage of the zero-deficit law in the Senate, and approved another $16 billion loan, conditioned on Argentina fulfilling its requirements.[28] Thus Argentina was asked to take a test of commitment to reform that it could never pass.

The IMF/Treasury policy consisted of a willingness to provide "economic help" but an unwillingness—and this is the crucial point—to provide political backing. Washington offered the Argentine governments no assurances of support. The United States did not say that it would never allow Argentina to collapse (as it said of Mexico when the latter was about to implode in January 1995). It never even proposed granting Argentina special market access and trade credits. Rather than take the lead, the United States decided to simply watch other actors handle the crisis. In an interview with the *Financial Times* this past July, O'Neill was asked to explain what kind of support he was providing Argentina "beyond the time you spent on the phone [with Minister of the Economy Domingo F. Cavallo]." O'Neill replied: "We've been supportive through the instrument of choice which is the IMF."[29] This at a time when the fund was becoming risk-averse.

In essence, the IMF said to Argentina, We are offering help, even though we do not trust you, your chosen policies, and the path that you are on, and we will not take any risks because there is no one to underwrite them. So, when Thomas W. Dawson, the fund's director of external relations, says somewhat cavalierly that "the IMF did help Argentina," he is half right.[30] Money came, but without any show of confidence in the policies the government was pursuing. The result was a pendular shift in the international political attitude toward Argentina, from blank check, to no check.

As the IMF's managing director admits, the fund was too lax when Menem was undoing the reforms of the early 1990s: "Our mistake is not having said sufficiently and firmly that, at the end of the 1990s, the disintegration of the institutions would have a high cost. We did not pay enough attention to the drifting of Mr. Menem's policies."[31] Arguably, these "low-intensity surveillance activities" continued up to the first year of the De la Rúa administration.[32] But in 2001, this came to an end, and the resulting shift in the international political attitude toward Argentina was as damaging to the economy as any other external shock.

Killing Convertibility

The new toughen-as-you-sink policy is dangerous. Although it increases the incentives for governments to embark on serious adjustment efforts, it also carries a high risk of failure for two reasons. First, it sends mixed signals to the market. Bondholders are less inclined to trust the Argentine government because there are no assurances that the IMF or the U.S. Treasury will come to its aid. That is one reason why Argentina's country risk, which had been high but relatively stable during much of Argentina's recession, skyrocketed after April 2001. Second, the policy is particularly tough on weak democracies. To understand this, one must understand how weak democracies respond to financial crises. Rather than rallying behind the flag, their citizens become more polarized. Tired of seeing their past sacrifices wasted, they take to the streets, calling for less austerity and more compensation, exhibit mistrust in their officials because they think that the crisis was mostly the product of corruption, and adopt attitudes of defensive self-protection rather than solidarity. Antiestablishment sentiments proliferate.

Under these conditions, politicians in weak democracies have fewer options than those in a dictatorship (which can always repress) or those in a strong democracy (where this type of crisis, or for that matter, antiestablishment sentiment, never reaches these levels). The IMF took the tensions in Argentina in 2001 as evidence that "there was no political cohesion" to manage the situation, as if its (and the U.S. Treasury's) new policy had had nothing to do with the political crisis. The IMF treated the the zero-deficit law as Argentina's last chance. But this was no chance at all, since Argentina was being expected to take a test that few weak democracies could pass.[33]

There is no doubt that De la Rúa's last minister of the economy, Domingo Cavallo (March-December 2001) made many policy mistakes. But some were made in an effort to save Argentina from the political shocks that merged in 2001: the state-without-a-party condition and the toughen-as-you-sink approach of the U.S. Treasury and the IMF. These political shocks forced Cavallo to try every possible gimmick. Since he was politically constrained to cut spending in the first half of 2001, he tinkered with convertibility and with industrial policy. When that failed, he tried to restore investor confidence by courting the IMF. That's when he promised the zero deficit and redoubled his efforts to negotiate a mega debt swap in the second half of 2001. This too failed. The ruling party continued to interfere with the minister's efforts—blocking the use of tax revenues to guarantee public debt and criticizing spending cuts.[34]

By October 2001, without the political support of the ruling party or of Washington, the De la Rúa government seemed powerless. Voters punished the government in the October 2001 midterm elections by voting for the opposition, abstaining, or deliberately spoiling their ballots to express their anger (the *voto bronca*). Now invigorated, the opposition had no reason to cooperate with a government that everyone else had shunned. In November, the legislature became less cooperative than ever. In explaining the reasons for his resignation in December, De la Rúa was clear: "The Congress left me without a budget...and tried to take away from me the special powers that it had just approved."[35]

Consequently, investors continued to desert Argentina, and smart savers responded as they should have—by emptying their bank accounts. In response to the November 2001 run on the banks, the government had to impose a bank freeze (the *corralito*), which furthered angered Argentines and led to the violent *cacerolazos*—public pot-banging protests—of December 2001 that ultimately forced the government to resign.

Crash Survivors

In the past, the power vacuum created by De la Rúa's resignation would have been filled by the military. This time, it was "handled" by the legislature, which selected Duhalde's predecessors, in accordance with the constitution. That Argentina turned into a quasi-parliamentary democracy for a brief moment in December 2001, rather than a military-brokered regime, attests to the resilience of democracy in the country.[36] Yet, this political transition introduced new complications.

First, because the legislature was controlled by the opposition party, it naturally chose a president from its own ranks, effecting a major political change—of ruling parties, no less—without the consent of the electorate. Second, at the time of the transition, the PJ was still divided between the Menem and Duhalde factions. The party first chose a governor, Adolfo Rodríguez Saá, who was somewhat of an outsider, well known for his modern-sounding reforms in his home province of San Luis (and an infamous sex scandal in 1993). But in less than a week, Rodríguez Saá proved unable to conciliate the different factions within the PJ and resigned. Next came the leader of the largest faction in the PJ, Eduardo Duhalde. As the PJ candidate for president in 1999, Duhalde, running on a populist platform, had suffered a serious defeat. But in December 2001, few other PJ leaders wanted the job of president, whereas Duhalde had been longing for it since the early 1990s. Argentines thus ended up with a president they had rejected three years before.

Upon taking office in January 2002, Duhalde confronted two major problems: containing the rising unrest at home, and regaining the confidence of the IMF. His approach was schizophrenic. On the one hand, he embraced an anti-market rhetoric, thinking that this would placate the citizenry. In his acceptance speech, he lambasted the old economic model and the new business groups that had profited from privatization, ignoring the fact that it was his own party that had pursued the market reforms of the 1990s. He devalued the peso, thereby ending convertibility by presidential decree. By jettisoning the convertibility law, almost all contracts, which were written in dollars, became subject to renegotiation. In addition, all bank deposits and liabilities were "pesified" (i.e., converted to pesos, now devalued), giving rise to acrimonious legal conflicts about whose deposits and whose liabilities would be converted at which rate. This "massive destruction of property rights" has fueled financial speculation and forced many utilities and large companies into bankruptcy.[37]

On the other hand, Duhalde began (gradually and almost secretly) to do as the IMF advised, not just devaluing, but also securing an agreement with the provinces to cut spending, unifying the exchange rate, and changing a bankruptcy law to match international standards. He even published an op-ed in the *Financial Times* declaring that "no one bears more of the blame than Argentina itself," repeating O'Neill and Köhler's diagnosis that this mess was all homemade.[38] And yet, the IMF further stiffened its posture, adding to the list of conditionalities: in June, it demanded a compulsory conversion of all bank deposits into government bonds; in August, it demanded that two public banks, the Banco Nación and Banco de la Provincia de Buenos Aires, cease accepting deposits until the financial system could be restructured.[39]

The IMF's persistent intransigence with respect to Argentina is hard to understand. It could be that it is the response of the failed advisor who, embarrassed at the failure of its prescriptions, conveniently invokes the "but-you-are-not-doing-enough" argument as a way to save face (Argentina's GDP contracted by a severe 15 percent in the first semester following the IMF-prescribed devaluation). Although most analysts today are critical of the fund's inflexibility, there is a new breed of analysts, both in Argentina and abroad, who condone its hard line, but for a different reason. In 2001, hard-liners criticized the fund's policies in Argentina because they disliked the convertibility law; today, they want the fund to continue its hard line as a way to punish Duhalde for dedollarizing the economy.[40]

The intransigence of the IMF ended up unnerving even the phlegmatic chairman of the Federal Reserve, Alan Greenspan. In June, when Köhler, in the face of Argentina's continuing political troubles, declared, "Argentina disappointed me," a dismayed Greenspan publicly chided him. The next day, bowing to pressure from the Fed and the G-7, Paul O'Neill had to persuade Köhler to become more cooperative. The IMF did not agree to provide Argentina with new cash, but it did agree to establish a commission of "international notables" to audit Argentina's account and mediate between the fund and the Argentine government.

Although the establishment of the commission of notables granted Duhalde some breathing room, it was not enough to save his government. A few days later, overwhelmed by growing domestic unrest and declining public support, Duhalde announced early presidential elections for March 2003. He also announced that he would not run for reelection. Perhaps we are seeing the beginning of a positive trend here in that Argentina's politicians are finally beginning to retire when they have outlived their usefulness.

Learning from Argentina

The onset of Argentina's recession had both economic and political causes; its longevity and depth have had mostly political causes. Two political shocks killed convertibility: infighting between the executive and the ruling party, and the toughen-as-you-sink policy experiment undertaken by the IMF and the U.S. Treasury in 2001. These shocks turned a mild recession, in a country whose economic fundamentals were no worse than those of many other Latin American nations, into a massive depression.

Analysts need to understand how economically damaging these shocks can be. The state-without-a-party condition undermines the quality of policymaking and the credibility of policymakers. Whether the shock is produced by presidential imperiousness or by a ruling coalition that comes to office technically unprepared for the job, the casualties are the same: macroeconomic stability, policy coherence, zeal for reform.

Weak democracies in emerging markets are susceptible to both of these ailments. The temptation of presidents to manipulate institutions is a recurrent plague of weak democracies. So is the difficulty of old parties to adapt to new circumstances by opening up to new ideas and new leaders (and retiring old ones). Organizations interested in promoting development ought to invest in improving the technical skills of politicians and parties in general. The World Bank already provides training in developing countries for members of nongovernmental organizations and cabinet officials. It is time to target professional party leaders, whether they are in office or not.

There is no denying that governments must be encouraged to engage in difficult reforms through a policy of carrot and stick. But the new technocrats at the helms of the IMF and the U.S. Treasury should rethink their toughen-as-you-sink approach. It converts the stick into a heavy club that pounds weak democracies far beyond what they can realistically sustain. It undermines the credibility of officials just when they need a boost. It treats democracies just as it would treat dictatorships, expecting a degree of policy correctness that ignores domestic political conditions. Officials at the IMF and the Treasury ought to study the political possibilities of the target countries as rigorously as they study their balance sheets.

Perhaps by 2001 Argentina could not have been saved from collapse. But the lesson from Argentina is clear. Politicians who ignore institutional boundaries, political parties that refuse to accommodate change and new knowledge, and superpowers that prefer to take to the sidelines when an economic crisis hits constitute real threats to new market democracies. ●

Notes

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1. The resignation of President Fernando de la Rúa in December 2001 brought about a succession crisis. Four presidents followed: Ramón Puerta (acting president December 20–22, 2001), Adolfo Rodríguez Saá (December 23–30, 2001), Eduardo Camaño (acting president December 31, 2001 and January 1, 2002), and Eduardo Duhalde (January 2, 2002, to the present). The real signs of the crisis were the two key presidential resignations during this period: those of De la Rúa and Rodríguez Saá, since the other two interim presidents never really wanted the job.

2. Following the resignation of Rodríguez Saá, Argentina's acting vice president, Ramón Puerta, submitted his resignation as president of the Senate. This precipitated a legislative crisis. Under the constitution, Puerta's resignation meant that both chambers of the National Congress, the Chamber of Deputies and the Senate together—rather than the Senate alone—had to agree on whom to appoint as president. Puerta forced this outcome because the infighting among Peronist senators was intense. He likely thought that the only way to escape the impasse was to take the decision away from them.

3. Steven Levitsky, "The Normalization of Argentine Politics," *Journal of Democracy*, vol. 11 (April 2000), p. 57.

4. See Susan Strange, *The Retreat of the State: The Diffusion of Power in the World Economy* (New York: Cambridge University Press, 1996); and Beth A. Simmons, "The Internationalization of Capital," in *Continuity and Change in Contemporary Capitalism*, ed. Herbert Kitschelt, Peter Lange, Gary Marks, and John D. Stephens (New York: Cambridge University Press, 1999).

5. See Rudiger Dornbusch, Yung Chul Park, and Stijn Claessens, "Contagion: Understanding How It Spreads," *World Bank Research Observer*, vol. 15 (August 2000), pp. 177–98; and Dani Rodrik, "Why Is There So Much Economic Insecurity in Latin America?" *CEPAL Review*, vol. 73 (April 2001), pp. 7–30.

6. See Guillermo O'Donnell, "El capital financiero y el futuro de la Argentina," *Página/12* (Buenos Aires), March 21, 2001.

7. See James E. Mahon, Jr. and Javier Corrales, "Pegged for Failure? Argentina's Crisis," *Current History*, vol. 101 (February 2002), pp. 72–75.

8. See Max Corden, "Exchange Rate Regimes and Policies: An Overview, " in *Exchange Rate Politics in Latin America*, ed. Carol Wise and Riordan Roett (Washington, D.C.: Brookings Institution, 2000); and Peter Montiel, "Argentina's Crisis" (remarks at the panel discussion, "Argentina: What Went Wrong?" Amherst College, April 2002).

9. Nouriel Roubini, "Should Argentina Dollarize or Float? The Pros and Cons of Alternative Exchange Rate Regimes and Their Implications for Domestic and Foreign Debt Restructuring/Reduction," December 2, 2001.

10. Paul Krugman, "Reckonings: A Latin Tragedy," *New York Times*, July 21, 2001; see also, Charles W. Calomiris, "How to Resolve the Argentine Sovereign Debt Crisis," April 6, 2001, mimeographed.

11. Guillermo A. Calvo, Alejandro Izquierdo, and Ernesto Talvi, "Sudden Stops, The Real Exchange Rate and Fiscal Sustainability: Argentina's Lessons" (Washington, D.C.: Inter-American Development Bank, Research Department, June 2002, mimeographed).

12. Carlos Zarazaga, "Convertibility Law, Optimal Policy Rules, and the Fate of Free Markets" (paper presented at a conference sponsored by the Teresa Lozano Long Institute of Latin American Studies, University of Texas, Austin, April 22–23); Steve Hanke, "The Hoodwinkers," *Forbes*, November 26, 2001; and Steve Hanke, "A Monetary Constitution for Argentina: Rules for Dollarization," *Cato Journal*, vol. 18 (winter 2001), pp. 405–19.

13. Carol Wise, "Argentina's Currency Board: The Ties That Bind?" In Wise and Roett, eds., *Exchange Rate Politics in Latin America*.

14. See Calvo et al., "Sudden Stops"; and Corden, "Exchange Rate Regimes and Policies."

15. Economic Commission for Latin America and the Caribbean, "Preliminary Overview of Latin American and Caribbean Economies" (Santiago, Chile, 2000).

16. See Vicente Palermo, "Crisis económicas y reformas de mercado: comentario," *Desarrollo Económico* (Buenos Aires), vol. 39 (October-December 1999), pp. 459–70; Edward Gibson, "The Populist Road to Market Reform. Policy and Electoral Coalitions in Mexico and Argentina," *World Politics*, vol. 49 (April 1997), pp. 339–70; Pamela K. Starr, "Government Coalitions and the Viability of Currency Boards: Argentina under the Cavallo Plan," *Journal of Interamerican Studies and World Affairs*, vol. 39 (summer 1997), pp. 83–134; Vicente Palermo and Marcos Novaro, *Política y poder en el gobierno de Menem* (Buenos Aires: Grupo Editorial Norma, 1995).

17. See M. Victoria Murillo, "Tango de un desencanto anunciado" *Foreign Affairs en Español*, vol. 2 (summer 2002), pp. 1–17.

18. Javier Corrales, "Technocratic Policy-Making and Legislative Accountability" (paper presented at the Midwest Political Science Association, May 2002, mimeographed); and Mark P. Jones, Sebastian Saiegh, Pablo Spiller, and Mariano Tommasi, "Professional Politicians, Amateur Legislators: The Argentine Congress in the 20th Century" (paper presented at the annual conference of the International Society of New Institutional Economics, September 22–24, 2000, Tübingen, Germany).

19. See María Matilde Ollier, *Las coaliciones políticas en la Argentina: el caso de la Alianza* (Buenos Aires: Fondo de Cultura Económica, 2001), p. 52.

20. *Microsemanario 420* (Buenos Aires), October 20, 2000. This statement was also a betrayal of Alianza's campaign platform, which explicitly called for the maintenance of convertibility.

21. In March 2002, López Murphy resigned from the UCR, citing the party's "refusal to support the [De la Rúa] administration" as one of his reasons. See his "Carta al Dr. Luis Mario Helfenstein, Presidente del Comité de la UCR de Almirante Brown," *La Nación*, March 27, 2002.

22. Dani Rodrik, "Promises, Promises: Credible Policy Reform Via Signaling," *Economic Journal*, vol. 99 (1989), pp. 756–72.

23. John Waterbury, "The Heart of the Matter? Public Enterprise and the Adjustment Process," in *The Politics of Economic Adjustment*, ed., Stephan Haggard and Robert R. Kaufman (Princeton, N.J.: Princeton University Press, 1992), pp. 182–217.

24. Marcello Bonelli, "Por qué José Luis Machinea decidió irse del gobierno," *Clarín* (Buenos Aires), March 4, 2001.

25. See Horst Köhler, "The Challenges of Globalization and the Role of the IMF" (remarks at a meeting with members of the German Bundestag, 2001, at www.imf.org/external/np/speeches/2001).

26. Anne O. Krueger, "The Evolution of Emerging Market Capital Flows: Why We Need to Look Again at Sovereign Debt" (talk delivered at the Economics Society Dinner, Melbourne, Australia, January 21, 2002, at www.imf.org/external/np/speeches/2002/012102.htm). Emphasis added.

27. Financial analysts spread the word that O'Neill had compared the level of U.S. interest in Argentina to its interest in Uganda in an interview on CNBC, and had said that Argentines "contribute nothing to the world economy," that "nobody will remember them in five years" (BCP Securities, "Latin American Daily," August 16 and 17, 2001).

28. International Monetary Fund, "IMF Managing Director Köhler Welcomes Argentine Senate Action," IMF news brief no. 01/67, External Relations Department, Washington, D.C., July 30, 2001.

29. "FT Interview with Paul O'Neill," *Financial Times*, July 25, 2001.

30. Thomas C. Dawson, "IMF Did Help Argentina," letter to the editor, *Daily Yomiuri* (Tokyo), February 25, 2002; see also Michael Mussa, "Argentina and the Fund: From Triumph to Tragedy" (Washington, D.C.: Institute for International Economics, March 25, 2002, mimeographed).

31. In Babette Stern, "Interview with IMF Director General Horst Köhler: The Argentineans Will Not Come Out Painlessly," *Le Monde* (Paris), January 23, 2002.

32. See Mussa, "Argentina and the Fund."

33. The zero-deficit law was Cavallo's own idea (interview with author). Yet, the IMF influenced this decision by maintaining unrealistic policy expectations. This was the only policy that was severe enough that could have pleased the fund in mid-2001.

34. Domingo F. Cavallo, "La lucha por evitar el default y la devaluación," *La Nación*, April 29–30, 2002.

35. See José Claudio Escribano, "Sereno y distante, De la Rúa cuenta por qué se fue," *La Nación*, July 23, 2002.

36. Héctor E. Schamis, "Argentina: Crisis and Democratic Consolidation," *Journal of Democracy*, vol. 13 (April 2002), pp. 81–94.

37. See Kurt Schuler, "Fixing Argentina," Cato Policy Institute Paper no. 455, July 2002.

38. Eduardo Duhalde, "Argentina Regrets," *Financial Times*, July 2, 2002.

39. Marcello Bonelli, "El FMI pone una exigencia más para firmar el acverdo," *Clarín*, August 25 and 26, 2002.

40. Steve Hanke, "Legalized Theft," *Forbes*, March 4, 2002; see also, Thomas Catán, "Foreign Banks Angry Over IMF-Argentina Deal," *Financial Times*, August 19, 2002.