Comments

Luis Servén: The cataclysmic magnitude of the Argentine crisis has triggered a soul-searching literature looking for the causes of the collapse and the lessons to be drawn from it. The various contributions to this literature revolve around three main themes: the hard peg, fiscal policy, and investor expectations. What differentiates them is the emphasis placed on the role of each of these ingredients in leading to the crisis.

This paper belongs to the group stressing the third of those factors. However, unlike other analyses underscoring the role of expectations, which attach a major weight to self-fulfilling investor pessimism in precipitating the collapse by coordinating on a sudden stop of external financing, this paper places much of the blame on overly optimistic expectations.[1]

The paper offers a detailed chronicle of events in Argentina, but its line of argument can be summarized in a few words. In the framework of convertibility, perceptions of booming future dollar incomes led to the accumulation of large dollar liabilities. Those expectations were proven wrong, and the debts unserviceable, by major unanticipated shocks, whose adverse effects were amplified by the failure on the part of the authorities to put in place adequate precautionary policies and institutions during the boom years.

In support of the central role of expectations euphoria, Galiani, Heymann, and Tommasi note that pressure on the exchange rate and concern with the deteriorating fiscal situation were largely absent until late in the game. Further, the paper argues that the overspending was not confined to the public sector, but also involved the private sector, thereby reflecting what must have been upbeat anticipations about future income.

I come back to these arguments later, but first let me comment on the role of unfulfilled expectations. Every economy is affected by unpre-

1. Sachs (2002); Dani Rodrik, "Argentina: Globalization Gone Too Far or Not Far Enough?" *The New Republic*, 2 January 2002; Joseph Stiglitz, "Argentina Shortchanged," *Washington Post,* 27 May 2002.

dictable shocks that render expectations wrong ex post. While expectations must surely have been greatly disappointed, the striking feature of Argentina is the fact that the shocks of the late 1990s led to a crisis of unprecedented severity, unlike in other emerging economies suffering similar disturbances. As I argue below, this characterizes the Argentine episode as one of missed opportunities—opportunities to adopt the policies that could have prevented the crisis—as much as, or even more than, one of unfulfilled expectations.

Unfulfilled Expectations and Missed Opportunities

Argentina's meltdown must have resulted from either much greater shocks than those felt elsewhere or a much higher degree of vulnerability of the economy, or both. The distinction between these two ingredients, bad luck and bad policies, is essential for drawing lessons from the crisis. The paper is not very precise on the nature and magnitude of the shocks—indeed, the term shock is used to refer to both exogenous and endogenous events, such as terms-of-trade changes, deposit runs, and revisions of expectations. An international comparison based on run-of-the-mill terms-of-trade and financial shocks quickly reveals that Argentina's luck was not particularly bad.[2] The fall in its terms of trade in the late 1990s was very modest compared to that suffered by other Latin American countries (indeed, its effective dimension was virtually negligible given the fact that Argentina is a very closed economy), and until late 2000 its capital inflows and sovereign spreads evolved more favorably than Brazil's and on par with Mexico's.

But Argentina was severely affected by two specific real shocks in the late 1990s—the appreciation of the U.S. dollar and the devaluation of the Brazilian real. Unlike with terms-of-trade or global financial disturbances, however, the country's vulnerability to these shocks was largely a result of its policy choices, relating particularly to the exchange rate regime. Rather than bad luck, the main problem was the vulnerability built into Argentina's policy framework.

This brings me back to the usual suspects—the hard peg and the fiscal policy stance. I will take them in turn. The paper devotes considerable attention to the convertibility regime, but the discussion needs to give due emphasis to a basic policy issue: the hard dollar peg was the wrong

2. Perry and Servén (2002).

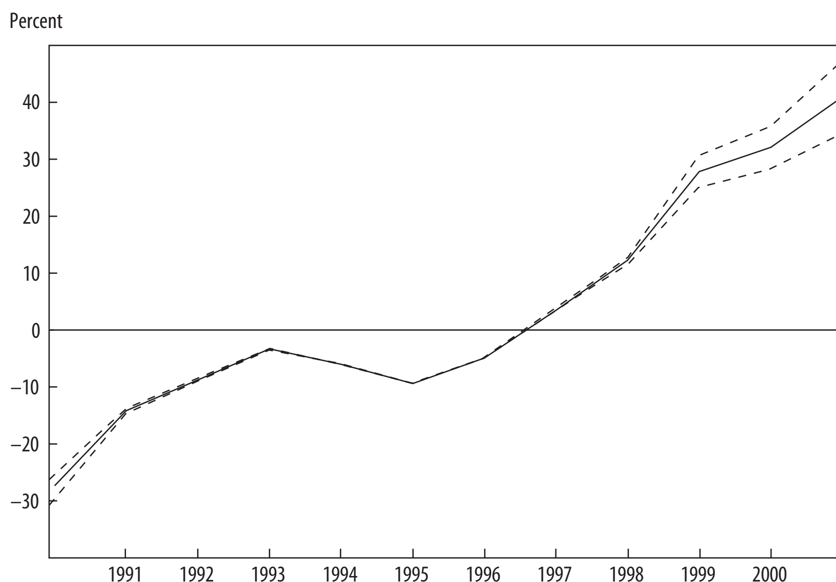
monetary regime from the perspective of Argentina's productive and trade structure. Argentina is very far from meeting conventional criteria for an optimal currency area with the United States. Only 15 percent of its total trade—less than 3 percent of its GDP—was directed to the United States. The scope for asymmetric shocks was very large, as the facts would eventually prove. Indeed, even if a hard peg or a currency union had been the optimal regime choice for Argentina—which seems unlikely as nominal price and wage flexibility were lacking—those criteria would have made the euro a less-inadequate choice.[3]

The peg provided nominal stability and encouraged financial deepening, at the cost of leaving the economy greatly exposed to real disturbances. The going was good while the real was overvalued and the dollar stable, but the appreciation of the dollar from 1996 on led to a mounting peso overvaluation, and the devaluation of the real in 1999 made it worse. To be sure, real misalignments can and do occur under flexible exchange rates, as well. But real exchange rate adjustments, such as those that would have been required after 1996, are typically much slower under hard pegs like Argentina's.[4] As a result, the overvaluation went unchecked. Alberola, López, and Servén find that the real exchange rate of the peso rose from a position of near equilibrium in 1996–97 to an overvaluation of over 40 percent in 2001 (figure 8).[5] Half of this total could be traced directly to the strong dollar, while an additional 10 percent was due to the devaluation of the real.

It is worth emphasizing that the overvaluation developed after 1996. While the peso had appreciated substantially in real terms at the beginning of the 1990s, much of the early appreciation was an equilibrium phenomenon, driven by a Balassa-Samuelson effect derived from productivity-enhancing economic reforms. Later in the decade, however, a widening gap opened between the observed and the equilibrium real exchange rate, as reforms came to a halt and fiscal and external imbalances persisted. Hence, the lack of concern with the exchange rate until late in the decade, which this paper poses as a puzzle, seems justified by economic fundamentals rather than a result of misguided expectations.

3. Alesina, Barro, and Tenreyro (2002).
4. Broda (2001).
5. Alberola, López, and Servén (2003).

FIGURE 8. Real Overvaluation of the Peso in Argentina[a]



a. Dotted lines represent 2-standard-error bands.

The peg undoubtedly promoted nominal stability and financial deepening. But along with financial depth came large currency mismatches in borrowers' portfolios, encouraged by the implicit guarantee that the fixed exchange rate appeared to provide. In this regard, the convertibility regime also played a more subtle destabilizing role, by hiding from public view the growing financial vulnerability implied by those mismatches. As the peso became increasingly overvalued, nontraded sector debtors and the government (and thus banks, as well) edged closer to insolvency at the equilibrium real exchange rate, while their debts still appeared manageable at the observed real exchange rate.[6] By sweeping the solvency deterioration under the rug until the overvaluation had grown disproportionately large, the peg made it more difficult to rally support for drastic adjustment measures while there was still time for an orderly correction.

As Galiani, Heymann, and Tommasi rightly argue, in the absence of an independent monetary policy, a solid fiscal base should have been built to

6. Perry and Servén (2002).

allow some degree of macroeconomic risk management. The failure to do so, especially in the boom years up to mid-1998—during which the authorities instead pursued an expansionary stance—was a major mistake that would later compound the hardship by forcing a retrenchment in the midst of the recession, which seriously damaged investors' perceptions about Argentina's growth prospects and hence about debtors' repayment capacity, thereby helping precipitate the collapse.

Did the authorities' misperceptions (that is, excess optimism) contribute to this expansionary stance during the boom? One might argue the same fiscal stance could have seemed neutral (or even restrictive) under a more upbeat assessment of trend growth. It is well known that assessing cyclical factors, and hence the cyclically adjusted fiscal stance, can be tricky in emerging and industrial economies alike.[7] In the Argentine episode, however, even a simple-minded measure of fiscal impulse such as Blanchard's, which uses no information on trend-cycle decomposition but simply compares current macroeconomic conditions with those prevailing in the preceding period, yields a clear picture of fiscal stimulus from 1996 to mid-1998, very similar to that based on cyclically adjusted GDP measures.[8]

Thus the failure to adopt a more cautious fiscal stance was not driven by growth misperceptions. Nor is it likely to have resulted from an underestimation of the risks it posed in the rigid framework of the convertibility regime. Instead, the failure to set public finances on a sustainable course during the years of bonanza echoes the chronic inability of Argentine policymakers to bring the government deficit under control. Ultimately, the country lacked the political institutions and failed to gather the political will that such control would have demanded. The fiscally decentralized federal structure added another layer of difficulty, as the provinces persistently ran substantial deficits whose correction proved to be beyond the reach of the central government.

That such ingredients, rather than expectations euphoria, played the main role is also suggested by the fact that after 1994 the private sector incurred current account deficits in only two years (1997–98), and surpluses in the rest, while the consolidated public sector ran a deficit every year from 1994 on.[9] Contrary to what the paper states, overspending was

7. Orphanides and van Norden (2002).
8. Blanchard (1993); Perry and Servén (2002).
9. Perry and Servén (2002).

mostly confined to the public sector, which was therefore largely responsible for the persistent current account deficits and the resulting accumulation of foreign liabilities that would eventually open the door to the financial crash.

The Lessons

The paper highlights policy lessons from the Argentine debacle. I conclude by emphasizing four such lessons. The first is clearly underscored in the paper; the others are equally important.

First, a hard peg is not a shortcut to policy credibility. Convertibility offered a seemingly quick escape from decades of monetary mismanagement—quicker, it was hoped, than a gradual rebuilding of confidence in the peso—but it was not accompanied by the development of a supportive institutional framework, which should have ranged from fiscal institutions to labor market reform and nominal price flexibility, that would configure a sound policy regime. The naïve presumption that a hard peg would somehow result in fiscal orthodoxy and flexible prices was shown to be clearly unfounded. Ultimately, hard pegs are no substitute for institution building—indeed, their institutional requirements may be as stringent as, or even more stringent than, those posed by credible floats.

Second, the hard realities of optimal currency area criteria cannot be ignored in the choice of currency regime. The dollar peg might have seemed a logical choice given the deep distrust of the local currency by Argentine asset holders, but it was ill-suited to the country's productive and trade structure. This conflict, combined with the above-mentioned nominal rigidities, was instrumental in the overvaluation of the peso in the late 1990s, which proved impossible to resolve within the straitjacket of convertibility.

Third, the Argentine experience illustrates the destabilizing powers of procyclical fiscal policy. Following the Latin American tradition, mismanagement of the boom was at the root of the collapse. The good times were a missed opportunity to build a solid fiscal position or undertake an orderly exit from the peg. Either would have required significant institution building on the fiscal front, which did not occur. Instead, the misguided expansion in the boom forced a self-destructing contraction in the recession. For Argentina and other emerging markets, this failure underscores the critical need to develop an institutional framework allowing the

conduct of countercyclical policy—in particular, by discouraging fiscal expansions during boom periods. It may boil down to the adoption of some kind of contingent rule that at a minimum allows automatic stabilizers to operate over the cycle. The structural deficit rule recently implemented by Chile could be a promising example.

Fourth, in highly dollarized financial systems, a real exchange rate adjustment can degenerate into a major financial crisis even with an apparently strong banking system. In the Argentine case, this became clear enough with the collapse of the peg, but even if the overvaluation of the peso could have been undone through nominal deflation and recession, the solvency of many nontraded-sector borrowers (and thus banks, as well) would have been threatened by old-fashioned debt deflation. This means that dollarized financial systems may require much tougher prudential regulation than previously thought.[10]

María Cristina Terra: In this very thoughtful paper, Sebastián Galiani, Daniel Heymann, and Mariano Tommasi analyze the unfolding of events in Argentina from the convertibility program to the current crisis, using a fresh perspective. They claim that a crucial element for explaining the Argentine crisis is the overly optimistic expectations held during the convertibility period, which led to excessive government spending and private consumption in view of the economy's path ex post.

The main piece of evidence of high expectations presented in the paper is based on the following reasoning. Had the government and private agents perceived the substantial increase of output in the early 1990s as a cycle, they would have saved part of their increased incomes. That is to say, government expenditures and private consumption should not have increased as much as output did. Figures in the paper show that those two variables increased at the outset of the convertibility plan, which is interpreted as evidence that both the government and the public viewed the higher output as permanent. One should look, though, to the evolution of those variables as a share of GDP, not in levels, as presented in the paper. Theory indicates that, in an open economy, a permanent positive shock to income will be totally transferred to higher consumption, with no effect on savings, whereas a temporary positive shock should increase savings. That is, if output is expected to stay at its higher level (or rise even further), con-

10. De la Torre, Levy Yeyati, and Schmukler (in this volume).

sumption should increase after the initial positive shock by the same (or a higher) rate than output. In the opposite case, when the output increase is viewed as temporary, agents should consume only part of the higher (temporary) output and save the rest.

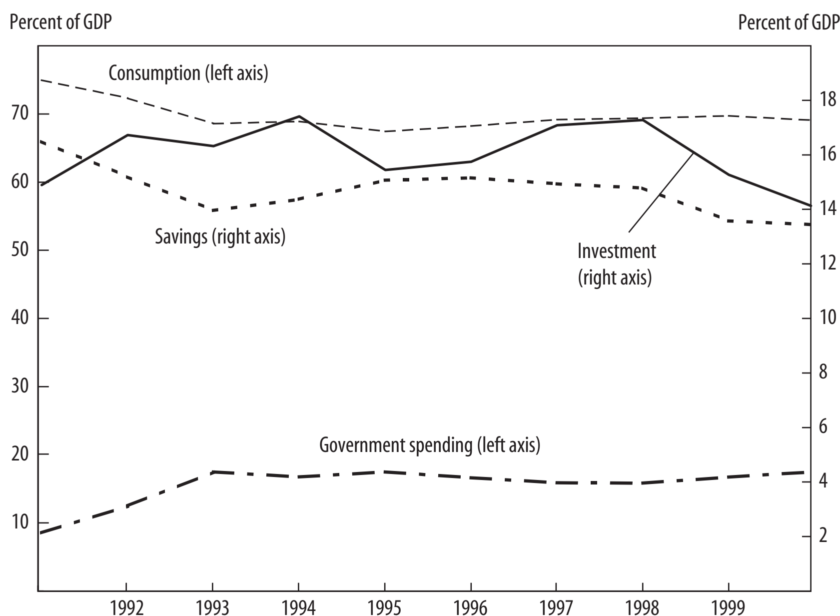
While it is true that both government expenditures and private consumption increased in levels, the authors fail to show that their share of GDP behaved quite differently. As presented in Figure 9, government spending as a share of GDP did increase, but the consumption share of real GDP actually decreased. The observed decrease in savings as a share of real GDP was thus due to government, not private, behavior. Following the reasoning in the paper, this would be evidence that the private sector was not as optimistic as the government about the future path of output.

Furthermore, the authors argue that higher spending could also have been used as a signal to the private sector, to boost their confidence so that they would not miss investment opportunities. This argument is not totally convincing. Such reasoning, which is formally presented in the paper's appendix, requires that the government should have had some private information on the probability of success of investment projects, not observed by the public. I wonder what is it that the Argentine government knew but the public did not—that is, what was the government's private information that had to be conveyed to the public through the higher spending signal? If the government had no private information, signaling would just create an illusion, rather than improving the private agents' expectations formation.

There is an alternative motivation for the government behavior not mentioned in the paper. It could have been the case that the higher government expenditures represented a policy resulting from political economy considerations, rather than the product of a benevolent central planner maximizing intertemporally. If that was the case, high government expenditures were not necessarily related to the government's optimism about the future. It could just have been the result of a noncooperative game of federal units seeking expenditure increases for their locality, in a not-well-designed institutional arrangement, granted by the positive economic environment.

External shocks hit the economy by the mid-1990s, decreasing growth and deteriorating the economy's fundamentals. The authors point out that the Argentine economy started running trade deficits in 1992, before the first external shock was unleashed by the Mexican crisis in 1994. Also, a

FIGURE 9. Component Shares of Real GDP in Argentina



pension system reform deteriorated fiscal performance early on. From the very beginning, therefore, long-run sustainability was based on the economy's rapid and steady growth, with a constant supply of foreign credit. That is to say, the economy was already pretty vulnerable when external shocks hit. I wonder why economic agents would have such overly optimistic expectations, as claimed in the paper, in such a fragile environment.

As the crisis mounted, expenditure-reducing policies could not help reverse the problem, for decreasing output would increase the government's budget deficit. It could also be argued that this could bounce back to the external constraint, because a higher budget deficit could increase the country risk, which, in turn, could further reduce capital inflow. Furthermore, exchange rate devaluation as an expenditure-switching policy was not allowed, unless the convertibility program was abandoned.

The authors present some very interesting data on polls showing that the vast majority of the population supported the maintenance of convertibility, owing to their perception of the extremely high costs an exit would

entail. The government authorities then chose, as the authors put it, to redouble the bet: they maintained the regime, increasing the exit costs even further. The economic situation continued to deteriorate with mounting government and current account deficits, and no economic policy was set forth to bring these variables to sustainable levels. In such an environment, I would think that redoubling the bet on convertibility would mean increasing illusions, as the situation was clearly not sustainable in the long run. The unfolding of events gives the impression that not even a good shock could have prevented a crisis in Argentina. It would really have taken a miracle.

All in all, it seems reasonable to state that there was a reversal of expectations, responding to the realization of the bad state of the (Argentine) world. It puzzles me, however, that in the early 1990s economic agents would place too high a probability on the Argentine economy following the high growth path, given its vulnerability from the very beginning and Latin America's history of being caught up by adverse international shocks. Expectations could not have been wrong enough to be crucial in explaining the depth of the present crisis. By this logic, it would have been more proper to title the paper "missed illusions" rather than "missed expectations."

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