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Argentina's Financial System Fenced In

The Argentinazo *was just what the word itself sounds like: a chaotic explosion of Argentinean-ness, during which hundreds of thousands of people suddenly and spontaneously left their homes, poured on to the streets of the capital, banged pots and pans, yelled at banks, fought police, revved motorcycles, sang football anthems and managed to send the president fleeing his palace in a helicopter. Over the following 12 days, the country would go through five presidents and would default on its $95 billion debt, the largest default in history.*

— *The Guardian*, January 2003.

Riots; lootings; political crisis; the suspension of peso convertibility; devaluation. The last months of 2001 were a period of chaos in Argentina's financial, economic and social systems. Through 2001, the country endured rising unemployment (reaching 22%), a substantial drop in GDP, a 20% fall in bank deposits, and the loss of almost half of the Central Bank's foreign reserves.[1] In late December, increasing social unrest and dire social conditions led people to take to the streets of the country's capital in protest against the emergency economic measures, notably the so-called *corralito* (a restriction on bank deposit withdrawals). In the rioting, at least 26 people died and a significant number of others were injured. Uncertainty and fear reigned.

In the aftermath of Congress' repeal of the Convertibility Law on January 6th and the associated 40% devaluation of the Argentine peso, on January 25, 2002, the newly appointed President, Eduardo Duhalde—previously senator for the province of Buenos Aires—announced the *corralon* (a further restriction on bank deposits). While the *corralito*, implemented two months earlier, had only partially frozen checking and saving accounts by introducing a US$1,000 limit on cash withdrawal along with other capital controls, the *corralon* imposed new terms on long-term deposits. Duhalde simultaneously announced that asymmetric pesification of bank deposits and debts was being considered as a palliative to reduce the burden that peso devaluation had imposed on Argentine debtors. Such forced pesification would further strain an already troubled financial system.

Estimates indicated a modest climb in the January consumer price index (CPI) of 2.3% over the previous month.[2] Yet uncertainty regarding inflationary pressures remained. Some economists argued that the lack of financial liquidity precluded the onset of hyperinflation, while others feared the inflationary impact of devaluation. The peso exchange rate had already climbed to 1.75 pesos per U.S. dollar (from its original level of parity), and the Central Bank had been selling dollars from its reserves to prevent further depreciation.

Professor Huw Pill and MBA class of 2003 students Claudia Onoforio and Romina Abal prepared this case on the basis of published materials. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Duhalde faced an apparently insurmountable situation. As he reflected on the task ahead, he considered how to reestablish macroeconomic fundamentals and restore confidence in the financial system.

A Decade of Reforms

After having experienced serious economic and financial difficulties in the post-1945 period, in the 1990s Argentina achieved the consensus necessary to implement substantial economic reform. In 1991 President Carlos Menem, in tandem with Harvard-educated Minister of Economics Dr. Domingo Cavallo, set out to reverse Argentina's economic decline through the implementation of free-market policies.

The cornerstone of these reforms was the Convertibility Plan of 1991. The Convertibility Law fixed the peso's exchange rate at par with the U.S. dollar and required the Central Bank to back at least two-thirds of the monetary base with dollar reserves, in principle eliminating the possibility of inflationary financing of the government deficit. Under convertibility, Argentines could freely convert a peso into a dollar. Devaluation risk was reduced and investor confidence increased. Foreign capital flowed into Argentina, in part through the privatization of the large number of public assets.

Against this background, a series of other reforms took place including financial liberalization, liberalization of trade and the capital account, and far-reaching public sector reforms.

The removal of barriers to trade and the free flow of cross-border capital opened the Argentine economy. The government eliminated export taxes, import duties, and most quantitative restrictions on trade. It allowed free entry and exit of portfolio capital and foreign direct investment. The size of the public sector was significantly reduced through privatizing major (and typically very inefficient) public enterprises. Subsidies to companies were practically eliminated, while the government encouraged the entry of foreign firms into the market.

Privatization was also an important source of income, which helped to cover the continuing public deficits while tax reform was implemented. That the federal government continued to run modest deficits throughout the mid-1990s despite a strong economy was due mainly to the unfunded public pension liabilities. At the provincial level, on the contrary, the fiscal problem reflected a lack of discipline exacerbated by a transfer of responsibilities from the federal to the provincial level in the second half of the 1990s. While salaries in the private sector remained stable or even fell in the 1990s, the public sector increased its average salary two fold.[3]

Another key reform of the monetary and financial system was the Central Bank Charter of 1992. This made the Central Bank independent of the executive and legislative branches and identified its primary goal of "maintaining the value of the domestic currency." Under the Charter, the Central Bank was expressly prohibited from financing provincial or municipal governments, public firms, or the private non-financial sector. While it could also back up to one-third of the monetary base with dollar-denominated government securities (valued at market prices), holdings of these securities could not grow more than 10% a year.

Reform of bank regulation increased competition in the financial sector. It allowed the free entry of foreign banks into Argentina and removed the restrictions on the opening of new branches of domestic banks. In September 1991, capital requirements were set at 3%. But by 1995, they had gradually risen to 11.5%, significantly above the requirement of 8% established by the

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Basel Committee on Banking Supervision (the so-called "Basel ratio"). Reserve requirements were set initially at 40% (later rising to 43%) on checking and savings deposits and 0% (later 3%) on time deposits. The elimination of deposit insurance and the *de facto* abolition of the lender of last resort role of the Central Bank (through the currency board) diminished the risk of moral hazard by limiting the safety net available to banks.

The so-called "tequila crisis," resulting from Mexico's peso devaluation in December 1994 and fears of subsequent debt default throughout Latin America, was the first trial of the new system. This crisis accelerated the restructuring of the banking system and acted as a catalyst for a further deepening of financial supervision and regulations. In only five months during 1995, 18% of deposits fled the banks, with severe repercussions for banking system liquidity.

In response, the Central Bank increased its capacity to restructure troubled banks through the creation of two trusts. The first trust helped with privatization of provincial banks and the second helped with restructuring troubled private banks. The restructuring process was seen as relying on market discipline, since banks were allowed to fail rather than being bailed out by government. Mandatory private deposit insurance (first set at the modest level of 20,000 pesos, although subsequently raised to 30,000 pesos) was established to restore depositors' confidence. Other changes included: new supervisory measures defined to assure more regulatory and market discipline on banks; the replacement of traditional reserves requirements with remunerated liquidity requirements "based on the residual time to maturity of deposits and other bank liabilities;" and capital requirements set according to market risk.[4]

Complementing the preceding measures, the Argentine authorities also created a new framework for banking regulation and supervision called BASIC (an acronym for Bonds, Auditing, Supervision, Information, and Credit Rating). The underlining idea of BASIC was that, when standing alone, both market and regulatory discipline were imperfect, given the existence of different sets of incentives, information, and legal enforcement. The BASIC system was designed such that regulatory and market approaches acted together, thereby reinforcing one other. It promoted greater transparency by making information available to supervision and auditing agencies as well as the market. It also established regulations for subordinated debt issuance and credit ratings. (For general regulatory measures timeline, see **Table 1**.)[5]

The banking and regulatory measures in place were considered a model for emerging markets. As one economist put it: "Indeed, Argentina was regarded as a country with a very sturdy banking system trailing behind only a few developed nations. This was the consensus at home and abroad."[6]

A wave of consolidation followed the tequila crisis. Between 1991 and August 1999, the number of banks in the financial system declined from 167 (of which 35 were publicly owned) to 119 (with 16 public banks). Many small provincial banks were privatized. Deposits held by the 10 largest banks increased substantially over the period.

Bank performance indicators improved throughout the decade. Deposits per bank employee rose from 96,000 pesos in private institutions (69,000 in public institutions) in March 1991 to 877,000 pesos in private institutions (729,000 in public institutions) in August 1999, despite Argentina having suffered two recessions. Monetization advanced rapidly and M3 reached 30% of GDP, from 20% in 1995.[7] The extent of this success could be measured by the fact that the Asian, Russian, and Brazilian crises—while they increased Argentina's country risk and helped deepen the ongoing recession—did *not* precipitate international or domestic capital flight from the banking system.

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Table 1

Main Regulatory Measures Timeline

April 1991	Currency board adopted
September 1992	New Charter of the Central Bank established
December 1992	Deposit insurance abolished
1992–1994	Basel capital requirements adopted. Raised to 11.5% in December 1994
1994–1995	Provisioning requirements tightened
April 1995	Limited, fully funded deposit insurance set at 20,000 pesos (subsequently 30,000)
August 1995	Liquidity requirement system (raised to 20% of deposits through 1997)
September 1996	Market risk capital requirements
1997–1998	BASIC introduced
March 1999	Capital requirements for interest rate risk

Between 1991 and 1999, general economic performance was remarkable. GDP grew 4.7% annually, exports increased 8.2% a year (by value) on average, and the employment rate increased by 12%. Despite this progress, the financial system remained small by international standards. Moreover, by the end of the decade, Argentina's economic dynamism had expired. Argentina fell into recession, in part because of the real appreciation of the peso through the mid-1990s.

The Presidency of Fernando De La Rua

In December 1999, Dr. Fernando De La Rua—presidential candidate of a coalition of parties called *La Alianza*—won the presidential election with a campaign based on ending corruption and reviving the economy. *La Alianza* was formed by a coalition of the Radical party (UCR) with *FREPASO*. The former was a traditional party founded in the late 19th century; the latter was a splinter group of left-wing former Peronists (the populist party named after its founder, Peron). De La Rua represented the Radical party, while his Vice-President Carlos Alvarez represented *FREPASO*. The *Alianza* was split by ideological differences between the coalition parties as well as within the Radical party itself.

With a fragmented political base, President De La Rua's task was challenging. The currency board had led to an overvalued peso, the fiscal deficit was greater than expected, and public debt had reached a historically high level. The government estimated that to finance itself through 2000, 17 billion pesos needed to be raised in the international capital markets. But given the seemingly unsustainable magnitude of the growing external debt, this objective was becoming increasingly difficult to achieve.

The government of President De La Rua, through his Minister of Economics Jose Luis Machinea, attempted to address the high and rising public deficit by raising taxes. This measure became known as the *Impuestazo* and was implemented in January 2000. It included an increase in tax rates on consumer goods, an extension of the value-added tax base to health insurance and transportation, and a broadening of the income tax base. Far from triggering faster growth, these measures were followed by a deepening of the recession. Consumption indicators worsened and the deficit remained higher than expected. Doubts about the sustainability of the government's debt dynamics were raised, exacerbated by the apparent political cost of such measures for a government that had been elected on promises of reducing government spending by improving efficiency and eliminating corruption, not by increasing taxes.

During the subsequent months, the government tried to address the ballooning public debt and fiscal deficit by reducing government spending, albeit with little success. By October 2000, an internal political crisis emerged with the resignation of Vice-President Carlos Alvarez. The official reason he gave for his resignation was the government's failure to address accusations of corruption in the Senate. However, many believe Alvarez resigned because he recognized that the redistributional promises that had been made by *FREPASO* during the electoral campaign would not be met. After Alvarez' departure, it became increasingly difficult for President De La Rua to gain political support for his decisions.

In December 2000, Economics Minister Machinea negotiated a U.S. $40 billion loan package (the so-called *Blindaje*) with international and domestic financial institutions on the basis of promises that economic reforms would be deepened and public expenditure reduced. At first, Argentine country risk fell. However, the political difficulties facing the government became evident shortly afterward, and investors began to question the likely success of the reforms. The economy as a whole continued to deteriorate as the fiscal deficit during the first two months exceeded agreed targets, consumer confidence failed to improve, and tax revenues did not increase.

Stymied by the political impasse, Machinea resigned in March 2001. He was succeeded by Dr. Lopez Murphy (previously Minister of Defense), a well-known and respected economist. Minister Lopez Murphy acknowledged that the source of the problem was the huge fiscal deficit caused by excessive government expenditure. He presented a program of public expenditure cuts in the order of U.S.$8 billion over a period of three years, with the severest cuts imposed on the education budget.

Six officials of the *FREPASO* resigned in opposition to these measures, and the leftist wing of the Radical party, led by former Argentine President Raul Alfonsin, fiercely opposed them. As President De La Rua lacked the political support or credibility to defend his Economics Minister, Lopez Murphy resigned within two weeks of taking office. The *Alianza* did not have a credible alternative to Lopez Murphy.

Domingo Cavallo Returns to the Economics Ministry

Against this background, President De La Rua invited Dr. Domingo Felipe Cavallo to become the Minister of Economics once again. It was rumored that De La Rua threatened to resign if the rest of the government did not support the appointment.

Cavallo—aware of the politics that had forced his predecessor to resign—focused his economic proposals on promoting growth. After being given special powers by Congress, Cavallo initiated policies with two objectives: increasing tax revenue and addressing the problems facing specific troubled economic sectors.

Cavallo began by developing so-called "Competitiveness Plans." The objective of these plans was to reduce the business costs in certain productive sectors by reducing or eliminating

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distortionary taxes. Businesses party to these plans agreed in exchange to reduce prices and maintain employment levels. At the same time, Cavallo also introduced a financial transactions tax.

The initial success of the plan relied on the expectation of increased revenues and economic improvement as well as on Cavallo's reputation, which helped the plan garner support from international markets. In this context and on the basis of the Convertibility Plan, Cavallo famously told financial analysts in a conference call: "I am a legend."

But economic recovery remained elusive. In April, the public deficit was again expected to exceed target. It became necessary to cut government spending to reach the deficit goals agreed on with the IMF. Confidence in convertibility began to weaken when Minister Cavallo acknowledged the need to modify current price and exchange rate relationships. He opined that the peso was overvalued by about 20% and that this fact was affecting Argentina's competitiveness. However, Cavallo indicated that the exchange rate was not going to be modified. He argued, on the contrary, the path to salvation lay in more rapid growth stimulated by reducing taxes, cutting tariffs, and speeding deregulation.

Although Minister Cavallo enjoyed "superpowers" granted by Congress, the lack of political support for his measures soon became evident. Confidence flagged, markets reacted negatively, and Argentina's country risk increased as a result. Because of growing uncertainty surrounding the country, rating agencies began downgrading Argentine public and private securities.

On April 16, Cavallo proposed an amendment to the Convertibility Law that would peg the peso against an evenly weighted basket of euros and dollars once the euro regained parity with the dollar. Although Cavallo emphasized the continuation of convertibility and presented this measure as an attempt to better align the peso with Argentina's trading patterns, markets interpreted it as a threat to the 1:1 parity on which the Convertibility Plan had been based.

To make matters worse, Pedro Pou, president of the Central Bank, resigned on April 25, citing disagreements with and pressure from Minister Cavallo and other government officials. As an appointee of the Menem government, Pou had been the target of criticism from *Alianza* politicians. Not only was he inclined toward dollarization of the economy, but he had been unwilling to reduce Central Bank reserve requirements so as to improve banking sector liquidity. Critics claimed he had not done enough to address Argentina's deteriorating financial situation. Pou was replaced by Roque Maccarone.

As a result of this ongoing political turmoil, reserves at the Central Bank had fallen by 4 billion pesos, while bank deposits had declined 5 billion pesos. Country risk exceeded 1,000 basis points. In May, the fiscal situation deteriorated further, requiring increases in the financial transaction tax rate and elimination of more value-added tax exemptions. Financing from capital markets dried up.

Cavallo began planning a voluntary debt swap, the *Megacanje*. The plan was approved in May and negotiations to implement the transaction began. Although the rates paid to borrow at longer maturities were high (around 15% *per annum*), capital and interest payments were to be reduced by U.S.$8 billion over the next year. It was widely believed that the debt restructuring would provide some needed breathing room for the Argentines in 2002.

Investors initially welcomed the program, but once the underlying fundamentals—such as tax revenues—did not improve, Argentina's economic situation fell apart once more.

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On June 15, new measures targeted at reactivating the demand for exports were announced. These included a new exchange rate for exports of 1.08:1, presented as a transition towards the adoption of a euro / dollar basket. Markets once more interpreted this as a sign of a weakened commitment to convertibility. Devaluation risk and shorting of the peso increased as a result.

> Argentina is running out of options. We believe such drastic budget cuts will require a level of political support not yet seen in the Argentine political establishment.
>
> —Goldman Sachs, July 2001.

In July, the government realized that the fiscal deficit could no longer be financed. The yields demanded by the market were simply too high to permit a sustainable debt position. In consequence, a zero deficit policy was implemented. Among the measures taken were reduction of public salaries and pensions and an extension of the financial transactions tax.

Again the government faced opposition from within its own ranks, as *FREPASO* and the left wing of the Radical party rebelled. Only after a substantial delay were the fiscal-tightening measures approved. The government then pursued negotiations with the IMF that, in August, resulted in a U.S.$8 billion loan package. Of this, U.S.$5 billion were to be disbursed in September to replenish Central Bank reserves, while the remainder would be disbursed in 2002, conditional on the achievement and maintenance of a zero fiscal deficit.

Yet Argentina's downward spiral continued. Country risk climbed to 1,700 basis points, surpassed only by Nigeria.

During the October Congressional elections, candidates publicly criticized the government. They demanded devaluation, the resignation of Cavallo, and a rejection of liberalism and globalization. Of course, such sentiments only served to undermine market confidence. As a result, interest rates soared and outflows of bank deposits accelerated.

In November the government announced a new debt swap guaranteed by fiscal revenue. In contrast to the *Megacanje*, the swap was not well received by investors. Moreover, the federal government and the provinces failed to reach an agreement on revenue sharing, and public deficits therefore continued to increase. Consequently, the IMF stopped disbursing funds to Argentina.

Unfortunately from Argentina's perspective, on November 26, 2001, Anne Krueger (the first deputy managing director of the IMF) gave a widely quoted speech at the annual meeting of the National Economists' Club in Washington on sovereign debt. She focused in particular on bankruptcy reorganization and debt restructuring for insolvent debtor countries. The prominence given to this topic only served to raise further questions for investor in Argentina.[8]

Faced with accelerating capital flight in December 2001, the Argentine authorities introduced desperate emergency measures that fundamentally changed the operation of convertibility. Sweeping restrictions (said to be temporary) on cash withdrawals from banks, foreign exchange operations, and deposit movements were imposed to halt the ongoing bank run and save the financial system. This was the so-called *corralito*, or "little fence."[9]

Naturally Argentines disliked the *corralito* and public protest sprang up ubiquitously. On December 19, 2001, President Fernando De La Rua declared a state of siege following widespread looting in Buenos Aires and the rest of the country. Minutes after the national announcement, thousands of people started what became known as the *Cacerolazo* protests—a vast expression of popular discontent. Each day, thousands of people congregated in the Plaza

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de Mayo in Buenos Aires and around Cavallo's house, demanding social justice. During these episodes, several banks were destroyed as the public vented their anger against the institutions that denied them their property; supermarkets were robbed; and more than 26 people were killed. This uncontrollable situation led to the resignations of President De La Rua and his cabinet on December 20.

On December 23, Rodriguez Saa, governor of the San Luis Province, was appointed the new interim president by the Legislative Assembly. To applause and shouts of victory, he declared a 60-day moratorium on external debt payments. Saa also announced the issue of a new currency, the *argentino*. But his government was soon under attack. Allegations of past corruption were made against members of his team, and Saa was forced to resign on December 28. The protestors' slogan "*que se vayan todos*" (everybody should go) was illustrative of the popular contempt for the ruling class in general and politicians of all persuasions in particular.

Eduardo Duhalde became the country's fifth president in two weeks on January 2, 2002. Within days, he officially suspended the currency board and announced the floating (and thus sharp depreciation) of the peso.

The Banking System

Industry overview before the crisis

At the beginning of 2001, the Argentine banking system consisted of four different types of entities. Public banks controlled 28% of total accounts, 25% of loans, and 33% of deposits. Domestically owned private banks, represented primarily by *Banco de Galicia*, held 17% of total accounts, 20% of loans and 16% of deposits.[10] Foreign-owned Argentine banks dominated the industry with 52% of total accounts and 35% of total loans and deposits. Branches of international banks represented the remainder.

The total net worth of the banking system was 17.3 billion pesos as of December 2000. Despite the apparent soundness of the financial system, return on equity was only 0.47%. An increasing number of non-performing loans and declining prices for government securities (roughly 10% of the total bank portfolio) adversely affected the balance sheet of many institutions.[11] Moreover, the Argentine financial system was heavily *dollarized*, with 70% of all credits and deposits denominated in dollars (see **Exhibit 16**).

Domestic Banks Locally owned banks were shrinking as a percentage of the market. Many of the larger domestic banks required recapitalisation and had been sold to international banks after the tequila crisis.

The market leader was *Banco de la Nacion* (100% state owned) with $17.7 billion in assets and $15.9 billion in deposits (as of December 2000). With over 600 branches, *Banco de la Nacion* enjoyed a broad presence in the country and remained the sole financial institution in many towns in the interior. *Banco de la Nacion* played two important roles: it was the major lender to agribusiness and was often used as a tool of economic policy to protect Argentine borrowers from rises in market interest rates.

The second largest bank in Argentina, and the largest private bank, was *Banco de Galicia*. It had 13.4 billion pesos in assets and 11.9 billion pesos in deposits (as of June 2001). The main shareholders were three Argentine families, and the bank's holding company was listed on the

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Buenos Aires Stock Exchange and on Nasdaq. *Banco de Galicia* was a major market maker in the government's Treasury bill auctions departments in the country.

Banco de la Provincia de Buenos Aires, with 14.5 billion pesos in assets and 13.1 billion pesos in deposits (as of December 2000) was the third largest commercial bank. The bank, fully owned by the province of Buenos Aires, had been somewhat affected by the province's poor fiscal situation. The creditworthiness of its loan portfolio was in doubt as the fiscal position of the state government deteriorated.[12]

Foreign Banks According to the Argentine Central Bank, foreign banks commanded about 50% of total assets in the banking sector and approximately 70% of all assets managed by private banks. Large overseas banks, such as *Banco Bilbao Viscaya Argentaria* (BBVA-Spain), *Banco Santander Central Hispano* (BSCH-Spain), Citigroup (USA), Fleet Boston (USA), Bank of Nova Scotia (Scotiabank-Canada), *Grupo Intensa* (Italy), and *Credit Agricole* (France), had taken over local financial institutions in recent years in order to increase their market shares.

Declining Confidence

> The Convertibility Plan is guaranteed and there is no possibility of devaluation…there are no significant deposit withdrawals because the Argentine people know that things are all right and secure, the convertibility plan will continue and the government is working to ensure economic sustainability for the next two years…
>
> —President De la Rua at a meeting with Fernando Henrique Cardoso (President of Brazil), Vicente Fox (Mexico), and Ricardo Lagos (Chile), Lima, Peru, November 2001.

During the last months of 2001, the Government and the Minister of Economics publicly claimed that ending the Convertibility Plan and devaluing the peso were inconceivable. The authorities pleaded with the population to act "rationally" and continue to hold peso deposits in Argentine banks. The public's perception—reflected in the drain of deposits from the financial system—proved to be the opposite.

Despite the government's efforts, by the end of 2001, four clear waves of bank deposit withdrawal could be identified. The first wave occurred in March as a consequence of the political uncertainty culminating in the resignation of Economics Minister Murphy and the appointment of Cavallo. The second wave in July occurred after Cavallo's public proposal to alter the peso exchange rate. The third, in August, was alleviated by the IMF agreement and the use of the financial system's contingency insurance. The last withdrawal, which proved to be terminal, took place during November and December as the *corralito* was introduced (see **Exhibit 13**).

Between December 2000 and December 2001, the financial system lost 22.5 % of deposits (19.4 billion pesos). Private sector deposits accounted for 80% of the capital flight, while the other 20% was due to a decrease in public and financial sector deposits. Within private sector deposits, current and saving accounts increased by 8.5 billion dollars over this period, while long-term deposits decreased by 25.6 billion dollars (see **Exhibit 17**).

Initially, domestic banks and foreign banks suffered similar decreases in deposits. However, during November and December, domestically owned public and private banks (mainly *Banco de*

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Galicia and *Banco de la Provincia de Buenos Aires*) started losing deposits at a much more rapid rate. A similar situation had been experienced during the tequila crisis (see **Exhibit 18**).

The role of large corporations and the public sector

Total bank lending fell by U.S.$21 billion between December 1999 and December 2001, which included a decrease in private sector lending of U.S.$15 billion. The public sector received $10 billion dollars of additional funding.

Corporate borrowing represented more than 90% of the loans provided to the private sector. Of this, 70% was concentrated in the 100 largest Argentine companies, such as YPF *Sociedad Anonima*, *Telecom Argentina*, *Correo Argentino*, *Loma Negra*, *Siderar*, etc.[13]

In December 2001, the public sector obtained 60% of its financing from national banks both public and private (mainly *Banco de la Nacion*, *Banco de la Provincia de Buenos Aires,* and *Banco de Galicia*). National banks devoted 27% of their financing resources to the public sector. The remaining 40% of government financing needs were met by foreign banks. This represented 18% of foreign bank liquidity. The high exposure of banks to the public sector implied that there was a strict correlation between country risk and the stability of the financial system.

The *Corralito*

By December 2001, the financial system was completely illiquid. Convertibility implied that peso deposits were fully convertible into dollars, but the banking system was unable to cover this dollar exposure. To avoid financial system collapse, the government implemented the *corralito* in December 2001.

The *corralito* limited monthly withdrawals from checking and saving accounts to $1,000 dollars per account. Larger transactions had to be completed using a credit card, debit card, or check. Approximately U.S.$6 billion were "quasi-confiscated" through this measure.[14] At the same time, foreign money transfers were limited to those operations related to trading activities (exports and imports) and those associated with previous foreign expenses that could be completed with credit or debit card only. In other words, extensive capital controls were imposed on the balance of payments, in stark contrast to the convertibility that had prevailed since 1991. Yet deposit transfers to other banks inside the Argentine financial sector were allowed.

In general, transactions that would decrease the liquidity of the Argentine banking system (i.e., removing cash from the banks or sending dollars abroad) were prohibited, while transactions that merely redistributed liquidity among banks within the Argentine system were permitted. As a result, Cavallo was able to claim:

> … Property rights will not be affected by the corralito. This policy was made to avoid citizens from losing everything. The main objective of the *corralito* is to stop capital flight by speculators who want to see Argentina devaluating and in chaos …
>
> —Domingo Cavallo, Minister of Economics, December 1, 2001.

According to Cavallo and, indeed, many prominent members of the Argentine financial community, the *corralito* was a measure designed to suppress the black market and thus reduce tax evasion, while pragmatically increasing tax collection by redirecting activity to the formal economy. Cavallo argued that "the *corralito* only implied a temporary control on transactions in foreign currencies … the *corralito* was a mere curb on cash withdrawals and financial transfers

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abroad … these methods of payment helped to improve tax administration … the *corralito* focused on preserving the value and availability of savings while the public debt restructuring process and the national and provincial fiscal readjustment plans were implemented ….”[15]

This manner of compulsory bancarization had two main objectives. First, it aimed to tackle the informal economy, representing almost 43% of all economic activity. Second, it aimed to increase fiscal revenues, in particular since all banking transactions had been subject to a transactions tax since April 2001.[16] An increase in transaction volume resulting from the *corralito* would directly and immediately be reflected in additional fiscal revenue.

Industry Overview: The Banks in December 2001

By the end of 2001, total assets of the financial system were 123 billion pesos (down from 163 billion pesos a year earlier), loans to the private sector were 52 billion (from 64 billion), and deposits were 67 billion pesos (from 86 billion). The sector’s net worth remained unchanged at 18 billion pesos, but only because the Central Bank continued to allow banks to record sovereign loans and bonds at book value, even though the government was already in default.

Domestic Banks The central bank committed itself to helping state-owned and private domestically owned banks stay afloat. Although official figures are not available, *Banco de la Nacion, Banco de la Provincia de Buenos Aires,* and *Banco de Galicia* received the most money from the Central Bank. *Banco de Galicia*, once the rising star of the Argentine financial system, rejected bids to sell for as much as three times book value in 2000, believing it would continue to grow. According to most observers, *Galicia* was a well-managed institution, but the government’s default, coupled with rumors of insolvency, precipitated a wave of withdrawals from its Uruguayan branch—where it had several billion dollars in deposits held by Argentine citizens. The situation in Uruguay eventually spilled over to Argentina, resulting in the need for a large financial package.[17] *Galicia* received a 4 billion peso bailout package from the Central Bank and a 2 million peso loan from *Sedesa* (the organization that manages the deposit guarantee system). A group of 17 local and international banks lent *Galicia* another 4 million pesos, with the bank’s mortgage portfolio acting as collateral.

Foreign Banks At the height of the crisis, several foreign banks considered the position of their Argentine branches. The only choices available were either to recapitalize their Argentine subsidiaries or to sell their assets to the highest bidder (often at prices well below what they had originally paid). Rumors about the Spanish banks (BBV and BSCH) leaving the Argentine banking system abounded. Top-level executives from *Santander Central Hispano* (*Banco Rio*) publicly acknowledged that they did not have any intentions to invest any additional funds in Argentina if the banking system broke down.[18]

New Government. New measures. What next?

At the beginning of 2002, President Duhalde announced the *corralon*. This measure prescribed the asymmetric pesification of bank balance sheets and the compulsory rescheduling of all certificates of deposit. Under the terms of the pesification, dollar reserves were seized from banks and converted into pesos at a rate of 1.4 pesos per dollar. Bank loans made in dollars were converted into pesos at one peso per dollar. Finally, bank deposits made in dollars were converted into pesos at the 1.4 peso per dollar rate. Unable to withdraw their deposits, Argentines saw their savings disappear as the peso-dollar exchange rate depreciated rapidly.[19]

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While the *corralito* implemented two months earlier had only partially frozen checking and saving accounts, the *corralon* was concentrated on long-term deposits reprogramming. Almost 9 billion dollars were held restricted. Most observers believed that this measure was implemented to rescue the public and domestically owned banks that had particularly high exposure to Argentine sovereign risk.

A heated debate emerged between Argentina's executive and the judicial branches about the *corralon*. They disagreed about the implications of the *corralon* on the institution of property rights and on the credibility of the constitution itself.

By this time, it was clear that gaining the confidence of the population was the most difficult task the new government would face. According to some polls, 65% of Argentines would not trust their money to any bank. Bank disintermediation became the natural choice as U.S.$ 31 billion were invested "under the bed." This figure equals three times the Central Bank's international reserves and 30% of GDP. It remained to be seen how President Duhalde would be able to restore confidence.

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Exhibit 1 National Accounts

	Unit	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Real GDP (US$ at 1996 prices)	bil USD	188.11	211.09	235.04	250.90	265.54	257.98	272.24	294.32	305.66	295.31	292.98	280.06
GDP (% real change pa)	%	-3.04	12.22	11.34	6.70	5.84	-2.85	5.53	8.11	3.85	-3.39	-0.79	-4.41
Real private consumption (US$ at 1996 prices)	bil USD	121.83	142.36	164.77	174.28	184.86	176.77	186.55	203.30	210.36	206.16	204.80	193.04
Real private consumption (% real change)	%		16.85	15.74	5.78	6.07	-4.38	5.53	8.98	3.48	-2.00	-0.66	-5.74
Real government consumption (US$ at 1996 prices)	bil USD	31.20	32.58	32.24	32.91	33.06	33.31	34.04	35.13	36.31	37.26	37.48	36.70
Real government consumption (% real change)	%		4.41	-1.04	2.10	0.44	0.76	2.17	3.22	3.36	2.62	0.58	-2.07
Real gross fixed investment (US$ at 1996 prices)	bil USD	n.a.	n.a.	n.a.	48.00	54.07	47.24	53.42	62.29	65.34	54.28	52.22	45.99
Real gross fixed investment (% real change)	%					12.64	-12.64	13.10	16.59	4.90	-16.92	-3.81	-11.93
Real exports of G&S (US$ at 1996 prices)	bil USD	18.69	18.01	17.83	18.67	21.53	26.37	28.39	31.85	35.23	34.79	35.73	36.71
Real imports of G&S (US$ at 1996 prices)	bil USD	6.85	12.34	20.44	23.49	28.45	25.66	30.16	38.26	41.48	36.81	36.75	31.63
Gross national savings rate (%)	%	17.22	14.30	14.22	16.24	15.63	16.50	17.12	16.65	16.11	13.67	14.37	13.92
Gross national savings/investment	%	123.01	97.67	85.19	83.88	78.31	89.09	87.13	79.79	76.68	76.32	82.15	89.41

Source: Adapted from EIU Country Data, 2003.

Exhibit 2 Government Finance

	Unit	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Budget revenue	bil ARS	n.a.	n.a.	n.a.	n.a.	51.08	50.29	47.67	55.38	56.73	58.46	56.57	51.32
Budget expenditure	bil ARS	n.a.	n.a.	n.a.	n.a.	51.36	51.67	52.93	59.70	60.80	63.22	63.36	60.04
Budget revenue (% of GDP)	%	n.a.	n.a.	n.a.	n.a.	19.84	19.49	17.52	18.91	18.98	20.62	19.91	19.10
Budget expenditure (% of GDP)	%	n.a.	n.a.	n.a.	n.a.	19.95	20.02	19.45	20.38	20.34	22.30	22.30	22.34
Budget balance (% of GDP)	%	n.a.	n.a.	n.a.	n.a.	-0.11	-0.53	-1.93	-1.48	-1.36	-1.68	-2.39	-3.25
Public debt	bil ARS	n.a.	n.a.	61.97	69.63	80.31	87.09	97.11	101.10	112.36	121.88	128.02	144.45
Public debt (% of GDP)	%	n.a.	n.a.	27.32	29.44	31.20	33.75	35.68	34.52	37.58	42.99	45.04	53.76

Source: Adapted from EIU Country Data, 2003.

Notes: NFPS revenue (excluding privatisation revenues). Central government receipts (including grants received and loan repayments).

Total debt (both local and foreign currency) owed by government to domestic residents, foreign nationals and multilateral institutions such as the IMF.

Exhibit 3 Monetary and Financial Market Indicators

	Unit	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Domestic credit	bil ARS	22.27	40.99	50.48	60.81	67.55	71.15	75.87	87.76	95.37	98.43	95.79	98.23
M1	bil ARS	3.07	7.63	11.36	15.12	16.36	16.62	19.04	21.48	21.49	21.84	19.84	15.84
M2	bil ARS	7.91	19.10	31.03	45.45	53.47	51.97	61.75	77.52	85.65	89.15	90.52	72.92
M1 growth	% pa	n.a.	148.57	49.02	33.04	8.22	1.57	14.58	12.81	0.03	1.62	-9.15	-20.13
M2 growth	% pa	n.a.	141.34	62.49	46.48	17.64	-2.81	18.82	25.53	10.49	4.09	1.53	-19.44
Lending rate	%	n.a.	n.a.	n.a.	10.28	10.06	17.85	10.51	9.24	10.64	11.04	11.09	26.47
Deposit rate	%	1,517.88	61.88	16.78	11.34	8.08	11.90	7.36	6.97	7.56	8.05	8.34	16.16
FX reserves	mil USD	4,592.00	6,005.00	9,990.00	13,791.00	14,327.00	14,288.00	18,104.00	22,320.00	24,752.00	26,252.00	25,147.00	14,533.00

Source: Adapted from EIU Country Data, 2003.

Exhibit 4 Monetary and Financial Market Indicators (Monthly 2001)

	Unit	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
M1	bil ARS	18.95	19.15	17.78	18.94	18.09	17.95	16.94	15.55	15.11	14.16	13.63	15.84
M2	bil Ars	91.56	92.00	88.28	87.90	88.27	88.31	82.90	79.32	80.03	77.64	74.09	72.92
M1 growth	%	-6.28	-1.35	-7.89	-2.27	-6.30	-7.97	-13.31	-17.31	-19.70	-21.39	-23.80	-20.13
M2 growth	%	2.36	3.10	-1.05	-1.72	-1.98	-3.11	-9.49	-12.95	-12.46	-13.84	-17.10	-19.44
Domestic credit	bil ARS	97.32	101.35	96.44	98.44	100.86	98.88	98.36	99.87	97.55	97.75	98.20	98.23
Lending rate	%	11.65	8.98	17.29	23.83	22.36	16.83	36.18	38.57	32.91	32.62	49.96	n.a.
Deposit rate	%	8.66	6.56	10.81	13.72	13.57	10.96	21.22	25.82	21.56	21.72	31.94	7.42
Stockmarket index	X	532.80	435.85	443.81	435.63	439.22	402.25	320.79	318.05	243.55	224.75	202.45	295.39
FX reserves	mil USD	25,436.00	25,366.00	21,919.00	20,540.00	20,202.00	21,078.00	16,699.00	14,399.00	20,555.00	18,056.00	14,723.00	14,553.00
IMF credit (net) (*)	mil USD	1,645.36	-16.15	-120.75	-97.31	778.35	-69.87	-80.55	0.00	3,734.99	-88.75	0.00	-69.25

Source: Adapted from EIU Country Data, 2003.

Note: * IMF purchases and loan disbursements minus repurchases and repayments of loans.

Exhibit 5 Other Indicators

	Unit	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Avegage real wage index (LCU, 1996=100)	X	n.a.	83.95	88.84	91.05	92.66	94.41	100.00	100.l88	101.18	101.87	103.62	100.46
Average real wages (% change pa)	%	n.a.	n.a.	5.82	2.49	1.77	1.89	5.92	0.88	0.30	0.67	1.72	-3.00
Population	million	32.63	33.08	33.53	33.96	34.39	34.82	35.24	35.67	36.10	36.53	36.96	37.38
GDP per head ($ at PPP)	USD	7,695.30	8,651.60	9,786.30	10,350.20	11,031.00	10,969.70	11,581.70	12,343.50	12,610.40	12,330.50	12,402.70	12,000.00
Population (% change pa)	%	1.37	1.37	1.35	1.29	1.27	1.24	1.21	1.22	1.20	1.19	1.18	1.20
Labour force	million	12.31	12.51	12.71	12.92	13.13	13.35	13.57	13.78	13.95	14.13	14.31	14.49
Recorded unemployment (%)	%	7.50	7.45	7.45	8.75	10.45	15.45	15.45	13.85	11.80	13.03	14.55	16.40
Real GDP growth per head (% pa)	%	-4.30	10.70	9.90	5.39	4.51	-4.04	4.27	6.81	2.62	-4.52	-1.94	-5.50

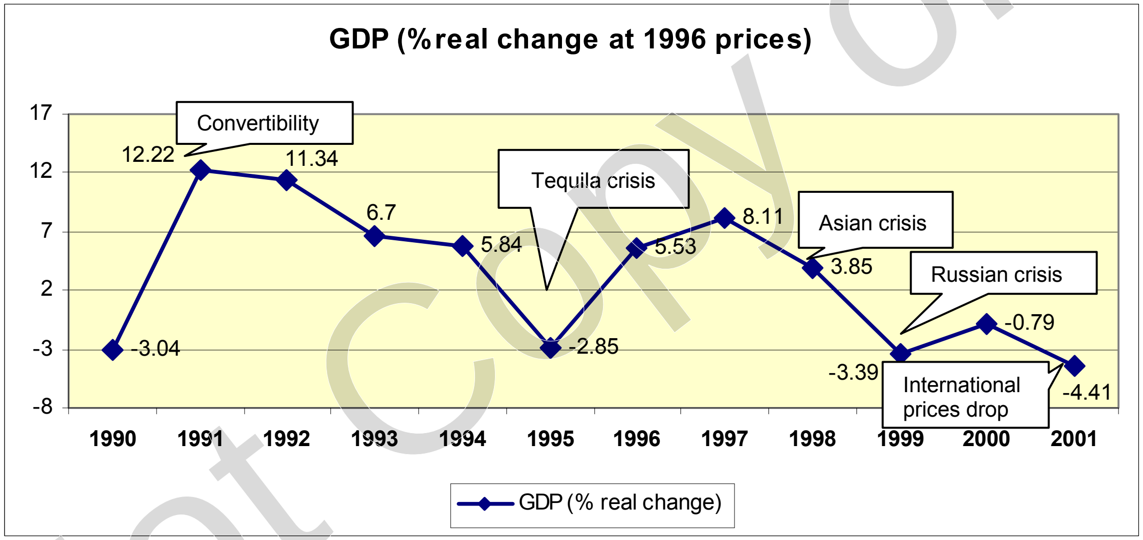
Convertibility: Backing of M1 money stock.

	Unit	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Stock of money M1	bil ARS	18.95	19.15	17.78	18.94	18.09	17.95	16.94	15.55	15.11	14.16	13.63	15.84
Foreign-exchange reserves	bil US$	4,592	6.005	9.99	13.791	14,327	14.288	18.104	22.32	24.752	26.252	25.147	14.553
Reserves/M1			0.79	0.88	0.01	0.88	0.86	0.95	1.04	1.15	1.20	1.27	0.92

								2001					
	Unit	Jan.	Feb.	March	April	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Stock of money M1	bil ARS	18.95	19.15	17.78	18.94	18.09	17.95	16.94	15.55	15.11	14.16	13.63	15.84
Foreign-exchange reserves	Bil US$	25,436	25,366	21,919	20.54	20,202	21,078	16,699	14,399	20,555	18,056	14,723	14,553
Reserves/M1			1.32	1.23	1.08	1.12	1.17	0.99	0.93	1.36	1.28	1.08	0.92

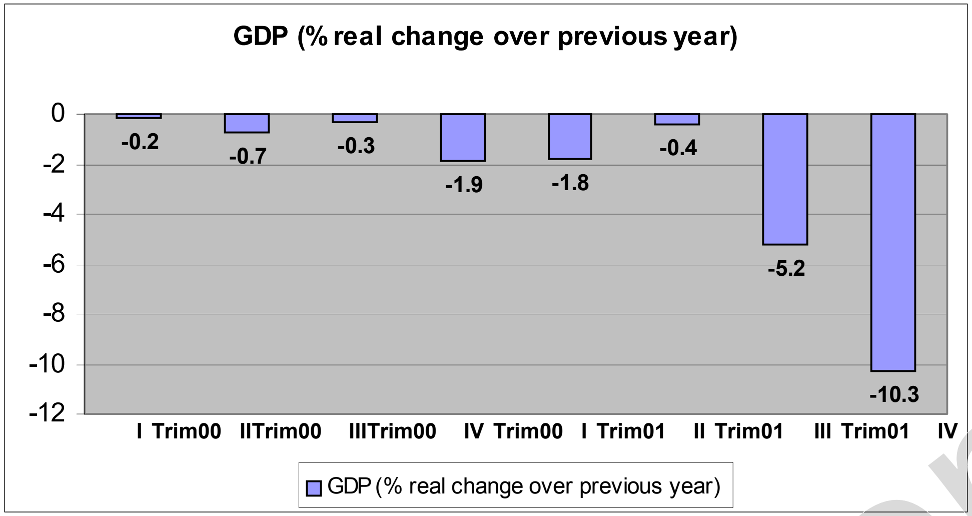
Source: Adapted from EIU Country Data, 2003.

Exhibit 6 Annual GDP Growth



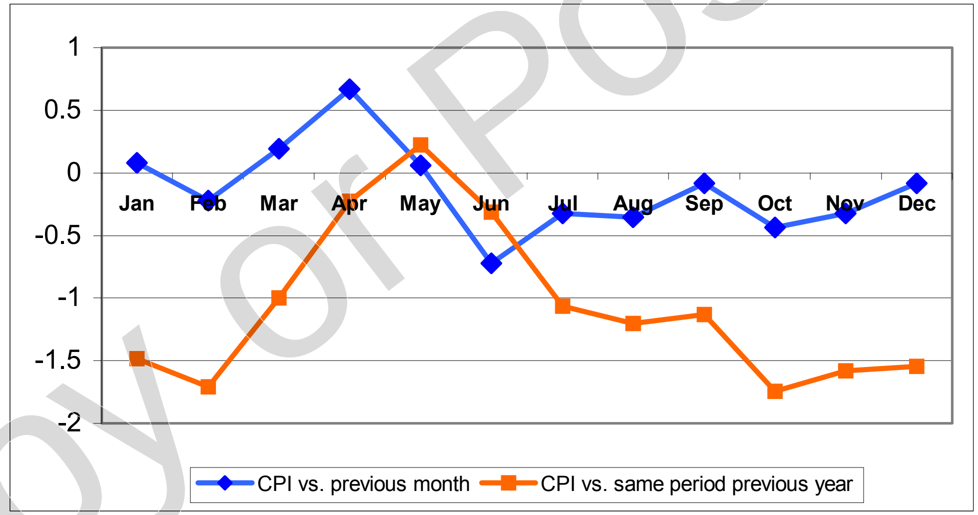
Source: Adapted from EIU Country Data, 2003.

Exhibit 7 GDP Evolution (quarterly at 1996 prices)



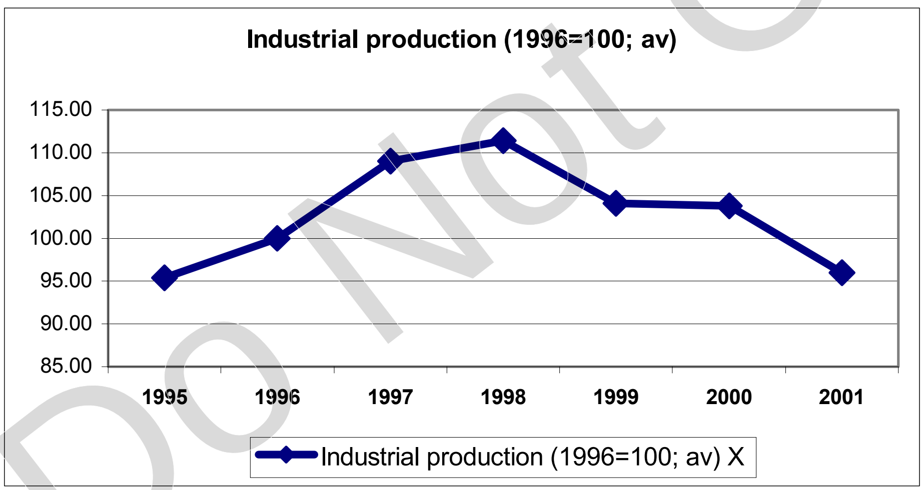
Source: Adapted from EIU Country Data, 2003.

Exhibit 8 Consumer Price Index (at 1996 prices)



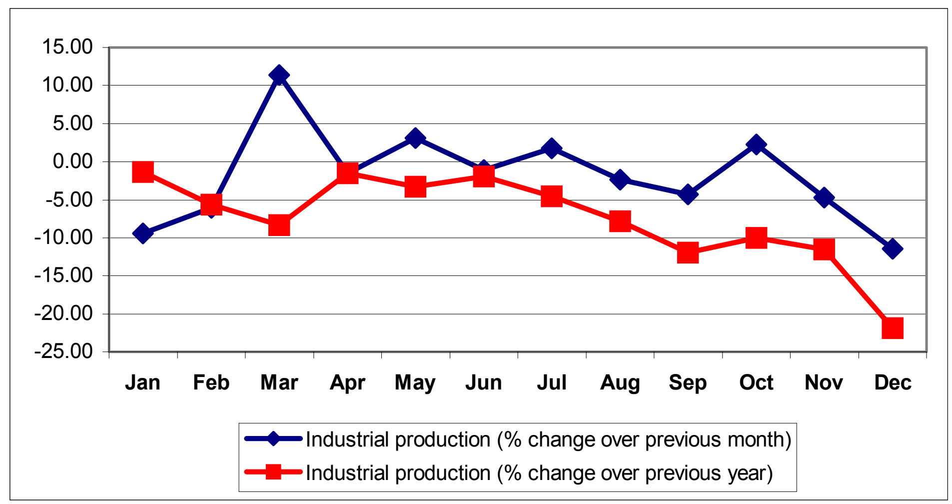
Source: Adapted from EIU Country Data, 2003.

Exhibit 9 Industrial Production Indicator Evolution (yearly)



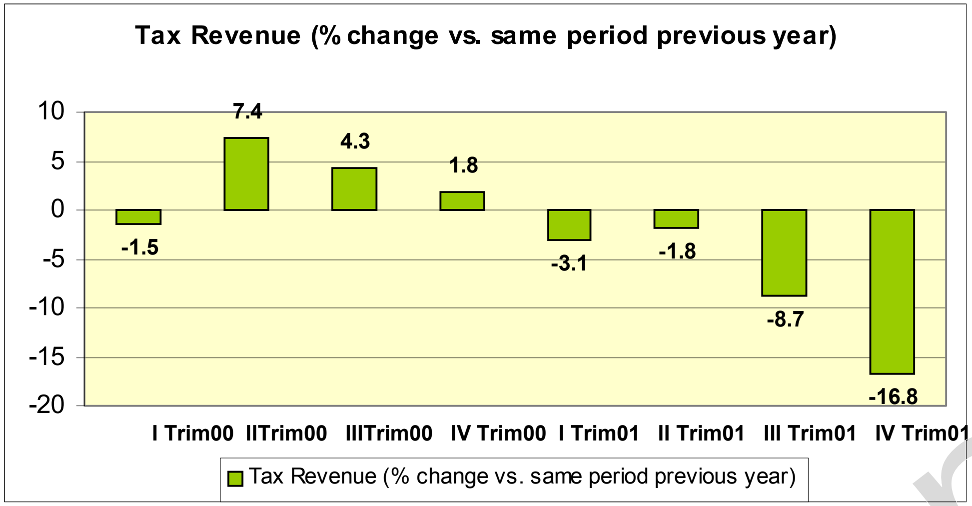
Source: Adapted from EIU Country Data, 2003.

Exhibit 9 (con't) Industrial Production Indicator Evolution (monthly 2001)



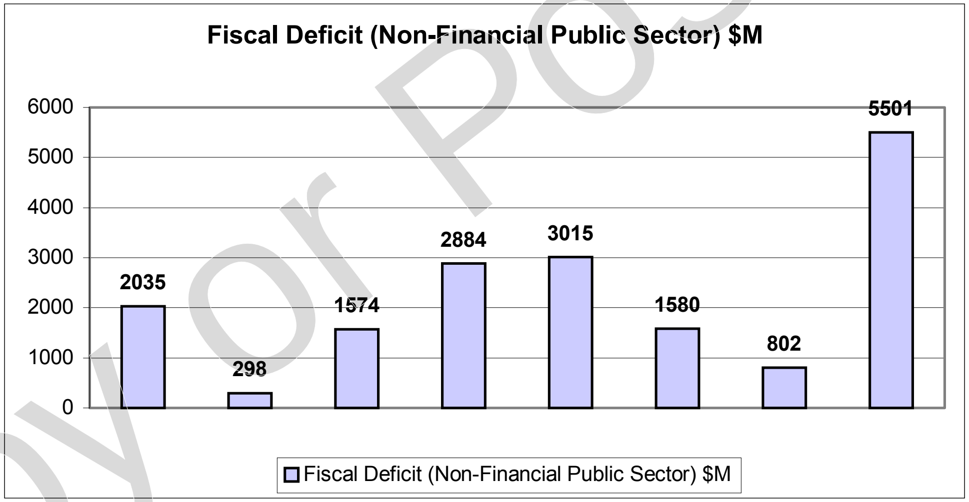
Source: Adapted from EIU Country Data, 2003.

Exhibit 10 Tax Revenue Collection (% change 2001 vs. 2000 same period)



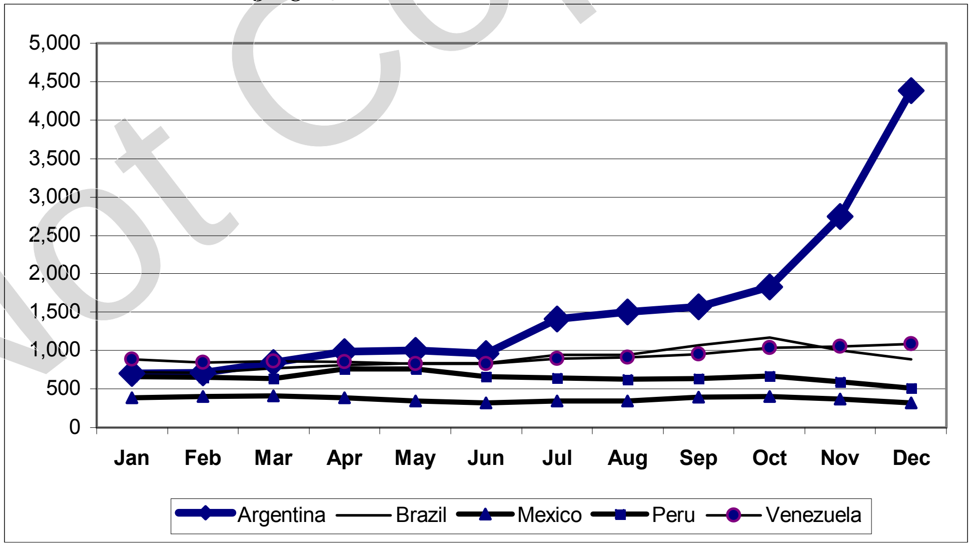
Source: Adapted from Ministry of Economics Argentina.

Exhibit 11 Fiscal Deficit Evolution ($ Millions)



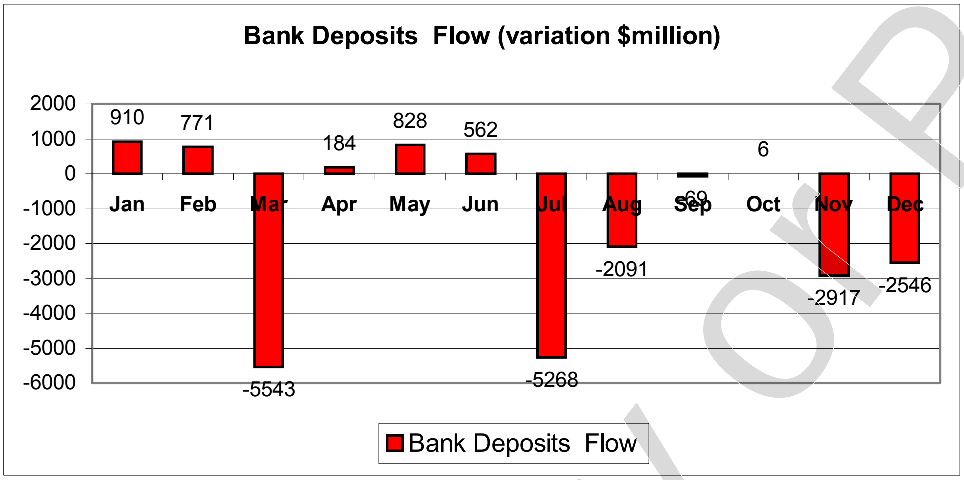
Source: Adapted from Secretaria de Hacienda, Ministry of Economics.

Exhibit 12 Emerging Risk Evolution (EMBI)[24]



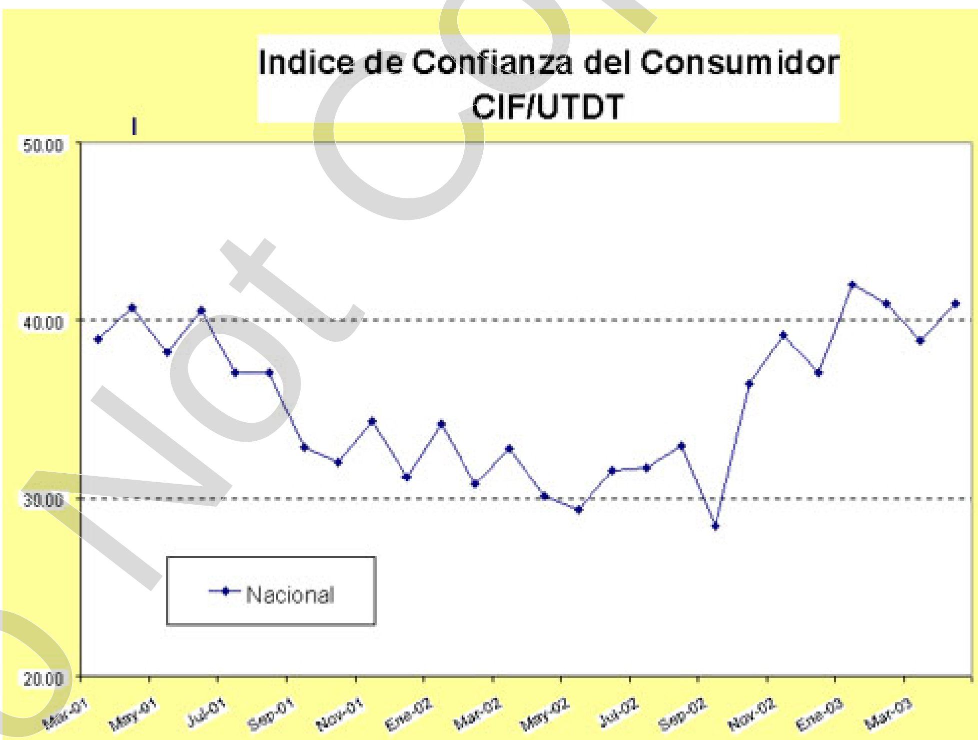
Source: Adapted from *Centro de Economia Internacional* and JP Morgan.

Exhibit 13 Bank Deposits' Evolution (variation in $Million)



Source: Adapted from BCRA.

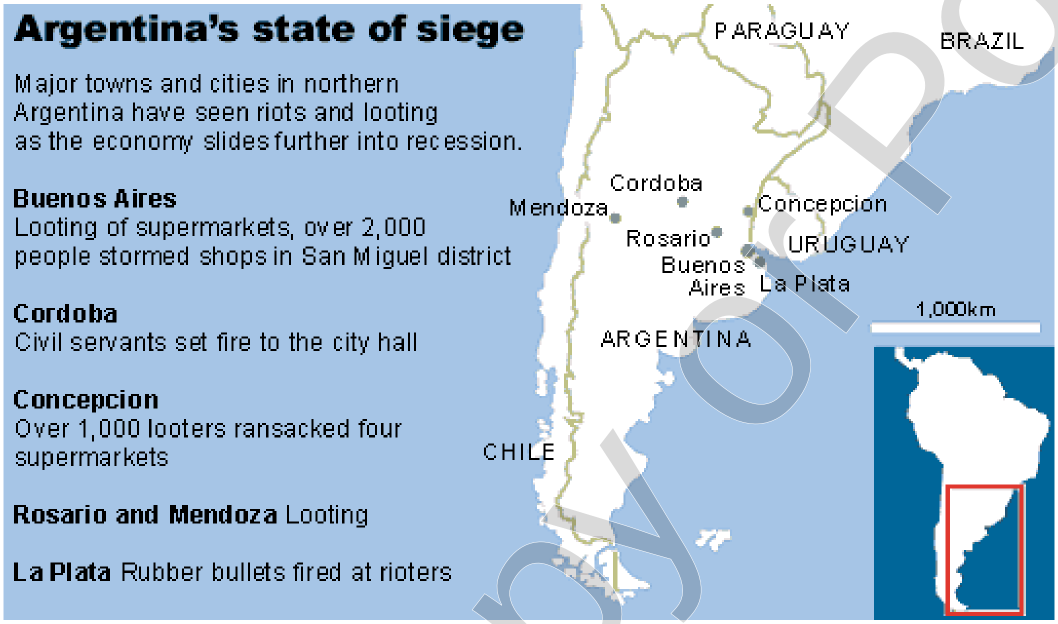
Exhibit 14 Consumer Confidence Index



Source: Adapted from Universidad Torcuato Di Tella.

[redacted]

Exhibit 15 State of Siege



Source: Adapted from Guardian Unlimited. Special reports.

Exhibit 16 % of Credits in Pesos and Dollars

	October 2001		December 2001	
	National currency (Pesos)	Dollars	National currency (Pesos)	Dollars
% of Credits in pesos and dollars				
Public Sector	6%	94%	4%	96%
Private Sector	37%	62%	28%	72%
Financial System	32%	68%	28%	72%

	October 2001		December 2001	
	National currency (Pesos)	Dollars	National currency (Pesos)	Dollars
% of Deposits in pesos and dollars				
Public Sector	87%	13%	75%	25%
Private Sector	35%	65%	26%	74%
Financial System	39%	61%	30%	70%

Source: Adapted from BCRA.

[redacted]

Exhibit 17 Financial Institutions

	Dec.-99	Dec.-00	Aug.-01	Sep.-01	Oct.-01	Nov.-01	Dec.-01
Credits	**119,730.00**	**131,575.80**	**103,326,30**	**99,659.70**	**98,446.00**	**102,101.00**	**98,174.00**
Public Sector	12,109.90	15,165.00	14,910.50	14,820.90	14,881.00	21,404.00	22,358.00
Financial Sector	3,752.60	3,592.50	3,155.60	3,195.00	3,212.00	2,390.00	2,585.00
Private Sector	65,867.10	62,442.20	54,530.10	54,280.30	53,104.00	51,759.00	50,381.00
Others	38,000.40	50,376.10	30,730.10	27,363.50	27,249.00	26,548.00	22,850.00
Deposits	**81,221**	**86,177**	**74,794**	**76,598**	**73,642**	**68,261**	**66,743**
Public Sector	7,244	7,289	7,064	7,721	5,239	4,750	4,430
Financial Sector	290	670	172	222	168	154	260
Private Sector	73,686	78,218	67,558	68,655	68,235	63,357	62,053
Checking Accounts	6,492	6,458	9,123	9,099	9,260	8,750	12,999
Saving Accounts	12,929	12,869	8,369	8,146	7,707	7,602	14,827
Fixed Term Accounts	51,224	55,713	48,064	49,326	49,127	44,902	30,037
Others	3,042	3,178	2,002	2,.084	2,141	2,103	4,190
Other Obiigations	**48,883**	**54,051**	**41,535**	**37,160**	**37,307**	**36,214**	**34,600**

Source: Adapted from BCRA.

[redacted]

Exhibit 18 Type of Banks

	Current Crisis (December 2000-August 2001)			Current Crisis (December 2000-December 2001)			Tequila Crisis		
	Deposits outflows	**% December 2000-August 2001**	**%/Total**	**Deposits outflows**	**% December 2000-December 2001**	**% Total**	**Deposits outflows**	**% December 2000-October 2001**	**%/Total**
National private	-2194	-17%	19%	-5665	-40%	29%	-3414.8	-21%	31%
Foreign	-4377.7	-11%	38%	-5085	-17%	26%	111.1	1.40%	19.60%
National public	-1876.1	-14%	16%	-2429.6	-18%	13%	-216.4	-3.20%	16.10%
National province	-2855.6	-19%	25%	-4083.6	-31%	21%	-937.2	-8.38%	25%
Others	-80.2	15%	1%	-2171	-19%	11%	-2075.1	-38.30%	8%
Total	**-11383.6**	**-13%**	**100%**	**-19434.2**	**-23%**	**100%**	**-6532.4**	**-13.83%**	**100%**

Source: Adapted from BCRA.

[redacted]

Notes

[1] Price-Waterhouse, Can Argentina Recover?

[2] Elaborated based on Country Data, EIU.

[3] IMF website, Anne Krueger Speech, July, 2002.

[4] Finance and Development, IMF magazine, Pedro Pou, March 2000.

[5] “Can Emerging Bank Regulators establish credible discipline? The case of Argentina, 1992-1999”. Charles Calomiris-Andrew Powell. Working Paper 7715. NBER, May 2000.

[6] Argentina’s Banks on the Road to Collapse. Guillermo Mondino. Comments delivered at NBER conference on Argentine Crisis, Cambridge, July 2002.

[7] M3 includes the monetary base plus both peso and dollar deposits and thus gives a measure of the size of the financial system.

[8] The Policy of Brazilian Debt Dynamics in the light of Argentina’s default. Cavallo, Domingo, January 30th, 2003.

[9] The Government issued the Decree 1570/01 which ruled the following : 1) according to the Convertibility Law the exchange rate keeps being US$1 ; A$1 ; 2) from now on every loan will be issued in US$, including the renovations of previously pacted credits ; 3) interest rates for time deposits in A$ will be the same than the interest rates for time deposits in S$, having the customers the option to change its deposits from A$ to US$ without costs ; 4) new loans greater than US$1,000 will be deposited in a bank account; 5) account holders are not allowed to withdraw more than US$ 250/week in cash, the rest of the operations will be handled by credit and debit cards and checks.

[10] Banco Central de la Republica Argentina. Informacion de Entidades Financieras. October 2001.

[11] Country Finance-Argentina. Released August 2001. The Economist Intelligence Unit.

[12] Ibid

[13] Banco Central de la Republica Argentina. Publicaciones Financieras, Ediciones August 2001.

[14] Clarin Newspaper. “Una flexibilizacion que liberaria 19, 8 milliones de pesos”. 11th August, 2002.

[15] Argentina 2002: when the attempt to set the right prices destroyed property rights. Domingo Cavallo.

[16] Economia Informal, Solucion, Deterioro u origen de la Guerra social. Armando Valiente. Country Finance – Argentina. Released August 2001. The Economist Intelligence Unit.

[17] Country Finance – Argentina. Released August 2001. The Economist Intelligence Unit

[18] Banco Economico Cinco Dias, January 2002.

[19] Argentina: Caveat Lector. Steve H. Hanke. The Johns Hopkins University and The Cato Institut.

[redacted]