Strategic Insight

Financial and Political Crisis in Argentina: Walking a Wobbly Tightrope

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Since December 2001, two months and five presidents have come and gone with no political stability in sight for Argentina. Argentina touted itself as the United States' closest ally in Latin America during the 1990s, closely following the U.S. lead in world affairs. It also was one of the strongest advocates in Latin America of U.S.-and IMF (International Monetary Fund)-sponsored neoliberal economic policies. Argentina's support for U.S. foreign policy objectives was rewarded with increased U.S. diplomatic and military recognition and billions of dollars in foreign investment during the 1990s. A bitter four-year recession, however, led to increasing popular protests against the government of President Fernando de la Rua, who was forced to step down this past December, half-way through his four-year presidential term. An interim president, Adolfo Rodriguez Saa, resigned after a week in the face of continuing protests, and Eduardo Duhalde, one of the leaders of the opposition Peronist party, has stepped into the presidency-for the moment. (The other two presidents were place-holders drawn from the leadership of the Argentine congress. Each held the title for no more than a day or two.)

President Duhalde and his staff seem to be holding their own while they attempt to correct a problem that had been brewing for over 10 years. Remarkably, Argentina's democracy has survived this political turmoil in accordance with the spirit (if not the letter) of its constitution. The political and economic crisis in Argentina, however, is bound to have negative repercussions for U.S. relations with the region. From the perspective of some Latin American countries, the fact that the Bush administration signaled early and often during the crisis that Argentina would be allowed to fail calls into question the reliability of the United States as an ally. The Duhalde administration has already begun to signal a shift away from support for some key U.S. economic and diplomatic policies. Nevertheless, the crisis in Argentina may yet provide an opportunity for advancing U.S. policies on free trade, since Mercosur, the Brazilian-led alternative to the Free Trade of the Americas regional trade pact, has been weakened by Argentina's economic collapse.

Background

At the core of the current economic crisis is Argentina's currency, the peso, which until recently was pegged to the U.S. dollar. In 1991, then-president Carlos Menem artificially tied the peso to the dollar at one to one parity through a currency board in order to generate financial stability. His actions effectively ended rampant inflation in the country and attracted billions in foreign investment. However, the currency board limited monetary growth by only allowing as many pesos to circulate in Argentina's economy as dollars held in the Argentine Central Bank's reserves. When foreign investment flowed in, as occurred during the mid-1990s, this had the effect of accelerating Argentina's economy by increasing the monetary supply. However, the artificial peg led to an overvalued currency that eventually made Argentina's exports uncompetitive while simultaneously encouraging high levels of imports. As long as foreign investments poured in, Argentina could cope with this situation, but once foreign investment dried up in the late 1990s, it was a recipe for disaster. Foreign debt swelled to pay for Argentina's imports, and national debt was compounded by the free-spending habits of provincial governments, who often took on unrealistic debt loads in the expectation that they would be bailed out by the national government. As Argentina's economy became uncompetitive, the currency board had the effect of deepening the four-year recession

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by shrinking the monetary supply as the country spent more on imports than it earned through exports. The slump sent unemployment spiraling to levels over 18 percent, creating the conditions for political unrest to reach dangerous levels.

In December 2001, the IMF signaled that it had lost confidence in the de la Rua administration's economic program by shutting off a crucial $1.3 billion bailout when Argentina failed to meet budget-cutting targets. That prompted Argentina to announce days later that it was suspending payments on its foreign debt amounting to $141 billion dollars. Then-President Fernando de la Rua, in order to halt a run on the Argentine banking system, which is largely dominated by foreign financial institutions, imposed a $250 limit on weekly withdrawals. Besides nearly freezing economic activity, this action provoked street protests around the country. Demonstrators attacked banks and looted supermarkets. In Buenos Aires, thousands marched on the presidential palace demanding food, jobs, and an end to the banking freeze. Over a dozen people died in confrontations with riot police or other demonstrators. The result was the resignation of the deeply unpopular de la Rua as president.

During the December 2001 holidays, it quickly became apparent that few Argentine politicians had the necessary political backing or popularity to lead their country successfully out of its economic crisis. After a false start under interim president Adolfo Rodriguez Saa, the Argentine congress appointed Eduardo Duhalde, a leader of the Peronist opposition, to serve out the remainder of de la Rua's presidential term. Duhalde took office announcing an end to the peso's parity with the U.S. dollar and creating a multi-tiered exchange rate to take its place. Although the rules have been shifting since the devaluation, there is now an official exchange rate of 1.4 pesos to the dollar for major international financial transactions, and a free floating exchange rate for most personal or individual needs. This devaluation could have potential explosive political implications since most salaries are paid in pesos, while most consumer debts and mortgages are valued in U.S. dollars.

Duhalde blamed the U.S. backed free-market approach for his nation's troubles, proclaiming it a "broken model," and warned that his government will aggressively protect Argentine industry and jobs. Duhalde and his team have since suspended government payment of debts to international creditors, introduced capital controls, and placed extraordinary taxes on oil exports. Commenting on his government's activities, Economy Minister Jorge Remes Lenikov said, "We have to lay bare several fallacies that we were getting used to. One is living at somebody else's expense; the other is having deposited pesos and thinking that they are dollars or that they were converted into dollars in an accounting entry." Duhalde's economic policies are largely short-term measures designed to stabilize the current economic and political situation. However, they risk turning Argentina into a pariah in global investment circles.

The United States and the IMF are taking a dim view of President Duhalde's tactics, and it does not look as if the United States is willing, at least at this point, to support Argentina during this crisis. In a recent meeting of the Organization of American States, President Bush said, "Argentina and nations throughout our hemisphere need to strengthen their commitment to market-based reform, not weaken it." The Bush administration has stated that Argentina will only receive U.S. assistance through international financial organizations, and only when it has a solid economic program that includes privatization, deregulation, and fiscal discipline. Similarly, in a speech in Chile, IMF First Deputy Director Anne Krueger said IMF support for Argentina is contingent upon the economic plan the Duhalde administration develops. She said Argentina should formulate a new monetary policy, a fiscal policy, and restructure the banking system. She noted that it would be very unlikely for the IMF to provide a solution for Argentina's economic crisis in the near term.

Argentina's largest regional trade partner, Brazil, is looking for ways to reduce the risk that the economic crisis will spread. Brazilian economists have said that their country's best protection from contagion by the Argentine crisis is for it to persevere with its own recent macroeconomic policies, including inflation targeting and a floating exchange rate. In fact, Brazil's 1998 devaluation of its currency, the real, contributed to making the Argentine peso uncompetitive even in trade with its Mercosur partners. Argentina's current devaluation will provide some benefits for its economy by making its exports more competitive in the larger Brazilian market.

In many respects, Argentina's economic collapse was telegraphed far enough in advance that key political and financial actors have had sufficient time to take measures to prevent a contagion of economic crises. For this reason, Argentina's collapse is unlikely to lead to a regional, let alone world-wide, financial crisis, as occurred in Asia in 1997 or following the botched Mexican currency devaluation in 1994.

Implications for Latin America and the United States

Remarkably, Argentina's democracy appears to have survived the political turmoil associated with its economic crisis. Only two decades ago, similar levels of confrontation and popular unrest would have provoked a military coup. This time, the Argentine armed forces have wisely chosen to keep a low profile. The degree of civilian control over the armed forces that has been institutionalized since the transition to democracy in 1983 makes a coup d'etat in the current crisis highly unlikely. The crisis has, however, demonstrated the bankruptcy of the Argentine political class. The difficulty of finding a successor to serve as president following the resignation of de la Rua shows that the ranks of politicians able to lead the country credibly have become dangerously thin. His eventual successor, Eduardo Duhalde, received less than 40% of the vote in the 1999 presidential elections, the worst performance ever for a candidate from the Peronist party. There seems to be no politician of any national standing who could credibly replace Duhalde if he stumbles as well. Given ongoing street protests in the face of the unpopular economic measures recently adopted by President Duhalde and the depths of the economic crisis, it is not unthinkable that Argentina could have yet another chief executive before the next elections, now scheduled for 2004.

The crisis also has serious implications for Argentine and regional security. In the short term, the heavy strain placed on Argentine police forces by frequent riot control duty in major cities is likely to erode their capacity to deal with other threats to internal security. In particular, terrorist groups linked to Hamas and Hezbollah are strongly suspected of operating in the tri-border region where Argentina, Paraguay, and Brazil meet. These groups are thought to have carried out the bombing of the Israeli embassy in Buenos Aires in the 1990s. A weakened Argentine security presence in this already under-policed region at a time of local political turmoil may create new opportunities for these groups to prosper.

In the long term, the Argentine military is likely to face a further decline in resources. Even during the flush decade of the 1990s, the Argentine armed forces survived on fairly limited resources. Argentina's designation as a major non-NATO U.S. ally was a source of great pride, but of little practical assistance to the Argentine armed forces. Budgets also were strained by the transition to an all-volunteer force in 1995, and the failure to downsize effectively in the face of a changing strategic environment. The result has been a defense establishment in which almost all budgets are destined to personnel costs, with very little available for maintenance, let alone operations. Almost any solution to Argentina's current crisis is likely to involve severe budgetary austerity by the central government. In this environment, defense budgets are likely to shrink further, operational capacity will diminish, and personnel retention problems are likely to increase.

Although the U.S. war on terrorism has shifted the Bush administration's focus away from Latin America, the Argentine economic collapse is likely to have serious implications for U.S. relations in the region for some time to come. While the Bush administration signaled a new toughness towards economically troubled debtor nations around the world by allowing Argentina to collapse, it may have sent a somewhat different message to Latin American audiences. For years, populist political leaders such as Hugo Chávez in Venezuela and Luis Inácio Lula da Silva (Lula) in Brazil have railed against IMF- and Washington-sponsored economic policies. The economic failure of Argentina, the most devoted follower of these policies during the 1990s, has been interpreted in some circles as evidence supporting the anti-IMF and anti-U.S. claims of populist leaders. This may be especially important in Brazil, where presidential elections are scheduled for 2002 and Lula is currently leading the polls.

The implications of recent events in Argentina for U.S. trade policy towards Latin America are less clear. Its economic paralysis has deepened the turmoil within Mercosur, the regional trade bloc led by Brazil.

Until now, Mercosur had been pushed by Brazil as a Latin American alternative or precursor to the Free Trade Area of the Americas (FTAA) initiative sponsored by Washington. From the Brazilian perspective, Latin American countries would have more leverage vis a vis the United States if they integrated into Mercosur first, then negotiated as a bloc over entry into FTAA. Until now, Argentines-deeply resentful of the Brazilian devaluation of its currency which undermined Argentine ability to export to Brazil-had rejected the Brazilian strategy of independence and opted instead to stick to their proven strategy of unabashed support for U.S. policies. On the face of it, Argentina's crisis may place the United States in a stronger negotiating position by undermining Mercosur as an alternative. The association of the FTAA with Washington-sponsored neoliberal economic policies, however, may make the Brazilian model of greater protection for local markets, currently embodied in Mercosur, more attractive to Latin American countries in the wake of Argentina's collapse.

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