Debt and Default from a Post-Keynesian Perspective:

A Historical Case Study of the Argentine Puzzle

Can Çınar

Department of Politics,
University of Otago

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Abstract

The subject of sovereign debt and default has received intense focus since the beginning of this century. This interest was fuelled by the largest default in history - by Argentina in 2001 - but it was the Global Financial Crisis of 2007-2008 and its effects that placed the issue of debt in the centre of attention. The ensuing debate has been stuck, however, in the contrived opposition between ‘fiscally irresponsible governments’ and ‘evil creditors’ in both mainstream neoclassical circles and among so-called critical scholars. This thesis overcomes this, and similarly untenable positions, by taking a long-term look at the nature and implications of sovereign defaults, focusing specifically on the experience of Argentina since its independence. With its complex and unique history of debt, Argentina provides the perfect vantage point and case study to compare different causes and impacts of sovereign default. In a contribution to the post-Keynesian literature on government debt, and particularly to the Modern Monetary Theory (MMT) school of economics, the thesis argues that sovereign defaults are not necessarily harmful to the health of an economy, and to the well-being of the people. Elaborating on MMT, it argues that preventing or postponing an inevitable default is sometimes more detrimental for the indebted country in the long-run. That being said, under certain conditions a sovereign default can also have devastating effects. Argentina’s history contains examples of both outcomes.

This raises a puzzle: What determines the outcomes of sovereign defaults? What makes them beneficial or harmful? To answer these questions, this study investigates the range of episodes during which Argentina fell into default (or restructuring) over a period of two centuries. It combines a historical process-tracing methodology with a theoretically informed and nuanced political-economic analysis of data in order to understand what determines the different outcomes. The main claim defended here is that it all depends on how governments approach defaults. If default is not seen as an inevitable evil to be avoided at all costs, but as a strategic option, space is created for government policy to prevent potential damage, and to exploit the opportunity to address underlying structural problems in the economy. Both the historical and political-economic analysis support this conclusion, and indicate the need for a broader reappraisal of official and public perceptions of defaults and their dynamics.
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<td>BCRA</td>
<td>Central Bank of Argentina</td>
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<td>GFC</td>
<td>Global Financial Crisis</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>HPM</td>
<td>High Powered Money</td>
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<td>IFI</td>
<td>International Financial Institution</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IRFs</td>
<td>Impulse Response Functions</td>
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<td>MMT</td>
<td>Modern Monetary Theory</td>
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<td>MTEySS</td>
<td>Ministerio de Trabajo, Empleo y Seguridad</td>
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<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
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<td>PJJH</td>
<td>Programa Jefes y Jefas de Hogar</td>
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<td>QE</td>
<td>Quantitative Easing</td>
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<td>S&amp;P</td>
<td>Standard and Poor’s</td>
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<td>SAPs</td>
<td>Structural Adjustment Programs</td>
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<td>SDC</td>
<td>Sovereign Debt Crisis</td>
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<td>SDRM</td>
<td>Sovereign Debt Restructuring Mechanism</td>
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<td>VAR</td>
<td>Vector Autoregression</td>
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Chapter 1

Introduction

Since the industrial revolution, the world has registered significant economic and social progress. This overall progress, however, has not been even, and has not changed the global pecking order. Despite 150 years of technological progress, the early modernisers (today’s ‘developed’ states) have remained rich and developing countries, the late modernisers, have stayed relatively poor, with the exception of a few outliers. Argentina is a particularly exceptional outlier, in more than one respect. It is the only country that was regarded as developed at the beginning of the 20\textsuperscript{th} century and entered the 21\textsuperscript{st} century as a developing country. This bizarre demotion, named ‘the Argentine Puzzle’, has been comprehensively analysed (Babb, 2014; Campos, Karanasos, & Tan, 2012; Prados de la Escosura & Sanz Villarroya, 2004; A. M. Taylor, 1992, 1998). The eventful history of Argentina has provided political economists with many variables to explain the phenomenon: 

Coups d’état, periods of hyper-inflation, waves of sweeping privatizations, populist movements and radical swings in the dominant ideology are all elements of a complex picture that numerous scholars have thoroughly scrutinized and quantified. These studies tend to agree that the country’s multiple sovereign defaults throughout its history are important contributing factors to the degradation of the economy. There is an influential, broad-based and empirically tested consensus, most recently formulated by Reinhart and Rogoff (2004b) that failing to repay debt is very harmful especially for developing economies and that Argentina, the ‘serial-defaulter’, serves as a cautionary tale for countries that consider defaulting on their debt.

A sovereign default refers to the failure or refusal of a sovereign state to pay back its debt. This definition makes it clear that a default can be a conscious strategic choice, and that there is nothing inevitable about it. It is this meaning that we wish to exploit in this thesis. Defaults can be due to: the repudiation of debt by a government, partial payment of due receivables, or de facto cessation of repayments because of insolvency. The technical definition of default that is widely used by experts is more limited, though. It refers to the “the failure to abide by the terms of bonds or other debt instruments” (Bhalla, 2014, p. 366).\footnote{Although this is a widely accepted definition of sovereign default, it fails to make clear-cut rulings. Different datasets and studies, for example, show different number of defaults for countries. The Bank of Canada’s database (Beers & Mavalwalla, 2017) and Reinhart and Rogoff’s (2010) dataset show different number of defaults for Argentina. This is due to the fact that every case of sovereign default is complex and multifaceted. There are cases where defaults are due to the inability to repay debt, and other cases where they are due to political or economic reasons.} There is an underlying assumption
in this definition and in the work of financial historians (Chancellor, 2010)\(^2\) and economists (De Paoli & Hoggarth, 2006) that a sovereign would not wilfully default; defaults only happen due to failures. In fact, extent economic literature seems to assume that sovereign debt is only possible because of the existence of costly sovereign defaults (Dooley, 2000a). As suggested above, I wish to challenge this mainstream conception of defaults, using the history of Argentinian defaults since the early 19\(^{th}\) century as illustrative material. The purpose is not to write a comprehensive history of the political-economy of debt in Argentina, but to use Argentinian history to highlight the range of choices that defaulters have, and to point out that certain choices (what I will call ‘strategic defaults’) have more salutary consequences than others.

Sovereign defaults have various costs and Argentina has suffered all of them. Studies on the reputational costs of defaults on the value of Argentine equities and the exchange rate (Schreger, 2015), exclusion from international trade (C. F. D. Alejandro, 1983), and the various political costs of the defaults (Cuadra & Sapriza, 2008) illustrate that sovereigns should pay their debt not only because of a fundamental moral obligation to obey contractual commitments, but also to avoid the real harms of sovereign defaults. It is important to note that the abovementioned studies focus on particular defaults and do not attempt to cover all of Argentina’s sovereign defaults. While there is an emerging interdisciplinary literature that combines history and economics and looks at the long-run economic determinants of major events over centuries (Baumol, 1986; M. Bruno & Easterly, 1998; Buiter & Rahbari, 2013), there is not yet any political economy analysis of all of Argentina’s sovereign defaults from a heterodox economic perspective and how the story, and the lessons learnt from that story, change if we lengthen the time scale and modify the economic lens we adopt.

This study seeks to fill this gap. In particular, it investigates the political and economic effects of sovereign defaults in Argentina since its independence in 1816 and attempts to build an alternative understanding of sovereign debt. Argentina provides the perfect vantage point for this endeavour since it has been through multiple defaults and its macro-economic policies and ideological position swayed from one extreme to another across all these defaults, and sometimes even within specific defaults. Some of these defaults happened due to insolvency,

\(^{2}\) In this work, Chancellor lists ten circumstances under which sovereigns defaulted in the past. All ten are related to a crisis, disaster or insolvency. None of the reasons listed were in control of a state.
while others followed strategic moves by the state; some defaults instigated long periods of growth, while others were devastating; some defaults took place in strictly fixed exchange rate regimes, while others occurred in more flexible foreign-exchange circumstances. Each Argentine default presents a unique case, but all are deeply connected and there are general lessons that we can learn if we are prepared to suspend the belief that all defaults are the same and that they are all bad.

Figure 1.1 below summarises the history of sovereign defaults and summarizes the growth experience of Argentina in terms of Gross Domestic Product (GDP) per capita from 1810 to 2016. The vertical lines mark the dates of sovereign defaults.

**Figure 1.1: Sovereign defaults and GDP per capita in Argentina, 1800-2016**

Although it offers a very condensed history of 200 years, the graph shows interesting patterns. First of all, we can see that Argentina defaulted in 1827 only 17 years after its independence. This initial default, however, does not appear to have had any adverse effect on the country’s growing prosperity. The 1890 default seems to have slowed down this upward trend for a year but is followed by a sizeable six-year growth. By 1896, Argentina's GDP per capita was almost twice the size of Canada’s and Spain’s. In 1875, 15 years before the 1890 default, its GDP per capita stood at 63% of that of the United States (US). Six years after the default, it jumped to
102% of the US level. Then, there is a 61-year long period with no default, but it is marked by high volatility and overall mediocre growth. This is also a time of multiple waves of default around the world as a large percentage of countries defaulted on their debt. During the 1930s, for example, half of all countries were in external default when weighed by their share of world income.

Interestingly, however, avoiding default for 61 years does not appear to have benefitted Argentina in terms of macroeconomic indicators. When we look closer at the different ways Argentina reacted to its various defaults, we see that these are usually followed by a period of rapid growth, with the exception of the 1982 default. In particular, the 2001 default, the largest default in the history of humanity, coincides with the fastest period of growth in Argentina’s economic history. This observation contradicts the conventional answer to the Argentine Puzzle in a number of respects.

Firstly, Argentina cannot be labelled a ‘serial-defaulter’ since it defaulted only six times, which is an average number for a sovereign and a low number for a Latin American country. Secondly, there is no clear correlation between defaults and the severe stagnation in the 20th century that demoted Argentina from a developed country to the status of a developing country. If anything, most of the defaults appear to end downturns and stimulate growth. By looking at the graph, one could even argue that Argentina’s economic stagnation in the 20th century was due to the lack of a sovereign default at the start of this century. The long period of substantial growth after the massive 2001 default supports this argument. Of course, there are many factors that affect GDP and this one-dimensional graph cannot comprehensively explain the effect of high sovereign debt levels in Argentina. But, since there is no uniformity in the reaction to defaults, it raises the question about the putative impact of sovereign defaults as ‘economic suicides’ (McNamara, 2012).

Figure 1.2 takes a closer look at this history and shows Argentina’s GDP per capita chained to purchasing power parity (PPP) relative to the US between 1950 and 2014. The graph clearly displays the contrast between the 1951, 1982 and 2001 defaults. While the 1951 and 1982 defaults reinforce the argument that defaults have adverse effects on the economy, the 2001 default contradicts that. This means that the effects of defaults are more complex than the way conventional wisdom portrays them. Two interlocking puzzles emerge here which this thesis examines:
• Why was Argentina demoted from a developed nation to a developing one in the course of the 20th century if it were not simply because of the defaults?
• Why do some defaults have a positive effect on the economy while some have adverse effects, and what determines the outcome?

Figure 1. 2 Purchasing power in Argentina and sovereign defaults, 1950 - 2014

To answer these questions, I will study the political economy of Argentina in the last two centuries with a focus on the causes and consequences of sovereign defaults, or lack thereof. The arguments I will develop are twofold. Firstly, drawing on the historiography of Argentina’s defaults since its independence, I claim that the effects of sovereign debt and default on the economy are mainly determined by the government’s actions and not essentially by external factors. The scholarly literature on the topic has focused on external and pre-determined factors including the size of debt (Dornbusch & Pablo, 1987) and the fluctuation of business cycles (Neumeyer & Perri, 2005). By examining the influence of government policies and approach

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Looking at the PPP inflates the growth in the period between 1989 and 2001, where the exchange rate of the peso was fixed to the US dollar on a 1:1 basis.
to sovereign debt crises, I will show that the outcome of debt crises depends primarily on the policies adopted by the state.

The second argument I will develop is that there are different forms of defaults and, depending on the circumstances, a sovereign default can be very beneficial for the indebted country. I identify two types of defaults in Argentina’s case: strategic defaults and orderly defaults. Simply put, strategic defaults transpire when a government decides not to pay its debt and fall into default purposefully to take advantage of a situation. During orderly defaults, however, the country defaults inadvertently while a government tries to avoid it and continues to make partial payments while in default, usually as a token of good-will. As we will explore through both qualitative and quantitative analysis in Chapter 5, these two types of default have fundamentally different short- and long-term effects on the economy. This argument disputes virtually all quantitative analyses that investigate the long-run determinants of sovereign defaults as very few econometric studies differentiate between different types of defaults (Buiter & Rahbari, 2013; Dooley, 2000b).

Strategic and orderly defaults are one of the dichotomies around which I will organise my arguments. Other dichotomies that will help me contrast and analogue various factors are domestic and external debt, fixed and floating exchange rate, and deficit and surplus. There are strong normative assumptions regarding these dichotomies that are in line with the neoclassical understanding of these concepts, especially in the literature on the history of the Argentine economy (Easterly, Rodriguez, & Schmidt-Hebbel, 1994; Rapoport & Guiñazú): deficits are bad whereas surpluses are good, a fixed exchange rate is stable whereas floating is erratic, external debt is developmental whereas internal debt is inflationary.

Although experts who specifically focus on these topics have developed more intricate understandings of how these concepts affect the economy (O. Blanchard & Milesi-Ferretti, 2012), the approaches of historians and neoclassical economists remain rather simplistic. That is why Argentine economic history is filled with “unthinkable achievements” of continuous budget surpluses (P. H. Smith, 1979, p. 4) and the success of maintaining low inflation during long periods of military dictatorships (Johnson, 1994). Such simplistic approaches to complex economic concepts do not only skew the historiography of Argentina, they also make it difficult to understand the nature of modern debt. As we will explore in Chapter 2, there are large gaps in and technical problems with empirical studies on the econometrics of government debt. My overall purpose is therefore to try and fill those gaps by using Argentina as a case study.
The pendulum history of Argentine debt and defaults since its independence serves as a case study to inductively develop an alternative theory of sovereign debt and default - inherent features of all modern capitalist economies by extending existing Modern Monetary Theory (MMT, see below) and applying it to a developing country (Eisenhardt, 2007 p. 26). The choice of a unique country-focused case study comprised of multiple case studies examining individual Argentine defaults (Yin 2009) in the last 200 years will enable me to offer insights into the changing socio-historical context and complex politico economic processes that surround debt and defaulting. In doing so, I will follow the replication logic underpinning case study research (Eisnehardt 2007, p.27; Yin 2009) and ‘Process tracing’ to identify the contextual and causal mechanisms which allow and/or produce the circumstances that enable these defaults (Mahoney, 2012), but are often missing from mainstream theories. Process tracing will enable me to derive causal inferences in history from diagnostic pieces of evidence which will help explain the underlying mechanisms of the defaults. This method employs causal mechanisms to select, test, and strengthen or infirm hypotheses by assessing them through observational evidence. Causal mechanisms are “…physical, social, or psychological processes through which agents with causal capacities operate… to transfer energy, information, or matter to other entities” (George & Bennett, 2005, p. 137). Focusing on causal mechanisms at the macro-level is a necessary element to help with the conceptualization of instances that have led to each default in the history of Argentina. I will use the historical analysis of the various defaults between 1800 and 1950 as an approach to build new theory and analyses of available econometric data of Argentina economy since 1950 to test key hypotheses emerging from the historical analysis (on theoretical sampling of single case studies: Yin, 2009). As I identify certain patterns of relationships and causal mechanisms within and across the series of defaults and restructurings that Argentina went through, and proceed through recursive cycling among the case data, emerging theory and extant literature on default in MMT, a coherent and novel theoretical construct of sovereign debt and default will emerge (on building theories based on case studies: Eisenhardt, 1989).

The core problem of mainstream analyses of sovereign debt crises is that they attempt to understand why crises happened in the first place. Following a linear line of succession leave researchers in pursuit of an ‘initial’ problem, i.e. increase in debt levels (Aghion & Bolton, 1990). Process tracing, on the other hand, does not simply ask why, instead it asks: “By the workings of what structures is the phenomenon produced?” (Dessler 1991: p. 345). This question connects the events to the structures that produced the events. Thus, the aim is not to find the starting point of a default in history, but to understand its process that is how it unfolds.
Indeed, rapid increase in debt levels (Event A) can trigger a default (Event B). Nonetheless, we need to analyse the process by which A produced B and which structures facilitated this process. In other words, instead of looking at why the debt crises hit Argentina five times in its history, the study will investigate the structures/forces that produced each default. The analysis follows a three-step process to conduct this investigation.

The initial step is to gather all the relevant data available on the topic. I have developed a dataset based on every record related to Argentina’s sovereign debt available to me. This dataset will provide the empirical foundation of this study. It incorporates datasets from secondary sources, like Thomson Reuters, World Bank, Comparative Political Data Set (CPDS), as well as data shared by authors who worked on the topic, like (C. Reinhart & K. Rogoff, 2010a) and Schreger (2015). Although I compiled both yearly and quarterly data, for this study, I only used yearly data, therefore there was no need to standardize the dataset.

The next step is to develop hypothesised causal mechanisms between one episode of causation and another. A causal mechanism transmits change directly and will be used to analyse micro-level events, such as a restructuring of Argentina’s debt. A process is a regular sequence of causal mechanisms and will be used to ensure spatial and temporal contiguity in the study, such as the consecutive restructurings of Argentina’s debt by the Paris Club in the 1960s. An episode is the macro-level transformation that we are trying to break down and investigate, such as the change in mentality as countries prefer not to default on their debt and instead began restructuring their outstanding debt. Our aim here is to go beyond the observable causal relations between institutions and sovereigns. The causal mechanisms that we develop should collect/group/explore the major forces in the governance of sovereign debt and every mechanism needs to have a uniform and immediate impact on the analysed event.

The third step is to sequence and operationalize these mechanisms to identify various processes. We will link the causal mechanisms and build concatenating sequences of episodes. Here, the purpose is to reveal how general movements, such as financialization, produce series of conditions and institutions that come together in a particular way to establish a new understanding of debt. For example, Chapter 4 investigates the newly developing circumstances and systems of beliefs that led to Argentina deciding not to default on its debt after the WWI. Our aim is not merely to give descriptions of a sequence of events, rather we will derive causal inferences from empirical evidences to explain the underlying mechanisms of major transformations.
The historical analysis will be driven by four key questions: (1) Are there any leaps in our logic? (2) Is every causal mechanism necessary to identify the broad process? (3) Can we measure the empirical impact of each causal mechanism? (4) How generalizable are our findings in relation to other cases? Here, focusing on only one country’s experiences with defaults through a case study provides consistency to the investigation, while the multiple case comprising it examining the frequent changes in the regimes under which defaults happened provides a strong basis for comparison and generalizability (Eisenhardt, 2007) of the causal mechanisms and outcomes of defaulting or not defaulting.

In figure 1.1 above, we briefly looked for patterns in the defaults displayed. This study is divided into chapters based on these patterns and an important part of this investigation is about grouping these defaults listed in Table 1.1. This division of defaults will also reflect the transformation that Argentina went through. To ensure coherence in each chapter, the defaults are classified and organised. This focus will provide the means to divide the timeline into fragments without any leaps in logic between parts. In this study, we will be primarily focusing on major events and shifts in Argentine history which means that the study will deliberately overlook some important historical events. It is not my aim to cover everything, as that would be impossible. We will use this logic as we conduct the quantitative macroeconomic analysis in Chapter 5 too. Instead of trying to build comprehensive models that attempt to cover every economic behaviour and indicator, we will use reduced form models to analyse the effects of the 1980 and 2001 defaults. This study will therefore tell the story of Argentine defaults in very broad-brush strokes to paint a more comprehensive portrayal which is not bogged down with ‘details’. For such an unapologetically largescale study like this, relatively large events can become minute. Additionally, the cut-off point of this study is 2010. Argentina defaulted in 2014, but this was an idiosyncratic default in the sense that even though the country made the necessary payments, the funds were blocked by a US based court. Including the 2014 default does not advance the discussion in which this study engages.

Before engaging in the historical analysis, we need a theoretical framework to understand sovereign debt. A decade after the on-going sovereign debt crisis following the 2008 Global Financial Crisis (GFC), new theories have been developed that offer nuanced understandings of debt and default. One such school of thought that expanded after the 2008 crisis is the post-Keynesian school.4 The crisis and the failure of the initial austerity measures reminded everyone

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4 These labels are rather confusing, and we will try to avoid them in this study. Neo-Keynesian, new Keynesian and post-Keynesian economics are all different schools. Neo-Keynesian and new-Keynesian economics are similar
that economic activity is demand-driven, as post-Keynesians emphasize. Within this school, a relatively new economic understanding called Modern Monetary Theory emerged. MMT provides a novel set of ideas free from neoclassical biases and enables a compound analysis of macroeconomic indicators. It does not provide rigid formulas to follow but instead offers tools that break from the established understanding of economics (Mitchell, Wray, & Watts, 2016; Tcherneva, 2006; Wray, 2015). It pays particular attention to the role and capabilities of the government sector in relation to external fiscal constraints. For instance, proponents of MMT have highlighted the unlimited capacity of currency-issuing governments to supply money. If a government can ‘create money out of thin air’, then it cannot be short of that currency, and insolvency and bankruptcy should always be inevitable for a sovereign nation (Tymoigne & Wray, 2013). This simple but universal axiom, ignored in the neoclassical literature, has significant implications on the discernment of debt.

MMT’s perspective is universal because it is applicable to any society that has a government and has the capability to print its own money. Any currency-issuing government under any regime, capitalist or not, can never run out of money while the state can finance any technically feasible activity. In Chapter 3, we will apply this perspective to 1820s Argentina and test this theory by comparing different regimes of production in terms of their productive capacity within different provinces. We will see that the development of industrial capitalism entailed high government spending and active state intervention in Argentina. Government investment did not occur on a for-profit basis, which freed industries from financial constraints.

This inextricable link between the formation of modern markets and the development of modern state has been clearly established by Polanyi (1944) and Keynes (1936). Polanyi showed that the economy is embedded and enmeshed in social institutions, and that the separation of market and state is simply a misconception. Keynes’ key achievement was to remind everyone that the state holds the primary responsibility for the economy because the market is not self-adjusting. We will move a step further here and argue that the state functions at an entirely different level and should be analysed as a separate entity that is above the markets.5

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5 To be clear, this is not a collectivist view of government in the Hegelian organismic sense of the state (Weiss, 1974). I am not ignoring the democratic boundaries that restrict state authority or the class relations that censor and curb the agency of the state. However, these discussions have no heuristic and explanatory value for this thesis since I am primarily interested in the empirical effects of sovereign indebtedness, ceteris paribus.
For example, the MMT perspective rejects theories like the ‘crowding-out effect’ (see, sections 2.4 and 5.4) where it is assumed that the state competes with the markets for credit and that this competition substantially affects the supply and demand of credit. When we accept the fact that the state does not need credit to fund its spending, we realize that the state does not compete with the private sector for any commodity, service or credit because a sovereign state can always buy anything that is for sale within its boundaries. This does not mean that MMT ignores the impact of net government positions on liquidity levels; on the contrary, by recentering the real agency of the state in shaping the society and the economy, it establishes the causation between government actions and their fiscal impacts much more accurately.

By rejecting the state-market dichotomy altogether and further developing the chartalist state theory of money (Lerner, 1947), MMT outlines a unique theoretical framework which frees state-market relations from the confines of a zero-sum game. From Adam Smith’s (1937) ‘invisible hand’ to Stiglitz’s (1991) theorem that ‘the competitive economy is always Pareto efficient’, dominant ideologies have consistently identified themselves by siding up either with markets or governments. Influential post-Keynesians, such as Galbraith (1998), have also fallen into the trap of underestimating the power of the state. Nonetheless, adopting this view of the state as an entity that is greater than the sum of its parts has implications on the methodology of this study too. The MMT standpoint conceptualizes the state as a much greater mechanism that functions beyond the capabilities of individuals, thus rejects the mainstream fixation of backing up macro-economic analysis with micro cases (Colander, 2006, p. 250). Thereby, it allows for a grandiose perspective that wilfully ignores single actors, like presidents or generals, in favour of depicting the bigger picture. Therefore, my focus will be on the macro level: I will conduct a macro-analysis of Argentina that spans through different centuries without giving the overpriced attention to small agents as is common in case study analyses.

This study builds on and contributes to this emerging literature and theoretical framework. Although the school is gaining momentum on account of the online blogs and writings of influential scholars (Mitchell, 2013; Mosler, 2011), there is a need for academic studies on the topic. The most underdeveloped part of the school relates to the historical evolution of modern

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6 This does not mean that the government should buy everything, or use this power indiscriminately. That would obviously be disruptive. However, it is important to acknowledge that a sovereign state holds this power as this approach establishes a different understanding of what is possible and what is not in an economy. We will return to this point and further explore it throughout the thesis.

7 If this was true, than any attempt at redistribution of wealth or share of power between state and private sector would break the Pareto efficiency. Therefore feeding on the same dichotomy built by Adam Smith.
monetary regimes. In this thesis, I will apply MMT’s theories to Argentina’s ever changing monetary and fiscal position over the last two centuries. Also, MMT has been heavily criticized for being a theory that is not applicable to the periphery since the developing countries are not conceived as fully sovereign in determining their own macroeconomic policies (Vergnhanini & De Conti, 2018). I will be testing this assumption by analysing the shifts in the sovereignty of Argentina, a peripheral country, since its independence.

Chapter 2 lays out how I use MMT and other emerging post-Keynesian theories to fill the gaps in the literature on sovereign debt and default. The chapter focuses on the shortcomings of influential studies that were published after the 2008 financial crisis, as these studies offer the most up-to-date and fully appraised positions to evaluate.

Having established the theoretical foundation of this study, Chapters 3, 4 and 5 then proceed with investigating the effects of changes in sovereign debt levels and the impact of defaults in the chronological order in which they occurred in Argentina since 1816. After a brief overview of the colonial era, Chapter 3 examines the accumulation of government debt by focusing on the causes and effects of defaults throughout the 19th century. The two defaults in this century display stark differences. While the first default of Buenos Aires province right after its independence triggered an experiment with fiat money in Argentina and propelled the province into the position of a dominant force, the second default at the end of the century crippled Argentina. The aim of this analysis is not purely historical; it also contributes to developing our understanding of government debt and how it functions under various regimes by iteratively returning to the theoretical analysis outlined in Chapter 2.

Chapter 4 covers the period between 1900 and 1950 and this time puts special emphasis on the lack of a default. It explores the emergence of different options for debt restructuring and evaluates the advantages and disadvantages of debt repayment. As one of the very few countries that avoided a sovereign default in the inter-war period in the 1930s, Argentina’s gains and losses in this period illustrate the cost of not-defaulting. Again, throughout this chapter we will interrupt the flow of the linear historical story to return to the theory and further elaborate the model of sovereign debt outlined in Chapter 2.

8 There is an extensive focus on the emergence of the concept of money in the ancient states (Semenova & Wray, 2015) and after the end of Bretton Woods, but I did not come across any study on the numerous fiat money experiments in the 19th century, for example. We will be looking at Argentina’s first issuance of fiat money and the structure of this early monetary experiment in Chapter 3.
Chapter 5 is a larger one that covers the period between 1950 and 2010 and explores a failed restructuring process in 1951 and two very impactful defaults in Argentine history; the 1982 and 2001. The 1982 and 2001 defaults draw a stark contrast that will enable a clear-cut assessment of the effects of different types of defaults. We will delve deeper into the empirical quantitative analysis of sovereign defaults by employing IRF econometric analysis to assess the influence of sovereign defaults on macroeconomic indicators.

The chapters are divided according to the changing paradigms that can be traced in Argentina’s approach to its debt. Each chapter is also built upon a comparative analysis of different types of default/repayment. Chapter 3 looks at the first two defaults, the 1827 and 1890 defaults. Although both stimulated the economy, it took decades for the 1827 default to be settled, while the 1890 default was resolved within a few years. Here, we compare the differences between resolving a default quickly and slowly. Chapter 4 analyses the non-existence of a default and enables us to compare the differences between defaulting and not defaulting. Chapter 5 covers three defaults; 1951, 1982 and 2001 defaults. The 1951 default happened as a result of a failed restructuring, which became inevitable after 20 years of debt postponement. Finally, the 1982 default was an orderly default while the 2001 default was a strategic one. We will use empirical tools to compare these two defaults. Table 1.1 summarizes the aims and approach of each chapter to contribute to a better understanding of Argentina’s responses to defaults and how the impact of these defaults changed radically.

Each chapter presents an investigation of a different era in Argentine history. Table 1.2 is useful as a reference point as it shows the periods of defaults and other relevant information.

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Period Covered</th>
<th>Focus</th>
<th>Aim</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 3</td>
<td>1816 to 1890</td>
<td>1827 and 1890 defaults</td>
<td>Comparing two similar defaults that were resolved differently</td>
</tr>
<tr>
<td>Chapter 4</td>
<td>1891 to 1950</td>
<td>Lack of a default in 1930</td>
<td>Evaluating the impact of not defaulting in time of a global debt crisis</td>
</tr>
<tr>
<td>Chapter 5</td>
<td>1951 to 2010</td>
<td>(1) 1951 default (2) 1982 and 2001 defaults</td>
<td>Assessing the costs of postponing an inevitable default Comparing two structurally different defaults</td>
</tr>
</tbody>
</table>
Table 1. 2 Overview of all Argentine crises

<table>
<thead>
<tr>
<th>External default/Restructuring</th>
<th>Duration (in years)</th>
<th>Domestic default/restructuring</th>
<th>Banking crisis dates (first year)</th>
<th>Hyperinflation dates</th>
<th>Years in external default</th>
<th>Years in inflation crisis</th>
<th>7 worst output collapses year (decline)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1827-1857</td>
<td>31</td>
<td>1890-1893</td>
<td>1885</td>
<td>1984-1985</td>
<td>68</td>
<td>39</td>
<td>1914(-10.4)</td>
</tr>
<tr>
<td>1890-1893</td>
<td>4</td>
<td>1982</td>
<td>1890</td>
<td>1989-1990</td>
<td>1917(-8.1)</td>
<td>1931(-6.9)</td>
<td></td>
</tr>
</tbody>
</table>

Number of episodes: 6

Memorandum item on IMF programs, 1952-2014

<table>
<thead>
<tr>
<th>Dates of programs</th>
<th>Total</th>
</tr>
</thead>
</table>

Source: Reinhart and Rogoff (2009); IMF (2016)
Chapter 2

Theory and Methods

“Thus, you do not ask who is beautiful, but what is the Beautiful.
Not where and when there is justice, but what is the Just.
Not how “two” is obtained, but what is the dyad.
Not how much, but what.”

Gilles Deleuze

2.1 Introduction

In this chapter, I take a step back from the assessment of the default history of Argentina in order to prepare the theoretical ground for the analysis in chapters 3-5. To do this, this chapter starts with a general theoretical appreciation of the nature of money and debt, before it tackles a range of common, but fundamentally flawed assumptions about “natural” constraints on government budgets and monetary policy. As I show below, these assumptions, despite being widely shared in the economics literature, see government debt as a burden on investment, on growth, and on the general well-being in a society. These assumptions cannot stand up to scrutiny, as is shown below. Once we appreciate the shortcomings of these mainstream assumptions, our whole approach to defaults in Argentina will have to change. This latter point is developed in detail in chapters 3-5. Here, we focus exclusively on the general theoretical argument that this thesis wishes to promote.

The history of government debt is as old as the first ‘money’ issued by a sovereign. Money, credit and debt were created simultaneously when a king or queen in Mesopotamia decided to pay their citizens for their services with shiny metals with their face printed on them. Since then, money has been an efficient way of mobilizing a population for a common cause. The first usage of money in history is a call to arms. Although money has been used in many different systems throughout its thousands of years of history, today in modern capitalist society money is still “a debt … and the value of money is maintained because of the need to make payments… by debtors and taxpayers” (Minsky, 1985, p. 4).

Every monetary system in history has its own structure and characteristics. In all of these structures there have always been tools to create and maintain the value of money. Increasingly, the destruction of money, through inflation, has become a main concern. The latest episode in the evolution of our global monetary system was the 2008 Global Financial Crisis (GFC) and
the resultant Sovereign Debt Crisis (SDC). Before these events, the dominant methodology in macroeconomic studies converged in such a way that, in Blanchard’s (2008) words, every article published followed “strict, haiku-like, rules” that are “simple, analytically convenient… and reduce a complex reality to a few simple equations”.

These rules and equations have a track record of missing virtually all major crises and predictions since they were introduced in the mid-1970s. For example, until the mid-1990s, it was assumed that if the unemployment rate fell below 6%, it would inevitably trigger spiralling inflation (Cashell, 2004). But the average unemployment rate fell below 4% in 2000 without any significant increase in the inflation rate. In the late 1990s in the USA, a clear majority of economists supported President Bush’s decision to pay off as much of the government debt he could, (Greene, 2015, pp. 95-106). Leading economists in the USA also “enthusiastically endorsed” (Mises Institute, 2000) the plan to solve the ‘debt problem’. The struggle to increase the surpluses and pay off the debt resulted in a shrinking domestic economy that did not have sufficient capital and eventually triggered the 2001 recession. The ‘haikus’ had thus failed to predict the 2008 crisis, while the mathematical models of post-Keynesian economists, like Godley and Wray (2000) and S. Keen (2013), had anticipated the collapse.

The failure of conventional economics to predict and solve the crisis led to the resurgence of different schools. As a part of the ongoing search for a way out of the GFC, many nations already experimented with Keynesian economics, through deficit financing (Mason, 2009, pp. 183-187), increased capital controls (Arora, Habermeier, Ostry, & Weeks-Brown, 2013) and paying more attention to averting large trade deficits as well as surpluses (Carabelli & Cedrini, 2007). The immediate revival of Keynes and the consensus on stimulus policies, however, had turned into ‘dissensus’ by 2009 (Farrell & Quiggin, 2012, p. 2). This U-turn was mainly instigated by the sovereign debt crisis. As the Greek debt crisis intensified and conservative parties gained momentum in Europe, the trend turned from supplying sustained stimulus to immediate fiscal consolidation. The rationale underpinning this sharp turn of events was simple. If a country is heavily indebted, and if it must pay its debt, the only way out is to decrease its spending by implementing austerity. The large stimulus packages were replaced by increasingly deeper cuts, instructed by politicians who single out the growing public debt as the main culprit. Famous academics like Alesina and Ardagna (2010) called for retrenchment of the state to revive investor confidence. Again, Greece was at the centre of attention as the starkest example of how markets punish those who choose fiscal profligacy. The global discourse around debt was thus re-shaped after the GFC.

16
The first objective of this chapter is to review the literature on sovereign debt and develop a theoretical framework. The primary purpose of this framework is to understand how scholars talk about debt and identify shortcomings in the current understanding of sovereign debt. In the first instance, the chapter focuses on popular and common understandings of debt. It then discusses orthodox and progressive definitions of basic concepts: credit, debt and money and reviews the most impactful and popular debates in the immense literature on debt. Instead of delving too deep into the technical aspects and theories, the chapter aims to outline a context that can explain how debt relations work at the very fundamental level, rather than develop a framework that is biased towards the neoclassical understanding of debt. Therefore, the other objective of this chapter is to start developing the post-Keynesian/MMT based reading of macroeconomics that guides the study.

2.2 Defining debt, credit and money

The history of debt became a popular topic after the 2008 GFC. The crisis endangered the assumption of equivalence among parties in the commercial exchange arena and disclosed the asymmetry of power in finance in Europe and North America. Ever more political theorists and economists have joined in questioning the soundness of the global financial system (Colander et al., 2014) and the current understanding of the concept of debt into question (Beyer, Coeuré, & Mendicino, 2017). The most read popular-anthropology book of the 21st century is Graeber’s (2014) “Debt: The First 5000 Years” (Oliver, 2012). Graeber’s 500 page-long book about how states oppress people via debt and credit, became a best-seller and sold 60,000 English copies in a few months thanks to this changing conjuncture (Stützle, 2012). Although the rekindling of the interest in debt has been fruitful, the discussion tends to be flawed due to issues of basic definitions. For example, the terms ‘debt’ and ‘credit’ have been used interchangeably in various contexts, not only by experts (Debt Canada), and in the media (Magnus, 2016), but also by Graeber himself who defines debt and credit as obligations that can be quantified, which makes it “simple, cold, and impersonal” (2014, p. 13).

This perspective of debt as an ill-disposed burden on communities is pervasive in modern societies. But it has become even more conspicuous as household debt soared in the new millennia. Between 2002 and 2007, household debt to income ratio increased by 39% and reached 138% in advanced economies (Leigh, Igan, Simon, & Topalova, 2012). Since being indebted is stigmatised as a form of inadequacy and inferiority, it is not abnormal that the reaction against rising debt levels has stirred debates. People are being crushed under this
burden and the discussion also takes place on the street. We saw popular movements that express popular anger towards debt and inequality, like ‘Strike Debt!’ in the US and ‘Que se vayan todos’ in Argentina. International movements like the ‘Arab Spring’ have also been linked to the sovereign debt crisis (Dodge, 2012; Winckler, 2013).

These movements did not organise solely as a response to debt and austerity, but they share a common enmity towards debt at the theoretical level. This anger can be seen in Ingham’s (2004, pp. 99-100) conceptualization of the establishment of the market with a variable exchange rate as the “military-coinage complex”; or when Baudrillard (2005, p. 173) claimed that “Credit brings us back to a situation characteristic of feudalism, in which a portion of labour is owed in advance, as serf labour, to the feudal lord”; or when Ardant (1976, p. 442) argued that credit is “one of the most effective instruments of exploitation man has managed to create”; and in countless other stories, from *The Merchant of Venice* (Shakespeare & Kaplan, 2002) to *Faust* (Goethe, 1965).

Recently, anger towards debt has been expressed as a desire to back up the currency and ‘base’ it on a tangible metal. This is understandable in times of uncertainty. Throughout the 2016 election campaign in the USA, many high-ranking Republicans advocated a return to the gold standard (Tepper, 2015). For instance, President Donald Trump said, “We used to have a very, very solid country because it was based on a gold standard” and that “[by] bringing back the gold standard… We’d have a standard on which to base our money” (Benko, 2017). Then again, it shows the fallacy in the popular understanding of money. A more coherent proposition was introduced by the campaign organisation ‘Positive Money’ in 2010. The pivotal point of the organisation is that fractional reserve banking creates privately issued money and this debt-based money is not sustainable for nations (Miller, 2011). This call for “debt-free money” is supported by the chief economist of the Financial Times (M. Wolf, 2014) and in 2014 their proposals were discussed in the British Parliament (House of Commons, 2014). Milton Friedman (1959, pp. 52-62) was a proponent of such a system. Another relevant ongoing discussion is that of Iceland’s monetary reform proposal to end credit-creation by banks that will be voted in 2018 (Iceland, 2016).

The core proposition of all these movements is that debt levels are unsustainably high because of an inherent structural problem with the concept of debt. This view echoes Proudhon’s (1873, pp. 141-144) understanding of capitalism as a mere matter of interest/usury and currency as a
creation of militaristic states.⁹ Each one of these popular movements makes valid arguments, and their voice is heard by policy makers. But as will be explored in-depth in this study, the popular discussion on debt has serious shortfalls and misunderstandings.

### 2.2.1 Necessity of Credit

Credit and currency are tools used to facilitate exchange. The difference between credit and debt is that credit is a financial tool which represents the value of money available for borrowing. A credit card with a limit of $1000 provides $1000 worth of credit. When this amount is utilized, credit (claim) is converted into debt (obligation). The nature of credit is that the creditors’ assets are always matched by the debtor’s liabilities. $1000 in someone’s bank account is their asset, while it is a $1000 liability for the bank. Assets and liabilities rise and fall simultaneously. Borrowing a $1000 from a bank creates debt in that person’s name, and it also creates a $1000 deposit of bank credit in the borrower’s account. For the borrower, the $1000 is an asset while for the bank it is a liability, and if the borrower fails to pay his debt, both the asset and the liability are cancelled concurrently.

To reiterate, every debt creates an equal amount of credit. Unless the person who provided the good or the service is reimbursed straightaway (then it is called barter), there is a need to keep track of any debt or credit. Credit is the basis of any financial intermediation structure and it’s fundamental role is to allocate resources over time and between economic units. It is a vital instrument for any economy. It is neither evil nor oppressive. The credit system increases the efficiency of circulation within the economy. Instead of being hoarded and left out of circulation, “one can understand the pleasure experienced when all these potential capitals… become disposable, ‘loanable capital’, money-capital which indeed is no longer passive and music of the future, but active capital growing rank” (K. Marx, 1976, p. 300).

The main function of the credit system is simply to decrease the costs of circulation while increasing its efficiency. It removes barriers and allows the free flow of capital. For example, commodities that require long production periods, like automobiles, can be paid for in instalments. This allows the money to flow between industries with different production times and, as a result, trade between more distant markets becomes smoother (D. Harvey, 2006, p. 263). The current credit system provides the necessary subsistence for multinational

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⁹ For Marx’s answer to Proudhon’s argument on how eliminating usurers would equalise exchange relations, see K. Marx (1976, p. 128)
corporations (MNCs) via providing large amounts of long-term credit. We can argue that the construction of contemporary society with its complex education, law, and welfare systems was possible only through an intricate credit system. Credit can be a force for egalitarian purposes. Someone with no capital can borrow money and participate in the economy and potentially be on par with the people with capital (Galbraith, 2017, p. 70). Basically, following K. Marx (1981, p. 147), we can argue that international commerce would not be possible without a credit system:

Credit is, therefore, indispensable here; credit, whose volume grows with the growing volume of value of production and whose time duration grows with the increasing distance of the markets. A mutual interaction takes place here. The development of the production process extends the credit, and credit leads to an extension of industrial and commercial operations.

That being said, we should recognize the asymmetrical power relation credit creates between creditor and debtor. We cannot ignore the fact that debt and credit are being used to intrude into people’s and countries’ decision-making processes and enforce modalities of subjection and exploitation (Derrida, 2012). The questions we need to ask here are: How should debt be talked about? What type of approach can explain how it functions?

2.2.2 Talking about debt

One of the most effective monetary policy tools available to nations is changing the interest rate. Most countries use the ‘equilibrium interest rate’ model built on the orthodox macroeconomic approach based on the demand and supply of money (Davies, 2015). The model assumes that credit/money is a scarce ‘gold-like’ resource and that there is a rate of interest at which this ‘supply’ and demand for money is in equilibrium. In mainstream economics, credit is a commodity (Yntema, 1938), and the interest charged is the price of this commodity. The two figures below contain simplified graphs representing hypothetical equilibrium points.

The first graph in figure 2.1 represents a basic supply and demand correlation graph. More sophisticated forms of this
are widely used to determine the discount rate of central banks. However, we know that credit does not draw a typical supply/demand chart (Médaille, 2010). In the commodity market, the seller does not consider the chances of getting paid, there are no credit scores or rating agencies involved, and therefore supply increases along with demand. Commodity markets and debt markets are governed by different rules.

When interest rates are high, the creditor becomes reluctant to lend as the number of debtors who can repay declines. The second graph therefore offers a more realistic representation of demand and supply in the debt market. When the price of credit increase, banks, private investors, and international financial markets prefer to wait for more suitable times to invest. There is no equilibrium point for the credit market because it does not behave like a commodity. This is currently happening in the world. Today, nearly 500 million people in the world are living in countries with negative interest rates (Randow & Kennedy, 2017). This means that instead of the borrower paying for the borrowed money, the debtor makes money from accepting a loan. This was unimaginable before the financial crisis because only unwanted, toxic things could have a negative price and money was supposed to be an object of desire.

Money is not an object of desire, money is not a thing. Money is a unit of account. There is a vast literature on the origin of money and how it emerged as a social relationship (Graeber, 2014; Polanyi, 1968). In this study, we only need to recognize that paper currency is debt and that we use money as a unit of measure. $1000 in a bank account is the bank’s debt to the account holder and $1000 in cash is the issuer state’s debt to whoever has the paper/currency. A thorough analysis of how money emerged is beyond the scope of this study, but extant literature convincingly shows that money is a form of debt (Grierson, 1977; Ingham, 2004, 2013; Innes, 2004).

In the modern world, nearly all money is in form of bank credit that exists as computer records. Bank credit and bank debt are correlated and arise simultaneously; they are not created as a direct result of production or trade. This is an important point as both the orthodoxy and some of its opponents are missing this trait of credit and money (Lavoie, 1984). The monetary reform proposal in Iceland or the campaigns calling for ‘debt-free money’ that we mentioned earlier are good examples. There can be no ‘debt-free money’ since money is itself a form of debt. Does this mean that we are destined to be crushed under ever growing debt as the private banks create debt/money out of thin air? To fully answer this question, we need to understand how money creation works.
When a bank extends credit, purchasing power in the economy increases equally. Borrowing $100 from a bank puts $100 in the economy, but for the borrower it also creates a $100 liability vis-à-vis the bank. For the money ($100 credit) that was created, an equal amount of off-setting liability ($100 debt) is created. On the other hand, when the issuer of the currency - i.e. the state - spends money, no offsetting liability is created. The state creates financial assets *ex nihilo*, while the commercial banks leverage the money created by the state. This difference, while overlooked by neoclassical, Marxist (Isaac, 1991) and some post-Keynesian economists (Davidson, 1989), is key to understanding modern monetary economics.

Credit created by banks falls within the endogenous circuit of money and it is demand-determined. As the private sector borrows, the money supply expands, and it shrinks as debt is paid. Post-Keynesian authors call this type of operations ‘horizontal transactions’ and point out that these transactions do not add to net financial assets (Kaldor, 1981). Only the state holds the power to engage in ‘vertical transactions’ and the money put into circulation by the state is called ‘high powered money’ (HPM). Vertical transactions do not have a corresponding liability within the private sector, while horizontal transactions create an offsetting liability within non-government sector. This means that only the government can directly alter the net financial assets in the domestic economy. For example, if we look at the balance sheet of the Central Bank of Argentina (BCRA)¹¹, or any other central bank that issues its own currency, we cannot see any domestic currency on the asset side. BCRA does not own any pesos. When the government of Argentina spends, BCRA deposits money into private accounts and this amounts to a net injection of reserves into the economy. Such a transaction is vertical because the money injected into the economy is not offset by a corresponding liability in the private sector and it therefore directly increases the net financial asset in the economy.

Banks provide HPM on demand, they do not create it. Banks are profit-seeking intermediaries. Therefore, constraints on banks, such as reserve requirements, are not effective tools in monetary policy. Countries like Canada and New Zealand have abandoned these requirements, while Argentina has one of the highest reserve ratio requirements in the world (CEIC, 2018).

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¹⁰ We should make clear that this is only true for countries that issue their own currency. For example, this does not apply to countries that adopted the Euro as their sole legal tender. By giving up the power to create their own money, these countries must now record an equal amount of liability when they engage in treasury operations, such as deficit spending.

¹¹ The balance sheet is available on the bank’s website: http://www.bcra.gob.ar/Pdfs/PublicacionesEstadisticas/i2007balance.pdf
In the perspective of this study, any regulation of private banks must be done at a more structural level than reserve requirements.

Unlike what some post-Keynesian economists claim (Dow, 1996), banks are not passive institutions that only provide HPM on demand. Beyond the measures like overdraft arrangements, banks are important in defining the elasticity of the supply of credit because they decide who is creditworthy and who is not. That being said, following horizontalist economists (Arestis & Eichner, 1988), credit rationing is a shifting variable and does not change the slope of the credit supply curve. In other words, it does not change the way credit works, it only alters the effective rate of demand.

On the other hand, commercial banks are not as influential as they used to be. Instead of resorting to banks for funding, depositors are increasingly investing directly in financial markets. Nowadays, only in the USA do mutual funds contain more than $16 trillion in assets (MutualFunds, 2016), while the ratio of household assets held in bank deposits is falling (Magrann-Wells, 2017). As bank intermediated finance is becoming unattractive, companies are seeking capital market funding and savers are actively participating in the financial market. Since the 1980s, this development has led to the rampant growth in the number, and power, of non-bank institutions such as credit rating agencies (CRAs). The number of actors participating in the financial sector has increased along with the number of complex instruments in finance, and CRAs have taken over the position of commercial banks in defining the creditworthiness in the convoluted area of finance. Current economic models do not take this development into account. To rectify this oversight, the effect of CRAs on sovereign debt will be discussed in Chapter 5.

2.2.3. The growing debt problem

Although sovereign debt is subject to different rules and limitations, it is important that we outline how debt works at the micro-level. The global financial economy is basically a massive spreadsheet where millions of interlinked networks keep track of the creation and destruction of debt on computer screens. By looking at the spreadsheets of households, firms and private and central banks, it is possible to follow the story of the modern world. Every increase in individual fortunes and the rising debt level of the masses, every era of growth and depression, every gilded age and lost decade can be tracked through balance sheets. Even physical cash is a part of the virtual balance sheet; withdrawn cash means that an account was debited, and deposited cash means that an account was credited.
Telling the story of flows of credit and debt between agents provides a complex but more complete picture. Building a macro-economic model based on tracking and integrating all the flows and stocks within an economy was first explored by Copeland (1949). In his seminal work Copeland asked: where does the money come from for expansion when GNP increases and what happens to the unspent money when GNP decreases? To answer this question, he built a quadruple entry system that was consistent both within and between stocks and flows. No real fund can vanish or appear out of nowhere. Every flow has an origin and a destination, and every stock has a liability holder and an asset holder. By tracking the ins and outs in spreadsheets, it is possible to trace imbalances as they build up in an economy. The analysis in this study does not build a full Stock-Flow Consistent model for Argentina, but uses this balance sheet approach to monetary policy which postulates that for every debt there is an equal amount of credit.

The popular approach to the rising debt problem fails to see this link between credit and debt. Decreasing debt means decreasing credit. Debt is not a problem that can be solved simply by decreasing it. It is not possible to reduce 5,000 years of human history into a dichotomy between peaceful ‘debt-free-economies’ and violent ‘military-coinage-slavery’ complexes. Without debt there would not be any credit either. Furthermore the ‘debt problem’ cannot be tackled through moratoriums as Piketty argued (Toussaint, 2017), or through debt restructurings as directed by the International Monetary Fund (IMF). Extinguishing existing debt does not solve any of the structural problems. To reiterate, sovereign debt is only a tool that is used by the state, and all private and public debt is determined by the macroeconomic approach of a country. Through its policy choices, the government decides which group is going to be indebted in a society and who is not. For example, university level education costs nearly twice as much as the average developed country in USA (OECD, 2018), and large portions of this spending is funded by the government in form of student loans. An estimated 86.8% of black students resort to these loans, as opposed to 59.9% of white students (National Center for Education Statistics, 2017). However, indebted students can join the US military to receive a sizeable loan forgiveness. As a result, impoverished racial and ethnic minorities consistently represent greater shares among enlisted personnel in the US military. In Argentina, it is indigenous people (Vivaldi Pasqua, 2016) and women (Chejter, 2004) who shoulder the heaviest burden of debt in their society. The government choses either to mobilize and channelize the indebted people into certain sectors, like the military, or push the indebted groups out of society through gentrification, as it is happening in Buenos Aires (M. C. Rodríguez & Di Virgilio, 2016), or make them work for very low wages.
This study looks at the source of the growing debt and what can be done about it at the state level, but it does not focus on the specific groups and classes that are carrying the debt burden. It is still important to notice that debt is used as a way to mobilize people as it reminds us that debt is primarily about power and distribution of wealth. The question is not necessarily why is there too much debt, but why did debt and credit consolidated so much in certain hands? Why don’t people/countries have the tools to discharge their debt, and what should an indebted person/government do? Popular books and movements do not answer these questions. To do so it is necessary to look into the more technical writings of political economists who work on debt at the macro-level.

2.3 Solving the debt formula

In order to move beyond abstractions that limit the theoretical understanding of how debt works, this section scrutinizes the most basic assumptions in the macroeconomic conceptualization of sovereign debt. Let us start with the accounts of the government cash flows. This sheet includes all the inflows and outflows of the state. The left side of the equation represents the government spending \((G)\) and the interest it pays on the national debt \((rB)\) as the outflows; the right side represents taxes \((T)\), new bonds sold \((\Delta B)\) and new high powered money (HPM) created \((\Delta M_h)\):

\[
G + rB = T + \Delta B + \Delta M_h
\]  

(1)

This equation puts the total government spending on one side and equates it to the sum of tax revenues, bonds issued and HPM issued. This is an accounting identity and will always hold true. Conventional economics then draws the ‘government budget constraint’ from this equation by moving the \(T\):

\[
G + rB - T = \Delta B + \Delta M_h
\]  

(2)

The left side of the equation now represents the net spending by putting the primary fiscal deficit \((G - T)\) and the interest paid on debt \((rB)\) on the same side (which constitutes the overall fiscal deficit), and this equals government ‘net income’ which is the sum of bond sales and money printed. The left side of the equation denotes the budget deficit, and the right side shows how the government can finance the deficit. It can sell bonds and/or print HPM. This equation can be found in any mainstream graduate-level economics textbook (for example, Walsh, 2003, p. 136). Yet some economists (Fincke & Greiner, 2011) do not include \(\Delta M_h\) into the equation, because they assume that printing money to finance a deficit would certainly be inflationary and not a viable option. The equation will always hold true regardless, but its interpretation can
change. From this equation, the orthodoxy derives that when there is a budget deficit \((G - T > 0)\) the government must borrow money. So, the possible solutions for the equation above include all values of \(G - T\) and \(\Delta B\), such that \(\Delta B\) is equal to \(G - T\). From this perspective, if the government wants to decrease borrowing, \(G - T\) should be as low as possible.

In the orthodox perspective, increasing the money supply by ‘printing money’ is not desirable since it is believed to be inflationary. Therefore, selling bonds remains the only option, but then borrowing increases national debt. To prevent inflation or to avoid increasing national debt, the government either should be required to match its spending with its revenues, or plan its fiscal and monetary operations in a way that prevents a need for ‘excessive’ borrowing. Most economists take the latter position; they do not argue for continued surpluses but make a case for pro-cyclical fiscal response (for example, Turrini, 2008). Freshwater economics schools that advocate for endless surpluses, such as the Chicago School, are exceptions here (O'Brien, 1981).

The concern that orthodox analysts have is that debt grows and becomes a substantial burden if left unchecked. It is worth demonstrating this graphically. Suppose that a country has a balanced budget and decides to give a tax break and run a $10,000 deficit at year \(t_1\) and borrow from the international bond markets with 5% annual interest rate, paid monthly. After 5 years \((t_5)\) the amount would have increased to $12,833, as shown in Figure 2.2.

The deficit caused by the initial tax break will grow at rate \(r\). The alternative, shown in figure 2.2 bottom graph, would be to stabilise the debt by running budget surpluses equal to the debt servicing cost. That would mean a small initial, but perpetual increase in taxes. ‘Perpetuity’, albeit impracticable in the real world, is

![Figure 2.2 Debt stock and tax increase relationship](image)
regularly used in analyses of government debt since all fundamental formulas are construed in an infinite time horizon. The first underlying assumption is that the deficit will sooner or later be paid by the people and it will cause an increase in taxes. If people enjoy the extra resources today, they will have to pay a price for it tomorrow. This assumption is based on the idea that taxes pay for budget deficits, and I challenge this idea below and throughout the thesis.

The second erroneous assumption of mainstream analysis is that private spending will be negatively affected by the deficit, because it is assumed that the government spending will limit private spending. People will presume that an increase in the deficit will have to be paid with their taxes tomorrow, so they start saving today. Quoting from a popular economic textbook, “A government budget deficit implies higher taxes, now or later, to pay off the Debt. If taxpayers realize they will have to pay the debt, they save more now to pay taxes later” (Thompson, 2006, p. 347). The idea dates back to 1820s, and was more recently revived by Barro (1989) under the name ‘Ricardian equivalence’. According to the theory, when sovereigns increase their debt, households will see this as deferred taxation and in anticipation of an increase in the taxes in the near future, will increase their saving and reduce spending.

Putting this erroneous assumption in different words: the lower the sovereign debt, the more demand there will be because the private sector will expect a tax reduction, or at least no tax increase. Lagarde, the current head of the IMF, followed the same logic when asked about the austerity measures without stimuli in the European Union: “[…] If we do not reduce the public deficit, it is not going to be conducive to growth. Why is that? Because people worry about the public deficit. If they worry about it, they begin to save. If they save too much, they don’t consume …” (ABCNews, 2010). Therefore, the general interpretation of Equation (2) is that running a deficit increases the debt levels without any real and long-term socio-economic benefit, and that government must keep its debt-to-GDP ratio at a sustainable level. Of course, economists acknowledge that governments might need to run deficits under certain circumstances, but the consensus is that these are exceptions and that deficits should only be tolerated for specific circumscribed production purposes. After all, they assume, debt is a constantly growing problem that requires great sacrifices to be handled. Most empirical studies of sovereign debt locate the problem as one of unbridled growth of interest payments (Auerbach, 2003; Gokhale & Smetters, 2003).

The budget constraint implied by Equation 2 is accepted in different forms and shapes by virtually every mainstream economic school, and even by some heterodox economists. For example, after the Global Financial Crisis, Krugman (2009) asked, “Should the government
have… permanent… budget deficits?” and answered his own question stating “Of course not… in the long run the government, like private individuals, has to match its spending to its income”. Deficit is considered a dangerous tool and the growing stock of debt is a threat for the prosperity of our grandkids since ‘one day’ it will have to be paid.

This idea that government budgets are thus constrained in principle naturally extends into a rejection of basic Keynesian ideas. Until the 1970s, it was widely accepted that stimulation via government deficit is necessary in times of stagnation. Then, further analysed in Chapter 5, a mental shift occurred in the late 1970s. For instance, Giavazzi and Pagano (1990) empirically showed that cutting public spending can increase private spending and developed an alternative to running budget deficits which they called “expansionary fiscal contraction”. There are various complex models that attempt to find the equilibrium for sustainable government spending, and others that seek debt stabilisation rates (Van Aarle, Bovenberg, & Raith, 1995). A common definition of a sustainable fiscal policy is “a policy [in which] the ratio of debt-to-GDP eventually converges back to its initial level, \( b_0 \)” (O. J. Blanchard, Chouraqui, Hagemann, & Sartor, 1991). But the question about what level of debt is sustainable and what level is too high remains unanswered. Despite many attempts and the existence of benchmarks such as the Maastricht Criteria, no credible and comprehensive study has yet come up with a definitive debt ratio that is stable and sustainable. The next section discusses some of the most influential attempts at finding a sustainable level of public debt.

2.3.1 Challenging the ‘Magic Ratio’

In the wake of the European sovereign debt crisis in 2009, Harvard professors Reinhart and Rogoff published two seminal studies that claimed to have identified such sustainable threshold. In their book, ‘This Time is Different’ (2009), they developed a comprehensive database that covers sixty-six countries, eight hundred years, and includes data on crises, currency crashes, inflation, defaults and long-run economic growth. The data bundle diverse economies together to offer a panoramic analysis in which they identify major default episodes spaced only a few years or decades apart. This study of defaults from Edward III of England in the 14th Century all the way to 21st Century Argentina, finds that the common problem in all crises and clusters of default is to be found in excessive debt accumulation. Published right after the GFC, the book lists the usual reasons the USA fell into deep recession as well; the current account deficit rose steeply, credit grew recklessly and financial liberalisation paved the way to the crisis (2009,
pp. 199-221). This process is mentioned multiple times throughout the book for different countries.

This popular book was supplemented with an academic paper titled ‘Growth in Time of Debt’ (C. Reinhart & K. Rogoff, 2010b). The authors identify 250 sovereign external defaults and 70 domestic defaults over eight centuries that reveal a negative correlation between debt and growth (2009, p. xxvi), and remind us that “financial crises are nothing new… earliest crises were driven by budget shortfalls often prompted by wars” and how “a permanent treasury deficit mean[s] that several loans… [create] hopeless credit situations”. Since “seldom do countries ‘grow’ their way out of debts” (C. Reinhart & K. Rogoff, 2010b, p. 380), and ‘on the eve of default… output declines… inflation truly gallops” (Reinhart & Rogoff 2009, p. 126), the only option is to decrease the debt to sustainable levels. The negative correlation between debt and growth, however, only becomes statistically significant once the debt-to-GDP ratio reaches 90%. They find that if a country goes beyond this point, it will suffer a 1% loss in GDP growth in the long-term growth rate. For developing countries, the negative effect of high debt is even worse. When a state has an external debt-to-GDP ratio of 60% or more, long-term growth slows down by 2%, and the economy starts to contract when the ratio reaches 90%. Also, for highly-indebted developing countries, the median inflation rate is 10.5% higher than developing countries with lower debt ratios.

Reinhart and Rogoff’s studies are, arguably, among the most influential economic analyses of the last few decades and their message is clear. The 90% and 60% tipping points have subsequently almost universally been accepted as the figures for responsible fiscal positions. Developing countries are constrained by 60% debt-to-GDP ratio, while developed countries can go up to 90%, but beyond this level it is uncharted territory. All nations received the message loud and clear, and provided the intellectual underpinning of austerity policies after the GFC. Politicians like George Osborne in the UK and Paul Ryan in the US quoted Reinhart and Rogoff repeatedly to defend austerity measures in the these countries (Cassidy, 2013). Reinhart and Rogoff are also very popular in Argentina. For instance, the founding director of Centennial Latin America, Claudio Loser, in 2017 suggested that Argentine investors should read ‘This Time is Different’, and pointed out how the current government’s attempts to pay off the debt with austerity makes Argentina a safe bet for investors (Wende, 2017).

Reinhart and Rogoff’s approach has met with significant criticism, however. Herndon, Ash, and Pollin (2013), for example, demonstrate that the empirics underpinning Reinhart and Rogoff’s findings are dubious. They pointed out basic spreadsheet coding errors, as well as
selective exclusion of data and unconventional statistical procedures by Reinhart and Rogoff. The critics find that without such errors and exclusions of data, the average growth of countries with 90% or higher debt rations is a positive 2.2%. Even without the coding errors the results are susceptible to doubt. In Herndon et al.’s (2013) words, “differences in average GDP growth in the categories 30-60 percent, 60-90 percent, and 90-120 percent cannot be statistically distinguished”. Despite these significant empirical doubts, Reinhart and Rogoff’s study remains very influential in economic, financial and policy circles for two reasons. First, unlike many other studies on sovereign debt, they applied a very long-term assessment of debt that included a historical analysis. There is a need for such a search for generalizable patterns in movements of sovereign debt in the literature. Secondly, their study provided substantial ideological support for the fiscal adjustment policies prescribed by the austerity promoters (who, coincidentally, benefitted most from these very policies). That is why, it is worth looking beyond the spreadsheet errors they made and explore the theoretical points they ignored (or missed) in their analysis.

The first conceptual/typological error lies in how they constructed the dataset. Countries with different monetary systems were amalgamated in the construction of the dataset. In the eight centuries covered in the dataset, nations went through gold standards to fiat money, fixed to flexible exchange rates, convertible to non-convertible currency eras. Sovereign defaulting, however, is an entirely separate event in every different monetary regime. A government that fixed its currency to a commodity (like gold) is financially constrained, while a free-floating currency issuer is not. For example, the USA defaulted in 1933, while it was operating under the gold standard. As Nersisyan and Wray (2010) argues, in 1933 the US government spending was only 6% of GDP, the debt was large for such a small government, but it was a relatively small amount compared to the GDP. Therefore, pointing out to debt-to-GDP or similar ratios without accentuating the context of the debt is misleading.

Secondly, Reinhart and Rogoff do not consider the difference between foreign-currency denominated and domestic-currency debt in discussing their results. They mention that this can have an impact on the effect of high debt but do not include it in their equations. This crucial point is overlooked in many studies on debt. After the 1980s’ debt crisis, the surge of empirical work on sovereign debt did not pay particular attention to the denomination of the debt (Berg & Sachs, 1988; Cline, 1984; McFadden, Eckaus, Feder, Hajivassiliou, & O’Connell, 1985). If we account for the denomination and the currency regime factors we get a different picture than what Reinhart and Rogoff paint. Even if we rely on Reinhart and Rogoff’s dataset, it is noteworthy that there is no default on either domestic or foreign debt by a currency-issuing
country with a floating exchange rate. Governments do not default on their debt if the debt is issued in domestic currency and if there are no operational constraints such as a currency peg. There can also be ideological constraints, like the desire to balance the budget or politically-inspired ‘debt ceilings’ (as in the US), but as these constraints are essentially fictitious (in the Polanyian sense of the word – Polanyi, 1968) they cannot, and they should not, compel a government to default.

This is a point that is emphasised by Modern Monetary Theory (Futtwiler, 2007; Kaboub, 2013; Mitchell, 2015; Nersisyan & Wray, 2010). MMT claims that the fiat money system functions on different rules than metal- or fixed exchange rate based- monetary regimes, and that the debt/credit issued in this system is not comparable to any other fiscally constrained entity or monetary system. Remembering the ‘government budget constraint’ formula condensed into ‘G – T = ∆B’ by the neo-Keynesian economists (Farnham, 2014, pp. 230-251), MMT highlights that there are other factors that have been excluded from the equation, particularly ‘∆Mh’, created by the new HPM. A sovereign currency-issuing government can always create money to pay its local currency debt or stimulate economy in downturns. The debt issued in local currency can never be a dire problem for the economy either. The currency of the debt changes everything. This study’s analysis of Argentina’s economic history will thus differentiate between types of debt according to the operational differences between different exchange-rate regimes, and between the ‘identity’ of the debt (whether it is denominated in local or foreign currency).

2.4 Types of debt

Sovereign debt is composed of internal and external debt, for which the central government eventually takes responsibility. Internal debt is contracted with a creditor such as local banks and/or residents. Internal debt is generally managed through straight-forward accounting mechanisms as it is expressed in local currency. External debt consists of private and public liabilities to non-resident individuals and institutions. Private external debt is the sum of all external liabilities of non-governmental firms/institutions and it is contracted or guaranteed by the state. Usually, public and private external debt is generated through different mediums and the responsibility is assumed by different parties. However, as we have seen in the 1982 and 2008 debt crises, when the governments decided to bail out private banks, the public sector assumed responsibility for (at least part of) private external debt. Although private and public liabilities are different in principle, the porous borderline between the two means that the public
(that is, the state) can also become responsible for private external debt. That is why many international financial institutions (IFIs) consider sovereign debt to refer to gross (public and private) external debt (for example: European Central Bank, 2013).

Public external debt also consists of various debts owed to IFIs, other sovereigns, private banks and financial markets. We cannot precisely distinguish between types of public external debt according to the creditor either, because nowadays debt is something that can be bought and sold like an asset. This ‘secondary debt market’ was developed in the early 1970s and allows investors to buy the non-performing debt of any country. It is generally the multinational banks that sell the debt of developing countries in order to reduce their exposure and lend new money. This has proven to be a highly profitable business.

For example, Elliott Management Corporation purchased $28.75m of Panama’s sovereign debt for $17.5m in 1995 and sued Panama for full payment and ultimately received $57m in 1996 (Cameron, 2015). The same company made over $90m over the sovereign debt of Congo, won a $58m judgement over $11.4m defaulted Peruvian debt and the same fund netted over 10 times of its original investment in Argentina (Cameron, 2015, pp. 290-293). In these cases, debt has not only changed hands, but also changed form. Under private banks, Argentina’s debt was a bond – an investment that is expected to be paid back over a set period of time with interest. When Elliott bought it, it became a commodity of the company because it did not expect Argentina to pay back the debt over time and used it as a lever to extort money from the country.

As we can see, sovereign debt is a very slippery notion as it can change shape and function and any attempt to capture its ‘unchanging essence’ usually fails (Krueger, 2002; Panizza, Sturzenegger, & Zettelmeyer, 2009).

At this point, we cannot even draw a watertight distinction between internal and external debt, and between private and public debt. The inconsistencies, innovations, and shifts in the meaning of modern debt instruments (loans, bonds, bills, stocks etc.) disturb even this very basic separation. As Balibar (2013: 3.3) highlights, the institutionalization of debt makes it highly challenging to draw a line of demarcation between public and private anymore. The pool of credit that states borrow from is itself a pool of borrowed money. Private banks use hedge funds and shadow banking as intermediaries to invest in sovereign bonds; big financial firms use laypeople’s savings to invest in sovereign bonds; sovereign states capitalize institutions that invests in sovereign bonds like the IMF; and individuals who can borrow large sums of money
can invest this money into sovereign nations. All this investment is performed by others’ money. It is thus safe to claim that it is impossible to trace the lent money back to its origin.\textsuperscript{12}

In addition, the distinction between production and finance has become blurred. Large businesses rely on extensive credit mechanisms and leverage and provide credit to an astronomical amount. Companies like General Motors’ major business is no longer automobile production anymore, but consumer credit, leasing, loans, and other financial instruments (Froud, Leaver, Johal, & Williams, 2006). That is how fraudulent businesses like Enron could be profitable for a very long time without producing anything. There is no class of creditors in the traditional sense anymore. Instead, there is a constant flow of money between creditors and debtors, mostly without the knowledge of the real backer.

Without the ability to identify creditors, analysing different types of debt becomes even more complicated, but also that more necessary. To illustrate this point, suppose we conduct a study searching for the hypothetical sustainable debt level of four countries, Argentina, Puerto Rico, Japan and Greece in 2017. Although we can compare various indicators like growth rate or levels of inequality for these countries, we cannot compare indicators related to public debt, like the level of indebtedness or the possibility of a default. The reason is that while Argentina and Japan have control over their fiscal policies and majority of their debt is issued in their domestic currency, Puerto Rico and Greece do not have the capability to manage their exchange rate through central banks and no part of their debt is denominated in their local currency, since they do not have a local currency. This difference sets today’s Argentina and Japan apart from Greece and Puerto Rico. The latter face operational and solvency risks while the former two are not operationally constrained; the limits that constrain one group is not applicable the other. Including Argentina and Greece with their current exchange-rate regimes into the same dataset would be tarring different monetary systems with the same brush. Furthermore, we need to be careful even while comparing figures on Argentina in 2002 and Argentina in 2014, since the exchange rate regime has changed between these two dates.

\textsuperscript{12} Most repayment on public debt are made to investors and foreign governments who hold government bonds. There are so called ‘creditor’ and ‘debtor’ countries, but again, there is no clear distinction. The most indebted country, Japan, is also the biggest creditor in the global financial markets. Similarly, most countries owe money to each other, but they do not cancel out debt because most bonds are incompatible with other financial instruments’ terms and conditions.
Table 2.1: The Debt Types and Ratios of Argentina, Puerto Rico, Japan and Greece

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt-to-GDP ratio</th>
<th>Economic level</th>
<th>Denomination of its outstanding debt*</th>
<th>Exchange Rate</th>
<th>Control over fiscal policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Under 90% (54%)</td>
<td>Developing</td>
<td>≈78% in Pesos</td>
<td>Flexible</td>
<td>Has control</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>Over 90% (68%)</td>
<td>Developing</td>
<td>In US dollars</td>
<td>Fixed</td>
<td>No control</td>
</tr>
<tr>
<td>Japan</td>
<td>Over 90% (250%)</td>
<td>Developed</td>
<td>≈%99 in Yen</td>
<td>Flexible</td>
<td>Has control</td>
</tr>
<tr>
<td>Greece</td>
<td>Under 90% (180%)</td>
<td>Developed</td>
<td>In Euros</td>
<td>Fixed</td>
<td>No control</td>
</tr>
</tbody>
</table>

Data on bonds derived from the cumulative volume of bonds issued, gathered from cbonds.com.*

The table above shows some basic information on the four countries. Despite the similar debt-to-GDP ratios and development levels, there is a very low chance of default for Argentina (Japan) and a very high chance of default for Puerto Rico (Greece).

In contrast to the mainstream approach, credit markets are very much aware of the distinctions captured in this table. Japan’s debt-to-GDP ratio is the highest in the world with 2.7 times the 90% threshold, and yet, at the time of writing, the yield on Japan’s 10-year government bond was a negative 4.35%. The debt-to-GDP ratio of countries with the lowest chance of a default, the USA and the UK, are over 90%. Not all debts are accrued, issued, and paid in the same way. While debt can be damaging when the sovereign does not have control over it, monetary and fiscal policies are merely instruments to help the sovereign to manage its debt, and are not in themselves the parameters within which policy choices must be made.

2.4.1 Futility of debt-to-GDP ratios

The fact that the concept of ‘debt-to-GDP ratio’ is being used as a tool to measure and understand economic performance shows the barrenness of the orthodoxy. The ratio, by itself, does not tell us anything. For example, Argentina recorded a government debt equivalent to 54.20% of GDP in 2016. We already clarified that not all portions of this debt are analogous, it

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13 Data available at: investing.com
blends domestic and external debt, debt that was issued in pesos and in dollars, debt that bears high and low interest rates. When we talk about paying government debt that was issued in domestic currency, we should remember that the government does not carry piles of cash to investors, instead it simply credits that financier’s bank account. This only causes an increase in the banking reserves by that amount. The government is not deprived of capital, and the private investor receives a steady income that works as further stimuli.

If this ratio was only derived from the USDollar-denominated external debt, would it tell us anything? Would Argentina, or any country, be better off without any external debt? There are various ways for Argentina to pay this debt in a very short time. For example, instead of suspending the activities because of pollution complaints, it could privatize and sell the Bajo de Alumbrera mine which exported $500 million worth of copper and gold in 2015 (Alumbrera, 2015). It could privatize the now state-controlled energy company YPF, which was nationalized by Cristina Fernández to bring strategic industries back under government control. Or, instead of trying to reduce domestic food prices and increase food availability for the internal population, the government could allocate less fertile land to rice and barley and more fertile land to cash crops, like soybeans and sorghum. Aggressive privatization and austerity measures would reduce the debt-to-GDP ratio to zero in a very short time, but also would have substantial intergenerational social and environmental costs.

In a different context, (Baker, 2013) outlines an even easier and ironic way to reduce the ratio for any country. Currently, the interest rate on Argentina’s long-term bonds is about 5%.\textsuperscript{14} Considering that the Federal Reserve expects to increase the interest rates in the coming years (Condon & Torres, 2017), the interest rate on Argentina’s bonds will increase too. The price of long-term bonds falls when interest rates rise. Therefore, the government could issue massive amounts of bonds today and buy them back for a fraction of the initial market value of the bond. Whenever interest rates rise, any sovereign government can buy back its own bonds at the discounted value and decrease its debt-to-GDP ratio instantly. Of course, doing this would not change the interest burden on the country at all. The debt-to-GDP ratio would fall because the interest rates on the bonds would increase exactly by that amount. The debt load would be the same but the numbers on some indicators would change.

What this suggests is that ratios like debt-to-GDP do not explain anything, and can in fact be quite misleading. Contrary to what many studies on debt imply, a decrease in this ratio does not

\textsuperscript{14} Data available at: investing.com
make a country richer or poorer (for a comprehensive critique of this approach: Irons & Bivens, 2010). However, there is an important line of reasoning that is missing in the work reviewed here. The orthodox approach to debt does not substantiate the assumed causality between an increase in public debt and a decline in growth. A correlation between the two can be observed, but causation should not necessarily be assumed, as some authors do (Checherita-Westphal & Rother, 2012). The common argument is that as public debt increases, interest rates rise, business confidence falls, crowding-out reduces private-sector spending and all this hinders growth. But causality can run in both directions. As growth slows down, tax revenues decrease and public social spending increases, which in the end, can increase the public debt. Since, in the current paradigm governments try to avoid increasing their debt levels, it is more likely that a slowdown in the economy incurs a rise in fiscal deficits and an increase of the debt levels. Given that a slowdown in growth can be a structural problem or simply part of a cyclical move, we are either looking at the problem from the wrong side or problematizing a cyclical variation. The assumption around causation in the economics of debt is not sufficiently questioned in contemporary discussion but will be the central element of the inquiry into the Argentine defaults that follows this chapter.

Too many and much too simplified assumed relationships between debt and growth have become prevalent because they make the analysis easier and they fit the ideological agenda of those who are in principle opposed to state spending. Due to the staggering complexity of the international financial structure, statements of regularity with clear patterns that connect ‘A’ (e.g. certain policies, actions) to ‘B’ (grandiose outcomes) became popular in the literature (for an early critique of this linear thinking in macroeconomics, see: Sims, 1980). The international financial structure consists of instruments that are purely representations and derivations of moments in the circulation of capital. In the ‘fictitious’ domain of international finance it is not adequate to merely point out to intervening variables and describe a sequence of events between A and B. The laws of nature do not apply in finance. This study will show that the common method of explaining global crises by highlighting a problem in one sector and arguing that there is a domino effect therein simply ignores the confounding factors. Indeed, ‘correlation does not imply causation’.

As we conduct the historical analysis of debt crises in Argentina, we need to be aware of assumed but spurious relations. Events that seem to have a causal relationship, like an increase in the external debt and a sovereign default, might be simply influenced by coincident effects of a common cause, like financialization. A global event, like securitization of sovereign debt, can cause both an increase in debt levels and the chance of default. This is one of the advantages
of taking a broader look and including all of the sovereign defaults of a country in one study; it is possible to detect over-arching patterns and affairs at the macro-level. Throughout the two centuries we will analyse various shifts in the rules of international finance with new policies, new financial instruments, new actors and major events.

2.5 Conclusion

The politico-economic paradigm around the issue of debt has been shifting constantly since the World War II (WWII). The prevalent Keynesian social democratic consensus after the war took a different approach to increasing sovereign debt than that which became popular in the post-1970s breakdown of the Bretton Woods monetary regime (but not a radically different approach, we will explore this in Chapter 5). Each era produced its own understanding of debt and the already large literature on sovereign debt grew. It is impossible to do justice to such a broad topic in this limited space. Instead, this chapter focused on the latest and most influential studies on sovereign debt, pointing out some of their main questionable attributes. The aim was to illustrate, and briefly criticise, the current dominant disposition towards sovereign debt, and to start preparing the ground for a different perspective on sovereign defaults.

There is a striking consensus today between all sides of the political spectrum when it comes to sovereign debt. National debt is regarded as ‘a real danger’ by both the Left and the Right, and both agree that debt must be curtailed. For example, in December 2017, The World Inequality Lab led by Piketty, Alvaredo, Chancel, Saez, and Zucman (2017) released a comprehensive reference report on income and wealth inequality. The report is the first of its kind and a valuable contribution to the discussion. The report, in its initial pages, points out that “While national wealth has substantially increased, public wealth is now negative or close to zero in rich countries. Arguably this limits the ability of governments to tackle inequality; certainly, it has important implications for wealth inequality among individuals” (Piketty et al., 2017, p. 10). The report calculates the public wealth as “public assets minus public debts” (2017, p. 11) and states that “Public investments are needed in education, health, and environmental protection both to tackle existing inequality and to prevent further increases. This is particularly difficult, however, given that governments in rich countries have become poor and largely indebted. Reducing public debt is by no means an easy task, but several options to accomplish it exist” (2017, p. 16).

The report provides important insight into inequality and the problem of increasing indebtedness. However, it is depicting the assumed ‘problem of debt’ exactly the same as the orthodox monetary thinking does. Governments are indebted, it is decreasing the public wealth
and although it is hard to pay it, we can and must do it. The theoretical framework we developed here diverges from this report’s and the vast majority of other studies’ conceptualization of debt. In what follows, I will develop the empirical and theoretical notions that underlie this alternative MMT/post-Keynesian approach in some more detail, using the history of Argentine’s debt for purposes of illustration and substantiation.
Chapter 3

Defaults of the Rich and the Poor:
Evaluating the First Two Argentine Defaults

3.1 Introduction

This chapter opens the historical analysis of sovereign defaults using the perspective outlined in Chapter 1 with the objective to provide a deeper examination of some parts of history of Argentina that have been overlooked. The chapter then applies and further develops the theoretical framework sketched in the previous chapter to analyse Argentina’s experience with sovereign debt.

Before delving into the analysis, and to remind us of an important suggestion in Chapter 2, we should note that ‘sovereign debt’ is an oxymoron, at least from the perspective taken here. When we refer to “sovereign debt” in the rest of this study, this caveat has to be kept in mind.

Per definition, a sovereign cannot be constrained in managing its money supply. The traditional definition of a sovereign, in the Hobbesian sense, is the supreme authority in a territory (Zalta, Nodelman, & Allen, 2003). One of the defining attributes of a sovereign is that it is above the law which it decrees itself (ab legibus solutus). Debt, on the other hand, by its nature, restricts and confines the debtor. It places the law above the debtor and subjects it to the “bitter necessity of submitting to rules he does not like in order to maintain himself against competing groups that had already begun to expand because they stumbled upon such rules earlier” (Hayek, 2011, p. 76). Although Hayek talks about individuals who ‘stumbled upon such rules’ that gave them an advantage in the market, we can also see the same dynamic working at the national and international level. Countries that developed complex financial institutions and employed fiscal policies to maximise their advantages in international markets also became the most successful colonial powers (Grafe & Irigoin, 2006). The Spanish Empire was one of the most successful extractive colonial powers and before delving into the historical analysis of Argentina, we will briefly look into the 1575 Spanish default.

The main reason to start the analysis at this point is because Argentina belonged to Spain before its independence in 1816. Since debt can only be arranged between two legally equivalent entities, Argentina could not accrue any debt before its independence in 1816. Nonetheless,
ironically, the extraction of resources from Argentina and from the rest of Latin America caused the Spanish Empire to default on its debt in 1575. This default occurred when the colonial empire was at the height of its power and had a ready and almost inexhaustible amount of resources flowing into its markets. Although it is not directly related to Argentina, starting with this default prompts us to question the variety of reasons that precipitate sovereign defaults other than just fiscal problems. We will not delve into the discussion on the relationship between the colonized and colonizer due to space constraints, although there are important lessons we can derive from this relationship for the theoretical framework we are developing here (Kaboub, 2018).

After having established that sovereign defaults are not simple cases of ‘scarcity of money’ and that the underlying rules of credit are different at state-level, the analysis moves to Argentina’s first default in 1827, 11 years after its independence. This default happened in an international gold-backed money system in which Argentina was not allowed to participate; it was effectively ‘locked-out of’ international bond markets for decades after this default. In this period, therefore, Buenos Aires\textsuperscript{15} began issuing its own inconvertible fiat currency. The very limited historiography on this fiat-money trial focuses on the uncontrolled inflation and mounting government debt in this period (Salvatore & Newland, 2003; Steil, 2007). The analysis in this chapter, however, takes a different tack: it focuses on the advantages of fiat money and how it was instrumental in establishing the domination of Buenos Aires over other provinces.

Finally, the analysis examines the patterns in the waves of Latin American defaults in international bond markets in the late 19\textsuperscript{th} century. The 1890 Argentine default is seen as the first modern emerging market crisis (C. Reinhart & K. Rogoff, 2009), because it includes all the elements of a modern crisis: As the debt crisis unfolded in 1890 the Argentine banking sector collapsed, maturity and currency mismatches caused chaos and the crisis became contagious, spreading to Uruguay (A. M. Taylor, 2003). The impact of the 1890 crisis should certainly not be underestimated. But, as will be shown, contrary to the assumption of mainstream theory, the default did not hinder capital flows to Argentina this time around. The country was the biggest recipient of capital in every renewed interest in Latin America. However, the volatility caused by each stop-and-go cycle was significant and has been well studied. Nevertheless, the discrepancy between the 1827 and 1890 defaults has yet to be explained. Why did the first default cause a lock-out while the second one did not? As we

\textsuperscript{15} To remind the reader what we mentioned in Chapter 1, Buenos Aires was a province and not the capital of Argentina until the unification of the country in 1862.
answer these questions and investigate the impact of defaults, we also address wider and more theoretical underlying issues.

3.2 Default by the colonial power (the rich)

In the 16th century, Argentina, then a Spanish colony, was the personal possession of the King of Spain. The monarch owned countries by virtue of a papal bull since the Pope had the authority to allocate land. Backed by the spokesperson of God, the colonial powers did not need to sign treaties with the natives. The Spaniards and Portuguese reorganized the life of indigenous peoples to secure cheap labour for the mining of gold and silver (Weatherford, 1997, p. 98). After the initial loot and raid of indigenous land, Latin America was seized by an efficient machine of extraction in this era (Galeano, 1997). As a result, from the 16th to the 19th century, the Americas provided 70% of the world’s output of gold and silver. Historians estimate that more than 145,000 tons of silver and more than 2,739 tons of gold were shipped out of the Americas to Europe (Barrett, 1990). At least 20% and possibly up to 40% of all the precious metals went directly into the treasury of the Spanish government (E. R. Wolf, 2010, p. 237). Argentina, however, was not as rich in deposits of silver and gold as Mexico and Peru, but it was good for producing agricultural products that sustained the mining facilities and Buenos Aires was thus used as a port.

Since gold and silver are metals of wealth, in principle, Spain was rich beyond imagination. The colossal amounts of value siphoned off for centuries was enough to make (almost) everyone rich in the country. The monarchy and everyone who relied on royal largesse and patronage became more than prosperous while artisans and labourers remained poor. The former wanted to buy more goods with the silver and gold they got hold of, and as the demand increased, inflation became rampant. Between the 16th and 17th centuries prices increased by 400%. The inflation on currency, however, did not alleviate the debt problem because the debt was in gold and most of the creditors were external (Drelichman & Voth, 2011). As early as 1628, a special commission identified the culprit: “Indies have been the cause whereby these kingdoms find themselves with few inhabitants, no silver, and a burden of commitments and expenses, serving

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16 Since the records were kept secret by the colonizers, researchers looked at the amount of mercury used to clean the valuable metals to make these estimations.
as a bridgehead for the transfer of silver to other kingdoms, all of which would have stayed in these if what went to the Indies were of our harvesting or manufacture” (Hauben, 1974, p. 299).

The flow of treasures meant that Spanish producers could get away with less factor productivity than other European manufacturers. Instead, they imported glassware from Italy, copper from Hungary, wool from England and weaponry from the Netherlands (Weatherford, 1997, p. 102). As Spain purchased more and more consumer and capital goods from abroad, other European countries increased their investments in improving their productivity. Spain’s gold and silver granted them a bigger share of the global medium of exchange and products. Based on the notion of a united Spain, in 1492, the monarchs expelled the Muslims and Jews. Both groups worked as merchants and in administration for the country. Other nations were quick to offer their services to fill the gap (Nadeau & Barlow, 2013). It was not only gold that departed Spain because of the increase in imports, unemployment also reached very high levels in this period. There are few periods in Spanish history where local economic and human resources were as drastically underemployed as they were in the 15th century (Day, 1987; Hatcher, 1996).

Why and how did the inflow of wealth cause all these problems? Simply put, excessive extraction of wealth from Latin America hollowed out the Spanish economy. The inflow of gold into the Spanish domestic market created a sudden upsurge in the nominal spending that was larger than the real capacity of the economy. Furthermore, the increased demand did not cause an increase in output responses because of decisions taken by the monarchy. While non-Spanish people were ostracized, the highest paying profession was being a soldier. This created demand-driven inflation as there was simply too much money in circulation and not enough production. In turn, this negatively affected the value of gold and degraded the services of skilled manufacturers and educated people.

Although there was a continuous production of gold and silver in the Americas, the shipment arrived once a year. The monarchy usually spent the money in advance, before the arrival of shipments, which meant that they had to borrow. Initially, the debt was a domestic matter; kings preferred to borrow from their loyal subjects. But without any penalty on domestic defaults, the sovereign family regularly defaulted on their domestic debt. Eventually, people hid their gold and the Spanish monarch had to turn to foreign creditors, some of whom charged up to 18% interest rates per annum (Weatherford, 1997, p. 103). The king spent in expectation of the yearly gold shipment, but with the interest and ever more increasing spending sprees, the Spanish debt-to-GDP ratio reached 50% in 1573 (Chamley, 2011).
In 1575, Spain, the world’s sole superpower at the time, defaulted on part of its foreign sovereign debt. The king suspended repayments on the short-term debt but not on the long-term debt. This move aimed to limit the negative impacts of a general default and to ensure the steady flow of gold from long-term bond issues. After the default, European foreign creditors cut the flow of funds and within a year the Spanish army rioted and started pillaging cities to supplement their declining income. The state issued new bonds and looked for alternative sources to borrow from, but the crisis deepened. Spain defaulted again in 1596, 1607, 1627, 1647, and 12 more times between 1647 and 1939 (C. Reinhart & K. Rogoff, 2009). The torrent of gold and silver, universally accepted and valued metals, did not help the country. While Spain was immensely rich in gold, it was poor in human capital.

Gold and silver did not give the Spanish any advantage in the 1635-59 Franco-Spanish war either. Inflation caused by the exogenous metallic wealth made the mobilization of real resources even harder. France, on the other hand, relied on a large productive agricultural population. The products of the land proved much more valuable than shiny ores in those times of perils, as they contributed directly to stimulating total factor productivity. Spain was thus caught up in an early episode of the ‘resource curse’.

The 1575 Spanish default and subsequent ones were all destructive. In a matter of months, mutinying soldiers began looting small cities while larger cities suffered due to decreased trade and spending. Until today, these defaults stand as examples of how harmful defaulting on debt can be. Historians focus on the squandering of wealth by kings and wasteful wars (Lovett, 1980), but the fact that the richest nation in the world defaulted and that it could not fully recover from this crisis for centuries cannot be explained by misspending. Spanish defaults remind us that sovereigns’ fiscal limitations are not necessarily about their revenue. Near unlimited flow of gold and silver did not protect Spain from defaults and neither did it make the nation wealthier or stronger. This indicates that the idea of ‘wealth’ or the answer to the question ‘what makes a country rich’ is more complex than it appears.

### 3.3. Default by the colonized (the poor)

Sovereigns have always borrowed and lent money, and a steady network of liquidity movement between European capitals was already established in the late 18\(^{th}\) century (Flandreau & Flores, 2009). Other than short-term loans, most of this flow was based on indemnity loans, war settlements and stabilization loans. This network suddenly extended beyond Britain, France and the USA as the Latin American countries gained independence after 1820. Cross-border bond
financing for governments emerged in early 1820s in Latin America, and four years after its independence Argentina started borrowing as well. To be clear, until 1862 Argentina was divided into different provinces that competed and waged war with each other. This section focuses on the province of Buenos Aires which was more connected to the rest of the world and became the seat of government in 1862 (Galasso, 2011).

Buenos Aires received the first Argentine international sovereign credit, borrowed from British Baring Brothers. The province, however, defaulted on the loan in 1827, nine years after the country’s independence. While some historians claim that this loan was extended for the recognition of the country (Platt, 1983) others have argued that the default was orchestrated by Britain to draw the country to its empire (Irazusta, 1963). It was not only Argentina, but also Brazil, Chile, Colombia, Mexico and Peru that issued bonds in London shortly after declaring their independence. By 1828, all these countries, with the exception of Brazil, had defaulted. The issued bonds realized a net total of £16 million to Latin America in 1824 (Della Paolera & Taylor, 2013). A United Nations study on foreign investment in Latin America described this amount as “relatively large” (Bernstein, 1966).

Given that by 1827 all but one of all bond issuers were in default, it might be surmised that a considerable amount of liability was involved. However, when we adjust this value for inflation, the debt seems relatively small. £16 million in the year 1824 is equivalent to £1.7 billion in purchasing power in 2018.¹⁷ Today, Argentina alone owes $208.6 billion (£147 billion), 86 times more than the ‘considerable’ amount that flew into the whole continent in 1820s. Yet, this amount is below average compared to the rest of the world. Notwithstanding, civil wars emerged in most of these countries shortly after they had declared their independence. Although the amount of money they borrowed was small, the governments still preferred to devote their resources to winning wars, rather than repaying debts.

After the 1827 default, Buenos Aires began issuing inconvertible fiat money and exclusively borrowed from domestic lenders until late 1860s. The government issued 6,000,000 pesos in Fondos Públicos National bonds in 1831 and distributed another 4,000,000 pesos the following year (Burgin, 1946). On the verge of a civil war and locked out of international markets, it issued more bonds throughout the 1830s to fund spending and to restore fiscal order. However, by mid-1840s, the newly independent country’s financial market had reached its saturation point. Instead of resorting to foreign lenders and borrowing money, the government began

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¹⁷ I calculated the amount according to the Office for National Statistics composite price index. The pound experienced an average inflation rate of 2.44% per year between 1824 to 2018.
expanding the currency base and printing money. Issuing fiat currency takes less time than issuing bonds and there is no amortization or repayment attached to it. According to some historians (Adelman, 2002; M. D. Bordo & Vegh, 2002; Irigoin, 2000), the then government could not use stable (fixed to gold) money without imposing extreme burdens on the state treasury. This episode, which lasted until the mid-19th century, was also a time of drawn-out civil wars in which Argentina lost Bolivia, a major mining territory, when it declared its independence (Reyeros, 1952).

Losing the mining region made bullion scarce and the only option left was to print money. In 1828, the Argentine government changed it monetary system out of necessity. It took control of all private banks, adjourned the convertibility of money to bullion, and began issuing paper currency (Burgin, 1946). This money could only be used domestically since it was not accepted by any other sovereign. But while the Argentine government was utilizing fiat money, other leading developed countries were fixing their currencies. Britain returned to the gold standard in 1821, followed by the vast majority of Europe, while the USA were gradually adapting to the gold standard system during this time. The launch of the inconvertible Argentine paper money was a bizarre experiment for its time that lasted over 40 years. Interestingly, as Irigoin (2000) points out, the historiography on this trial of fiat money is very limited.

Due to Argentina being cut off from international capital markets, some economists consider this period to be a form of ‘financial hibernation’ (Della Paolera & Taylor, 2013). Although both exports and the overall productivity of the country went on increasing, the economy suffered from a shortage of capital because of the lack of credit in circulation. Despite taking different approaches in their analysis of this period, historians Chiaramonte (1974) and Cortés Conde (1997) both reach the conclusion that the scarcity of financing was due to a short supply of institutional creditors. In fact, from the early to mid-19th century, finance became a purely domestic issue in Argentina. Although the country was locked out of international debt markets with insufficient domestic lenders and faced a dire bullion scarcity, Buenos Aires had an abundance of cattle hide, tallow, salted beef and wool (Irigoin, 2000) that made the province a net exporter. Between 1792 and early 1850, the volume of hide exports -the main exported product- increased more than 5.7 times, from 460,000 units to 2,662,000 units (Amaral, 1987). The economy grew due to increasing exports and the real GDP per capita reached $1,311 in 1870. This income level was on par with Western European countries and had surpassed Spain’s GDP per capita by 1840. The so called ‘financial hibernation’ thus placed the country in a favourable position. The problem of credit scarcity was solved by the state becoming a source of credit and the growing population was successfully mobilized by the government.
Argentina, however, was not yet unified at this time and other provinces competed with Buenos Aires. Unlike its’ neighbours like Chile and Bolivia which were unified after relatively brief and decisive civil wars, Argentina remained divided and in an extended civil war for almost four decades. Until unification all provinces were locked out of capital markets due to the 1827 default of Buenos Aires and faced the same shortage of credit. In 1840, for example, the main rival province, the Tucumán League, attempted to issue paper money to fund its army. When all neighbouring governments and other trading partners only use bullions or gold-backed money, why would people accept fiat money? The Tucumán government tried imposing its paper money by law. The government forced merchants to accept payments in their currency and anyone who would refuse to accept the fiat money would be put to death (Halperin Donghi, 2002). Eventually, the inconvertible paper money could not be widely levied, and due to various reasons, the Tucumán League lost the war. Buenos Aires, on the other hand, implemented the paper money by implementing a new tax mechanism. The government asked its people to pay a certain amount of tax and made the peso the legal tender. In other words, the government in Buenos Aires did not enforce the usage of its money, it just created demand for its fiat money by establishing a successful network of taxation. This important point requires further explanation.

3.3.1 Explaining the 1827 default

We saw that the government issued sizeable bonds, but we should clarify that a distinction can be made between domestic and foreign bond payment mechanisms, as noted in Chapter 2. Buenos Aires initially issued bonds in British pounds in London and, after an inevitable default, the province borrowed only from domestic lenders. In the 19th century, when a sovereign bond matured in London, the government paid investors in metallic currency with added interest. The borrowed gold was only temporarily available to Buenos Aires and metallic money representing a higher value than the borrowed amount, was sent back after a designated period. The system works differently, however, when a government issues its own floating fiat currency and borrows from domestic lenders. Once the bonds mature in the fiat-money regime, the government pays with a currency that it can create out of thin air. By paying its debt back to domestic lenders, the government provides more capital to the domestic investor, which works as further stimuli. Eventually, the government is not deprived of capital by paying back and the lenders have more capital to invest. Depending on the structure of the economy, the impact of domestic and foreign debt on a country’s finance are entirely different.
The question is then, why did Argentine investors accept the peso, a nonconvertible fiat currency, as a mean of payment? The general understanding of money in the 19th century was that currency had to be backed up with a promise to convert it into gold or a foreign currency at a fixed value. People trusted money because of the fixed value attached to it. When it was not pinned to gold, however, the Argentine peso did not have any intrinsic or promised value. The important point is that residents could pay their tax in pesos. Instantly, this created a demand for pesos. Let us assume a case where a citizen in Buenos Aires in 1826 was sceptical about using pesos and preferred having and saving gold coins instead. In spite of their scepticism, they would still be willing to do work or sell goods in exchange for pesos because they could then pay their taxes in this currency and spend their own metallic money on acquiring required goods and services. The government did not need to force people into accepting pesos, it only needed to establish a system where residents paid their taxes in pesos and provide enough pesos for them to do so. Now, suppose that this citizen sold enough supplies to the government to pay his or her taxes. They would not need to work again until their taxes were due and would not be interested in saving in pesos since they did not trust the currency. Thus, in order to mobilize people who did not trust the peso, the government would have to raise taxes to higher and higher levels. The idea that a self-interested individuals would not want to save in worthless pieces of paper and that fiat money is inherently hyper-inflationary is a common critique of fiat money (Hoppe, 1994). But this critique misses the point that the sceptical citizen’s neighbours must also pay their taxes, and that the sceptic can use the additional pesos he has earned to buy something from his neighbour. This is why people in Buenos Aires in 1828 worked for pesos. Pesos bore another use outside of paying taxes, they became a means of exchange (which is one of the fundamental functions of money, apart from being a store of value and a tool for accounting purposes).

Even so, creating trust in a piece of paper was not easy when people relied on gold-backed money for generations. This problem could be exacerbated when the issuer of the paper money became involved in an external war and had to raise revenue to fund it. This could lead to a massive depreciation against gold, undermining the state’s ability to meet its foreign commitments. Then again, that would trigger Gresham’s law, a principle in economics which states that ‘bad money drives out good’ (Rowland & Marz, 1982). If there are two different currencies in circulation, one with high commodity value (good money/gold) and one with lower commodity value than its face value (bad money/pesos), people would prefer to use the bad money in daily transactions and hoard the good money. Instead of paying with gold,
everyone would prefer to use pesos thus strengthening this currency while gold is progressively removed from the market.

This early experiment with fiat money in Buenos Aires carries important lessons that apply to modern governments. Firstly, we can derive the origin of modern money. Pesos were not issued by private banks or borrowed from London. They were created by the sovereign. Before taxation could be instituted, the government had to create the money and put it in circulation by spending it. In other words, a budget deficit was inevitable in both the short- and long-run. The government could not mine or borrow pesos. If the sovereign decided to tax its citizens heavily to maintain a balanced budget, the peso would have lost its value as a medium of exchange since there would only be a very small amount of pesos left in circulation, if any at all. Taxes and spending had to create an equilibrium between supply and demand for the fiat money, thus securing its domestic value. Obviously, there are also other uses for taxation than creating demand for fiat money. Taxation can stabilize the purchasing power of money, be a powerful redistribution tool, subsidize or penalize industries or groups, and help to isolate and control the costs of the provision of public goods, railways, for instance (Ruml, 1946).

The second lesson deals with the monetary capacity of the government. Is there a limit to the number of pesos the government can issue? The answer is No. The government is also not dependent on revenue to finance its spending as it could spend unlimited amount of pesos. As long as there was demand for the fiat money, people would trade their goods and services for it. The government’s aim was not to earn pesos and be peso ‘rich’, the goal of issuing paper money was to mobilize its workforce without an external constraint, such as the amount of reserves held by the treasury. Then again, we know that the government continued issuing bonds in pesos after converting to fiat money. If the government could spend an unlimited amount of pesos, why did it have to ‘borrow’ its own money from the citizens?

Technically, when governments issue bonds in domestic currency they do not borrow anything. A domestic bond is more like a contract. It offers people payment in fiat money, if they agree not to spend a part of their money for a fixed amount of time - say 25 years. This suddenly takes a relatively large amount of fiat money out of circulation and reduces interest payments for the bond holder. The government does not ‘borrow’ its own money, because it cannot owe something it creates (which is what ‘fiat’ refers to).

Bond issuing was necessary for fiscal sustainability in Buenos Aires in 1827. We should remember that this was a time of war between provinces. The Argentine War of independence, between 1810 and 1817, did not give rise to national unity right away and a lengthy civil war
between Federalists (who supported the autonomy of provinces) and Unitarians (argued for centralization around Buenos Aires). The struggle to decide the organization of the country continued until the formation of the nation state in 1852 (Rock, 1987, pp. 120-131) and the war officially did not end until 1880. In this period, the government in Buenos Aires spent the fiat money it issued mainly on its army, and not so much on productive investments. The supply of goods and services did not increase at the same pace as that of the number of pesos issued. The sudden increase of pesos in circulation was not offset by an equal increase in the goods and services available in the economy and it caused depreciation of the paper money (Irigoin, 2000). Nevertheless, not enough taxes were collected to take the excess money out of the system. Tax collection was inefficient and was usually done *ad valorem*. Furthermore, taxation was not done on the most important source of wealth; exports. According to Alvarez (1987) most items were exported duty free from Argentina until 1858. Since taxing the excess money could not be done efficiently, the government used bonds to slow down inflation. This shows that, although the state holds the power to create unlimited money, doing so is inflationary. During the mid-19th century, Buenos Aires created pesos but there was not enough production within the country to offset this additional money in circulation. This encounter with inflation was a first of a series that has plagued the country throughout its history. The analysis continues by investigating these encounters and developing a better understanding of inflation.

3.3.2 Benefits of fiat money experiment

As has been mentioned, in the 1830s Buenos Aires was at war. There were also serious administrative disorders in the young province, and it lacked modern banking infrastructure and technology. As a result, the system experienced high volatility, inflation, and widespread corruption in the public sector. In 1867, after having used inconvertible paper money for 41 years, Argentina eventually returned to a gold-backed currency. In this period, per capita tax receipts in Buenos Aires were six times higher than in Entre Ríos, the province with the second highest figure (Bértola & Ocampo, 2012, p. 64). Banco de la provincial de Buenos Aires was also the most developed financial market in Argentina (Bértola & Ocampo, 2012, p. 134). There is thus a general consensus in the historiography that Buenos Aires was the leading province in almost every respect. Of course, all this success cannot be credited to the use of fiat money. Buenos Aires had many competitive advantages such as an abundance of fertile lands and having access to a natural port. Scobie (1971, pp. 76-85) gives a detailed account of the rapid expansion of the city and its economic success. Fiat money does not create a natural endowment, but as stated, it can stimulate domestic investment and domestic demand.
Instead of looking at indicators like GDP per capita, we can look at the utilisation of labour and land in Buenos Aires and compare it to that of other provinces. The province of Córdoba provides a good point of comparison here since it started at a similar level as Buenos Aires did. After independence, both provinces were demographically similar, ran a livestock-based economy, and were geographically close and climatically similar (Ferrer, 1967, pp. 48-66). The amount of land used for livestock in Buenos Aires between 1820 and 1833 tripled; and between 1810 and 1865 the number of cattle heads increased from one to five million (Gelman, 2009). During the same time period, Córdoba did not experience significant growth, especially after the downturn in the mining industry (Bértola & Ocampo, 2012, p. 63). More significantly, news about wage incentives and employment opportunities in Buenos Aires drew migrants from many provinces, including Córdoba (Della Paolera & Taylor, 2003, p. 30). In the 1870s and 80s, huge numbers of European immigrants, attracted by the promise of high wages, arrived in Argentina. In 1881, the system of convertible money ended after a coup and the government began issuing gold pesos.

Buenos Aires became the leading province not only because of its competitive advantages, but also due to the way it managed itself. It became a hub of productivity right after the default of 1827 thanks to its fiat money which eliminated external financial constraints. As previously stated, inflation became a problem at the last stage of the experiment. For neoclassical economists who study this period in Argentina “the inflationary consequences are obvious” (Dorn & Xi, 1990, p. 104). The conventional wisdom interprets similar trials with fiat money in 19th century Russia, Austria and Argentina as ‘great confidence tricks’ (Burgi, 1994). But, as suggested here, the ‘trick’ is to make people believe that the money is valuable, it is about creating demand for something that is not inherently valuable by taxing it. This neoclassical understanding is based upon another basic theory in orthodox economics; the ‘Quantity Theory of Money’ (Friedman, 2017). Before continuing the historical analysis, we turn to the theoretical critique of fiat money printing.

A common equation found in Economics textbooks (Mankiw, 2014, pp. 235-259) is $MV = Py$. $M$ is the size of the nominal money supply, $V$ is the velocity of money, $P$ stands for nominal price level and $y$ is the real GDP. The assumption derived from this equation by classical theorists is that an increase in $M$ directly leads to inflation. This is done by assuming that $V$ is

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18 The discussion on adopting fiat money as opposed to the gold standard in Russia began in the early 19th century, long before the formation of any Marxist group in Russia. There is a rich discussion on how periods of using leather money or paper assignats managed by the state produced economic development and industrialization (Garvy, 1977).
constant, and \( y \) is at full employment level. That would explain why Argentina’s first experiment with fiat money ended in high inflation: without any constraints, the government increased the level of \( M \) and therefore \( P \) increased. In Chapter 1, we analysed a similar equation associated to ‘government budget constraint’. The conventional interpretation of both equations is that the government must borrow when it spends more than it earns, or there will be inflation.

First, it must be acknowledged that \( MV = Py \) is another accounting identity. \( MV \) is all the transactions in an economy and is always equal to \( Py \) which is the total value of production; this is a tautology. Secondly, taking \( V \) as constant is not realistic. If \( M \) doubles at full employment, \( P \) can double, or \( V \) can decrease. A decrease in \( V \) would mean an increase in demand for money. Creating demand for pesos is what Buenos Aires tried to achieve. Furthermore, issuing pesos was a mean of increasing the real output, \( y \). An increase in \( M \) will first increase \( y \) in an economy that is not functioning at full employment. Businesses respond to higher nominal spending (an increase in \( M \)) by first increasing their production levels. When there is spare capacity (unemployed people), businesses increase their output before increasing prices. As a well-known phrase, quantity always adjusts more easily than prices adjust in the long run (Textbook Equity Edition, 2014, p. 107). When there is idle land and labour and other productive resources are not utilized at high capacity, businesses respond to positive demand impulse, - i.e. higher nominal spending - by increasing production (Mitchell & Mosler, 2001). Inflation does not happen when there is more money in circulation. Inflation is a result of an excess of aggregate demand over the capacity of the economy to respond in real terms. It took 41 years of fiat money printing for Argentina to reach that stage, and it still remained an attractive land of opportunities for people for another 40 years after that.

### 3.3.3 Money as a tool

The analysis of the government budget-constraint equation explains why the orthodoxy is wary about issuing bonds; too much debt supposedly limits governments’ range of action. According to classical economists, running budget deficits by borrowing from the private sector decreases the supply of loanable funds which causes an increase in interest rates and “reduces the equilibrium quantity of loanable funds” (Mankiw, 2014, p. 262). The equilibrium shifts due to

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19 The same logic was applied during the recent adoption of expansionary monetary policies in Europe, but strategies like Quantitative Easing (QE) that boosts total \( M \) did not cause inflation.
the decrease in available domestic debt, bond markets start to dictate the cost of borrowing and
this regulates the government. During the fiat money era in the mid-19th century, Buenos Aires
mostly ran fiscal deficits (Irigoin, 2000), and a sizeable government debt slowly formed as
government issued domestic bonds. We also mentioned a saturation of financial markets in
Buenos Aires. Could we say that mid-19th century Argentina proves the orthodoxy’s point?

The short answer to this question is, No. We have already explained that the government did
not need its own pesos since bonds were only used as tools to control inflation. Fiat money
issuing governments do not ‘race’ for loanable funds because they do not require those funds
to finance their spending. The large deficit spending was financed by printing money, which
secured investment and productivity gains in Buenos Aires and made the province a leading
force. By running budget deficits, governments can keep aggregate demand high and stimulate
investment. In a new state, the most important objective is to build up the fundamental facilities
such as infrastructural improvements like roads and water supplies that will serve the country
well over the longer term. Correspondingly, the government can only borrow what it has spent.
If it does not inject its paper money into the economy, there would not be any saving to borrow
from. In short, domestic bond markets cannot have any real authority over the state. Then, the
reason for saturation of bond markets must be the inefficiency of management and the ongoing
civil war. This does not mean that we are denying the role that fiat money has on inflation.
Although using gold can lead to such increase in prices, paper money can be more inflationary
than metallic money, depending on the conjuncture.

The perspective developed here can explain why there was upward pressure on prices, that is,
price inflation. The central point of the analysis is that one person or government’s spending is
someone else’s income. This is also the first rule of accounting - and also the first law of
thermodynamics-, in Lavoie and Godley’s (2001) words, “everything comes from somewhere
and everything goes somewhere”. When governments spend, this spending does not necessarily
make them less wealthy. If the economy is growing, then incomes, spending, wages, savings
and other directions of economic flows will grow along with it, accompanied inevitably by
inflation. But, if only wages increase while revenues decrease in a growing economy, this would
be a sign that there is a problem, and *vice versa*. We will delve deeper into the theoretical
analysis of the concept of inflation in the following chapters.

Beyond the mechanics of money, we should realize that there is a common rationality behind
every monetary decision by the state. Societies use various mechanisms/moneys, some based
on oral practices, some written, to organise people and improve their living standards. Be it the
1575 Spanish default, the issuance of fiat money in 1826 in Buenos Aires, or the taxation since the emergence of states, monetary systems and decisions transpire to mobilize the workforce. Leaving labour and land idle or overworking people to a point where they cannot consume the products that they produce are both wasteful. The most wasteful regimes are thus the ones that fail to utilize their citizens who want to contribute to society. In other words, the ones that have high unemployment. What Argentina’s experiment blatantly displays is that money is a tool to utilize the labour force for a cause in an efficient way, and it should be used as such.

3.4 From avoiding a world debt crisis (1873) to a default in 1890

In 1871, the German Empire decided to stop minting silver coins and use only gold coins. Following this, the USA dropped the bimetallic standard and began using the pure gold standard exclusively from 1873 onwards (Kindleberger, 1990, p. 310). The reason behind this decision in the two countries was the idea that the money supply should be limited and tied to a physical asset (Denzel, 2017, pp. 327-382), a reasoning briefly explored in section 2.3.1. Conversion to a de facto gold standard created a currency shortage. Two major powers in the world put extreme limits on the amount of money they could inject into their economies. This move may have protected the value of currency from inflation, but it put massive pressure on debtors, limited the manoeuvre space for fiscal intervention by governments, and limited the credit creation power of the banking sector. A world debt crisis ensued.

Less available money in circulation exposed the indebted investors to more risk. While the interest rates did not change, debt servicing became harder overnight. The ensuing currency shortage during a heightened stage of industrialization and urbanization in the USA and Germany created local crashes and bankruptcies within these countries (Gourevitch, 1977). When a struggling debtor fails to pay his or her debt due to a decrease in the availability of credit, both the creditor and the debtor suffer. The creditor also owes money to some other agent in a financialized economy. Banks owe money to their account holders, investors owe money to leveraging institutions, so on and so forth. A shock to this interconnected structure causes a domino effect. Furthermore, the panic of a crisis also distorts the market’s assessment of other actors’ debt issues. Credit becomes even less available, increasing the exposure of debtors and causing more defaults. The 1873 crisis began with these confined local crashes and evolved rapidly into a widespread sovereign debt crisis. By 1878, 40% of all sovereigns were in external default or were restructuring their debt in one way or another (C. Reinhart & K. Rogoff, 2009).
The transmission mechanism that conveyed the crisis from the local indebted businesses that were starved of cash in a couple of countries to a global level has not been thoroughly investigated. There is an inconclusive discussion on the domino effect in the context of financial crises despite the fact that a number of empirical studies try to trace how exactly crises spread (King & Wadhwani, 1990; Reinhart & Kaminsky, 2000). The domino effect theory implies that the domino pieces will fall due to a crisis without an external body stopping the sequence. Without a coordinated governmental intervention to prevent the crisis from spreading, the crisis will only deepen. As the number of defaulters increase, the pressure on debtors will grow and more and more pieces will fall.

Argentina was not one of the pieces that fell in this worldwide domino sequence. Argentina’s major trading partners defaulted: Paraguay and Peru in 1875, Uruguay in 1876, Chile and Colombia in 1880, and Venezuela was already in default since 1860 (C. Reinhart & K. Rogoff, 2009). The crisis had major impacts on Latin America, and this negatively influenced Argentina’s ability to repay debt. Due to British support and some tactical decisions, though, Argentina could defer its own default. The first step, when the pressure of debt became too high, was to suspend the convertibility in early 1876 (Della Paolera & Taylor, 2003, p. 68) and move to a flexible exchange rate regime, in which Argentina remained until 1881. This released all the pressure stemming from local currency debt and enabled the government to replace some of the fleeing capital (due to crisis and debt repayments) with fiat money it issued. Also, capital investments from Britain increased from 20 million pounds in 1880 to 157 million in 1890 (Ford, 1969), offsetting the effects the crisis had on the flow of capital to Argentina. During the 1870s and 1880s the economy grew consistently at a rate of around 5% (Bethell, 1993, p. 49), made possible by a strong financial sector that provided the necessary flow of credit and money for growth. As we touched upon in Chapter 2, in a growing economy the monetary base must expand accordingly, and this is what happened in Argentina’s case (Takahashi, 1971). A flexible exchange-rate regime was also crucial in this respect. Until 1881, this enabled the government to absorb external shocks and increase money supply to meet the needs of an expanding economy. The exercise of sovereignty, one can say, avoided a sovereign debt crisis. These elements removed considerable pressure over the government and Argentina remained solvent for a long time. However, continuing large repayments while its neighbours and creditors (e.g. Spain, defaulted in 1877) in default proved not easy to sustain. As the pressure mounted, the president of Argentina, Nicolás Remigio Aurelio Avellaneda Silva (president, between 1874 to 1880), stated that “there are millions of Argentineans who would economize even to their hunger and thirst to fulfil the promises of our public commitments in the foreign
markets” (Sabino, 2014). And as Avellaneda promised, they did: Argentina delivered a balanced fiscal account for the first time since mid-1850s (Della Paolera & Taylor, 2003, p. 68). This mentality of ‘repaying debt as an honourable act’ became more popular as the National Autonomist Party (Partido Autonomista Nacional) won the elections in 1880. In 1881, the national gold peso was introduced, and the country re-adopted a gold standard, albeit in a different form. To supply the necessary initial reserves, the central bank borrowed 20 million pesos worth of gold from foreign countries (Cortés Conde, 1993, p. 344). This amount had to increase every year along with the growth of economy, which led to a rapid growth of debt-to-GDP ratio.

In 1881, Argentina’s economic output was 21% below the long-term trend of the country (Tomz & Wright, 2007). To my knowledge, no historical economist draws a direct correlation between the fall in the economic output and the sudden shift in the exchange rate regime. A detailed and comprehensive study needs to be conducted to find a link of causation between these two events. Nevertheless, the drop in economic output placed considerable strain on the domestic market. But the drop was offset by the foreign investment fury into Latin America that began in the 1880s. The amount of capital flowed into the continent increased by 12% per year on average between 1880 and 1890, and this rate was even higher in Argentina at an incredible 20% (A. M. Taylor, 2003). The gigantic flow of capital was concentrated on Argentina: 37% of all inflows ended up in the country, and 60% of all new government loans went to Argentina and Uruguay (Della Paolera & Taylor, 2013). Every wave of borrowing increased the amount of capital in transit. The increase in the total money moving from one continent to the other is well beyond the rate of growth in Argentina and other Latin American countries.

The inflow of capital increased after Argentina returned to the bimetallic standard, terminated its national monetary authority and made its money convertible again in 1881. In this period, Argentina was borrowing in gold and lending in pesos (A. M. Taylor & Paolera, 2001). Until the 1930s, it remained one of the biggest borrowers in the world. The inflow of capital, however, did not permanently increase the economic output as it continued performing below trend

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20 Tomz and Wright (2007) compiled the data on Argentina’s economic activity between 1874 and 2004, removed the cyclical components and short-term fluctuations by Hodrick-Prescott Filter and calculated the trend of Argentina’s economic output.
throughout most of the 1880s\textsuperscript{21} and it was 12\% below trend in 1897 (Tomz & Wright, 2007). When faced with similar pressures on domestic economy during and after the 1873 crisis, many other developed and developing countries defaulted on their debt (Fishlow, 1985) to enable recovery to begin. Argentina, on the other hand, managed to prevent a sovereign default until 1890, much later than its neighbours’ and European counterparts’ defaults.

The 1890 Argentine default is seen as the first modern emerging market crisis (C. Reinhart & K. Rogoff, 2009), because it includes all the elements of a modern crisis: as the debt crisis unfolded in 1890, the Argentine banking sector collapsed, maturity and currency mismatches caused chaos and the crisis spread to Uruguay (A. M. Taylor, 2003). By no means we can underestimate the impact of the 1890 crisis. However, the macroeconomic data does not portray a devastating default. After the default, the amount of capital flowing into Argentina continued increasing at 18\% per year on average, 2\% less than the pre-default rate (A. M. Taylor, 2003). The increased risk that this newly defaulted country did not discourage the capital from pouring in. This is contrary to all major expectations. After such a large sovereign default, one would expect Argentina to receive a fraction of the foreign capital inflows it was receiving, it should have been locked out of bond markets for some time, and when it eventually returned to foreign bond markets the country should have been liable to paying very high interest rates to lure the capital back into the country. But in this default, the capital never left Argentina.

The first signs of a change began in Argentina after the 1890 default. For the first time since 1840s,\textsuperscript{22} in 1891, the net migration rate in Argentina was negative. The net migration rate between 1870 and 1889 was over 60,000. In 1891, almost 81,932 people left the country while only 52,097 immigrants arrived (Cortés Conde, 1993, p. 336). Imports were cut sharply too. In 1889, a total of 164.6 million gold pesos worth of imports reached Argentina, and in 1891 this value dropped to 67.2 million (Cortés Conde, 1993). There was not much change in the exports, though. The export sector continued working at a high rate, and other than a drop in 1893, Argentina started running trade surpluses every year. This is a major shift from the previous trend. Between 1870 and 1890, Argentina ran small trade deficits 15 out of 20 years. After the default, between 1891 and 1914, Argentina ran trade surpluses for 22 out of 24 years. We will be analysing this shift in Chapter 4.

\textsuperscript{21} The trend rate of growth is the long run average rate of growth of a country. There are different measures to calculate this trend and calculating the underlying rate of growth requires complex calculations. For more information, see Solow (1994)

\textsuperscript{22} There is no data between 1820 and 1840, but looking at the historiography, this potentially was the first time in the history of the republic where more people emigrated than immigrated.
3.5 Conclusion

Neither creditors nor debtors anticipated the Latin American sovereign defaults in the 1820s. The lockout of Latin American countries from European bond markets after the series of defaults ensue because no one knew how to react. Sachs and Cohen (1982) explain how intermittent bond defaults were nuisance for both parties. Europe wanted to shift its capital to the periphery and the newly shaping Latin American countries were hungry for capital. That being said, trade between the creditor (the UK) and the debtor (Latin America) continued growing after the defaults, and the new independent governments were focused on using their domestic funds for credit. Instead of resorting to external funding options, Buenos Aires began issuing its own inconvertible currency. The very limited historiography on this fiat money trial is not very positive on the outcomes of the experiment. The uncontrolled inflation and mounting government debt are shown as reasons for the ‘failure’. We analysed the reasons and effects of these outcomes and, by comparing Buenos Aires to its neighbouring provinces, we concluded that fiat money was a necessary and effective way of managing the limited resources, but it had its limitations.

After the 1820s wave of default, many Latin American countries were locked out of the international bond markets. This was not a punishment on the defaulters though, there was not much of an interest from Latin America on the foreign bonds. For example, Brazil did not default in the 1820s and it still hardly participated in foreign debt markets until the 1880s (Flores, 2015). The lack of interest from Latin America and the absence of sovereign default settling mechanisms dragged the lockout of Argentina and its neighbours from international capital until the mid-1850s.

The borrowing cycle recurred two more times before the end of the century, with increasingly larger amounts. Argentina was the major recipient of capital in the renewed interest in Latin America, and the volatility of this stop-and-go cycles were harmful to all debtor countries. In his work, A. M. Taylor (2003) examines the external bond spreads in Latin American countries. His finding is that while the booms led to a significant convergence in bond spreads, the sudden stop of flows increases the country risk and the cost of borrowing for these countries. His study also shows that the bond yields for Argentina was consistently lower than other Latin American countries. After being locked out of the market for 50 years after the 1827 default, Argentina still enjoyed low yields and high capital inflows.
The renewal of interest in Latin America after the settling of debts in the 1860s brought much larger investment stocks. Between 1850 and 1880, a total of £179 million - £20.7 billion in today’s money when we adjust for inflation - flowed from Britain to Latin America, and the majority of this flow, approximately £123 million, was in form of government bonds (Della Paolera & Taylor, 2013). Most of the debt was gold-denominated. Argentina entered the sovereign bond markets in 1857, later than its neighbours. According to historian Platt (1983), Argentina did not need credit in foreign currency at that time and the government did not need to settle the 1826 default. The final settlement happened because of the country’s “pride and sensitivity to lose it national honour” (Platt, 1983, p. 32).

The mid-19th century exposed the pattern of sovereign borrowing in developing countries. Once there was an abundance of capital in Europe, it penetrated developing countries, then within a decade the debtors would default in one broad swoop that was followed by renegotiations. The second wave of borrowing began in the 1870s and ended with a massive default within in a decade. By the end of 1880, £71 million of the £123 million government bonds were in default (Della Paolera & Taylor, 2013). This time creditors and debtors were more informed, and the renegotiation process was much faster. So much so that already in the early-1880s the governments that had defaulted in Latin American had resolved their outstanding debt and started borrowing at even higher rates. By the end of 1890, £426 million -£50.2 billion in today’s money - flowed from Britain to Latin America, and £194 million of this was in government bonds (Rippy, 2000). From this point on, the cycle of borrowing blended with the waves of defaults. While in the past sovereign default meant being locked out of the international bond market for decades, in late the 19th century governments began the borrowing process while still in default.

Although the 1890 crisis was impactful, it did not scare foreign investors and did not harm Argentina’s reputation. Defaulting on debt was seen as an ordinary part of large borrowing cycles. Whenever there was a sovereign debt crisis in a continent, the majority of borrowers expectedly defaulted. Investments, however, did not because of something as normal as a default. This does not only show us that there was a major shift in the understanding of default in the last century, it also indicates that there is no unified effect of sovereign default. One default can lock a country out of capital markets for decades, while another one can increase the flow of capital. Despite gaining the reputation of a ‘defaulter’, Argentina reaped the benefits of being seen as the land of opportunity by the Europeans and the rest of the world until the late 1880s. Although it is hard to display the econometric causation between the issuance of fiat money and Argentina becoming a hub of opportunities, we tried to explain the importance of
having enough monetary base in an economy during periods of growth. The period between 1820 and 1890 in Argentina presented two defaults, a consistent rate of growth, an impressive mobilization of human power and the beginnings of a shift in the macroeconomic ideology for us to analyse. In the next chapter, we will investigate the absence of a sovereign debt and how that decision affects the economy to get a clearer picture.
Chapter 4

Resisting the Default:

Analysing the emergence of an austerity paradigm in Argentina between 1890 and 1955

There are four kinds of countries in the world: developed countries, undeveloped countries, Japan and Argentina.
Simon Kuznets

4.1 Introduction

The 19th century was an era of sovereign defaults all over the world; waves of defaults capable of knocking down even the most stable economies occurred every few decades. Yet, as seen in the previous chapter, these numerous defaults did not leave lasting scars on the credibility of economies or countries. While wave after wave of market crashes and major defaults fell on still evolving markets, large borrowings and defaults were followed by substantial debt forgiveness and multilateral rescheduling of debt repayments particularly at the end of the 19th century. They did not incur hefty penalties for the defaulters and did not significantly immobilise the flow of capital. That being said, there is no consensus in the literature on the effect of sovereign defaults on capital flows. An influential opinion is that defaults cause capital flows to be suspended (Reinhart & Rogoff, 2008), while others show that access to investment capital is not hampered by the frequency of a country’s defaults (Gelos, Sahay, & Sandleris, 2011).

The analysis in this chapter approaches this question from another perspective and looks at the effects of a non-default. Argentina tried and succeeded to resist the wave of default that hit the whole world between 1931 and 1936. Following the Great Depression, this period represents the largest wave of sovereign default as almost 45% of all national governments suspended interest and principal payments on their foreign loans (Reinhart & Rogoff, 2015). In this chapter, I will focus on the reasoning behind Argentina’s resistance to defaults in this period, and the short- and long-term effects that this had on its economy. Argentina is also a unique
case in Latin America; it is the only major country that did not default, and therefore it provides a vantage point to gain better understanding of what happens when a country does not default while most other sovereigns succumb to waves of defaults.

The analysis in this chapter starts with a review of the changes in government policies triggered by the 1890 default, such as the termination of immigration subsidy programs and policies aimed at decreasing imports. Section 4.2 covers the period 1890 to 1929 and looks at Argentina’s standing during WWI and the inter-war period when the government sought export-led growth and accordingly re-designed the economy. Section 4.3 investigates how Argentina resisted default between 1929 to 1950. I will draw comparisons between Argentina and other Latin American countries that did default to analyse the impact of avoiding a default. Finally, section 4.4 concludes the analysis by looking at the aftermath and the recovery after the crisis and evaluate Argentina’s decisions in retrospect.

This chapter will scrutinise the exceptional absence of a default in Argentina’s case at a time of global crisis. Examining the non-existence of an event complicates the process of analysis. Hence, I will not try to cover all political incidents at that time, but will only look into the major events that had a direct impact on Argentina’s indebtedness level and its macroeconomic structure. The chapter takes matters up until the mid 1950s. This is chosen as a cut-off point because Argentina was able to honour its repayments for 20 years after the crisis hit in the early 1930s. By 1956, however, after postponing a default for over 20 years, Argentina could not continue with debt repayments and was forced into a debt restructuring programme, which will mark the start of the period examined in Chapter 5.

4.2 From default to export-led growth, 1890 to 1929:

Figure 4.1 below displays how Argentina’s first two defaults (shaded vertical bars) coincided with, or followed spikes in the portion of countries (weighted for their share in global income) that went into default. Between 1890 and 1980, there are multiple spikes in the number of countries in default, especially in the era of the Great Depression. But, strikingly, Argentina did not default. It even resisted the 1930s wave of sovereign defaults which was the most widespread and largest sovereign debt crisis in history. Argentina paid all its debt in gold after World War II and its debt was restructured and rescheduled in mutually agreed terms in 1951 and 1956. A complete default was avoided for almost a century. During this period, however,
the country was well integrated into the global financial system and was borrowing heavily. Hence, avoiding a default was not due to isolationist macro-economic policies.

**Figure 4.1 Percentage of countries in external default/restructuring weighted by their share of world income**

The analysis in the previous chapter concluded with the 1890 default and explained how it triggered multiple failures in the finance and production sectors that left Argentina in the depths of domestic contraction. Nevertheless, the country entered the 20th century as a member of a select few high per-capita income countries. At $2,750, its GDP-per-capita was higher than in Sweden, Spain or Portugal in 1900. The republic benefitted from a credit rating higher than most European nations and low bond yields that came with the confidence reflected in these ratios. It was known for its production of high quality and highly sought after goods, its impressive government buildings and the underground railway in Buenos Aires (a rare transport infrastructure at the time), as well as its growing international scientific community (Gallo, 1986). The influx of monetary and human resources also continued at an unprecedented pace and approximately 47% of total fixed investment was foreign financed (C. F. D. Alejandro, 1970, p. 31).

The creditors in the 1890 default was again Baring Brothers. The debt was in the gold denominated common-currency. Under the ‘gold exchange standard’, Argentina had agreed to fix the rate at which the peso could be traded for a certain number of ounces of gold. By the time of the default, the cost of external debt servicing had reached more than 50% of governmental receipts, close to 40 million gold pesos (Fishlow, 1989, p. 88).
continued servicing its debt under this level of pressure for two years and directed its tax and export receipts to this effort. In 1890, when the pressure became unbearable, the government defaulted. This default temporarily halted the inflow of foreign credit but, as seen, it did not cause any serious change in foreign direct investments.

After the default, both Argentina and Britain wanted a swift return to normality. Britain sought to recover the marketability of the Argentine securities it held and to return to trade, while Argentina wanted to continue specifically with the purchase of industrial machinery from Britain. From this perspective, the default was more stressful for London than for Buenos Aires. Investing in foreign bonds can be both a profitable and risky venture for a creditor, particularly when a heavily indebted debtor fails to make a payment. The British Central Bank had to bail out Baring Brothers (Körnert, 2003) unleashing a wave of distrust in the bond markets. Regardless, neither party wanted the default to stop the mutually beneficial trade arrangements. Therefore, even though the repayment negotiations took a long time, commercial transactions between the two countries were resumed in 1893.

As renegotiations continued, Argentina offered its own plan of repayment but needed more credit to cover its existing debt and to get out of default. Britain offered the necessary credit with harsh conditions, which the Argentinian government eventually yielded to in 1899. As described by Fishlow (1989, p. 90):

*The loan was realized... with more than depressing conditions for the honour of the country and of the government. Its product exclusively dedicated to the service of the other foreign debts; the coupons of the loan to be received in customs in payment of tariffs; the government obligated to deposit daily in the bank, in a special current account, the funds necessary for the service of the loan, able to be audited by agents of the creditors; the government also obligated not to contract other loans or to grant new guarantees for three years; the government obligated to withdraw from circulation 15 million pesos per year in inconvertible notes...*

While the default of 1827 lasted for over 30 years, the 1890 default was resolved in only nine years. In the aftermath, the Argentine economy grew and managed to reduce its debt liability. By the turn of the century, significant amounts of capital flowed again into the country, mainly to help finance infrastructural and mass employment programmes. Negotiations on debt restructuring continued, however, as Argentina continuously struggled to manage its gold-denominated external debt. Still, owing to strong external demand, Government spending did not decrease. During this period, growth was fuelled by increasing exports of agricultural products, particularly beef, grain and wheat. The resulting demand for labour was met by the
large influx of European immigrants which reached a saturation point in 1917 (Bunge, 1917). In the preceding and following years, the demand for labour kept on growing.

Argentina’s economic output remained relatively high during this period. The country’s ratio of GDP-per-capita steadily increased between 1891 and 1897 and by 1906 had surpassed Western Europe’s GDP-per-capita (Campos, Karanasos, & Tan, 2016). This was achieved by the strategy of industrialization by mechanization. In less than a decade, the volume of wheat exports increased almost tenfold; from 179,000 tons in 1888 two years before the default to 1,608,000 tons in 1894 (Cortés Conde, 1993). The private building sector also grew during this period. Taking 1885 as the base year, the index for private construction increased by 63 points (Cortés Conde, 1993). An important source of power for this progress was government expenditure which steadily increased from 50 million gold pesos in 1895 to 69.6 million in 1900 (Cortés Conde, 1993). Between 1903 and 1913, the GDP increased at 7.7% on average annually (Rocchi, 2005, p. 70). At the end of 1913, Argentina was producing 1.2% of the world’s economic output (Della Paolera & Taylor, 2003, pp. 299-301). This level of expenditure and growth meant that approximately 15% of the labour force was working in manufacturing jobs, and 20% in commercial activities (Ades & Glaeser, 1995, p. 221). All the while, European countries were struggling with unemployment.

It would seem that the 1890 default, with the subsequent debt restructuring and increasing debt level, did not significantly hinder the continuous growth that the Argentine economy experienced for a century. The bottom line of my argument is that defaults can indeed be catalysts for renewed growth. However, what has to be explained, then, is why, after this ‘Belle Époque’ of Argentinian prosperity (Conde, 2009; Villarroya, 2007) did Argentina decide to avoid defaults, seemingly at all costs. Yes, numerous factors affect the growth of an economy, but Argentina’s two defaults show that they did not necessarily hamper economic growth. Until 1947, Argentina remained ranked 10th in the world in terms of per-capita income (Alston & Gallo, 2010) and the country was only downgraded to the low and middle income country category after 1950s (C. F. D. Alejandro, 1983). When and why did the decline of Argentina begin then? Before solving this puzzle and investigating any possible relationship between the decision not to default and the decline of the Argentine economy, we will look at the country’s changing political and economic context in the early 20th century.

23 Based on GNI per capita, calculated using the World Bank Atlas method.
4.2.1 Paradigm shift

The substantial augmentation in production and exports mentioned above was only possible on the basis of mass employment and the resulting growth of the urban proletariat, which increased from 29% in 1869 to 53% in 1914. As elsewhere in Latin America, the nature of labour changed in Argentina between the 19th and 20th century. In the 1800s, Latin America was still using rural, serf-like labour. From the early to mid-19th century, massive resources were consumed by revolutions, warfare between and within emerging states\(^{24}\) and most people worked to survive. The formation of industrial labour was on par with continental Europe at the end of the 19th century. In 1887, there were 6,128 industrial establishments in Argentina. By 1895 this number had reached 8,439 and the number of wage earners had doubled (Munck, 1987). In contrast to the beginning of the 19th century, mechanization had become the order of the day and workers started to work side by side in large factories. This growing industrial workforce made the country one of the richest nations in the world.

Argentina sought export-led growth and a large portion of its annual output was exported to Europe. Until 1929, it was the world's largest exporter of beef, maize, oats and linseed (Rock, 1993b). The excessive demand from continental Europe before the WWI coincided with Argentina’s shift to export-led growth strategy. In some sense, this can be considered as luck. In the literature, Argentina’s ‘bad luck’ is mentioned by some economic historians during its decline after 1950 (Glaeser, Di Tella, & Llach, 2018; Hadass & Williamson, 2003), but there is only one reference that draws attention to how Argentina had a lucky commodity draw in the ‘commodity lottery’ (C. F. D. Alejandro, 1984, pp. 17-49). Whether it was luck or a calculated decision, boosting exports while curbing imports brought in increasingly more foreign currency from ‘outside’ into Argentina, leading to the country’s steady industrialisation of production and growth of the country.

Such export-led growth, however, requires high competitiveness based on cheap prices and relatedly low wages. If unemployment is low and demand is high, how can a country keep wages low to ensure high competitiveness? The solution adopted by the Argentine government throughout the 20th century was to undermine wages and working conditions while other countries were institutionalising workers’ rights including minimum wages, eight- or ten-hour working day, and retirement and pensions provisions (Pianetto, 1984). Of all the factors

\(^{24}\) The period between 1790 and 1820 is labelled as ‘The Latin American wars of independence’ (S. J. Stein & Stein, 1970), and the period between post-independence and 1950s is regarded as a time of “political instability and violent conflicts” (Bates, Coatsworth, & Williamson, 2007).
discussed here, it was this policy, aimed at increasing Argentina’s external competitiveness, which contributed to declining prosperity, worsening labour relations, and the eventual emergence of right-wing militarism. The desire to avoid defaults at all cost, one can say, ended in the emergence of the military as a defining force in Argentina during the 20th century.

At the same time, thanks to the high demand for labour, the landless and unskilled peons gained skills and power. This led to the formation and establishment of trade unions resulting in extensive advances for the Argentine proletariat. Godio (2000, p. 219) explains that “the successes in the trade union and parliamentary fields were so notable that they made the Argentine labour movement, in spite of its limitations, into the most developed and prestigious throughout Latin America”. In 1896, the first industry-wide strike happened inaugurating a new era, as “the proletarian protests [were] no longer relatively spontaneous and isolated outbreaks… The class as a whole was beginning to act” (Ratzer, 1970, p. 62).

The state responded by brutally suppressing the protests. On May Day 1909, the Argentine police killed 30 workers who were demonstrating for the institution of eight-hour working day (Trigona, 2009). In 1916, there were 80 strikes in the federal capital with 24,231 strikers. By 1919 this number had reached 367 strikes with 308,967 strikers (Munck, 1987) and the conflict between labour and the state reached its peak. On May Day of that year, workers joined in the international demand for eight-hour working day by organising a general strike. The violent police crackdown that ensued and left hundreds of dead and tens of thousands in jail is remembered as *La Semana Tragicá*, the Tragic Week. After the suppression of labour protests, the export sector grew even more. For instance, the annual average export of chilled beef increased from 25,000 tons between 1910 and 1914 to 400,000 tons between 1925 and 1929 (Rock, 1993b). Similar leaps in other exports can be observed until the Great Depression.

The ‘success’ of these crackdowns created a new political and economic paradigm and paved the way for several military dictatorships in Argentina. The new paradigm was one of docile workers with low wages. Productivity increased exponentially after the 1920s, but there was no corresponding wage increase in Argentina for years (Pianetto, 1984). The new paradigm thus also curbed domestic demand and enabled the control of inflation. High productivity, cheap labour and low inflation made Argentina even more attractive to foreign capital.

The impact of the 1890 default, the following clampdown on wage-earners and the new macroeconomic strategy of Argentina are all interrelated. The default did not hurt Argentina’s standing among international investors and creditors, but it triggered a change in the country’s strategy. The debt restructuring and the resulting agreement to make large payments in gold
pushed the government to curb imports and focus on increasing exports by making the country more competitive. The ensuing low-wage regime has significant implications for the country’s approach to its debt and the economic structure it built in the early 20th century.

In the theory chapter (Chapter 2), we established the fact that wages play the dual role of affecting both the costs of production and the demand for products. If workers do not get paid enough, they cannot buy what they produce and the domestic demand decreases. Decrease in aggregate demand means decrease in supply and a shrinking economy. Since Argentina relied on export-led growth, this logic does not apply in the early 20th century. As long as there is high enough external demand for domestic goods and if the production is strong enough to consistently run large trade surpluses, technically, the economy does not need to depend on domestic markets to increase its GDP.

The Argentine state re-constructed the economy and specifically designed fiscal interventions to decrease aggregate demand and dampen domestic non-tradable activity. In his analysis of labour income shares in Latin America, Frankema (2010) shows how urban wage income as a percentage share of GDP per worker dropped from 87.5% in 1870 to 39.3% in 1918. This was the result of policies that were designed to curb inflation by decreasing the purchasing power of wage earners. The lack of quality diversification in the main export items and due consideration for the consumption needs of population led to rapid changes in the country. Despite the flood of foreign money and Argentina being one of the richest countries in the world, poverty became a growing problem. In the comprehensive work edited by Bethell (1993), Rock (1993a) gives a detailed summary of life in Buenos Aires in 1913: “From time to time newspapers would publish dramatic exposés of what they called the 'begging industry' in which would surface alleged practices such as the hiring of diseased or handicapped children for seeking alms” and “at the apex of society was an elite composed of the great landowners and other large property owners, bankers, and those who controlled the main flow of foreign investment and trade”. People did not share in the economic growth generated by exports and did not have the purchasing power to absorb their own output, putting the fate of the economy in the hands of other developed markets.

There is a strong body of literature in heterodox economics that shows that export-led growth is not a sustainable path if it ignores the imperative of developing domestic demand and neglects addressing the legitimate social and political demands of labour on whose efforts export is based (Onaran & Stockhammer, 2005; Subasat, 2002). This Keynesian and post-Keynesian critique of export-led growth can be applied to explain the problems of Argentina’s approach in this
period. Argentina focused on increasing its agricultural exports at the expense of domestic demand. Large trade surpluses during this period mostly benefited the upper-class, as is evident from the rampant inequality documented in historical records. Large trade surpluses also create competition for the limited external demand. Argentina’s neighbours, for example, had to settle for a smaller share of international trade. The sheer scale of goods moved from Argentina to Europe poached demand and employment in other Latin American countries. This contradiction in export-led growth was first pointed out by J. Robinson (1947) in her analysis of the competitive devaluation that arose in the 1930s. Weaker neighbours led to a plethora of social and economic problems on the continent in the long-run.

In addition, large trade surpluses trigger the simple supply-price relationship that drives down the prices of main export commodities. For example, if the supply of wheat increases by more than ten-fold, as it did in Argentina in 1888, then the price of wheat will inevitably fall. A drop in prices does not only hurt other agricultural product exporting countries, but it also harms the main exporter. In order to restore the previous levels of profits, the exporter will have to increase the quantity of primary commodities even more. What usually perpetuates this system is: debt. An indebted country must make regular payments on the principal and interest of its debt. This requires a steady flow of money from the indebted to the creditor. If the price of wheat drops by half because of an increase in supply, the country has to increase the supply at the same ratio to keep repaying its debt and to keep growing. Obviously, this would exacerbate the problem, and lead to what Singer (1950) called a ‘race to the bottom’ dynamic.

It is not my intention to disregard the positive effects of international financial investment or defend isolationism. The general structural Keynesian critique is that export-based growth delivers low quality growth and not deep prosperity (Palley, 2002). High quality growth cannot be achieved with a structural dependence on weak external factors. Argentina experienced just this with the Wall Street crash and the ensuing Great Depression. The sudden collapse of external demand had devastating effects. Yet, as the fall in commodity prices preceded the Great Depression, Argentina’s economic downturn had already begun in 1927 (Bethell, 1993, p. 170). This means that major crises do not necessarily trigger the collapse of export-led growth.

What would then deliver ‘high quality growth”? Numerous policies and tactics can be applied to achieve this. For instance, Argentina could have taken several steps to build a stronger economy such as: linking wages to productivity growth, fair share of output between workers and investors, increasing infrastructure and public goods investment by government, implementing labour rights and protection standards, instituting balanced tax structures and
building safety nets. Argentina did not take any of these steps because its economic aims changed after the 1890 default. Each one of these abovementioned steps would require two significant economic policy changes, however: an increase in government spending and a decrease in international competitiveness. After the default, Argentina’s target was to fulfil the obligations imposed by the new credit agreements. The obvious way to meet the new commitments of the 1899 agreement was to ‘make money’ by running surpluses. Under a fixed exchange-rate regime and tied by external debt, successive Argentine governments decreased their spending and looked for ways to increase their income to ensure the payment of their debt.

This assumption that exports are akin to ‘income’ for countries and the ‘more you export the richer you get’ is still alive today. Trade surpluses are seen as a sign of economic strength: “much like a profit-making business… [a country that runs trade surpluses] has more money in its bank account” (Harris, 2018). After the 1890 default, Argentina, like many other countries employed policies that directly increased its ‘income’. Since the beginning of the 20th century, every developing economy, even the most isolated, have been competing to sell their products and resources in exchange of foreign currency to achieve a ‘favourable trade balance’ (Greenwald & Stiglitz, 2017). By winning the trade war, countries ‘kept the jobs’ in their country. By maintaining huge trade surpluses, Latin America has been a consistent ‘winner’ of the trade wars between continents for two centuries. But what have Argentina, or any other country that run trade surpluses, won? Being a net exporter means sending billions of dollars of value (goods and services) in excess of what is received. Argentina received fiat money in exchange of real wealth for decades. In other words, the rest of the world did not send an equal value of goods and services back to Argentina whenever it ran trade surpluses. As Mosler explains (2010, p. 59), “The real wealth of a nation is all it produces and keeps for itself, plus all it imports, minus what it must export”. Building up foreign currency reserves can be advantageous for countries, but not as beneficial as having a well-nourished, productive and healthy population.

Concentrating on exports is prescribed to indebted countries (M. Wolf, 1985), with the assumption that the ‘income’ from exports helps to pay-off the outstanding debt (Dornbusch & Fischer, 1986). But there is another dilemma here. A net exporting country needs to keep its fiscal policy tight, domestic demand low and its currency weak. However, if other markets want to buy more of Argentina’s domestic goods, services and assets, then the demand for pesos will

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25 The reason I put the term ‘income’ in brackets is because countries do not have incomes as households do.
increase. Also, in order to be a net exporter, the country needs to limit its imports. When Argentina imports fridges from Britain, for example, it must pay in pounds and to buy pounds it must sell pesos, which would increase the supply of pesos. Thus, by employing protectionist policies, net exporters increase the demand for their currency and limit the supply of their currency simultaneously. As a result, the currency gains value and a strong currency is bad for exports. This is an inherent inconsistency in export-oriented policies. To artificially decrease the value of the currency and keep the competitiveness up, net-exporters further reduce domestic wages by increasing the level of unemployment. At the same time, a weak currency is bad for debt repayments. It takes more pesos to pay the interest of a debt in pounds if the government purposefully decreases the value of the peso. The debt problem becomes permanent.

The approach taken by Argentina during WWI is an example of this. As a neutral state, Argentina took advantage of the stimulus of wartime demand and increased its exports to Allied forces but an uncharacteristically high rate of unemployment emerged in Buenos Aires (Rock, 1993b). Furthermore, while exports increased during the war, imports and relatedly tax revenues kept falling, because the taxation system was built upon high import duties and government spending depended on the income from these taxes in gold-backed currency system. Argentina tried to close this gap with short-term loans. During war time public floating debt tripled, reaching 711 million pesos in 1918 compared to 256 million pesos in 1914 (Rock, 1993b). The massive trade surpluses enriched a small part of the population while public debt grew.

The story of Argentina began with waves of immigration from Europe that were integrated in its labour force and served to increase its productive capacity. Efficient use of the labour force increased its GDP to some of the highest in the world. Argentina was thus tapping into the power of ‘hitherto untouched masses’ that Hobsbawm (2017, p. 105) talked about: “all social movements expand in jerks; the history of all contains periods of abnormality, often fantastically rapid and easy mobilisations of hitherto untouched masses”. Yet, the management of human and capital could only be functional if it had a positive impact on the productivity and lives of Argentinian people in the long run. Argentina, however, used this power to supply Great Britain with chilled meat and grains in exchange of money. This

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26 It is thought-provoking that a similar wave of migrations is ongoing today in 2018, and that these ‘untouched masses’ of people are not considered as an asset, an addition to the labour power. Instead, immigrants and refugees are seen as liabilities. It is as if modern states forgot how much one person can produce in a lifetime.
arrangement created an informal and fragile dependency to the detriment of Argentinian workers who were repressed and did not benefit from imports of real goods and services in return.

4.3. The aftermath of the Great Depression 1929 to 1950: Argentina avoids default

When the Great Depression hit Argentina in October 1929, foreign investment ceased, exports dropped by 40% and unemployment became a systemic problem (B. Keen & Haynes, 2012, p. 365). Within two months, Argentina dropped the gold-standard. Instead of targeting gold reserves to back money supply, the central bank began putting caps on the nominal quantity of money in circulation. This was a highly unorthodox move for its time and it got rid of the inflexibility of the gold standard. The convertibility of the peso was entirely suspended between 1931 and 1933, and this unilateral change in the monetary policy underlines one of the main tenets of the approach taken her, namely that any fiscal limit on the state can be overcome. After amassing gold by running decades-long trade surpluses, Argentina decided to stop giving away gold in exchange of its paper currency. In the end, the country had one of the highest per-capita gold reserves in the world (Gerchunoff & Machinea, 2015) and insulated its currency against fluctuations in the turbulent external sector of its time. This was an opportunity to industrialize the economy with the gold reserves that were accepted all around the world and invest in the population through education, health and infrastructure programs.

Policy decisions during that period had the opposite effect, however. The gold-standard was abandoned to devalue the peso in order to increase the competitiveness of exports. In line with this, successive governments tried to grow the economy with an import-substitution based strategy. Tariffs and quotas for final products were raised to decrease the flow of real goods into the country while increasing the volume of exports (Conde, 2009). This approach, however, is flawed. The only reason to export real goods and services to other countries should be to import real goods and services in return. Restricting imports denies the population the opportunity to consume what other economies are willing to supply in exchange for the domestic currency, which can be printed at will. This does not mean that certain domestic sectors should not be protected from unfair international competition, in fact, that should be a priority. But if a British company wanted to trade cars for pesos, then it would a good deal for the Argentine people, particularly in this case as the country exported more real goods than it received for many decades.
In 1930, the military overthrew the government, ending the experiment with democracy and marking the beginning of what was called the ‘infamous decade’ in Argentina (Tamarin, 1985). For the next 13 years, while the first global capitalist crisis was unfolding, the military brutally repressed its opponents and any dissent. In 1931, every Latin American country, with the exception Argentina, began defaulting on its loans. Defaulting subsequently spread through Europe and became a debilitating sovereign default crisis for creditors who could not grant new debt due to the shortage of liquidity and for debtors because it became impossible for them to pay back due to falling prices and shrinking markets. Avramovic, Husain, and Weille (1964, p. 46) gathered data on the ratio of public debt service as a percentage of total exports between 1926 and 1933 for Argentina and this is displayed in Table 4.1 below:

Table 4.1 Argentina's debt service as a percentage of the value of exports

<table>
<thead>
<tr>
<th>Year</th>
<th>Debt Service/Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1926</td>
<td>10.0%</td>
</tr>
<tr>
<td>1927</td>
<td>7.9%</td>
</tr>
<tr>
<td>1928</td>
<td>8.9%</td>
</tr>
<tr>
<td>1929</td>
<td>10.4%</td>
</tr>
<tr>
<td>1930</td>
<td>18.2%</td>
</tr>
<tr>
<td>1931</td>
<td>22.5%</td>
</tr>
<tr>
<td>1932</td>
<td>27.6%</td>
</tr>
<tr>
<td>1933</td>
<td>30.2%</td>
</tr>
</tbody>
</table>

Table 4.1 shows that, as it was the case in other Latin American countries, it took almost one third of the real value shipped to other countries to service Argentina’s debt in 1933. It would be unrealistic, however, to expect a developing Latin America to sustain or repay a debt burden of this size. The entire system had crumbled, and it was beyond the capacity of sovereign nations to postpone the waves of defaults. While nations all over the world were defaulting, in December 1933, the Mexican Foreign Minister proposed to establish a Sovereign Debt Restructuring Mechanism (SDRM), an international organization to manage debt negotiations. Latin American governments supported this proposal to give sovereign defaults a proper structure and a procedure. Only Argentina, Haiti and Chile did not support this proposal, fearing that associating themselves with the plan would decrease their perceived creditworthiness (Brooks & Lombardi, 2016). The lack of widespread support caused the proposal to fail.
4.3.1 Repayment options

We mentioned how Argentina’s initial response to the global crisis was to break the gold-standard and devalue its currency. Although a devalued currency initially relieved the pressure on the economy, it proved to be a significant disadvantage to repaying the debt overtime. A 10% decrease in the value of the peso directly increased the country’s outstanding external debt obligations by 10%. As a result, Argentina’s debt therefore grew rapidly but it did not change its borrowing habits. When debt servicing costs 30% of total export receipts, there are few options for the debtor country to continue paying off its debt. So what could have Argentina done to repay this colossal debt?

(1) It could have increased its total exports, but this would have led to a drop in commodity prices. Considering that other countries were also struggling with debt and were resorting to selling more of their output, supply would have soon exceeded demand for these goods. In this case, while the quantity of goods exported increased, total income would have fallen. Also, this would have meant using more human and natural resources to provide real value to other nations, rather than Argentina.

(2) Instead of growing wheat and beef, it could have allocated more land to growing coffee, cocoa, groundnuts and other cash crops that are not consumed by the local population but sell for higher prices in the international market. This would have created an even more dangerous state of dependency on external demand, and again, in a global downturn this would not be a reliable strategy.

(3) The last option would have been to liquidate most of its gold reserves and pay off a portion of the debt with what the country had built throughout years of net exporting.

Argentina chose the third option and continued to repay the interest and the minimum on its debt. This amounted to $913 million in 1930, then decreased to $888 million in 1932, but eventually rose to $966 million in 1934 (Dornbusch & De Pablo, 1989). The question, however, is why would any country try to service this vast amount of debt? Unlike in the 19th century as we saw in Chapter 3, there was no threat of gunboats of creditor nations blockading ports and seizing fiscal control in indebted countries. There are no records of any Western state enforcing the payment of a debt through military force after WWI (Hagan, 1973). What kind of pressure could the creditors put on defaulters then? They could stop the flow of money by refusing commercial credits to defaulters, but this would make matters worse in the debtor country and make the resumption of debt servicing even more unfeasible. The punishment would effectively hurt both parties.
Furthermore, the flow of goods was continuing from developing nations to creditors. Exporter countries were still selling goods and the funds for these goods were kept in the bank accounts of the creditor country. For example, the US could confiscate the dollars it was supposed to pay for coffee it bought from Colombia, or any other nation with which it was running a trade surplus. Private bond holders, however, were pushing for a swift solution to the Columbine sovereign debt crisis. This was quickly rejected by the then American Assistant Secretary of State (Securities, Commission, & Douglas, 1937):

“The position of the department is that the primary purpose of the trade agreements… is the revival of international trade, and the agreement with Colombia does not, therefore, contain provisions specifically relating to the resumption of service of Colombian dollar obligations. However, inasmuch as the decline in international trade was one of the principal causes of financial difficulties in many countries, it is to be expected that the revival of international trade which the trade agreement program seeks to foster will aid in remedying conditions which have led to defaults”

In other words, linking trade and debt was not a viable option, neither was punishing the debtors with limiting their access to capital. Private creditors made an investment and took the risk of losing their capital even though they could have bought British bonds with lower yields but not prone to default. In 1930, the average bond spread for Argentina was 300 to 500 basis points higher than in Britain, a considerable difference between the core and the periphery (A. M. Taylor, 2003). This indicates that investors knew what the risk was: that a default was probable, that the age of gunboat diplomacy had ended, and that sovereign countries could not be forced to repay. Until the 1950s, sovereign debt collection remained impractical and a long history of default with impunity developed because there were no sovereign debt restructuring mechanisms (SDRMs), or means to force debtors to repay, or powerful private credit rating agencies that kept a public record of defaults.

Figure 4.2 below displays the percentage of countries in external default or restructuring between 1800 and 2015. We analysed Argentina’s involvement in the first two default waves that emerged in the 1830s and 1880s in the previous chapter. As we can see in the graph, the 1930s default spike was much larger than the 1830s wave; it is the largest sovereign date crisis to date. In the following sections we will investigate why so many countries defaulted in this period. We will also look into the sharp decline in defaults after 1950 and the mechanisms that were installed to make this possible.
4.3.2 Defaulting options

During the sovereign debt crisis of the 1930s, creditors had to negotiate with debtors to get a portion of their investment back. In the negotiations that were conducted to secure this, debtors had significant power since they had more options than the creditors. The debtor could ask for a partial write-off of its debt and favourable readjustment arrangements for easier repayment. If the creditor did not agree and stalled or suspended the negotiations, the value of the debt investments (bonds) would drop even further, hurting the investors. This happened and indebted Latin American countries bought back their own depressed bonds for significantly lower prices. During the crisis, Bolivia paid three cents on the dollar for $3 million worth of outstanding Bolivian bonds; Peru bought back 31% of its debt at an average price of 21 cent on the dollar; and so did Colombia and Chile (Jorgensen & Sachs, 1988).

During the 1930s’ sovereign debt crisis, every passing day in default further damaged creditors’ investments more than it harmed the debtors. For example, the Foreign Bondholders Protective Council, the American bondholders’ negotiating organization, protested against Colombia’s Minister of Finance for “enunciating the policy of Colombia to be to lower the interest rate as much as possible in order to depress the value of the bonds and take advantage of the necessities of the bondholders who are obliged to sell their bonds at the low prices forced upon them by the Colombian Government itself” (Council, 1934). The council was one of the first examples...
of a private organization designed to undertake the critical policy foundations of the international debt markets and global finance. The failure of the Council in settling sovereign debts brought a premature ending to the experiment.

Argentina was the only major Latin American country to accept the original bonds contracts and to repay its national debt without any reduction on the original value (the others were Haiti and the Dominican Republic which had relatively small outstanding debt). While other nations in Europe and Americas were defaulting and reducing their debt burdens, Argentina chose not to take advantage of the situation. The question is why? Either the government must have assumed that losing creditworthiness would be costlier than defaulting, or it made a decision to repay its debt based upon a naïve notion that it was the morally right thing to do, possibly as part of “Argentina's honourable discharge of a moral obligation” (Robertson, 1930, p. 228). This moralism costed Argentina dearly.

Figure 4.2 below displays the value of all nationally guaranteed bonds between 1920 and 1931 and the total repayment on these bonds of selected Latin American countries before and after the 1930s’ debt crisis. The green portion represents the credit borrowed in the 1920s and the orange section indicates the debt repaid. All values are in millions of dollars and the charts are divided into slices to illustrate the proportion of debt borrowed and debt repaid. The size of the charts and the divisions are proportionate to the total outstanding debt of each country. The figure illustrates that Argentina had the largest external debt among other major Latin American borrowers represented. The pie charts illustrate that only Argentina paid debtors more than the foreign capital it borrowed. All the other countries had negative net present value on their debts. For every dollar lent to Argentina, creditors received $1.25. There was an outflow of money on bonds between 1920 and 1931.
What were the advantages of being the only major Latin American country that did not default? First and foremost, international credit markets remained open to Argentina while that gate was shut to other countries on the continent. Argentina also benefitted from lower interest rates. The new bonds issued in 1938 yielded an average 4.7% (Jorgensen & Sachs, 1988); this was neither high nor particularly low. In exchange of creditors’ confidence, Argentina gave up a large sum of the gold that it could have used to import real goods and services from the rest of the world.

We should clarify that Argentina did not pay off all of its debt in this period; it continued to pay interest and the bare principal. This means that Argentina still owed money and a substantial portion of the new loans was being used to repay existing loans. At the same time, other countries were buying their debts in secondary debt markets at significant discounts. When the wave of default is this extensive, the overall trust in sovereign bonds markets falls. Surrounded by defaulters, Argentina’s sacrifice did not shine brighter in the eyes of creditors; it continued to be perceived as a risky investment. This was why yields did not drop further. When every other country is defaulting on a continent, it would be impossible to retain very low bond yields.

Until the late 1940s, net flows of external finance to Latin America remained negative yet outstanding bonds shrank substantially. For example, the total value of bonds denominated in dollars decreased from $2.1 billion in 1930 to $1.3 billion by 1945 (Mikesell, 1955). This drop is due to both the repayment of debt and the loss of value in bonds following defaults. Furthermore, studies (Eichengreen, 1987; J. W. Wilkie, Alemán, & Ortega, 2002) show that, when capital began to flow again to the continent in the 1950s, creditors did not take Argentina’s sacrifice into account. The country did not benefit significantly more from the new wave of capital flow than its neighbours. For instance, if we look at the average external financial flow
to export ratio, defaulters received the same or larger capital flows than Argentina (Jorgensen & Sachs, 1988). There was also no systematic difference between defaulters and non-defaulters in Latin America in terms of the volume of foreign direct investment received in the 1940s either. In other words, there was no significant advantage in not defaulting for Argentina. More disturbingly, this episode had a lasting effect on Argentina’s ability to deal with its chronic indebtedness.

4.3.3 Constraints of Fixed Exchange Rates

In 1943, Argentina experienced another coup d'état and the military government established policies that would prevent a default (M. Kaplan, 1957). In 1946, Perón, one of the engineers of the coup, became president with the promise of higher wages and more social security. The early Perónist era saw an increase in state intervention into the economy through higher government spending. Factory workers received paid vacations, unions gained power and the economy grew on average 6% annually in this period until 1956 (D. Cavallo & Mundlak, 1982). British owned railways were nationalized and extended (Todesca, 2006), 22 hydroelectrical power plants were erected and gas distribution was vastly extended (Gerchunoff & Llach, 2007). However, the new government was using an expansionary macroeconomic policy to redistribute wealth in a quasi-fixed exchange-rate regime. Since 1940, Argentina had been using the crawling-peg regime, which became a fixed exchange-rate regime under the Bretton Woods Agreement in 1956 (Frieden & Stein, 2001). The only way to raise capital in a fixed exchange-rate regime, however, is through taxation and/or borrowing.

Perón was also a nationalist, of the ‘put-Argentina-first’ type. He sought import substitution industrialization; a strategy in line with the fixed exchange-rate regime but that requires substantial amounts of foreign reserves to sustain. We highlighted potential problems with export-oriented policies earlier in the chapter. In spite of his anti-imperialist expressions, Perón repeatedly tried to get Argentina a membership in the Bretton Woods institutions, particularly in the World Bank (Kedar, 2012). By being a part of the Bretton Woods agreement governments agree to give up a central part of their autonomy; the ability to control their currency. The system was built upon a premise that rendered issuing external debt a necessity.

Most governments were under fixed exchange-rate regimes in this era with the expectation that they would provide certainty and stability. It is also believed that fixed exchange-rates are more resilient as a bulwark against speculation (Pastine, 2002). These assumptions hold true as long as a government can maintain the peg, i.e. back up their currency with sufficient foreign
reserves or gold. Breaking the peg is not different than defaulting. Therefore, if a country has a substantial amount of foreign currency in its reserves, it might be able to keep the peg for a long time. But a government that is spending to expand the economy usually does not have that option. Under a fixed exchange-rate system, the state becomes revenue-constrained; it can only spend the reserves available in its central bank. Going beyond that means having to borrow or tax more. Needless to say, most countries have since dropped out of this abstract and self-imposed restriction.

Under the fixed exchange-rate system imposed by the Bretton Woods agreement, the IMF was given the responsibility to adjust exchange-rates, leaving countries without control over this process. In order to balance a deficit in foreign exchange reserves or counter the effects of devaluation, governments needed to control the nominal exchange-rates. IMF’s decisions were very influential in this regard and regular interventions were required to keep economies stable. Nations that ran external deficits consistently experienced persistently high unemployment and below potential economic growth rates because they could not depreciate their own currencies. This also produced political pressure on governments. Certain measures have been proposed to make the system more flexible since its introduction. But the IMF, the sentinel of the global fixed-exchange rate, rejected them all, even in the 1970s when the Bretton Woods started to fall apart (Williamson, 1981).

In the late-1940s, there was an increase in the commodity prices which intensified after the Korean War in 1950. This augmentation created a problem of balance of payment in Latin America. The problem was especially serious in Argentina (Ocampo & Ros, 2011, p. 189) because of the lack of foreign reserves after the decision to not default in the 1930s. Argentina was the first country to break the shackles of Bretton Woods by adjusting its nominal exchange-rates in order to stabilize real exchange-rates and increase its exports in the late 1940s (Ocampo & Ros, 2011, pp. 189-190). This manoeuvre stimulated growth and the trade balance was consistently positive for the next decade. The share of the non-traditional exports increased by 20% between 1940 and 1956. Even though net exports were increasing, government spending was higher than the export receipts. Under the fixed-exchange rate regime, expanding monetary base causes inflation to rise. Until the mid-1950s the largest yearly increase in prices was 39% (Bailey, 1961). Considering the large amounts of public spending under the fixed-exchange rate regime, 39% is not a high number and it did not pose a serious problem until 1955. During this period, income inequality slightly decreased as well. Shortly after, most of the other Latin American countries followed Argentina in flexing Bretton Woods rules.
By 1956, Argentina’s problems with its outstanding debt started to surface anew. Its performance during the Great Depression had not solved the problems, but merely postponed them. After another coup that toppled Perón in 1955, keeping up with debt servicing and keeping the peg became impossible. Faced with another case of potential default, creditor countries established an informal and *ad hoc* assembly called the ‘*Club de Paris*’. The Club started negotiating with Argentina in 1956, and the implications of this emerging mechanism will be analysed in the next chapter.

### 4.4 Conclusion

In this chapter, we set out to explain why Argentina broke the mould and took leave, during the period 1929 to 1950s, of its 19\textsuperscript{th} century practice of defaulting on its debts. The explanation that emerged in our analysis is that a paradigm shift occurred in response to labour started to develop a class consciousness and demanded better working conditions in Argentina in response to the austerity policies that successive Argentinian regimes pursued. Throughout the 19\textsuperscript{th} century, the large export sector boosted the economy which grew rapidly, provided high employment and brought immigrants who wanted to work. The export sector benefitted the Argentine people as it provided the foreign currency necessary to import machinery and develop the country’s mechanization and industrialization. In the early 20\textsuperscript{th} century, the direction of this relationship changed, as the economy was re-designed to boost exports at all costs (and especially at the cost of labour). In order to increase net exports, the government focused on augmenting the competitive advantages of Argentina by decreasing wages. Under this new paradigm, the Argentine people and the economy became the slaves of the export sector. We were able to detect this change by looking at indicators like labour income share, the number of protests and exponential increase in exports. But the clearest sign of the change was the *Semana Trágica*. The death of hundreds of protestors exposed the new political ideology of Argentina which remained in place for half a century owing to numerous ensuing *coups d’état*.

After the 1890 default, Argentina accepted a harsh repayment deal from the UK to restructure its debt as. To fulfil the requirements of the deal it had to ‘make money’ by increasing its competitiveness. As the domestic markets weakened between 1900 and 1930 due to suppressed wages, Argentina’s economy became even more integrated in and dependent on external markets. The strong external demand from Western European countries became the only dependable source of utilisation of the productive capacity. Domestic purchasing power was not enough to keep growth at the same level after the depression of wages in the early 1900s.
The money that flowed from outside was concentrated in the hands of a few, and was used to keep the new police state stronger through increased spending in the military and police complex (Gargiulo, 1988). In spite of the growing revenue from net exports, debt levels did not decrease in this period. Other than the increased spending in unproductive areas such as the military, closer relations with developed countries meant more borrowing to keep these relations.

The consequences of developments reviewed in this chapter are significant. The new macroeconomic direction did not only make Argentina dependent on external demand and financing, it led to a paradigm shift from ‘economy for the people’ to ‘people for the economy’. This change led to a wide array of economic reforms that came into play after the 1950s, such as the removal of trade barriers, the privatization of state enterprises and mass layoffs. These reforms are analysed in the next chapter.

The 1930s crisis critically tested the economy of every sovereign nation. Argentina’s deep integration in the world economy meant that it had built large gold and foreign reserves and could use its reserves to pay off its debt. In 1932, payments on public debt reached 29% of total expenditures, whereas only 5% of it was devoted to public works (Sachs, 1990). While other countries preferred to create room in their external balance by defaulting on their debt, Argentina did not take this opportunity. Our analysis, however, has shown that there was no systematic difference between defaulters and non-defaulters in terms of the treatment they received from international capital markets, the interest rates they were charged or the amount of FDI they received in the long-run after the crisis.

The analysis has shown that while defaults reveal structural imbalances, - a fundamental problem in the system - and, ideally, they can also help with resetting arrangements, so that uneven flows can be corrected. Defaults create many opportunities for the debtor. The indebted nation can buy back its debt at discounted prices which opens up more fiscal space. As defaulting economies momentarily fall out of international debt markets, this period allows governments to focus on cultivating domestic demand instead of trying to attract international investors. Defaults also represent opportunities for investors. A nation that has defaulted has more liquidity available than a nation struggling with repayments. Defaulters thus bring higher yields and can become more attractive than countries that barely make repayments. That is why, sometimes capital movements even intensified while countries were in default in the 1930s crisis, as happened in the case of when both Germany (Ritschl, 2002) and Greece defaulted in 1932 (Tsoulfidis & Zouboulakis, 2017). This means that a default can be tool of pro-people
restructuring. As this chapter has shown, resisting a wave of default is a temporary evasion of the problem. In the next chapter, we will see how the repeated postponements of an inevitable Argentine default led to the largest sovereign default in financial history. The next chapter analyse the run up and the impact of this extraordinary default.
Chapter 5

Dis-ordering the default:

How Argentina evolved from internalizing financial discipline to resisting fiscal constraints, 1950 to 2010

5.1 Introduction

The last 70 years of economic history in Argentina tell both a familiar and a unique macro-economic tale. It is familiar in that it reminds us of what happened in many other parts of the world as structural adjustment programmes were imposed on developing countries and served to establish a hegemonic neoliberal political economic order. But it is also unique given the extent to which such policies were implemented in Argentina. This chapter provides a critical assessment of the economic transformations of Argentina between 1950 and 2010 with the overall purpose to gain a better understanding of the causal links between the reasons and the varied outcomes of eight Argentinian defaults. We will pay particular attention to the actual process of default, because with the introduction of Sovereign Debt Restructuring Mechanisms (SDRMs) in 1956, the process of default began to depend on meetings and discussions with creditors and debt restructuring became a more discernible and discrete policy option. As this chapter will demonstrate, the variance created by the introduction of SDRMs in the process precipitated some major structural transformations in sovereign debt in the second half of the 20th century. We will track these changes from the 1950s through to the turn of the century while analysing the impact of the policies established by successive military and democratic governments on Argentina in this period.

The first objective of this chapter is to identify broad patterns that emerged with respect to how different political regimes in Argentina have dealt with external public debt since the 1950s. On the one hand, military regimes, especially in the 1950s, inculcated a new state mentality by implementing austerity measures that resulted in expenditure cutbacks with long-lasting negative effects on the welfare state. This mentality survived until the late 1990s under different regimes. On the other hand, in stark contrast, the period after 2001 witnessed a rapid expansion and deepening of the welfare state in Argentina. As this chapter will show, the main factor that
made all the difference is the attitude that different sets of Argentine decision makers displayed towards the spectre of default. Trying to avoid or postpone default led to stagnation and the pruning-back of welfare gains for the population as a whole. Embracing default empowered both state and people, and enabled Argentina to register some of the best welfare gains in its recent history, particularly after 2001. But does this mean that sovereign defaults are always good for the economy? As evidenced by the catastrophic fall-out of the 1982 default, they are not. Sovereign defaults can be very costly for a country, both financially and in terms of reputation. How can we then explain the difference in outcomes between Argentina’s various defaults? At what point and why does it become beneficial to default? These are two questions this chapter seeks to answer.

The second objective of this chapter is to further substantiate our argument that a sovereign government cannot be limited by fiscal constraints, only the availability of real resources, such as land and labour. This means that balancing the budget or keeping low debt-to-GDP ratio or other indicators at certain levels do not make a sovereign country fiscally sound. As the chapter will demonstrate, the country’s direction was shaped by its approach to sovereign debt and we will investigate the connections between the state’s capabilities and its approach to debt.

In Argentina’s case, we can divide this five-decade-long period between 1950 and 2000 into three phases: (1) the financialization of sovereign debt that began in the 1950s; (2) the consolidation of neoliberalism and the restriction of state powers in the 1980s; and (3) the state reclaiming its control over monetary and fiscal issues at the turn of the millennium. Each of these three phases corresponds to a default or a period of restructuring; the 1956 restructuring, which involved the postponement of a debt that lingered from the 1930s crisis and saw the founding of the Paris Club; the 1982 default which caused Argentina to fall into default while still making large payments on its debt; and the third in 2001, which was the largest sovereign default in world history. These three phases are interconnected and interrelated, but, as we will analyse, there are also important differences in the administration of sovereign debt between them, which I differentiate by introducing the concepts of orderly default and strategic default. The 1980 default can be seen as an example of an orderly default, while the 2001 is an example of a strategic default.

Besides the theoretical contribution outlined above, this chapter makes a methodological contribution. Contrary to previous chapters where we solely relied on a historical process tracing, the large volume of economic data available on Argentina since 1950 enables an econometric analysis. We will use the technique of Impulse Response Function (IRF) to explain
why and how the 1982 and 2001 defaults are structurally different. IRF is commonly used in the study of finance to compute changes in highly volatile securities, but we will modify it to gauge the effects of these two defaults. Extant empirical studies on these two defaults place them in the same category and analyse them as analogous cases (Furceri & Zdzienicka, 2012; Sutton & Catão, 2002). Our analysis, however, will show that these defaults had diverging, and in some respects even opposite effects on the economy. By investigating three different possible approaches to a debt crisis (postpone, repay, or default) via econometric and qualitative tools, this chapter will discern what determines the outcomes of different types of defaults.

This chapter follows the pattern of Chapters 3 and 4 by tracing the pendulum swings that form the patterns of self-discipline which Argentina imposed on itself until the 2001 default. In Figure 5.1, which displays the changes in Argentina’s GDP relative to the US, we can see two more swings of the pendulum. The figure does not capture the complex and volatile debt-history of Argentina since 1950, but provides a general overview of the key shifts in the Argentine economy around which this chapter is structured. The graph covers four periods and shows how aggregate domestic expenditure, as a fraction of US domestic expenditure, has changed in Argentina since 1950. The dotted lines are the dates of coups and the highlighted areas are the periods of accelerated growth between 1989 and 1996, and 2002 and 2011. The first period, between 1950 and 1980, saw a very long and severe stagnation with political crises and coups and repeated debt restructuring. The second, between 1989 and 2000, after the resolution of the 1982 default, brought significant growth, but was followed by a significant depression between 1996 and 2001. The third period covers 2001 to 2010 which saw an upsurge of growth after the monumental 2001 default. Since 2010, as shown in the fourth period, another recession has been looming over the country.
In section 5.2, we will cover the period between 1950 to 1970 and examine how Argentina continued to postpone an inescapable default in the 1950s and the impact of its restructuring through financialization. In section 5.3, we will then move to the period between 1970 and 1980, during which the neoliberal political economic system consolidated. This leads us to the period between 1980 to 1990, covered in section 5.4, where we will assess the reaction of the Argentine economy to the 1982 default via a measurement strategy called an orderly default. In section 5.5, we will examine the measures creditors imposed that restricted the Argentina state powers and led the country to strategically reject the payment of its debt and go through the largest default in history in 2001, a decision that we will analyse in section 5.6. Section 5.7, finally concludes the chapter.

5.2 Restructuring the debt: 1950 – 1970

This section focuses on the financialization of monetary and fiscal coordination that characterised the restructuring of debt in Argentina between 1950 and 1970. We start our analysis from the 1950s because this period saw the emergence of financialization as a global phenomenon. We will focus on how financialization was utilized as a tool to reshape the management of government debt via new repayment methods. Financialization is a term that captures the seizing and overpowering of the real economy by expanding financial markets, institutions and instruments that impose a hegemonic discipline on private and public decision makers. Here, the ‘real economy’ refers to the sphere where goods and services are produced,
as opposed to the virtual and fictitious side of the economy which is constituted by the tools-of-trade of the financial sector. The growth of this fictitious, but nevertheless very influential dimension of the Argentinian economy coincided with the world-wide growth of financialization (Epstein, 2005, pp. 291-295). The differences between the two ‘sides’ are not clear and there are various ways to draw a line between the real and the virtual economies (Neiburg & Guyer, 2017). From the perspective of this study, the most important difference between the two is that the real economy is constrained by the availability of tangible resources, while the virtual economy can grow unconstrained and infinitely. For example, the number of people that can be employed in a country is limited by the number of available job seekers. At full employment, any additional government spending would cause interruptions because the amount of money that can be spent for employment is limited. On the other hand, operations like quantitative easing, asset buy-backs or the derivatives market can grow in size indefinitely. Like a bottomless pit, financial instruments can absorb ever larger amounts of money and resources. We are interested in this redirection and the financialization of the Argentine economy since the early 1950s because the rate of return on financial capital outperformed the return on fixed capital.

Starting the analysis of financialization process in the mid-1950s might seem counterintuitive but it follows from the macro-level focus of the post-Keynesian perspective underpinning this study. Most theorists who work on financialization assume that the process began in the 1970s or 1980s. Among them, political economists, who focus on the meso-economic level, are interested in the increasing prominence of the ‘shareholder value’ in modern corporations in the 1970s (Cheng & Xiong, 2014; Froud, Haslam, Johal, & Williams, 2000; Rappaport, 1986). Sociologists and behavioural economists, who focus on the micro-economic level, however, pay more attention to the incorporation of the everyday life of citizens into finance in the 1970s (Haiven, 2014; Martin, 2002; Pfeil, 2004). A third strand of literature on financialization led by post-Keynesian economists concentrates on the macro-economic level and the relationship between falling wages and increasing public indebtedness (Aglietta, 2000; Boyer, 2000; Van Treeck, 2009). We follow the latter school, since it is the only one to particularly focus on the macro-level financialization. Only a few scholars have specifically focused on the financialization of sovereign debt and international debt markets, and the limited studies on this topic concentrate on contemporary government debt markets (Preunkert, 2017; Trampusch, 2015) and not pay much attention to the emergence of these markets (as an exception, see: Fastenrath, Schwan, & Trampusch, 2017)
We can trace financialization in the private sector by looking at the preference to invest in financial instruments, but financialization of the government sector is much more complex. Households and businesses can decide to allocate more of their income and money to finance capital, but a currency-issuing sovereign government does not have an ‘income’ the way households do. As explained in Chapter 2, currency-issuing governments do not have ‘budgets’ and are not fiscally constrained. Currency-issuing governments do not need to ‘make money’ to spend it. Therefore, we cannot discuss the ‘allocation of money’ when we talk about an entity that creates money. This is why governments do not directly invest in the securities market. With their unlimited power; they only regulate it.27

There are instances, however, where governments forfeit this power and establish strict currency regimes, which effectively makes them revenue-constrained. In a free-floating exchange rate regime there is no requirement to adjust primary surpluses or actively regulate the private sector’s present-value budget constraint. On the contrary, pegging the domestic currency to a foreign one means committing to fiscal and monetary tools that maintain the peg and pledge fiscal solvency for various sequences of prices. We explored the restraints this puts on governments in Chapters 3 and 4, as Argentina implemented such rules in the late 19th century and in the first half of the 20th century. Between 1931 and 2001, Argentina never fully reclaimed its power to create money. There was either a currency peg, a moving band in place, or hyper-inflation that made money issuing meaningless. These limitations were upheld in Argentina throughout most of the 20th century and facilitated its deeper integration in the international financial system. A revenue-constrained government with fixed exchange rates was more disciplined and dependable, as it had limited spending power, like a private company.

To be clear, the aim of this chapter is not to discuss the advantages and disadvantages of various exchange-rate regimes. We are interested in the exchange-rate regimes only to the extent where they limit or free authority over state’s own capabilities. Most importantly, following the trends in exchange-rate regimes in Argentina will help us organize the multifaceted episodes between 1950 and 2000. The discussion highlights that we should distinguish between (a) monetary unions, (b) currency boards, (c) pegged regimes, (d) crawling peg regimes, and (e) floating exchange rate regimes. These are not clear-cut categories and countries can adopt regimes that fall in-between these categories. A currency board can provide clarity for investors, while a

27 There are a few exceptions to this, such as New Zealand and Norway. However, New Zealand allocates a very small amount for investment and the funds are heavily regulated, while Norway’s fund can only participate in ethical investments (Reid, 2018).
free-falling exchange rate can be seen as volatile. The exchange rate regime also strongly influences debt levels. A country that designates the US dollar as its reference currency will need a sizeable foreign exchange reserve.

Table 5.1 below shows the official exchange-rate arrangements between 1930 and 2000. Here, we can observe the fluctuations in the exchange rate regime. These variations reflect the disposition of the Argentine government towards its debt and provide some insights about its perception of how to efficiently run the economy. The table shows that Argentina experienced and experimented with different exchange-rate regimes, and the regimes changed numerous times; once every seven years on average. Four out of ten shifts were initiated by a military government and, interestingly, these changes were not necessarily stricter than changes initiated by democratic governments. This table is a point of reference that shows changes in the government’s capabilities.

<table>
<thead>
<tr>
<th>Year</th>
<th>Classification of the exchange rate arrangement</th>
<th>Level of strictness</th>
<th>Modifier Party</th>
</tr>
</thead>
<tbody>
<tr>
<td>1931-1933</td>
<td>Convertibility suspended, heavy capital controls</td>
<td>5</td>
<td>Democratic</td>
</tr>
<tr>
<td>1933-1940</td>
<td>Dual peg to franc and sterling</td>
<td>4</td>
<td>Democratic</td>
</tr>
<tr>
<td>1940-1964</td>
<td>De Facto Moving band +/-5% - dollar is reference currency</td>
<td>3</td>
<td>Democratic</td>
</tr>
<tr>
<td>1964-1971</td>
<td>Pre-announced peg to us dollar – widespread controls</td>
<td>5</td>
<td>Military</td>
</tr>
<tr>
<td>1971-1979</td>
<td>Freely falling(^{28}) - Dual market</td>
<td>3</td>
<td>Military</td>
</tr>
<tr>
<td>1979-1981</td>
<td>de facto moving band narrower than +/-2%</td>
<td>5</td>
<td>Military</td>
</tr>
<tr>
<td>1981-1984</td>
<td>Freely Falling</td>
<td>2</td>
<td>Military</td>
</tr>
<tr>
<td>1984-1986</td>
<td>Pre-announced peg to US dollar</td>
<td>6</td>
<td>Democratic</td>
</tr>
<tr>
<td>1986-1991</td>
<td>Freely Falling</td>
<td>2</td>
<td>Democratic</td>
</tr>
<tr>
<td>1991-2001</td>
<td>Currency Board Arrangement</td>
<td>6</td>
<td>Democratic</td>
</tr>
</tbody>
</table>

Since there is no definite way to identify the level of strictness, the values are estimations of the strictness of the regime in comparison to each other. The higher the value is, the stricter and farther away it is from a floating exchange rate regime. The information on the de facto exchange rate regime is gathered from Levy-Yeyati and Sturzenegger (2005); Reinhart, Rogoff, and Ilzetzki (2017); Yeyati (2004)

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\(^{28}\) ‘Freely-falling’ is a term coined by Reinhart and Rogoff (2004a, p. 38), and it signifies a floating-rate regime under the effect of large downward shifts on a routine basis for extended periods of time. Episodes where the 12-month rate of inflation exceeded 40%, or when there was a sudden changeover from a fixed or quasi-fixed regime to a floating regime after a currency crisis, are labelled as ‘freely falling’ instead of floating rate.
5.2.1 ‘Treating an addict’

By the 1950s, Argentina had become dependent on external credit. Here, we will be suggesting that its condition could be likened to that of an addict, irrevocably hooked on a substance. Hence, Argentina’s responses to debt are similar to the struggles in which an addict finds himself as he undergoes treatment for his addiction. Addiction is the “repeated involvement with a substance or activity, despite the substantial harm it now causes, because that involvement was pleasurable and/or valuable” (Cooper, 2012). As we will see and explain, the first debt treatments were very impactful and had a similar effect on the Argentine economy as opiate does when introduced in the blood stream of an addict. The underutilized and under-employing economy (approximately 40% of the active population was underemployed in the 1950s (United Nations, 1968, p. 10) needed external credit to sustain itself and grow under the fixed exchange rate regime. At the same time, the successive military and civilian governments tried to solve the debt problem by paying it off. Massive cuts in public investment (Saxton, 2003) and return of state enterprises to private ownership (Ghigliani, 2010) throughout the 1950s were painful but necessary to solve the debt ‘problem’. Although the debt-to-GDP ratio was only 20.5% in 1950, the austerity policies had brought down the ratio to 8.4% by 1960. In the previous chapters, we discussed how fiscal prudence is not sustainable in the long-run. In Chapter 2, for instance, we explained how decreasing government spending reduces the circulation of money in the private sector and decreases productivity, which in turn amplifies the negative effects of sovereign debt on the economy by making it harder to repay it. Today, this process is commonly known as the ‘treatment that cures the debt but kills the patient’ (The Conversation, 2015). Argentina was the first country to undergo such treatment in the modern sense, as its creditors imposed a severe debt-restructuring programme on the country.

Debt restructurings are not new financial processes, they have occurred repeatedly throughout history. When the nobilities of ancient cities and states borrowed money from merchants and when they could not pay back, they would either work out a deal with the merchant or default on it. Velde (2016), for example, gives a detailed account of a debt restructuring carried out by Louis XV and his creditors in 1721. Similarly, we saw how during the 1890 default, Argentina and Baring Brothers, as the legal creditor person, negotiated restructuring options. As secondary debt markets emerged in the 20th century direct negotiation between debtor and creditor became impossible, however. Today, information on the identity of creditors in the modern sovereign debt market is dispersed under and obscured by layers of privilege-creating regulations and market instruments. Major companies and supra-national institutions can keep their investments secret, and so can creditors. Until 1956, creditors were not represented by any
association. But, this changed that year, as the Paris Club was established in an attempt to allow
Argentina to negotiate its debt with its major creditors.

The Paris Club comprises officials from major creditor nations in the Organisation for
Economic Co-operation and Development (OECD) and operates in close coordination with the
IMF. It has become the institution that represents the interests of creditors by offering sovereign
debt restructuring options. It is the only institution that belongs to creditors and unites them.
The word ‘institution’ is not a perfect fit for the Paris Club, though. It does not have a judicial
existence or any statutes, nor can it be held responsible for any of its decisions. If anything, the
Paris Club is a phantasm; it does not have physical reality or the power to enforce anything, but
it is an impressive instrument of stage-craft. It institutionalised the restructuring process of
government debts after its establishment and has reached more than 430 agreements and dealt
with more than $580 billion worth of debt since 1956.

The Paris Club follows a three-step debt restructuring process. The first step is the
commencement of negotiations between the IMF and the debtor country. The IMF generally
grants an initial balance of payments loan in exchange for the implementation of an array of
fiscal programmes by the debtor that are designed to eliminate the payment problem (Feldstein,
1998). In the second step, the debtor country meets with the officials of creditor governments
to restructure the outstanding debt into an easier repayment model. Sometimes this means a
haircut, lower interest rates, maturity extensions, or a mixture of the three. Lawson (2004) gives
a detailed account of the almost ritualistic nature of these meetings; the delegates from creditor
countries sit around a table in alphabetical order and discuss the situation with the debtor, then
the debtor leaves the room and the delegates decide what to do. In order for the meeting to take
place at all, the debtor country must have already accepted the initial IMF requirements.

Between 1956 and 2014, Argentina underwent eight such ‘treatments’29 for debt relief by the
Paris Club. To treat Argentina the Club has primarily relied on the suspension of the accruing
penalty interest and the deferment of amortization. The real appeal of the Paris Club is that it
provides instant access to large sums of credit from the IMF, albeit with many structural-
adjustment strings attached to those loans. In 1956, these strings were tied to a gradual process
of fiscal consolidation and configuration of trade under the guidelines of the General Agreement
on Tariffs and Trade (GATT). The IMF also officially requested that Argentina eliminate the
multiple exchange rates system it was running and adopt a dollar system instead, and change

29 ‘Treatment’ is the term used by the Paris Club.
its statistics compilation methods (D. Cavallo & Runde, 2017, p. 1962). In this respect, these policies were the archetype of the infamous Structural Adjustment Programs (SAPs) of the 1980s.

Debt restructuring provides a temporary relief by postponing the burden. Therefore, it is not surprising that Argentina returned to the negotiation table in Paris only six years after the first treatment in 1956. Figure 5.2 below displays the change in the gross central government debt-to-GDP ratio of Argentina between the first and second treatments.\(^{30}\) This figure displays the initial relief following the treatment as well as the sudden surge in the debt-to-GDP ratio in 1962, which necessitated another treatment in the same year.

![Figure 5.2 Total debt/GDP ratio of Argentina and the first Paris Club treatments](image)

With each treatment, Argentina has seen its debt accrue. So, far from curing the patient, debt restructurings only increased dependency. As suggested above, the country had become addicted to the new debt that came from these ‘treatments’. The first inflow of credit into an underutilized Argentine economy created growth, as could be expected. After the 1956 treatment, the GDP per capita increased by 4.2%.\(^{32}\) However, every subsequent treatment had diminishing effects on the economy. After the 1962 treatment, there was only a 0.9% increase in the GDP per capita. After the 1965 treatment, the GDP per capita shrank by -0.003%.

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\(^{30}\) Although the graph shows Argentina’s debt level at around 25%, the bulk of the government debt originated in bilateral agreements and a large portion of this debt ($260 million) was due in 1956. Long-running nationalization of private companies and especially the strict peg had rendered the country insolvent. For more information see D. Cavallo and Runde (2017).

\(^{31}\) World Bank (2017), dataset available at data.worldbank.org, for the rest of the thesis, under figures, it will be cited as ‘World Bank’.

\(^{32}\) Data on GDP-per-capita gathered from Mauro, Romeu, Binder, and Zaman (2013)
marginal productivity of sovereign debt kept decreasing and new credit stopped relieving the pressure on the economy.

This is why the drug analogy is popular among journalists (Barboza, 2011; Pham, 2017) and scholars (E. A. Bruno, 2006) when they talk about debt addiction. Depending on debt for development creates even more dependency on debt and a cutback of debt can have devastating consequences on the health of the “patient”, very much like a heroin addict in withdrawal. In contrast to heroin, which has no salutary effects on the addict’s health, debt is much more addictive, because it can help utilize unused potential in an economy and stimulate growth. The heroin-addiction image is thus only partially useful. Debt is probably more akin to the use of ‘antibiotics’. It can treat problems and help the economy, but when carelessly and/or over prescribed it can be harmful: Eventually the increased debt in circulation creates resistance and decreases its own effectiveness. Furthermore, long-term dependence on credit and debt restructuring leaves the debtor country weaker in the eyes of investors. Like a sick person with high resistance to drugs, the debtor becomes more and more desperate for ‘relief’. A country that regularly needs the help of supra-national institutions to stay afloat does not instil confidence in investors, but mostly attracts risk-seeking investors who are enticed by high yields.

The growing immunity to credit of the Argentine economy in the 1950s can be explained in numerous ways. A central reason, however, lies in the increasing financialization of the economy in this period. Demir (2009) empirically explains how from that decade onwards in Argentina and in other developing countries the rates of return on financial capital began to outpace the return on fixed capital, and how the real sector increasingly invested in short-term financial assets and fixed investment rates began to decrease. This is what we called the financialization of the real economy. The new credit that Argentina acquired from the international capital markets was being captured by the growing financial sector. While the 1956 credit treatment successfully reignited growth in Argentina, it also fed the financialization of the economy which redirected the next flow of credit into itself. Instead of using the new capital to expand the real economy, the financial sector strengthened itself to demand more credit.

Figure 5.3 shows Argentina’s first eight treatments by the Paris Club and the gross central government debt-to-GDP ratio between 1952 and 2004; the black horizontal lines are the dates of treatments. The graph shows that the Paris Club treatments came in quick succession. Although the debt-to-GDP ratio decreased after every Paris Club treatment in the very short
run, it rose to even higher levels only a few years after the treatments. In a similar way, many other developing countries, like Brazil and Turkey, returned to the Club only a few years after their initial treatment and kept returning for more afterwards. However, the graph also shows a long interlude in treatments between 1965 and 1985. After the 1965 treatment, Argentina did not require another debt rescheduling for 20 years from the Paris Club and the debt-to-GDP ratio appears to have been relatively stable until the early 1980s. How did the 1965 treatment differ from other treatments? What happened in this period that enabled a long deferral of a sovereign debt crisis?

![Figure 5.3 Debt-to-GDP ratio of Argentina and all Paris Club treatments](source: World Bank)

### 5.2.2 The financialization of sovereign debt

One of the central arguments we made in Chapter 4 is that postponing or restructuring debt is not a permanent solution as the very logic of restructuring leads to austerity measures and an underinvestment in the domestic economy. We established that frugal domestic policies contract the economy. In this chapter so far, we have noted how the debt restructuring process creates vicious cycles of more indebtedness and further dependence on debt. While the first two treatments successfully decreased the level of debt in the short run, they ultimately resulted in
creating a debt-dependent economic structure which was unilaterally connected to the relations established with the international capital markets.

The third treatment inflicted on Argentina by Paris Club in 1965, however, defies the common understanding that debt restructuring is inherently untenable. This treatment succeeded in keeping the debt levels low for well over a decade and Argentina was able to avoid another restructuring process for 20 years. Referring back to the drug addiction metaphor33, Argentina went ‘cold turkey’ in this period. So, was the addiction cured? Answering this question requires further investigation and can be explained within the theoretical framework established in this thesis. Thus to understand why the third treatment was a success in the sense that it did not cause instability in the mid-term, we will first look at the domestic policies that were implemented by successive military governments in Argentina, and then we will question whether this was due to a major break in the dominant macroeconomic ideology or due to what we will call ‘the financialization of sovereign debt’.

The 1960s and 1970s were transitionary periods in which there was a major shift in macroeconomic thinking in the world. In the mid-1960s, monetarism emerged and slowly but decisively replaced Keynesian economics as a leading set of analytical and policy ideas. Piloted by Milton Friedman, this new school of economics focused on the “potency of monetary policy” (Friedman, 1995). As opposed to the dominant Keynesian idea that countries should use government spending and taxation (i.e. fiscal policy) to stabilise the economy, Friedman argued that controlling the money supply is a more efficient and stable path. The basis of monetarism lies in the idea that banks need to have sufficient reserves to lend and that if the central bank ensures a steady increase in the money supply through open market banking operations, then the efficiency of markets will take over. In contrast, the post-Keynesian theoretical framework developed in Chapter 2 sets out that banking operations do not need any reserve to function and that the money supply is endogenously demand-driven. As explained, the money supply expands as the private sector borrows and it shrinks as debt is paid back.

In the post-Peron era, which began in 1958, Argentina gradually adopted these emerging monetarist ideas under several transitional military governments. Between 1958 and 1966, the military was either in power or had strong influence over the state. The government deficit

33 Using metaphors can cause confusion and it is not widely used in scholarly writings in economics. However, we need to recognize that metaphors have always been how humans make sense of economy. In Aristotle’s (Aristotle, Politics, Book V, Chapter III, 1302b 35-1303a) words “the analogy of the body is instructive”. For more on body/economy metaphor, see Ghiselin (1978).
began decreasing as a result of new policies that reduced public expenditure, tightened monetary policy, and increased taxes and utility prices. The new mind set in the world and in Argentina was against discretionary monetary and fiscal interventions to stabilize the economy. Instead of preventing economic downturns by increasing spending, post-Peron Argentina depended on the free market to correct itself. Figure 5.4 shows the Argentine government’s final consumption expenditure in pesos between 1960 and 1976.\(^{34}\) This graph shows that the government spending was basically frozen for 13 years between 1960 and 1973. The government did not employ policies that directly affected domestic demand. Figure 5.5 displays the gross domestic savings over the same period, to show the accounting identity between the two indicators; the private sector can save exactly as much as the government spends. We explored the meaning of this relationship in Chapter 2.

**Figure 5.4 Government spending between 1960 and 1976**

\[\text{Source: World Bank}\]

\(^{34}\) The data are in current LCU here, therefore the graphs are susceptible to the sudden increases in inflation in the mid-1970s and that explains a large portion of the surge after 1975. We could use current US$ since it produces very similar graphs, but data on 1960-62 and 1972-74 are not available. Nevertheless, between 1962 and 1976 the general government final consumption increased only by $1.839 billion in current US$. 
Limiting state intervention in the economy translated into a fall in real wages. The average of deflated money wage rates for unskilled and skilled workers dropped 21.9% between 1950 and 1972 (Marshall, 1980). Considering the growing power of organised labour in the Peronist era, such a fall resulted in protests and strikes. Right after President Arturo Frondizi consented to a recommendation by the World Bank to abandon a third of Argentina’s railroad tracks and lay off thousands of workers in 1961, unions replied with a 42-day strike and stopped all railroad transportation in the country (Socialista, 2013). As a supplementary strategy, the new government implemented a strict peg to the US dollar along with strict exchange rate controls in 1964. Even then, the suppression of real wage was not sustainable in the long-term in a democratic society with organized labour. The friction between the unions and the state resulted in a coup d’état in 1966, only two years after the first Paris Club treatment.

While the military intervention between 1958 and 1966 was temporary, the junta established in 1966 aimed at instituting a permanent type of new governance. The junta pursed programmes that concentrated and centralized capital in few hands, privatised government owned sectors and sought international financial investment (W. C. Smith, 1991). The military government actively suppressed wages and focused on fighting inflation. Lower wages meant a reduction in household consumption and an increase in the demand for credit. Figure 5.6 displays the upward trend in the need for domestic credit in the private sector in Argentina, which increased from 10.6% of GDP in 1964 to 19.1% in 1974.
Despite the harsh austerity measures the GDP grew at an average annual rate of 5.2% between 1966 and 1970 (W. C. Smith, 1991, p. 77). This growth was possible due to the very strong support from the international financial community through direct investment and loans (Yergin & Stanislaw, 2002), and funding from supra-national institutions like the IMF and World Bank. The junta continued to hold onto the export-led growth strategy while keeping inflation low, a contradictory tactic that we criticised in Chapter 4. The other source of this growth was the increase of private sector debt. Households and companies funded their consumption with credit since wages were not increasing. When households and companies are short of liquidity they resort to the financial sector. This is a win-win situation for everyone in the short-run; households enjoy a low inflation economy and can keep their purchasing power high; companies enjoy high demand for their products and a strong peso; and bankers and financial industry enjoy the interest paid on these debts.

The inherent problem with this tactic is that the accumulated savings for the private sector are finite; eventually people will want to decrease their debt levels and will reduce their consumption to do that. Private banks also decrease their lending if the stock of household debt increases too much, and this creates instability. Argentina underwent all these problems at one point or another in its history. The economy had a shortage of private savings in the 1960s, suffered from plummeting foreign direct investment in 1999 and did not have access to adequate international credit in 2002. Such bottlenecks are inevitable when the economy solely depends on external financing. All these sources of money are finite and depend on external circumstances. The only infinite source of finance is in the form of pesos and the only issuer is
the state. A sovereign government that can issue its own currency can always provide the necessary demand stimulus for sustainable growth.

By suppressing wages, the junta aimed to redistribute national income from wages towards profits so that gross capital formation could surge and make the country richer, a macroeconomic policy that is very much in line with monetarism. All the junta’s endeavours at mass privatisations and promoting competition in this period were aimed at increasing the net physical assets in the economy (Yergin & Stanislaw, 2002). As Figure 5.7 displays, however, these attempts resulted in a slight fall in gross capital formation between 1961 and 1974. This means that there was a contraction in public investment regardless of all the polices aimed at boosting it. Although data on public consumption is not available, looking back at Figure 5.5, we can see how private sector indebtedness increased and then plateaued after 1970, which suggests that public consumption spending must have also stagnated between 1964 and 1975.

![Figure 5.7 Gross capital formation between 1960 and 1974](image)

Nonetheless, the military government was successful in paying off the debt while maintaining the peg. Argentina thus became the ‘poster child’ of a new understanding of macroeconomic stability. External debt might have been paid off, but in the process, the private sector became more indebted, democracy was suspended, dependence on foreign resources increased and workers had to endure a decade-long suspension of wage growth. Just before the talks with the Paris Club ended in 1965, and a total restructuring of the debt was achieved, Argentina had converted to a much stricter exchange rate regime which helped with the remaining repayments. The austere cuts in government spending succeeded in reducing the debt-to-GDP ratio to below
7.5% by 1970, something which often applauded as an important achievement (Buera & Nicolini, 2010).

All these developments point to the radical transition from Keynesian to monetarist economics (J. L. Stein, 1982). Some scholars see the decrease in the government’s involvement in the economy as a result of the so-called “fall of Keynes” in Argentina (Román, 2012, pp. 130-133), while others have been dubbed the increasing financialization of the Argentine economy “Keynes’ nightmare vision” (Ranis, 2004). This transformation in Argentina towards less government intervention has been construed as another round in the grand fight between Friedman and Keynes, a fight that was waged in the 1950s and was lost by the Keynesians in Argentina in the 1960s. This theme is used extensively by scholars who attempt to find the breaking point in Argentina’s history that created the ‘Argentine paradox’ mentioned in Chapter 1. Was there really a deep theoretical break that transformed the macroeconomic policies in Argentina from Keynesian to monetarism?

The obsession with repaying sovereign debt was not unique to Argentina in the 1960s. Figures 5.7 above and Figure 5.8 below, which are based on Figure 4.1 in the previous chapter, display the long durée between 1951 and 1981 that saw a very sharp decline in the number of sovereign defaults. Figure 5.8 displays the percentage of developing countries in external default or restructuring weighted by their share of world income. The three-decade long lull between waves of defaults is an extraordinarily long time. We looked at the broad pattern drawn in the last 200 years in Chapter 4 and mentioned how every one or two decades a large number of sovereigns have defaulted on their debt. According to my calculations based on the Maddison Project’s dataset (Bolt et al., 2018), on average, every 10.8 years there has been a sudden sizeable increase in the number of countries in default between 1800 and 2000. The longest quiet interval began in 1951 and ended in 1981. Between 1951 and 1981, Latin America was virtually devoid of sovereign defaults. Argentina and Brazil restructured their debt in the early

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35 I identified a ‘wave’ of sovereign default as an over 4% increase in the percentage of countries (weighted by their share in the world income) in external default within 3 years. According to this definition, there were 17 ‘waves’ of default since 1800. This is a very simplistic definition of a ‘sovereign default wave’. There is a very large body of literature on this topic, interestingly, since it is connected to the concept of ‘Kuznets Swing’ which identifies medium range (10-15 years) economic waves that governs the international economic structure (Abramovitz, 1968). I do not have the space here to delve into this discussion. Suter (1989) gives a detailed definition of these waves and ways to identify them.
1950s but did not default on their debt. Only Chile fell into default between 1972 and 1975. What was special about this period?

**Figure 5.8** Percentage of developing countries in default weighted by their share of income

One common answer to this question points to how the long period of tranquillity between waves of default overlaps with the ‘Golden Age’ between 1950 and 1970 (United Nations, 2007). However, the drop in sovereign defaults began before the post-WWII economic boom and lasted during and after the 1973-75 global recession. Another explanation depicts the boost from Keynesian full employment policies and well-regulated markets as the policies that warded off another wave of default (UNCTAD, 2010, pp. 135-155). However, how were developing economies able to increase their public spending while paying off their debts? In the next section, we will look at Argentina’s economy in the 1960s and scrutinize the idea that Keynesian policies led to stability in sovereign debt markets. Our answer to the above question

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36 To remind the reader, there is no definite distinction between default and restructuring. Different datasets have different definitions. Throughout this study we used the datasets compiled by the Maddison Project (Bolt et al., 2018) for their consistency and C. Reinhart and K. Rogoff (2009) for their comprehensive approach, and when in conflict, I used the Maddison Project’s figures.

37 Data on defaults gathered from Reinhart and Rogoff (2009); data on share of income of countries gathered from Bolt et al. (2018). The percentage of countries included in the ‘developing world’ is taken from: Morales, Sachs, and Sachs (1989). Including all countries, instead of only developing countries draws a similar graph, which I added in the appendix. The main difference is that the fall in the rates of defaults after 1945 is slower and the contrast between the two periods (pre- and post-1950) is less clear. This is due to the defaults of some major European countries in the 1950s, like Russia and Germany. Although this is very worthy of discussion, the chapter needs to keep its focus on Argentina and the developing world.
is that such a large gap between sovereign default waves cannot be explained without reference to the implementation of a different approach to sovereign debt. There was a global shift in the way sovereigns tackled their debt problem. However, this new approach was not a result of Keynesian economics being implemented, but was the outcome of a change in the nature of sovereign debt markets and creditors. Next, we will be looking at the shifts in the dominant theoretical understanding of debt which precipitated the ‘new mentality’.

5.2.3 Analysing the ‘new’ mentality
At the outset, the story of Argentina in the 1960s is a familiar story of successive military governments forcibly breaking the welfare state apart and enforcing a monetarist economic ideology. This story depicts a change from better to worse, from welfare to monetarist, from Keynesian to Friedmanite. But when we look closer into the theoretical background of Keynesian and monetarist macroeconomic approaches, we can see that there is no major difference when it comes to the topic of sovereign debt. Both classic Keynesian and neo-Keynesian approaches are in line with the monetarist understanding of sovereign debt. Keynes (1940) himself was wary of inflation and believed that it is a form of tax on the poor. Consequently, he was cautious about fiscal deficits too. Keynes did remind governments that when there is a deficiency of effective demand, deficits can fill the gap, but he also argued that in ‘good times’ governments should run surpluses on non-capital items. Discussing Germany’s post-WWI debt problem, Keynes argued that Germany should improve its trade balance and grow its manufacturing production so that it could make the payments on its debt (Nelson, 2015).

This way of thinking is in agreement with the basics of monetarist ideology. Both approaches accept the notion of revenue-constrained government budgets and see high debt as a threat to stability. From this perspective, mid-1960s Argentina employed both Keynesian and monetarist policies by running surpluses and focusing on repaying debt in ‘good times’. The 1960s was the golden age, the height of such ‘good times’. From 1960 to 1962 Argentina’s current account balance was negative to the tune of $1 billion (G. Di Tella & Dornbusch, 1989, pp. 152-154). The new government ‘fixed’ this by running a current account surplus that reached $490 million (G. Di Tella & Dornbusch, 1989, p. 153).

Argentina also ran trade surpluses and paid a large portion of its outstanding external debt with the help of debt restructurings. In 1965, debt repayments represented 40% of all exports and by 1966 this proportion reached 50%. At the same time, the debt-to-GDP ratio continued falling:
from 23.4% in 1963 to 9.4% in 1968. Combining deep fiscal retrenchment that decreased government spending and other programmes that were aimed at increasing productive capacity made the debt burden appear sustainable. But in reality, we saw how much these cuts to welfare and employment programmes cost the population and how these programmes were anything but sustainable. A total sovereign debt repayment is in fact seldom sustainable.

At the same time, if we rule out the option of a strategic default and if we accept that there is a limit to running fiscal deficits, the debt burden appears unsustainable again. Eventually, the only way out of the debt bondage appears to be running surpluses and paying off the debt. Both Keynes and Friedman agreed on this point. The way to achieve a sustainable and growing economy was vastly different for these two economists, but their fundamental understanding of government debt was the same. But they did not agree on the timing and size of budgets.

The approach that we are taking here differs fundamentally from both the Keynesian and monetarist understanding of sovereign debt because we reject any arbitrary fiscal constraint that operates to run a balanced budget. Governments do not have ‘budgets’ and their spending and income cannot be balanced. In Chapter 2, we explained that continuous fiscal deficits are not necessarily inflationary and that there is no reason to issue debt to pay for them. The government can always create money by directly debiting bank accounts (i.e. engage in overt monetary financing or in ‘printing money’).

There was no radical change in the macroeconomic direction of Argentina in the 20th century. Throughout the 20th century, Argentina had one consistent macroeconomic ideology that was aimed at repaying debt and being fiscally responsible. Although it is perceived as a ‘serial defaulter’ today, we have seen that Argentina went beyond the call of duty in the 1930s to not default. When the government debt became unsustainable again in the 1950s, a military government, once more, prevented the default. The political policy response of democratic and military governments to sovereign debt did not change in Argentina. What set the 1960s and 1970s apart from the previous era was not internal but external factors. It was not Argentina’s

38 Of course, there are many important distinctions between Keynes and Friedman, especially when it comes to the topic of employment. However, Keynes did not focus on the particulars of fiscal policy in his works. Brown-Collier and Collier (1995) has compiled all of Keynes’ discussions on the topic and their summary of Keynes’ writings point out to this: “The government should not deficit finance current expenditures. Public investment expenditures should be financed by borrowed funds that are repaid over the service life of the project” and “There should be no deficit in the current or ordinary budget. In economic downturns the automatic variation in the collection of social security contributions might result in a deficit in that fund. However, in prosperous times, the fund should automatically run a surplus”.

39 For a relevant discussion on the topic, see: Mitchell (2015, pp. 371-372)
approach to its debt, but a global transformation in the management of a sovereign’s fiscal power that altered the rules of repayment and default. It was not a shift towards neoliberalism at the state level, but rather a global transformation that reduced the number of countries in default.

We will theorize that this long pause between defaults was a result of the ‘financialization of sovereign debt’. We have already explored the first signs of the financialization of the Argentine economy, and now we will explain financialization of the sovereign debt. A combination of two events enabled this type of financialization and precipitated the change in the conjuncture: (1) internalization of fiscal and monetary discipline, and (2) concentration of debt in big banks. We will explore these two changes to define what we mean by financialization of sovereign debt.

5.2.4 Internalizing fiscal discipline

If the macroeconomic inclination of Argentina has always been towards repaying debt, why did the first SDRM emerge only in the 1960s and not earlier? Why did creditors not unite right after the 1930s debt crisis and form an institution like the Paris Club against other defaulters? The answer lies in the form of restrictions on sovereigns that gradually emerged during the era of financialization discussed above. In the 19th century, the limit of a sovereign’s financial freedom came in the form of the gunboats of colonial powers. An outcome of default could be the total loss of sovereignty, including fiscal autonomy (Suter & Stamm, 1992). As mentioned, gunboat diplomacy stopped being a factor in international finance after the turn of the century, the danger of a powerful country attacking the indebted country died out. In the 1930s, as we discussed in the previous chapter, the loss of credibility was the main deterrent against default. Although being labelled ‘unreliable’ can be problematic many sovereigns still decided to default, and this era saw the largest wave of sovereign defaults in the history. Without a powerful deterrent, sovereigns that desired to maximize their short- and mid-term benefits from financial markets easily chose the defaulting option.

The so-called golden age of capitalism, from 1951 to 1973, gradually introduced another type of discipline, one that depended on currency arrangements and thus was closely related to the emergence of financialization. The first period of a globally organized exchange rate regime after the demise of the gold standard began with Bretton Woods in 1944 and lasted until 1971. In Chapter 4, we explained how fixed exchange rates worked in this regime. The gold standard constricted and disciplined every nation’s fiscal space. Fixing the exchange rate is a constraint
on the available monetary policy actions since it means defending a set parity against the pegged currency. Every economy was responsible for managing their foreign currency reserves and keeping their promise to convert domestic currency to US dollars at a fixed rate.

Countries under this system required dollars to keep the exchange rate stable, and for developing countries the easy way to maintain the influx of dollars was running consistent trade surpluses. As we suggested, most developing countries, like Argentina, organized their economies in a way that ensured a steady trade surplus: wages were kept low to increase competitiveness and domestic aggregate demand was kept low to reduce imports. Sovereigns had to operate within the limits of their financial resources. This was an external limitation, built by the US and enforced by the IMF, and opting out of this system would mean alienation from the largest international financial system of the time. It was therefore an externally imposed disciplinary system.

Here, we use the word discipline in the way Max Weber (Gerth & Mills, 2014, p. 253) used it:

> those who obey are not necessarily obedient or an especially large mass, nor are they necessarily united in a specific locality. What is decisive for discipline is that obedience of a plurality of men is rationally uniform.

One of the main effects of Bretton Woods was to arrange this rational uniformity. In fact, the history of the world economy since the end of WWII is the history of ever-increasing institutions of discipline, reflected in a range of intergovernmental agreements and institutions (such as the OECD, the IMF, NAFTA, the EU Maastricht treaty, etc) and in private agents of discipline, such as CRAs (Ardagna, Caselli, & Lane, 2007; Partnoy, 2006). The common aspect of these disciplinary institutions is that they all create binding constraints that isolate a certain part of macroeconomic decision-making from democratic accountability (Dahl, 1999; van Waarden & van Kersbergen, 2009).

Bretton Woods bound all participating sovereigns under one regime. It was very influential, but still, it was an external constraint upon sovereigns, and nothing can, and in principle, should constrain a sovereign. An entity that can be confined by external constraints is not sovereign. As was to be expected, states resisted this attempt to limit their sovereignty. Hence, the system never functioned as intended as countries reneged on the deal in various ways. As early as the 1950s, the IMF started changing its approach to capital controls. In a report published in 1950, it stated that “exchange restrictions, which have in many cases been devised to prevent the escape of capital[,] have also on occasions strengthened tendencies toward escape” IMF (1950, p. 28). By 1956, the IMF (1956, p. 57) had already decided that its “members are free to adopt a policy of regulating capital movement for any reason … without [the] approval of the fund”.

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Argentina became directly embroiled in this system of discipline from 1956 onwards. After the sovereign debt crises of the 1930s, Argentina suspended the convertibility of its currency due to insolvency and in 1939 it introduced a managed floating system with the dollar as the reference currency. This was a relatively more relaxed exchange rate regime compared to its neighbours and it lasted until 1964. Juan Peron (president, between 1952 – 1955, 1973 – 1974, 1946 – 1952) utilized the limited flexibility of this exchange rate regime especially in the early-1950s (Escudé & Powell, 2001). Nevertheless, Argentina became a member of the IMF in 1956. At this point, the disciplinary force was still in the form of an external organization limiting Argentina’s power to employ fiscal policies, and although Argentina and other countries willingly accepted placing these restrictions upon themselves, they constantly twisted and turned the underlying rules of the system (M. Bordo, 1993; Edwards & Santaella, 1993).

As sovereign countries started to stretch the rules of Bretton Woods, the system came under mounting pressure and eventually crumbled from the mid-1960s onwards. The exchange rate regimes in place became less and less effective as exogenous constraints. After the de-facto end of the fixed exchange rate system in the mid-1960s, sovereign governments stopped being revenue-constrained in their spending and no longer had to issue debt to balance their economies. Once the system collapsed, however, countries introduced their own constraints as strict pegs and currency boards emerged. Around 60% of all regimes were pegs after Bretton Woods, and Reinhart and Rogoff (2004a) show that 53% of all officially floating exchange rate regimes of the 1980s were actually de facto pegs, crawling pegs or operating in narrow bands. There was no external institution that obliged countries to peg their currency or to confine themselves to a promise to convert their money to another currency at the pegged price.

These countries decided to make a promise to keep the rational uniformity unbroken, not because an external body compelled them to, but because these countries believed that it was in their own interests to do so. The main message given to investors and citizens with the promise to keep the peg is that the government would not use all the sovereign’s powers to spend domestically. However, giving a promise to the rest of the world increases the risk of insolvency and default, especially so with a peg to the US dollar since the dollar benefits from nominal exchange rate swings.

When sovereigns voluntarily accept this risk they ‘internalize discipline’. The breaking point for Argentina came in 1964 when it changed its exchange rate regime. We can give more examples of countries imposing budgetary constraints on themselves in the 1960s. The internalization of discipline was a widespread phenomenon. The sovereign incorporates the
idea that by limiting itself it becomes more stable and more attractive to investors. The result is a state that is more similar to a large company than to a sovereign country; the budgetary constraints become real constraints, and the country must make money to spend money. This ‘company-like’ government needs to attract foreign currency and needs to sell its goods to outside countries. It is also important to note that the internalization of discipline did not emanate from a break with Keynesian ideology, but was an extension of it. Other than the internal developments in sovereign debt management, there was also an important development in the way international debt markets functioned as government debt was bought and sold and concentrated in a few hands.

5.2.5 Concentration of debt

In the early-to mid-19th century, only governments and accredited large institutions (like Baring Brothers) had the capacity to participate in the sovereign debt markets. The secondary debt market, the place where Chile, Bolivia and other Latin American governments bought back their debt for discounted prices in the 1930s, was not yet available. In the mid-20th century the market opened to everyone. Any investor could buy stocks, bonds, options and futures; the debt was owed to widely dispersed private investors. As financial tools developed, the capital in circulation increased and ever more investors joined in the sovereign debt markets. When a country stopped repayments on its government debt, it defaulted on hundreds and sometimes thousands of creditors in different countries. It was not possible to bring all these people and companies together to start a negotiation between the debtor and creditors.

However, in debt markets, very large capital owners have considerable advantages over small investors to increase their market share and translate that into power differentials. A single creditor like the IMF or a large investment bank can prevent a default and secure its own investment merely by trusting in a government. Larger creditors also have better inside information due to their superior information-gathering methods (Hu, Li, Lin, & Xie, 2011). And the value of inside information enables the economies of scale to work in debt markets too; the cost of information gathering drops if an institution already has a database on a certain economy and the neighbouring countries. In general, very much like in any other industry, the larger capital ‘eats’ the smaller capital in the sovereign bond markets. In Marx’s (1867) words,

“It is [by] concentration of capitals already formed, destruction of their individual independence, expropriation of capitalist by capitalist, transformation of many small into few large capitals [that] ... Capital grows in one place to a huge mass in a single hand, because it has in another place been lost by many”.
The natural evolution of debt markets led to the concentration of debt in the hands of a few. This made it easy to organize and gather creditors under one name and amplify their power over debtors. The Paris Club is an outcome of this development. Officially, the Paris Club represents creditor countries, but it also holds regular technical meetings with agents of major private creditors. Unifying creditors strengthens their hand and creates a more real and direct threat against defaulting. A collective action against a defaulter and cutting major foreign direct investment flows is much more threatening than some potential reputational costs. In this sense, the Paris Club has been revolutionary for the management of sovereign debt.

The decrease in sovereign defaults between the mid-1950s and the early 1980s was therefore a result of the power difference between the organized creditors and the self-restricting debtor countries. These two developments created a new setting that not only convinced sovereigns to forfeit some of their monetary and fiscal powers, but also made it costly and unfeasible to default. This was the result of a radical change in the way sovereign debt worked. We touched upon how creditors simultaneously became anonymous and also institutionalized under the Paris Club; how the fixed exchange rate regime started crumbling with the Bretton Woods but was also adopted voluntarily by counties; how states became free of external constraints, but also created internal ones. During the investigation of these inconsistencies, we tried not to fall into the trap of explaining everything as a theoretical move from Keynesian to monetarist economics. We will further elaborate on and develop the concept of internal discipline as we move onto the next period.

5.3 Consolidation of neoliberalism: 1970–1980

The final step in the transformation of Argentinian debt that we are tracing in this chapter developed along the consolidation of neoliberalism during the period 1970 to 1980. This was a process that played out both globally, as discussed by D. Harvey (2007), as well as nationally. As discussed by Portes and Roberts (2005), in Argentina, the military junta saw in neoliberalism a means of consolidating their power. In this period, we can see both the development of policies that are in line with the changing understanding of state capacity, and the initial results of these policies.

Argentina entered the 1970s with total gross central government debt-to-GDP ratio of below 10%, but this increased over the next decade, pushing the average ratio between 1969 and 1981 to 18.1%. Historians (Rock, 1975) and political economists (Dornbusch & Pablo, 1987) who
work on this era of Argentine history take the low level of debt as an accomplishment, a healthy point of departure. Braun (2006), for example, starts his paper by pointing out the low levels of debt and then asks, “what went wrong?”. In terms of the perspective developed in this thesis, this is the wrong question to ask. The very low level of debt was one of the roots from which subsequent problems developed.

Figure 5.9 shows the debt-to-GDP ratios of the 1970s and 1980s. The black bars represent Argentina’s debt-to-GDP ratio, and the light-coloured line shows FDI over GDP. FDI includes all direct investments made by foreign firms and individuals in Argentina. It is a useful indicator that shows how attractive the country was to foreign investors. This figure shows that there was a positive relationship between central government debt and inward FDI, refuting the notion that rising levels of debt scare off investors. However, this ill-informed notion became the orthodoxy for Argentinian decision makers in the 1980s, signifying the consolidation of neoliberalism there.

The consolidation of neoliberal orthodoxy was also evident in other respects, and, in particular, in the steps that robbed the state of its monetary policy role as it was handed over to private banks. Argentina entered the 1970s with food riots in major cities (Serulnikov, 1994), an inflationary currency crisis under the fixed exchange rate regime, and decelerating urban migration (Yergin & Stanislaw, 2002). The military government did not use its fiscal powers to prevent the crisis. Instead, in a series of attempts to end inflation, the junta freed the interest rates on both bank deposits and loans (McKinnon, 1993, p. 3). In a fixed exchange rate regime, money is a scarce resource, and giving the power to define the ‘price’ of money, i.e. the interest rate, to the banks is giving these private institutions total power over money supply. This sudden liberalization of credit increased domestic indebtedness. The amount of domestic credit extended to the private sector by banks as a percentage of GDP increased from 13% in 1969 to 17.4% in 1971 (World Bank, 2018). Unrestrained private banks became the custodians of Argentina’s money supply, which led them to behave *ex ante* as if their capital would be insured by the state. This privatised the supply of public currency by linking it to the supply of credit.
After 1971, the *de facto* junta\(^{40}\) was not able to back up the pegged exchange rate (pegged to the US dollar) anymore and opted for a free-falling dual market regime. This momentous step, which undermined the ability of the Argentinian state to maintain control over monetary policy, coincided with the official termination of the post-WWII Bretton Woods financial regime globally. The main victims of this was the Argentinian people. The junta’s frugal social spending became the norm. As a result, the manufacturing industry entered a period of continuous decline in 1972 after a long period of growth (Kosacoff, 1860). Industrial development was suspended, which decreased output sharply (Dornbusch & Pablo, 1987). In turn, chronic inflation became a part of life in Argentina as the average inflation rate per year between 1975 and 1991 was over 300% (Veigel, 2005) which grounded upward social mobility.

Looking back, it is clear that these social costs could have been avoided if the Argentinian state had more carefully protected its capacity to shape monetary policy. With the collapse of Bretton Woods and the abandonment of the peg, the peso was no longer valued against the US dollar and there was no need for IMF loans to subsidise shortages in Argentina’s foreign exchange reserves. With a floating currency, the country could engage in open market operations and

\(^{40}\) Alejandro Agustín Lanusse (president, between 1971 and 1973) was appointed by the Military Junta.
raise the money it needed, or it could print money to alleviate public debt that was issued in its own currency. Starting from 1971, it could have financed its welfare state services through its own currency and, as long as government spending was productive, it would have been able to create growth and reduce inflation. As productive spending, the government could have invested in the public provision of infrastructure or increased government spending which could have improved investment technologies, such as the education system. Instead, a year after floating its currency, Argentina resumed borrowing from the IMF at an average of $286 million (in current US$) every year until 1978 (World Bank, 2017). If ever there was a true indicator of the extent to which the neoliberal financial orthodoxy took hold of Argentina in the 1970s, this was it.

This self-imposed ‘austerity’ policy continued even after the democratic elections in 1973 that brought a Peronist government back into power. The extent of Argentina’s austerity policy is well reflected in how its government expenditure fell behind global levels. Between 1970 and 1979, the average general government final consumption expenditure was 10.7% of GDP in Argentina, while the global public expenditure-to-GDP ratio was over 15.5%. The governments of Canada, Sweden and Denmark were spending over 25% of their nations’ GDP.41

In 1976, after the brief experiment with civilian democracy, the military took control again. This led to a further consolidation of the austerity regime that the military had launched before the elections of 1973. Shortly after the 1976 coup, successful negotiations with the IMF expanded country’s foreign reserves (Veigel, 2010) and signalled to investors that the military junta was a ‘credible’ and ‘disciplined’ regime. Although the junta borrowed money heavily, the debt-to-GDP ratio was kept very low in this period due to low interest rates and substantial repayments. In 1975, Argentina’s disbursements on publicly guaranteed external debt totalled $492 million, and in 1976 Argentina made a total $1.9 billion repayment on its public debt (World Bank). The dictatorship borrowed excessively, forcing public companies into debt. Large portions of this debt never reached Argentina, though; it remained in corrupt officials’ bank accounts. For example, between July and November 1976, the central bank borrowed $30 million every month at a rate of 8.75% from Chase Manhattan Bank, while over the same period, the same bank was receiving monthly deposits of $22 million from Argentina on which the bank only paid 5.5% interest (Millet & Toussaint, 2004, pp. 24-25). In this respect, every cent borrowed under the military regime amounted to what is known in international law as

41 Gathered from WorldBank.com, data not available for Argentina after 1979, until 1987.
‘odious debt’. Demonstrably, the money was not spent on the Argentine people and every creditor that willingly lent to the dictatorship invested in enriching the military elite and its private sector cronies, not the state as such. Under the mainstream interpretation of international law’s doctrine of odious debt, none of this debt should be enforceable (Jayachandran & Kremer, 2006)

Argentina’s short-term external debt stocks tripled between 1976 and 1978 (De Beaufort Wijnholds, 2003), while the long-term debt stocks gradually increased. In late 1978, the junta negotiated a standby arrangement with the IMF and the country was able to go into surplus in its external account and overall balance of payments as a result of numerous fiscal reforms led by the Fund (Boughton, 2001). From 1976 to 1978, as external debt grew, the current account balance of Argentina as a percentage of GDP became positive. In terms of neoliberal orthodoxy, this was regarded as a sign that Argentina was on the right macro-economic track. In 1978, the sum of net exports of goods and services and the net ‘income’ of Argentina had reached 1.856 billion current US dollars (World Bank, 2017).

Despite running a positive financial balance, the domestic economy was suffering. Gross output was sinking while inflation reached 175% in 1978 (Boughton, 2001, p. 328). To fix the inflation problem, the government introduced tablita, an active crawling peg, in 1978. Instead of using the fiscal and monetary policies available, the central bank attempted to depreciate the value of the peso by binding it to the dollar again and announced new rates on a regular basis. Due to the high levels of inflation, the real exchange rate outpaced the rate of depreciation, which in turn caused overvaluation and ultimately a massive capital flight (De Pablo & Dornbusch, 1989). The result was the drastic deterioration of economic conditions in Argentina in which profitable capital accumulation was no longer possible. In terms of the argument developed in this thesis, these negative tendencies were all due to the ceding of monetary sovereignty on the part of the military junta.

The junta’s slogan was “hay que pasar de una economia de especulacion a una de produccion” (“we must go from an economy of speculation to one of production”). It brutally attacked inflation by freezing wages and by implementing a ‘rationalization scheme’ that targeted the payroll of the large state sector (Review, 1977). In 1977, after freezing all prices in the country for 121 days, the junta radically reformed the banking system as well. The reform completely liberalized interest rates, removed entry regulations in the banking sector and blocked the financing of government owned firms by the central bank (Calvo, 1986). This meant that the
government could only spend the pesos it taxed or had to borrow any excess; a reform that exemplified the internal fiscal discipline that we mentioned in the previous section.

Having turned its back on the option to create/print interest-free money, the government needed another source of capital flow. Private international banks stepped up to fill this gap in the market. High liquidity in the international capital markets meant very low, close to zero, real interest rates that were tied to US nominal rates. Argentina and other developing countries ‘took advantage of’ the low interest rates. This imposed financial integration and increased indebtedness. ‘Releasing’ central banks from the influence of politics rendered them subject to ‘credibility’ in the eyes of shareholders/investors. This move also incurred a central shift in the power of the sovereign, from the governmental decision-making system to submitting to the conditions dictated by bondholders and credibility rating agents. The Central Bank of Argentina (BCRA) became the most limited central bank in the region in terms of its ability to provide monetary assistance to the government or financial intermediaries after the implementation of the rule in the 1980s (Jácime, 2001, p. 11). All of this was self-imposed, although external trends tended to reinforce it.

One such external trend was the obsession with curbing inflation that took hold in the US in 1979. In that year, the Federal Reserve increased the nominal rates from 9% to 20% (Lazzarato, 2012, p. 26). Such a sharp increase retracted the US dollar from the rest of the world back into FED, which in turn reduced inflation levels in the US. The capital shortages this created elsewhere amplified other countries’ interest rates. The previously low interest rates on bank loans to Argentina skyrocketed overnight because these loans were de facto tied to the US nominal rates. Interest payments on external debt as percent of GNI increased from 1.4% in 1979 to 3% in 1980. In current US dollars, this meant a sharp increase from $967 million to $2.3 billion in interest payments in a year (World Bank, 2017).

Similar huge leaps in interest-rate occurred in the account of every developing country in 1979 and created ripple effects. As the dollar gained value, indebted countries had to procure more of their currency to pay the creditors, and developing countries were forced to produce and export more to pay for the suddenly increased debt. This flooded the markets with raw materials and agricultural products, which were the main export sectors of Argentina, and caused steep falls in prices. In turn, Latin American countries borrowed more to pay their debts. By 1981, Latin America borrowed $100.7 billion from commercial banks and the IMF. Large amounts of credit were being used for the payment of the outstanding debt. Between 1982 and 1991 the continent paid back $240 billion but already indebted of over $450 billion (Isla, 1993). The
tension created by the unending debt payments led to another wave of sovereign defaults in 1982. Inevitably, heavily indebted Latin American countries announced that they could no longer continue servicing their debt. Mexico capitulated first in 1982 and Argentina and Brazil rapidly followed suit.

The bottom line of the whole process traced in this section are the results of the financialization of sovereign debt in Argentina. Within almost a decade, the country, with its vast resources and human capital, had exhausted itself in order to reduce inflation and pay off government debt. And yet, the end result was another debt crisis that led to the 1982 default. This period of Argentinian history highlights the inherent ineptness of exchange rate and inflation control policies at stabilising debt levels and improving the general health of the economy. As we outlined in the theoretical chapter, inflation is a symptom of an underlying structural problem. Policies that are only aimed at fighting inflation, like freezing wages and interest rates, do not help with structural problems. The macroeconomic understanding that was precipitated with theoretical changes in the 1960s created the policies we analysed in this section. It is worth bearing in mind that even today, after almost 50 years of such flawed policies, inflation targeting is the dominant regime in the world.

5.4 The new wave of orderly defaults: 1980–1990

We come now to one of the main purposes of this chapter, namely to contrast the default of the 1980s with that of 2001. The internalisation of debt and neoliberal discipline discussed above eventually gave rise by 1980 to a new wave of defaults in the world. What was different between this new wave and earlier waves was the way in which countries defaulted. Instead of cutting payments altogether, in the new wave, some of the defaulters continued reimbursing creditors as much as they could. In previous defaults, we saw how defaulters had to endure the disadvantages of defaulting, such as limited access to debt markets, but they also enjoyed the large amounts of capital released from repayments, and advantageous restructuring plans. In the new wave, the defaulters suffered all the drawbacks, without any of the gains. I call these ‘orderly’ defaults, in contrast to ‘strategic’ defaults, building upon what Buiter and Rahbari (2013) established. The main difference between these types of defaults is the approach of the government towards the default before and after it happened. To put very simply, if the government attempts to avoid the default as it happens and tries to work with creditors and
according to creditor’s demands to control the impact of the default, I call it an orderly default, and 1982 Argentine default is the perfect example.

The military held power until 1982 in Argentina and successfully followed the IMF prescribed macroeconomic stabilization programmes. The defining moment was the independence of the central bank. When the junta blocked the central bank — the only body that could supply the market with net financial assets (i.e. net savings in pesos) — from employing any fiscal intervention to help with the crisis, private liquidity was squeezed out of the economy. Domestic savings diminished, and the country fell into a demand-draining fiscal drag. Concurrently, the government sector shrunk, expenditure on welfare reduced even further, and mass privatizations ensured that market prices dictated resource allocation in the country. IMF and self-imposed structural adjustment programmes were implemented throughout the entire continent of Latin America and resulted in the ‘lost decade’ of the 1980s, which was marked by negative per capita growth and a significant increase in poverty (Killick, 1990; O’Hara, 2002, p. 1117).

The headcount poverty rate in Latin America grew from an average of 26.5% in 1980 to 31% in 1989 (Psacharopoulos, Morley, Fiszbein, Lee, & Wood, 1997, p. 52). At the same time, inequality grew from 50.1 on the Gini scale in 1980 to 51.9 in 1992 (Gasparini & Lustig, 2011). The lost decade in Latin America witnessed a number of sovereign debt crisis and a series of defaults. First Mexico in 1982 declared a unilateral moratorium of 90 days and suspended payment to its creditors, then Argentina followed suit and approached the IMF for financial assistance (De Beaufort Wijnholds, 2003). In 1982, government officials invited IMF staff to Buenos Aires for a review of the economy in which they found serious structural problems (De Beaufort Wijnholds, 2003). For the IMF, the failure of the Argentinian government to address these meant that no agreement was possible until 1984.

The literature on the sovereign debt crises in Latin America in the 1980s tells a straightforward story of insolvency triggered by adverse shocks. The 1980s is hence usually depicted as yet another chapter in the history of systemic crises (M. Bordo & Eichengreen, 1999; Reinhart & Rogoff, 2011). Most empirical work on this period follows the same way of thinking. For example, Kaminsky and Vega-Garcia (2016) identify the crisis as the suspension of amortization payments and outright defaults. However, this is not an entirely accurate description of the 1980s defaults.

When we look at financial flows, it can be seen that this crisis was different from others in the way sovereign countries responded. At the outset, there was no major change in the disbursements on publicly guaranteed external debt. In fact, Argentina and Brazil repaid larger
amounts of debt while they were in default in 1982 than during the previous year. In 1981, Argentina’s total disbursement on its long-term debt was $1.908 billion and in 1982 this figure reached $4.765 billion. The year it defaulted, in 1982, Argentina paid 2.5 times more than it had paid in the previous year. For other Latin American countries, there was no drastic change in the total disbursement on debt – repayments continued as usual. For example, Mexico’s payment decreased only marginally from $13.326 billion in 1981 to $11.923 billion in 1982. Brazil paid $11.36 billion in 1982 and although this amount dropped to $7.722 billion in 1983, the country paid back $10.491 billion in 1984 (World Bank, 2017). There was no debt forgiveness or debt reduction for these countries, and until the end of the decade none of the above-mentioned countries received a haircut (World Bank, 2017). Although debt repayments continued to fall in the mid-1980s, they never stopped. In contrast, during the 1930s crisis for example, we saw a total suspension of repayments after a country was declared in default. In the 1980s, all these countries were officially in default and the aftermath of the default was as painful as, if not more than, the 1930s defaults. Argentina had very limited access to credit and the available credit was tied to further austerity programmes. Moreover, between 1983 and 1989 the annualized growth of GDP-per-capita was -1.51% and poverty rate increased from 19.1% to 47.3% (Braun, 2006). In this period, large fiscal deficits in a de facto crawling peg regime were causing harmful inflation and still the debt was growing due to accumulation of arrears. Similar conditions could be observed throughout the rest of the continent. The defaults caused serious downturns, and yet all the defaulting countries continued with their repayment.

This was a radical departure from other sovereign debt crises we have analysed so far. The 1982 default was neither a strategic default where the government took advantage of the released capital, nor a case of bankruptcy where repayments stop because of total insolvency. There is no specific term for this type of default in the literature. The closest term available is ‘orderly default’, which became popular after the Greek default in 2012.42 This type of default is managed by the creditors and the ex ante aim is to avert the total insolvency of the debtor country. The debtor receives enough funds to float somewhere in between failure to pay and full reimbursement. This means that the country neither defaults nor fully repays.

42 Before it was declared in default by CRAs in December 2012, the creditors proactively engineered a methodical debt restructuring process for Greece and the largest bond swap in the history was carried out in 2013 (Watts, 2012). Although being declared in default after missing a payment, Greece continued repayments and received another bailout package from the IMF. The bond swap enabled another postponement. The newspapers and politicians dubbed this process ‘an orderly default’. In contrast, for example, Iceland defaulted on its debt in 2008 and in two separate referendums, Icelandic citizens voted to not to repay foreign creditors (BBC, 2011). This clear example of strategic default led to 3% growth in Iceland while the Eurozone shrank by 0.3% in the same year.
What were the consequences of such an *orderly* default in the case of Argentina? One possibility is that the markets may rally behind the country that shows an effort to repay initially, but with the deteriorating prosperity levels, that support usually does not last. Also, the government may get immediate temporary access to debt, but this does not extend in the long run. Due to the ambiguity that resides in *orderly* defaults, we should assume that the impact of this type of default is multifaceted and that the impact may change over time. The initial year of default and the following years might see different responses to the news of an inadvertent default. What we need is a method that can graphically express the direction of the relationships between various variables over time. In this case, the variables of interest are Argentina’s debt service on external debt in current US dollars (DEBT), general government final consumption expenditure in current US dollars (CONS), unemployment level (UNEMP), and domestic credit to private sector by banks as a percentage of GDP (CREDIT). DEBT is the independent variable, while CONS, UNEMP and CREDIT are the dependent variables. We will be looking at the responses of these dependent variables on shocks to DEBT between 1982 and 1989. The four-dimensional vector autoregression (VAR) is the baseline regression we built for the IRFs, which will measure the impact of any increase or decrease in the debt servicing levels.

We can display and evaluate the dynamic relationship between these variables by drawing impulse response functions (IRFs) that are based upon the moving-average representation of the VAR model. To emphasize, we are building a reduced-form model and not a structural model. We are not interested in characterising structural hypotheses. This analysis will only distinguish the dynamic relationships between the four indicators. The VAR is especially useful for our study as it helps us to avoid spurious a priori constraints that the exogeneity of sovereign debt can cause in domestic econometric equations. What this means is that sovereign debt has a predetermined value, but at the same time, other indicators depend on the sovereign debt levels. The IRFs will be the representations of VAR and the graphs will display the direction and magnitude of response of one variable to another, specifically the response of a variable to a 1% standard deviation shock to another variable. This way, we can see how each variable reacts over time to a rapid fluctuation (‘shock’) in debt repayments, which in this case were made under an *orderly* sovereign default.

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43 McMillin and Koray (1990) conducted a similar analysis on the relationship between debt and exchange rates and explain in detail why reduced-form VAR provides many advantages for such a study.

44 See the Appendix for the simultaneous matrices of the coefficients that represent shocks.
Figure 5.10 presents the IRF results. The x-axis represents time in years after the initial shock. The y-axis represents the variable’s response to a shock in DEBT over time; note that CREDIT and UNEMP are denominated as percentage points, while CONS is in billion US dollars. The top left figure shows the response of the government’s final consumption to a positive shock (i.e. a sudden increase) in the government’s debt servicing, the top right shows the response of domestic credit provided by private banks to a positive shock to DEBT and the bottom left figure displays the response of unemployment to a shock to DEBT. We will use the same variables and the same matrices to analyse the impact of the 2001 default in the next part of the chapter.

A quick survey of the three figures suggests that during the insolvency-led default in the 1982-89 era, the responses of unemployment, government consumption and domestic credit are sizeable. The responses are downward trending for CONS and CREDIT, while UNEMP’s response displays sharp turns. To clarify, a downward trend implies that, after a substantial amount of debt repayments, there was a decrease in the indicator for the next five years; an upturn indicates the opposite; and wide fluctuation mean that the impact that the debt repayments had on that indicator changed with time. These changes are not actual figures, they are the results of the hypothetical model I built based on the real figures. The difference is, the model calculates the impact of debt repayments and how its influence changes over time.
Looking closer at the CONS’s response, we see that the response of the government’s final consumption remains negative and initially causes an approximate $400,000 decrease per 1% standard deviation change in DEBT, then stabilises at around $900,000 between periods 2 to 3 and then causes further decline after the third year when it reaches $1.3 million. This is in line with our argument that an increase in debt repayments exponentially decreases government consumption in the mid- to long-run. The effect of a 1% standard deviation positive shock in debt repayment reaches its maximum impact four years after the shock and then slowly stabilizes. Although this response is consistent with our reasoning, the magnitude of the impact is nevertheless remarkable. This gives further validation to the hypothesis that large debt repayments persistently and negatively spur government spending and the main effect of debt disbursements reaches its full potential only after four years. The year of repayment has a very minor effect on government consumption and the impact exponentially increases.

Domestic credit provided by banks appears to respond by following a persisting upward trend in the allocation of credit to the Argentine economy, but the initial effect is negative, and it climbs up to positive only after the end of the second year. The upward trend is in line with the reasoning we developed in this study; this observation is due to the decrease of high-powered money supplied by the government. When government spending decreases, the private sector goes into exactly that much deficit (minus any trade surplus). The initial 1% decrease is not unexpected either. This must be due to the government’s reliance on private banks to finance the deficit caused by the debt repayments. We know that the Argentine government did not use overt monetary financing to match its deficit spending. Instead, they issued bonds to private banks and bond markets. C. A. Rodríguez and Faini (1991, p. 6) stated that in the 1980s the Central Bank of Argentina became the borrower of about 80% of all lending power of the private banks.

Combining this information with our IRF results, we can conclude that the central bank crowded out the available funds in private banks in the first two years after a large debt repayment. By crowding out, I mean the government absorbed all the available funds at the private banks, which decreased the credit available to the private sector and slowed down investments. However, since government consumption continued to decrease (as shown in the first IRF figure), the demand for credit from the private sector must have increased even further after three years. This translates into extremely high interest rates. In 1982, the deposit interest rate in Argentina was 126%, and this rate soared to 630% in 1985 (TradingEconomics.com). Rising interest rates equate to price increases, and the cost of credit is reflected in the price of all goods and services. Higher prices mean inflation, which explains the steady increase in
inflation between 1982 and 1985, which ended with the hyper-inflation of 1990. These two graphs validate our assumptions on the relationship between government consumption and economic stability in fixed-exchange rate regimes. We can clearly see the snare the government put itself into in 1982 by continuing the debt repayments in a fixed exchange rate system while in default.

As we move onto the last graph, it can be observed that a shock in the sovereign debt repayments led to a somewhat vacillating but persistently positive response in the unemployment rate. The initial response to a shock in DEBT is a remarkable 1.05% increase in the unemployment rate, which slightly decreases to a 0.92% increase in the second year but climbs up to 1.14% in the third year and then slowly stabilizes after the fourth year, but remains significant in the fifth year too. An orderly default is estimated to lead to over five years of higher levels of unemployment. This is an expected result given the direct relationship between unemployment and government spending. A decrease in government spending lowers the relative price of goods and services and dampens labour demand, hence increasing unemployment. Since Argentina was operating in a fixed exchange rate system, any fiscally expansionary move would have had to be financed by external debt, which would have resulted in higher spreads on the government bonds. Instead, the government clung to contractionary policies. Our IRF results contribute to the ongoing debate on the positive or negative impact of an increase in sovereign debt levels on unemployment (Bianchi, Ottonello, & Presno, 2016). Responses of both CONS and UNEMP to DEBT amplifying in the third and fourth periods in an orderly default is a particularly significant finding. This means that when analysing large sovereign debt repayments’ effect on the economy, we should not only look at how the country was affected in that year, but we should also focus on how markets and households were affected 3-4 years after the repayment.

The 1982 default had clear adverse and very complex effects on the economy. Although the results we obtained from the IRFs are broadly in line with the understanding we developed in this study, the results are quite ‘disorderly’. Ironically, this orderly default resulted in disorderly consequences. The frenzied increase in unemployment and the crowding out of much-needed domestic credit from private banks tells us that the orderly default was only advantageous for creditors. For Argentina, the 1982 default caused only disorder. While a graph or trend of these
variables could give us an idea of how they unfolded, the IRFs specifically show how these individual variables respond to shocks in the economy reflected in debt defaulting over time.\textsuperscript{45}

The 1980s debt crisis was the first after the internalization of discipline and we can see it reflected in the results. With no debt reduction, reduced access to capital markets and limited conditional credit, there was no reason to continue repayments after being declared in default. Consent to all the disadvantages of a sovereign default but not taking advantage of the process can only be explained by a submission to what we called the internal disciplining mechanism. The Argentina of 1982 was suffering under both the strains of the debt it owed to the IMF and other international creditors, and the strains that it put on itself. For many scholars this period in the 1980s shows how far the state retreated globally (Schuster, Schmitt, & Traub, 2013), how the free-market and supra-national institutions took control of the economy (Overbeek, 2002), and how the concept of sovereignty was ‘unbundled’ in the world (Hudson, 2000).

In the midst of all these, in April 1982, the military government decided to reclaim the contested Falkland Islands for Buenos Aires. The sudden move of the military government to invade the islands was unexpected since the state was not capable of financing a war at the time. The internal political and economic struggles of Argentina were at their peak, and as Zakaria (1999, p. 38) puts it,

\begin{quote}
"The stronger the state, the greater its ability to extract national power for its ends... Nations try to expand their political interests abroad when central decision-makers perceive a relative increase in the state’s power".
\end{quote}

Clearly, in 1982 Argentina was not powerful and could not extract its national power. From a realist perspective, this was one of the worst possible times to come into conflict with a country like the United Kingdom. The result of the war was a massive depreciation of the peso and more debt due to external arrears. Although one reason why the military government chose to wage this peculiar war was to distract people from the unfolding economic crisis, one might still ask how did a ‘disciplined’ government wage war against a global power? Does this contradict our depiction of Argentina as a country that submitted to international powers and their disciplinary actions?

The short answer to this question is, no. When we mentioned the fiscal disciplining of Argentina, we emphasized the ‘internal’ aspect of this disciplining. There is no power over any

\textsuperscript{45} All results are statistically significant and within the 2 standard deviation band around the mean; see the appendix for the representation of the simultaneous matrices of the VAR I used.
sovereign; the state never ‘unbundled’ or retreated in Argentina. It is a misconception that being indebted weakens the state. When scholars talk about how “the often weak and debt-ridden economies of many third world countries leave them vulnerable and dependent on economic forces and relations over which they have little, if any, control” (Held, 1992, p. 32), they ignore the capacity of newly industrialized and heavily indebted countries, such as Singapore and Taiwan, to influence and form transnational networks; how unexpected waves of socialism captured debt-ridden Latin American countries and challenged international forces many times, the latest being in 2003; and how exceedingly indebted countries, like Japan and the US, are also major global creditors. Being indebted does not and cannot weaken a modern, fiat currency-issuing sovereign. The Argentine state can and could always buy anything that is for sale within the country.

States’ fiscal capability should be interpreted in this way. The Argentine government was able to pay for high-priced policies like war, state repression and economic reforms in the midst of economic problems in the 1980s because the state can always afford anything in its own currency. In order to mobilize its power in 1981, the exchange rate regime was changed to a freely falling/floating regime. The instant the junta sought to mobilize people and resources, it switched back to a freely falling exchange rate regime. In 1984, after the failure of the war, the country introduced the ‘Austral Plan’. This new programme froze prices and wages, halted all increase in the monetary base and made further spending cuts. The plan ended the inflation in an instant, but it also tied the government’s hands in a way that it could no longer interfere with any fiscal or monetary practice. Therefore, when we talk about how the total public debt of Argentina increased from $8 billion to $45 billion in seven years under the military (Cibils, 2006), we should not interpret this as a sign of a weakened sovereign but as a change in the economic reality within which the state apparatus works. By the same token, we should interpret the rise in cross-border bank lending between 1980 and 1990 from $324 billion to $7.5 trillion (W. I. Robinson, 2004, p. 24) as an upsurge maintained by states internationally. From this perspective, we can better grasp the nature of internal disciplining and voluntary constraints on sovereigns.

The 1982 Argentine default lasted until 1993. Between 1982 and 1993, the country’s total disbursements on publicly guaranteed external debt in current US dollars came to $29.695 billion. The limited credit available was very expensive since officially the country was in default. The average interest rate on new external debt commitments in the 1980s was 10.3% (World Bank). High yields attracted speculative investments that brought immediate liquidity to the economy, but due to the volatility of these investments, the influx of money did not
significantly encourage productive investment (Cantamutto & Ozarow, 2016). When interest rates go beyond a certain point, hedge fund speculation on sovereign debt takes over any meaningful investment. Only a particular group of creditors, who actively seek high-risk investments, were interested in Argentina after the default. The only persistent source of credit was the IMF, as the Fund wanted to keep its ‘poster child’ afloat (L. Taylor, 2001). In 1988, the Fund refused to resume lending as the tension that the Austral Plan put on the country was becoming too much for the economy to bear. The year 1989 was one of hyperinflation, massive riots and looting in big cities. In order to continue repayments, the government froze deposits in local banks in 1989, and technically confiscated people’s savings accounts and used the money to repay a part of the government debt (Crowe, Johnson, Ostry, & Zettelmeyer, 2010, p. 546). Eventually, in 1989, the president resigned, and Carlos Menem (president, between 1989 and 1999) was elected, technically ending Argentina’s lost decade.

5.5 Restricting the Sovereign: 1990–2000

Up to this point, we have investigated every major event, regime and movement that had an impact on Argentina’s position in the international debt markets in the last two centuries. The 1990s do not present anything we have not analysed yet. The same policies were recycled again. In order to restore ties with the IMF and to defeat inflation once more, Menem tied the peso to the US dollar at a one-to-one rate in 1991. The change in the exchange rate regime was a part of the deal that took Argentina out of default (Buera & Nicolini, 2010). The change meant that the money supply in the country was limited to the amount of dollars in the central bank. Under this deal, the IMF and international creditors returned to Argentina and the capital inflow led to an investment boom that lasted until 1996. Figure 5.11 displays the boom, along with some other crucial indicators. The bars show the GDP in current US dollars, the shaded area represents the gross savings as a percentage of GDP, the line with markers signifies the average gross capital formation in Argentina, and the plain line represents total unemployment as a percentage of the total labour force between 1988 and 2001. There are two vertical value axes on the graph; one for gross savings, unemployment and capital formation, which are represented as a percentage of GDP, and one for GDP in current US dollars. The graph shows the increase of GDP from $76.6 billion in 1989 to $228.7 billion in 1992, which was an extraordinary achievement. However, in the same period, gross savings as a percentage of GDP decreased; average gross capital formation slightly decreased; and total unemployment soared.
The return to a strict fixed exchange regime was assumed to be vital to regenerate the credibility of the government and revive investor confidence in Argentina. Soon after their implementation, the counter-inflationary policies were so successful that, in 1995 Argentina met all the key Maastricht criteria on inflation, government budget deficit, government debt-to-GDP ratio, exchange rate stability and long-term interest rates for entry into the European Monetary Union (Esfahani, Facchini, & Hewings, 2011, p. 236). This accelerated the inflow of capital in various forms. One major form of capital was in ‘Brady Bonds’. These bonds were initially designed by the United States Treasury Secretary, Nicholas F. Brady in 1989 to tackle the sovereign debt crisis in Mexico and aimed at restructuring commercial bank loans. Securing an IMF extended loan agreement was considered a precondition for entering the Brady debt-reduction programme (G. Marx, 1992). The agreement was finalized in Argentina in 1992 and approximately 37% of Argentina’s commercial current debt was exchanged for a combination of discount bonds at market interest rates (G. Marx, 1992). Another condition for eligibility to convert current debt to Brady Bonds was to block any internal mechanism that depended on printing money. The Economist (The Economist, 2002b) said that under this arrangement, Argentina “instead of printing money, as in the bad old days, printed bonds to finance its fiscal deficit.”

Large capital inflows under a fixed exchange rate regime decrease foreign investors’ risk, but do not eliminate it. The promise not to print money transfers the risk that is supposed to be taken by speculators and creditors to the government. The growth of the economy under the

Sources: Thomson Reuters Dataset, Bloomberg Terminal, World Bank
strict peg pushed out the current account deficit and this deficit had to be financed by capital flows. Figure 5.12 shows the external debt stocks represented in bars, and the current account balance as a percentage of GDP represented in a line. It can be seen here that an important portion of the capital inflow was in the form of external debt issued by the government. The external debt stocks increased at a steady rate after 1993 and this increase speeded up after 1996. More capital in circulation means accelerating money supply. However, looking back at Figure 5.11, we see that the rise in unemployment after 1998 was accompanied by a decrease in GDP. This means that growth in nominal demand must have surpassed the real capacity of the domestic economy somewhere between 1996 and 1998. Normally, we can see this expressed as inflation, but inflation was kept under control by the currency board. The real value of the peso was supposed to fall, especially after 1998, but it was kept anchored by the government. Seeing this, speculators began to sell the pesos they were holding in exchange of dollars at a one-to-one ratio. Because of the way capital flowed in, it began to leak.

**Figure 5. 12 External debt and current account balance**

As we saw in the 1960s and 1980s with the shift to a fixed exchange-rate regime in Argentina, the strict peg induced privatisation of key state-owned assets, cuts to welfare programmes, and the deregulation of both the banking and financial sectors. When governments decide to forfeit their currency sovereignty, generally, they also follow neoliberal programmes. This is not unique to Argentina. Mexico fixed its peso to the dollar in 1988, followed by far-reaching privatisations, and the system collapsed in 1994 with a caustic crisis. In Turkey, full capital
account liberalisation came before the pegging of the lira and the crawling-band regime could be sustained only for two years between 1994 and 1996, and it also ended with a deep economic crisis in 1996. There are many more examples from different periods, but the extent of privatisation programmes under Menem was among the deepest and widest ever implemented in the world (Önis, 2006). Furthermore, during the sale of state-owned companies, the government agreed to take its own bonds as a mean of payment (Buera & Nicolini, 2010). This kept the apparent debt-to-GDP ratio lower than it actually was by extinguishing outstanding bonds. In other words, the government put itself in a situation where it had to issue foreign currency-denominated debt, and then traded its real assets for these bonds. Ironically, Menem called the sale of all national enterprises the “Shock Programme”, much alike Klein’s (2007) “Shock Doctrine”.

This new exchange rate system in Argentina had first been tested on the Mexican peso during the 1994 crisis. The economic slow-down, decreasing wages and rising unemployment created a deflationary problem. The artificially strong peso forced the country into large trade deficits, which is dangerous for a country that depends on foreign exchange. The East Asian financial crisis that began in 1997 pushed the fragile system in Argentina to its limits. The IMF’s stand on contractionary fiscal policy did not change in this period even though they were clearly inciting a substantial slow-down in every developing country that adopted one (Stiglitz, 2002). When the crisis spread to Russia and the Brazilian currency was severely depreciated in 1998, the collapse of the Argentinian economic structure also became inevitable. The IMF had to lend increasingly greater amounts to prevent a default. Some economists (Feldstein, 2002a) already began wondering why the IMF continued supporting Argentina and its fixed exchange rate in this period. We have to remember that Argentina was still the poster-child of the success of neoliberal policies and the IMF was still advertising how its borrowers did not default on their loans in the mid-1990s (Feldstein, 2002b). It was only natural that the Fund attempted to keep the country afloat to ensure that Argentina would not default and prove the strength of its treatment.

By 1999, it became obvious that the one-to-one peso-dollar parity could not be sustained. The rigid system broke down in 1998 and Menem was ousted before the end of his term in 1999.

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46 The amount provided by the IMF for the principal and interest payments in one year reached over $5 billion in 1998. While in the English-speaking media this was called a ‘bailout’, in the Spanish speaking media these payments were dubbed as blindaje, ‘armour’. While bailout has a negative connotation, blindaje is more affirmative. In my brief examination of the Argentine media in this period, I saw that the increasing sovereign debt levels were appreciated as a confirmation of Argentina’s trustworthiness, not as a potential problem.
That year, the foreign exchange reserves of Argentina, including gold, were $26.35 billion, but by 2002 this had dropped to $10.49 billion.\(^{47}\) The government ran out of foreign exchange reserves while trying to keep the peg fixed. The state had decided not to interfere in the growing disparity between the real and the pegged value of peso. In the absence of a regulatory body, private banks started charging over 25% interest rates on dollars lent (The Economist, 2002a). The first act of the new president, Fernando de la Rúa (president, between 1999 and 2001), was to seek support from the IMF and announce $1.4 billion in cuts to government spending. At this point, the spread on Argentina’s bonds was 610 basis points higher than the spread on comparable US treasury bonds, while the external debt-to-GDP ratio was around 50%. The IMF advised the new administration to focus on balancing the budget by intensifying existing austerity measures. Just before the end of the century, the new government announced a $40 billion multilateral assistance package organized by private lenders, Spain, the World Bank and the Inter-American Development Bank (J. F. Hornbeck & Marshal, 2002).

Argentina devoted the second half of the 20th century to paying its debt and keeping the inflation levels low. The first sovereign debt restructuring mechanism, the Paris Club, was established in 1956 to restructure Argentina’s debt. The initial 1956 and the following 1963 restructurings failed to stabilize the debt problem; they ultimately aggravated the debt crisis, and Argentina relapsed back into the restructuring process. Meanwhile, the conjuncture was evolving in the 1960s and a new theoretical school that supported perpetual austerity was emerging. With the junta’s effective deployment of austerity, Argentina became the first case of a successful restructuring by the Paris Club. After the 1965 bailout from the Paris Club, Argentina fully paid its debt until 1982. We analysed this 20-year period as a transitionary episode where the form of financial discipline changed.

The transition in Argentina began in 1964 with the changes in exchange rate regime when the military government pegged the peso to the US dollar at a pre-announced rate with wide-ranging controls on the exchange rate. Even though after the collapse of Bretton Woods system governments did not have to defend a fixed parity against a foreign currency, Argentina and many other countries surrendered their fiscal and monetary powers voluntarily. The fiscal constrictions were internalized by making the state revenue-constrained; the government could only spend what it earned in dollars.

\(^{47}\) Data gathered from ‘theglobaleconomy.com’, available at: www.theglobaleconomy.com/Argentina/Reserves/
As a result, the state was not only stripped off its monetary apparatuses in the 1970s, but state intervention itself was demonized. Under the management of a revenue-constrained state, even a moderate attempt to redistribute wealth is not acceptable, due to its inflationary tendencies. The emerging neoliberal theories popularized the argument that government spending causes instability by creating inflation. The idea that there can be too much money and the ‘excess’ causes inflation placed money as an external object to the state. When the state forfeited its authority to create money, money became an object that could only be arbitrated by monetary policies. The rise of fixed exchange rate regimes was supposed to be a permanent solution, but as we have seen in our analysis, they were not. Sticking to frugal policies and punctually repaying its debt for 20 years brought low growth to Argentina (an average of 1.91% yearly between 1965 and 1985, with high volatility between one year to another) and made a sovereign default inevitable. Due to insolvency, Argentina could no longer pay all of its due debt anymore in 1982 and was declared in default, but the military government continued straining the economy to pay the debt as much as it can. We have called this an ‘orderly default’ and scrutinized its impact on the economy.

The disastrous policies of successive military governments were catastrophic for Argentina. Unemployment rose from 3% in 1980 to 20% in 2001, the number of people in extreme poverty rose from 200,000 to 5,000,000 and functional illiteracy increased by 5% to 32% in this period (Gabetta, 2002). As the new governments tried to fight inflation with more integration and privatization in the country, the asymmetrical distribution of wealth increased and concentration of wealth reached new levels; from 1980 to 1997, the richest 10% of the urban population in Argentina increased its share of national income from 30% to 36% (ECLAC, 1998). Similar levels of degradation happened across the continent. Furthermore, between 1980 and 2000, Latin America’s share of world trade fell from 6% to 3% (J. Wilkie, 1995), while the total volume of exports to the rest of the world increased. The Human Development Index ranking decreased for Argentina, along with that of Chile, Uruguay, Costa Rica, Mexico, Panama, Venezuela, Colombia, Peru, Nicaragua, Ecuador, Guatemala, Bolivia, Honduras, El Salvador and Brazil (W. I. Robinson, 2008, p. 254). Ultimately, the increasing number of financial crises created a culture of permanent emergency where cutting government spending became the obvious and legitimate solution. This means that, as government spending decreases, unemployment increases and aggregate demand decreases, which causes the tax revenue to dwindle and necessitates even harsher austerity measures for the government to balance its budgets. This vicious cycle may seem unbreakable, but the next part of this chapter
will investigate how Argentina cracked the vicious sequence of austerity with a strategic default.

5.6 From an orderly to a strategic default: 2000—2008

Argentina entered the new millennium in the midst of an economic recession. Although De la Rúa’s election and the ongoing talks with the IMF triggered widespread optimism in the markets, the GDP contracted by 3.4% in 1999. In furtherance of the IMF deal and to instil confidence into private investors’, the new government realigned its policies to ensure that there was no problem with debt repayments. The first move was a $1.4 billion cut to government spending in the last weeks of 1999 (Krauss, 2000). Media coverage (The Economist, 2000) and IMF reports (IMF, 2003) paid particular attention to the persistent and widening current account deficits in Argentina. Yet, this seems biased, because Argentina had been recording government budget surpluses since 1996; in 1999 this amount equalled to 3% of the country’s GDP. As expected, however, unemployment increased to historic levels in this period and in 1999 unemployment was at 16% in Argentina. Cutting government spending was not feasible any more. Since the convertibility plan prevented the government from expanding the money supply, printing paper notes to pay the debt was not an option either. The new management had one option left to ‘make money’: increasing tax rates. A $2 billion in tax increase and a further $938 million in government spending cuts was announced in early 2000.

This move was supposed to reinvigorate foreign capital inflows and help with the external imbalance so that the convertibility plan could be sustained. Although the fixed peg was putting immense pressure on the economy due to the overvalued peso, the government was determined to keep it. The new government even announced that Argentina was going to peg the peso to euro in addition to the US dollar (The New York Times, 2001). After the implementation of the austerity programme, a three-year $7.2 billion stand-by agreement with the IMF was signed. More budget cuts were announced in May, sparking a massive protest by 20,000 people. Troubled with high unemployment and a deepening recession, Argentina was paying up to 900 basis points more than the US Treasury to borrow, and the average interest on new external debt commitment was 9.9%. As a result, foreign debt piled up to $128 billion and De la Rúa’s administration reacted by freezing all government spending, slashing retirement benefits and announcing massive cuts in education (The Guardian, 2001). All these policies purposely tried to contract the domestic economy and reduce imports, so that the reserve deposits of dollars could build up and the debt could be paid. However, completely sealing off the government’s
contribution to the spending capacity in the economy dampened the aggregate demand and the real output. In 2000, the household consumption expenditure fell below $200 billion\(^48\). The IMF assumed that the economy would grow by 3.5% in 2000 when the bail-out package was signed, but in reality, the GDP contracted by 0.8%, and there was no significant increase in capital inflows into the country. International financiers did not want to invest in a country with a deteriorating labour market and falling living standards. Notwithstanding, the IMF announced a $40 billion financial aid package in December 2000 (Calcagno, Manuelito, & Titelman, 2003).

Declining economic health and a slackening dollar inflow increased the premiums on new credit that Argentina had access to. By July, the spread on Argentine bonds expanded to 1300 basis points higher than the US Treasuries (J. F. Hornbeck & Marshal, 2002). The high interest rates did not only make access to future credit more expensive, the government was also making agreements with creditors and restructuring its short-term debt with long-term maturity and higher interest debt (J. F. Hornbeck & Marshal, 2002). In addition to these temporary debt relief bids, the government also changed prudential regulation rules to reduce the liquidity requirements of banks and demanded local banks to buy bonds to satisfy lowered liquidity requirements (D'Amato, Burdisso, & Cohen Sabban, 2002). Taking these extremely high premium prices on those bonds into account, this move exposed local banks to the increasing sovereign debt problem and amplified the possibility of a liquidity shortage. Argentine people had already experienced the seizure of their bank deposits in 1989 when the government confiscated their savings accounts to repay a part of the government debt. In a sense, every aspect of life was yet again absorb into solving the sovereign debt: Savings accounts were again seized as debt repayment tools, rules and regulations became ways to decrease the apparent debt level, pensions became as risky as government bonds, and everyday headlines were about the rising debt problem.\(^49\) The constant reminders of the fear of a default increased the risk of a run on the banks, and consequently a sovereign default.

In July 2001, all the CRAs downgraded Argentina and premiums increased to 16\% higher than the US Treasuries. As a response, the government passed the ‘zero deficit law’ at the end of July, which aimed at eliminating deficit spending entirely (R. Di Tella, Pill, & Vogel, 2005, p.\(^\text{48}\) This amount is in current US dollars. Since Argentina was maintaining keeping the 1-to-1 ratio with the dollar in this period, this value is over-estimated. The real value of the peso was much lower than the dollar. Two years later, in 2002, when the peso floated the ratio became 1-to -3.8 in five months. This value still shows the degree of reduction in the household spending level though.

\(^{49}\) Based upon my observation of El Cronista newspaper; archived issues are available at: www.cronista.com/.
The new bill slashed salaries and pensions by 13% even though Argentina was still running trade and capital account surpluses in 2001. In August, another set of talks with the IMF began with the objective to extend and increase the existing standby loan agreement. Nonetheless, the bank run began at the end of November when Argentine people withdrew $1.2 billion from their bank accounts to convert pesos into dollars. On 2 December, De la Rúa enacted the corralito, freezing all bank accounts for a year and allowing only $250 in cash to be withdrawn from banks. Four days later, the government announced that they would be transforming fixed-term deposits in private pension funds into government-backed loans and bonds (R. Di Tella et al., 2005, p. 227). On 17 December, the government announced further cuts of 20% in the 2002 budget. De la Rúa resigned four days later on 21 December, after 28 people lost their lives in massive protests against the cuts. Two days later, Argentina defaulted on its $132 billion public debt, - one seventh of all money borrowed by the developing countries (Simpson, 2001). The story heretofore unfolded the way 1982 default occurred. It is the story of insolvency after the collapse of exports and FDI, where investors charge extremely high yields on the credit available to a government that runs a strict exchange rate regime. Today in hindsight, economists (Mitchell, 2015) and journalists (McBride, 2011) call this ‘the Greek scenario’ or ‘the Greek tragedy’.

The initial acts – or in Greek tragedy terms the ‘protasis’ – of both Argentine and Greek scenarios followed the same pattern: the government decides to run a strict exchange rate regime and subscribes to a system where it cannot engage in overt monetary financing. Since the state needs to run deficits in the long run in a growing economy, the government borrows money and builds up a compounding debt stock. In the second act, or the ‘epitasis’, the increasing levels of debt cause the yields to rise on the credit available to the government and when repayment becomes unworkable, the debt gets restructured with austerity attached as a condition to the agreement. When the government tries to run surpluses to repay the unpayable amounts, unemployment increases, household consumption and tax revenues decrease, and GDP starts shrinking. The depression slowly causes the collapse of exports and FDI and eventually paralyzes the country. This exact scenario took place during the 1997 East Asian financial crisis, the 1998 European crisis and of course the 1982 Argentine default. The next act is the ‘dénouement’, when the crisis is resolved. The Greek sovereign debt crisis has been devastating the economy for eight years now with no end in sight. The 1982 Argentine default lasted for eight years and was resolved with a radical change in the economic structure that postponed the default. In contrast, the last act of the 2001 Argentine default unfolded in a different way.
After the default in the last days of December, a heated debate on the optimal next step began in Argentina. The debates continued throughout the decade, but the government never fully adopted a clear direction towards solving the problem. It is hard to even identify the default as an *orderly* or *strategic* default until 2003. In this regard, 2002 was a very long period of exploration and experimentation with various policies for Argentina. For example, on 6th January, Duhalde, the acting president, abolished the currency board and announced plans to devalue the peso to a 1-to-1.4 ratio for imports and exports and free-float the peso for all other transactions. Initially, the cost of devaluation of the existing debt was planned to be passed on to creditors (J. F. Hornbeck & Marshal, 2002). This amounted to a sizeable cost as the peso devalued rapidly to almost a 4-to-1 ratio after the suspension of the convertibility scheme. But on 10th January, Duhalde declared that the government would guarantee dollar deposits and convert all dollar-denominated debts under $100,000 into pesos at the old rate of one peso to the dollar, thus covering all the costs of creditors. On 3 February, the government decided to convert, or ‘pesofy’, all dollar-denominated debts into peso-denominated debt at the 1-to-1 ratio. Although this move protected the creditors and companies that borrowed in dollars, the senate also passed a new bankruptcy law in January that restricted payment of foreign private debt payments (Edwards, 2010, pp. 155-157). Therefore, it was not clear who was going to bear the costs of the default; the citizens of the debtor country or the creditors.

The ambiguity deepened in February of that year. After allowing the peso to float freely, the government presented a new budget that promised a cut of 15% in expenditure and a 20% increase in taxes on energy exports. Meanwhile, talks with the IMF continued and Argentine representatives asked for $23 billion of assistance from them (Rohter, 2002b). While all these moves point to an *orderly* default in which banks and corporations received preferential treatment and the population bore the bulk of the cost of the default, the government also declared that the proceeds from the increase in taxes would be used for general government expenditure, not for bond repayments (Wallin, 2002). This mismatch between the government’s discourse and actions continued throughout the year. Duhalde was a Peronist who blamed the crisis on the free-market system, but his administration employed austerity programmes intended to regain creditors’ confidence. In March, additional taxes were introduced, provincial governors signed a budget accord that cut 60% of provincial deficits, and unemployment reached 22% (J. F. Hornbeck & Marshal, 2002). In May, Argentina resumed debt repayments while in default; first a $159 million repayment was made to the IMF on 11 May and then a $680 million to World Bank on 13 May (Cohen, 2012, p. 70). These repayments and cuts on government spending were carried out only to secure external aid from international creditors.
Half of the population fell below the poverty line, unemployment reached 28% and large demonstrations became a daily event by mid-2002. An estimated 40,000 people found work as cartoneros, scavenging the bins for cardboard (CNN, 2003). According to Duhalde, the only way to revive the economy was to receive sizeable capital that could kick-start the economy.

We mentioned that in January the government ended the convertibility system and floated the peso, which means that the treasury could withdraw any amount of pesos from the central bank and use it as the necessary capital. Pesos could be created out of thin air or the treasury could sell corresponding amount of government bonds to the central bank. This form of money creation was desperately required, especially in the provinces where public finances have dried up. Despite the fact that inflation soared to 40%, due to the devaluation of peso, public sector salaries were not adjusted (Cohen, 2012, p. 72), and government spending cuts created strong demand for cash to the extent that provinces began issuing their own complementary currencies like patacones and lecops to pay the salaries of their employees. People needed cash and government needed to spend, and yet the central bank did not print money. People began creating their own networks to partially restore economic life. The unemployed and the disenfranchised created a vast economic scheme where people exchanged their goods and services for pieces of paper they created themselves. Only one such network, the ‘National Barter Network’, provided the necessary economic support to 640,000 Argentine families at its peak (Katel, 2002). Unemployed doctors, teachers, bakers, entrepreneurs and others offered their labour for scrip called créditos, which could then be spent to buy other goods and services from other voluntary participants. It is not surprising that people did not devolve their economic relationship to the level of barter trade but instead developed a new currency that substituted for the facilitating functions of the fiat currency.

Argentina remained on the horns of a dilemma between default and repayment until May 2003. This was precipitated by the many extensions on large debt payments by creditors. For example, on 5th September the IMF granted Argentina a one-year deferment on a $2.8 billion payment, and on 15th October the World Bank paid $250 million for the Series D coupon bonds that it guaranteed in Argentina’s name (EuroMoney, 2002). Although such extensions enabled the government to continue repayments on its debt, the insolvency of the state prevented full reimbursement of the debt. For instance, on 14th November, Argentina made $79 million worth of interest payments to the World Bank but could not make the $726 million payment on the principal of the debt due that year (M Weisbrodt & Cibils, 2002). Technically and practically the country was in default and all negative impacts of a default were there; FDI virtually stopped, every major CRA had already decreased their ratings to the lowest possible rating, and other
than extensions on the debt there was no aid from supra-national institutions. And yet Argentina continued the repayments. On 18th December, Argentina made a $124 million payment to the IMF, World Bank and International Development Bank as a ‘good faith gesture’ (J. F. Hornbeck & Marshal, 2002).

The term ‘good faith’ comes up a few times in the negotiations between the IMF and Argentina in this period. Although the IMF usually uses a clear and technical language, in 1999 it began making use of a principle it called ‘the good-faith criterion’ (IMF, 1999). Simply put, the criterion questions whether the indebted country is making genuine efforts to reach a collaborative agreement with the creditors. In 2002, Argentina was doing exactly that. During a deep recession, in default and without sufficient foreign reserves, Argentina was still making payments. Compared to the $2.7 billion that was due to be paid to the IMF in 2002, repayment of $124 million may appear little in proportion to the total amount, but these payments showed willingness, good faith and compliance. Nevertheless, on 19th December, a day after the $124 million ‘good faith’ payment to the creditors, negotiations over a new bail-out plan for Argentina were unilaterally cancelled by the IMF after Argentina’s failure to pay $805 million in arrears owed to the World Bank (J. F. Hornbeck & Marshal, 2002). Ultimately, we can argue that the 2001 default became an orderly default in 2002. The ongoing repayments during default, employment of austerity and postponement of growing sums of debt point to an orderly default similar to the one in 1982; a default of a country that had ‘good faith’, but insufficient funds.

5.6.1 Defaulting strategically: The discovery of the ‘magic money tree’

A central notion in Jean Paul Sartre’s (1943) philosophy is ‘mauvaise foi’, literally ‘bad faith’. Mauvaise foi exists when people deceive themselves in order to avoid short-term pain but thereafter endure long-term mental impoverishment. According to Sartre, social forces can compel innately free people to adopt false values and deny the existence of their freedom. Sartre gives the example of a waiter who believes that being a waiter is what defines his being – that is, his ability to make of himself what he wants to in freedom. The waiter persuades himself that being a waiter is all he can do or is meant to do, that there are no other options. But existentialists remind us that there are always choices to be made. Although Sartre uses the term exclusively about individuals, Argentina’s acquiescence to the rules of default can be explained by mauvaise foi. Even though Duhalde was a Peronist politician who chanted “Fuera FMI” (IMF out) along with his supporters before coming to power (Prevost, Campos, & Vanden, 2002),
the crisis without the Fund’s assistance. He wanted to reject neoliberal policies and he started new social programmes like Programa Jefes y Jefas de Hogar (PJJH – Unemployed Heads of Household Plan), but these did not have an impact on society because the government deemed itself not solvent enough to disburse sufficient amounts of money for them. Of course, after the end of the convertibility plan, the government could have funded any stimulus measures and pay for any goods or services available in the country. Moreover, Duhalde understood that fiscal contraction was worsening the situation and he was aware of the need “to take steps to reactivate the economy” (Rohter, 2002a). But in the words of Argentina’s then Central Bank Governor, “there was no room to manoeuvre on the fiscal side; the only option was a tighter fiscal stance… There was little firepower!” (S. B. Kaplan, 2013, p. 44). There was no other choice but austerity, even though everyone, including the IMF, knew that it did not work.

Argentina lingered in this state of mauvaise foi until May 2003. On 15th January 2003 the country defaulted on a $680 million payment to the International Development Bank, and then on 17th January the government made a $1 billion payment to IMF (The Economist, 2003). Again, these payments allowed for roll-overs on large sums of debt and more credit. Four days after making $1.5 billion payment to the World Bank and International Development Bank, on 28 January, Argentina received $1.6 billion from the IMF and World Bank (J. F. Hornbeck & Marshal, 2002). By 2003, the economy had shrunk by 20% since 1998 (IMF, 2003), total external debt had reached $164.7 billion, unemployment passed 25% and consequently economic output decreased by 15% (Veigel, 2005), and 54.3% of the population was living in poverty (Lopez Boo, 2006).

In May 2003, Néstor Kirchner became president and in his first annual address to congress said that “Argentina, the multilateral credit sectors and the Argentinean private creditors must have the acknowledgement that these are the existent resources and this cannot be miraculously increased” (APArchive, 2015). This was a statement of the obvious. In January 2003, the total foreign exchange reserves of Argentina were $8.296 billion, the lowest since 1991. In fact, Argentina had used up its supply of money years ago and had been repaying debt with new debt since late 1990s. After pointing out that Argentina could not pay its debt any more, Kirchner stated in a speech that

The so-called “vulture hedge funds” who, together with the most recalcitrant and insatiable financial interests in the world, are trying to cash in on a difficult situation... They (are) destined to failure, they’ll come to understand the strength of our national posture... This government, with all rationality and prudence in each case,
will continue the firm principles of negotiations with those who hold our debt and will try to move out of default without putting the growth of our national accounts at risk as indicators show. **We will not pay if the cost is that more Argentines do not have access to education, healthcare, housing, and decent employment.** Growing our economy will better our capacity to pay. As we say here: We are not the project of default. We know that our debt is a central problem. But we will not pay by any means necessary. (Lopez, 2012)

This is a radical departure from the discourse held by all previous administrations. Kirchner clearly declared that his government would not repay the debt, regardless of the solvency of the country. The new government stopped the payments and on 9\textsuperscript{th} September Argentina defaulted on a $2.9 billion repayment to the IMF, the largest non-repayment of an IMF loan to this day (R. Di Tella et al., 2005). A day later, on the 10\textsuperscript{th} September 2003, under the political pressure of being responsible for the default, the IMF agreed to a deal in which Argentina would pay only the interest on its loans and roll over $12.5 billion in multilateral debt (T. Smith, 2003). The central bank of Argentina had $13 billion in currency reserves on the day of default. The total defaulted obligation with arrears and interest was still over $77 billion at this point. Kirchner took a very unorthodox stance against the creditors and demanded a 75% haircut on the outstanding debt. Kirchner offered 25 cents in the dollar owed with an extended maturity term and lower interest rates. The same year, in 2003, investors in Uruguayan bonds accepted a 7% haircut and there were fiery discussions on, in a CRA’s words, the ‘loss imposed on creditors’ because of this haircut (Moody's, 2013). Kirchner’s administration took a so-called ‘take it or leave it’ stance. Argentina refused to make payments to private creditors until they accepted the offer.

The government not only moved from what we call an **orderly** default to a **strategic** default with this move, but Kirchner also changed the domestic functioning of the state apparatus. Previously, in the IMF’s words in April 2002 (Singh, 2002),\textsuperscript{50} the aim of the central bank was to “strictly limit the growth of its own credit” and had instituted “a full-fledged inflation-targeting regime”. After the assertion of the strategic default, the government did not have to continue running surpluses to make repayments and therefore did not have to dampen the growth of credit. As a result, the government consumption increased by 1.5\% of GDP in 2003 and 2.7\% in 2004, and public social expenditures tripled between 2002 and 2010 (Mercille, 2014, pp. 165-166). Consistent with the accounting identity we defined in the theoretical

\textsuperscript{50} In the same press release, the IMF demanded the provincial currencies to be phased out, with no new issuing of currencies.
chapter, private consumption increased by 8.2% of GDP in 2003 and 9.5% in 2004; and the gross fixed capital formation increased by 38.2% in 2003 and 34.4% in 2004 (Mark Weisbrot & Sandoval, 2007). After the economy contracted 10.89% in 2002, Argentina grew by 8.84% in 2003. The sizeable increase in the private spending and gross fixed capital formation shows that the increased government spending was successful in stimulating the economy and was able to halt the downward spiral of lost production and idleness in the economy.

Government spending increased for various items, except for military expenditure which gradually decreased between 2001 and 2007. The most important channel of spending was the various employment actions programmes. Under Kirchner, the total budget of the Ministry of Labour, Employment and Social Security (MTEySS - Ministerio de Trabajo, Empleo y Seguridad) reached 15.7% of the total national budget, and 4.9% of the total budget was devoted to the PJJH programme. However, due to fiscal constraints the program the PJJH programme, started in 1995 by the World Bank, did not reach nearly enough people until the fiscally contractionary policies were abandoned in 2003. Very basically, the programme offered four hours of community work per day for unemployed heads of households who had children under 18, were disabled or pregnant. There were minor changes in the eligibility requirements, but there was no skill test or other requirements. In a few months, before the end of 2003, PJJH was expanded to employ over 2 million people, that is 5% of the population and 13% of the total labour force. As a result, unemployment dropped to 13.6% in 2004 and to 11.5% in 2005. Extensive reviews of the programme are available from both MTEySS (2003, 2005) and from the World Bank (2003).

For a minimum of four hours of work, the head of household received 150 pesos per month, and 65.2% of the workers received between 150 and 550 pesos per month from the programme (MTEySS, 2005). The payments were made via bank account transfers, so there was not a major increase in the amount of pesos printed physically because of PJJH. In large cities the government distributed special debit cards where the workers’ salaries were deposited (Kostzer, 2008). The programme needed a sizeable investment and a large expansion in spending. Although the investment was made by overt monetary financing, there were two main explanations for the ‘source of this money’. One group pointed out the shift away from debt repayment and towards the fulfilment of domestic needs, and another group called attention to the commodity boom that increased exports and brought in foreign currency. The latter is used in mainstream commentary to claim that the source of the money Kirchner was spending was external. In the Irish Times Kirchner was referred to as ‘an aggressive president who is financed by a boom in commodities’ (Mercille, 2014, p. 164) and an article titled “Raw materials have
ensured the success of Kirchner in Argentina” was published in *Le Monde* (Hutchinson, 2010); and in another article in *Le Monde* the reporter (Gatinois & Legrand, 2012) suggested that Greece should not try the Argentine model since its soil is not rich and is “only raw material is the sun”.

The argument that the main reason for such a strong recovery was inflated export prices continues to be prevalent. Some scholars (Richardson, 2009) and news agencies (Romero, 2012) argued that the upward growth trend in both periods was merely fuelled by the increase in the international commodity prices and Argentina ‘rode’ the export boom. For example, the president of Inter-American Dialogue, Michael Shifter, wrote that “If the sales and price of soybean[s], Argentina’s principal export (mainly to China), remain high, then the country may be able to continue its path of economic growth” (Weisbrot, 2012). The numbers do not support this argument that the post-default growth was a simple export boom though. Exports accounted for only 12% of Argentina’s real GDP between 2002 and 2010 (Mark Weisbrot, 2012). There was a considerable rise in the price of soybean, which may have served to boost Argentina’s economic prospects in several respects. However, the dollar value of its main exports did not grow faster than the rest of the economy; agriculture, hunting, fishing and forestry exports combined accounted for 5% of GDP in 2002 and fell to 3.7% of GDP during the commodities boom of 2010 (Doyran, 2017). The manufacturing and industrial manufacturing industries constituted around 6.9% of GDP (Mark Weisbrot & Sandoval, 2007, p. 7). Furthermore, consumption and investment (fixed capital formation) accounted for 45.4% and 26.4% of GDP, respectively (Mark Weisbrot & Sandoval, 2007). This is why we can safely assume that this was a demand-led and not an export-led growth. In fact, by looking at the decreasing influence of exports on GDP (in 2002, exports accounted for 24.9% of the GDP and the proportion dropped steadily until 2010, when it was down to 18.4%), the World Bank also defined the growth as a “demand-led recovery” in its reports (Valdovinos, 2005), not an export-led growth.

The increase in commodity prices indeed had a positive impact on the balance sheets. But not the export earnings, or the dollars that remained in the central bank’s accounts after the default, or tax earnings financed Kirchner’s social programmes. The payments were made by the central bank and they were in pesos; the treasury simply credited certain bank accounts. There was no source of funding which means that pesos were created ‘out of thin air’, so to speak. A magical money tree has been discovered, one can say. The same process was repeated when the government enacted lump-sum increases in the minimum wage in December 2003, or when the ‘Universal Allocation per Child’ programme was launched in 2009, or when the government renationalized certain strategic economic sectors in 2012. As long as the payments were made
in pesos, nothing funded$^{51}$ these policies. The increase in spending can only be explained by Argentina’s break from its mauvaise foi.

As one would expect, the “lavish and ever-rising social spending and fuel and transport subsidies” were highly criticized by mainstream commentators in the media, because the government had “increasingly taken to printing money to cover the gaps which has further fed inflation” (The Irish Times, 2012). We explained in the second chapter that the connection between government spending and inflation is spurious. As a matter of fact, inflation halved after the implementation of the programmes; it dropped from 25.8% in 2002 to 13.4% in 2003, and then to 4.4% in 2004. This is an expected result as PJIH established a wage floor and formalized the informal sector by establishing compositional shifts in employment$^{52}$. What is more, according to influential economists like Robert Lucas (2001) and Burstein and Hellwig (2008), inflation has almost no perceptible impact on productivity and that even a mild recession reduces the total GDP of a country more than 10% persistent inflation would do. In the end, the government’s decision to move away from inflation targeting practices, restore central bank sovereignty and invest heavily in social programmes produced an almost instant reaction in the economy and the country returned to growth. The impact of the largest sovereign default in history was mitigated and neutralized in a fairly short time. It took four months of negotiations for the government to impose a roll-over on its debt to the IMF, three months to employ 2 million people, and one day to change the orderly default into a strategic default.

**5.6.2 Explaining the Recovery**

The economic recovery after the election of Kirchner was immediate and between 2003 and 2007 the Argentine economy grew at a rate that was more than twice the world mean. After the 10.82% contraction in 2002, Argentina grew consistently over 8% for the next four years. Figure 5.13 displays changing levels of real GDP per capita between 1962 and 2014. The shaded areas are the periods of growth. We should bear in mind that the graph is in current US dollars and therefore the values for the era of convertibility are artificially inflated in the graph

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$^{51}$ This is a discussion of semantics, more than technicality. The dictionary definition of ‘funding’ is “providing financial resources to finance a need, program, or project” (Business Dictionary, 2018). Our argument here is that the default or the increase in commodity prices did not provide the necessary financial resources. The amount of pesos the government had in its disposal has not changed since the collapse of the convertibility regime. There are no pesos in the central banks account, and the treasury has unlimited financial capacity. Therefore, when the government spends pesos, the spending is not ‘funded’ by anything.

$^{52}$ For more information on how job guarantee programs do not cause inflation but stabilizes it, see: Mitchell (1998)
due to the overvalued peso between 1989 and 2001. The one-to-one exchange parity did not reflect the real value of the peso, and even then, as the graph displays, by the end of the 2002 GDP per capita actually fell below the 1990s levels and then steadily climbed for over a decade.

Figure 5. 13 Trends in real GDP per capita, 1960-2015

![Graph showing trends in real GDP per capita, 1960-2015](source: Thomson Reuters Dataset)

However, this graph also displays the stop-and-go nature of the Argentine economy. This aspect of the economy is well-known and well-researched (Diamand, 1986; Kiguel, 1991). In fact,
some scholars (D. F. Cavallo, 2014; Damill, Frenkel, & Rapetti, 2015; Gruss, 2014) and the conventional media (The Economist, 2014) fingered the stop-and-go cycles as the main reason for the growth after default. Argentine people also use the ‘swings of a pendulum’ as a metaphor to describe the wild swings the economy experiences (Fonseca, 2016). We can also detect this so-called swing of the pendulum in other main economic indicators as some of them draw double-top double-bottom charts that resemble the swings of a pendulum. For example, Figure 5.14 shows the unemployment level as a percentage of the total labour force. While there were large fluctuations between 1995 and 1998, we can see the overall dramatic increase between 1989 and 2002 and the rapid fall after 2002. This may be interpreted as a sign that soon there will be another increase in unemployment as the pendulum swings the other way.

The total dollar market value of Argentine companies, displayed in Figure 5.15, follows the same pattern. In this graph, the looming recession is more visible as well. When we look at Standard and Poor’s average sovereign rating for Argentina, we can see another swing of the pendulum, only one with a considerable delay. The graph also shows the numericized values of Standard & Poor’s ratings, 10 being BB (the highest rating Argentina ever received from S&P) and 1 being ‘D’ for default. Argentina enjoyed relatively high ratings before 2002 and the ratings did not fall even during the early 2000s, which were marked by a deep recession. Even after the upgrades since 2005, two years after the return of the growth, the sovereign ratings did not reach the same pre-2001 levels.

Figure 5.15 Market capitalization and credit rating

Moreover, both periods of growth are closely related to the sovereign defaults that preceded them. The 1982 default regressed the economy and hindered progress for eight years, but then the radical responses to it, in the form of a fixed exchange rate, privatisations and austerity, brought a sizeable growth to Argentina. Similarly, the 2002 default brought a set of radical changes, followed by an even larger rise in prosperity. From this perspective, the growth after
the 2001 default may appear as another boom that will inevitably be followed by another bust. For some scholars (Edwards, 2010; Tanzi, 2007), the success of populist experiments brought a temporary surge in growth and it will inevitably lead to rapid inflation, stagnation and crisis. However, when we look closer we will see that different factors fuelled the 2003 growth. Looking back at Figure 5.14, we can see that unemployment actually draws a bell curve that follows the opposite of the pattern to the pendulum swing of other graphs. The growth in the 1990s was driven by increased unemployment that made labour cheap and temporarily lowered inflation. Consequently, inequality increased sharply during this period, as is shown in Figure 5.16. The 2003 recovery on the other hand was stimulated by increased employment and decreased inequality. Equating the two eras of growth as different faces of the same coin would be inaccurate. We have already described the stark difference between the political and economic situations in these two eras.

There are other indicators that do not follow the swing of the pendulum. Figure 5.16 shows the budget balance as a percentage of GDP and it shows a dramatic change after 2003. For 37 years, between 1963 and 2001, the total revenues of the government were greater than its total expenses. Throughout the coups, hyper-inflation and war, the government took more money out of the economy than it spent and ran budget surpluses. This can only be achieved through intense privatization, accumulating high export incomes, very low welfare spending and low government investment into the private sector. And it is exactly because Argentina was able to follow this programme for so long that it was called ‘the poster child of neoliberalism’. After 2002, we see that balancing the budget was not a priority anymore and that the government started running deficits. The government ran relatively high fiscal deficits and this was heavily criticised by the media, supranational institutions and especially by the CRAs (DeFotis, 2016). The critique that the recovery is just another phase of the same old stop-and-go cycle that characterized Argentina,

Figure 5.16 Budget balance and GINI index
that it is bound to failure due to its ‘fiscally irresponsible’ approach, became prevalent.

We have already explained that the myth of ‘fiscal responsibility’ is an unsustainable and fictional goal. Furthermore, as we touched upon in the theoretical chapter, balancing the budget is not an achievement, it is simply moving money from private sector to public sector, since the government budget deficit equals to net private saving. Increasing one decreases the other at the same rate, plus or minus the external balance. The following graph shows the fitted regression line to illustrate the relationship between the budget balance (predictor variable) and the total credit to non-financial corporations (response variable) in Argentina between 1970 and 2014. Although we are omitting some important variables like the trade balance, there is still a high linear correlation evident in this graph. We can see that as the government runs a surplus, private sector’s borrowing increases. Between 2001 and 2002, for example, the household final consumption expenditure dropped from $189 billion to $59 billion in Argentina (IndexMundi, 2016), while in the same period the government ran a $10 billion budget surplus, by following the IMF’s prescriptions onto slashing the non-interest government spending (Henry, 2014, p. 254). This has always been the official stance of IMF towards government budgets. “For countries with a large outstanding public debt relative to GDP, achieving a primary surplus is normally viewed as important, being usually necessary for a reduction in the debt/GDP ratio” (IMF, 1995, p. 14). Argentina’s recovery after 2003 refutes all arguments for austerity and reminds us the simple fact that if the sole-issuer of the currency does not spend enough, the private sector cannot spend enough either. The only way out of a recession is an increase in spending. The growth after the 1982 default was funded by an increased foreign capital inflow and support from supranational institutions. There was a need for a source of funding for government spending due to the convertibility scheme, but after 2001 the government did not
have to find a source for its spending as it could create it out of thin air. This simple and technical difference between the two eras of growth creates a significant variance.

The following graphs show that while the general government consumption steadily increased since 2002, domestic sector indebtedness remained stable after 2004; military expenditure fell to historically low levels; and contrary to the conventional wisdom, average interest on new external debt was lower than the 1989 levels after the 2002 default.

**Figure 5. 17 Fitted regression - Relationship between private demand for credit and balanced public budgets**

![Graph showing the relationship between private demand for credit and balanced public budgets](image)

Source: Thomson Reuters Dataset

### 5.6.2 Comparing orderly and strategic

The 2001 default was not an effortless debt jubilee. The restructuring of the debt owed to private creditors was very problematic. After the default in 2001, many creditors sold Argentina’s debt in secondary debt markets and some of the new and original owners sued Argentina and demanded to be paid in full (El Observador, 2011). There was a massive discrepancy between what Argentina offered and what the creditors demanded. For example, a US retail bondholder, Mark Botsford, purchased Argentina’s bonds after the default for $120 million and demanded to be paid $724 million, while Argentina offered only a fraction of this amount (Roth, 2004).
The negotiations continued, largely unsuccessfully, until 2005 and did not lead to a meaningful conclusion. This problem extends beyond private creditors though and has become a predicament for other major creditors too. For example, the IMF does not consider a formal programme if the private creditors are not offered an acceptable proposal in ‘good faith’, and the Paris Club does not consider any sovereign debt restructuring request unless the country has an active IMF lending programme in place (J. Hornbeck, 2013).

On 14th January, 2005, Argentina ended the negotiation process and made a unilateral offer to the remaining creditors. The discount bonds offered by the Kirchner administration had 25% of the original bonds’ nominal value. The total face value of the outstanding bonds was $81.8 billion, plus a past due interest of $20.8 billion. Argentina offered $35.2 billion on the face value and did not recognize the past due interest. After making the offer, the government removed the remaining private holdout debt from its official financial statements and enacted a new law that barred the state from making another offer. After this ultimatum, 93% of the remaining bondholders accepted the offer, while the remaining 7% opted to litigate instead. Although the bond owners who decided to hold onto their bonds won the right to be paid in full in the US courts (Fontevecchia, 2012), various sovereign immunity laws meant that Argentina has state immunity and cannot be forced to repay. The dispute continued for 15 years and was only resolved after the election of Mauricio Macri in 2015.

During these 15 years, the average interest rates on new external debt commitments by Argentina never reached the levels of the late 1990s rates. In 2000, on average, Argentina paid 9.9% interest on its debt it borrowed, in 2004 this rate was 2.6%, and it remained under 6.5% until 2016. Argentina did not only default on the largest stock of debt in the history, it also refused to show good-faith in negotiations after 2005 and refused to comply with the US courts’ orders. According to conventional wisdom, each one of these moves was supposed to be effectively an economic suicide (Huffington Post, 2013). And yet, not only did Argentina restore its prosperity within a few years, its borrowing costs were lower than pre-default times. This is not only important for over 50 governments that are struggling to pay their debt today, but it also has implications for the ongoing discussion on establishing sovereign bankruptcy laws. Many think-tanks (Brookings, 2013) and popular economists like Stiglitz (2013) advocate and urge for the establishment of a Sovereign Debt Adjustment Facility that would create the international equivalent of national bankruptcy laws. As Argentina’s case clearly displayed, sovereign debt is not enforceable. There cannot be any institution or body that can impose on or administer any kind of bankruptcy law for a sovereign nation. Establishing an institution to
oversee or manage a sovereign default process would not be helpful, even if it was supposedly on the debtor’s side.

In June 2005, a report released by the Ministry of the Economy presented the level and composition of the public debt. The total official public debt was $126.5 billion, down by $64 billion from the first quarter due to the restructuring. More importantly, 41% of the total debt was denominated in pesos (Cibils & Arana, 2018). This change in the currency composition of Argentina’s debt is a major modification compared to the pre-2001 era, in which 98% of the debt was dollar-denominated. Effectively and nominally, the peso-denominated debt does not constrain the state’s fiscal space in any way. In terms of the state’s ability to service its debt in domestic currency, it is not important whether this debt is held by foreigners or local agents. The government can always pay it.

At the end of 2005, Kirchner announced that they government will pay all of the $9.5 billion owed to the IMF. This was a controversial move to say the least. It surprised people who had been advertising the default as a defeat for the IMF and neoliberalism, and it surprised the mainstream media which had been presenting the default as a sign of Argentina’s inability to pay. John W. Snow, the then US Secretary of the Treasury, mentioned in one of his speeches that this repayment by the Argentine government "showed good faith" in one of his speeches (Montenegro, 2005). Nevertheless, there were periods during this strategic default when large repayments were made strategic default, as well as periods of sudden drops in debt repayments. We developed a tool to analyse the impact of positive shocks in debt repayments on the economy in the previous section. We can use the same IRF models to compare the effects of payments in two different types of default and display the dissimilarities.

We will use the same baseline regression we built to draw IRFs in the previous section where we looked at the impact of debt repayments in the 1982 orderly default. We will use the same four-dimensional VAR that contains Argentina’s debt service on external debt in current US dollars (DEBT), general government final consumption expenditure in current US dollars (CONS), unemployment level (UNEMP), and domestic credit to private sector by banks as a percentage of GDP (CREDIT). DEBT is the independent variable, while CONS, UNEMP and CREDIT are the dependent variables. This way we can compare the responses of three major economic indicators to the same independent variable in two different types of default. The IRFs display the direction and magnitude of response of a variable to a 1% standard deviation shock to DEBT. the figure 5.10, the IRF results of the 1982 default from section 5.4 is also added below, for easier comparison.
Figure 5.18: IRFs of Argentina's exposures to shocks in debt repayments - 2000s

Response to Cholesky One S.D. Innovations

Response of CONS to DEBT

Response of CREDIT to DEBT

Response of UNEMP to DEBT

Figure 5.19: IRFs - 1980s

Response to Cholesky One S.D. Innovations

Response of CONS to DEBT

Response of CREDIT to DEBT

Response of UNEMP to DEBT
A quick glance at the three graphs suggests that after the strategic default of 2001, the responses of unemployment, government consumption and domestic credit are sizeable and stable. The responses are upward-trending for CONS and CREDIT, and downward-trending for UNEMP. The IRF results on CONS and UNEMP are almost exact opposites of the results we got from the previous IRF analysis. Looking closer at the CONS’s response, we see that the response of government’s final consumption remains positive and initially causes an approximately $0.7 billion increase per 1% standard deviation change in DEBT. The impact of changes in debt servicing increases as the time goes and reaches to a $3.4 billion increase in government spending after five years. The sudden increase in debt repayments causes an increase in government spending and the impact increases in the mid- to long-run. This is interesting, since debt repayments were usually associated with a decrease in government consumption. Although debt repayments were relatively small, there were still a number of large settlements between creditors and the government. Although we can discuss the political and moral aspects of making such large sums of payments to the IMF, this graph shows that during the strategic default, Argentina’s payments on its debt had a positive impact on the government spending.

Domestic credit provided by banks appears to respond by following a persisting upward trend in the allocation of credit to the Argentine economy. After a shock in debt repayments, there was an increase in the demand for credit. This is not a puzzling response since it is in line with the orthodoxy. One might argue that due to the increase of high-powered money supplied by the government, the need for domestic credit should decrease. However, we know that after the 2001 default, the government jump-started the economy and there was a sudden increase in the economic motion with the increase in investments. Combined with the low interest rates offered by domestic banks after the default, the surge in the demand for credit is understandable.

As we move onto the last graph, it can be observed that a shock in the sovereign debt repayments lead to a persistently negative response in the unemployment rate. The initial response to a shock in DEBT is a remarkable 1.15% decrease in the unemployment rate, which steadily increases and reaches a 1.169% decrease after the fourth year. Debt repayments during the strategic default are estimated to lead to over five years of lower levels of unemployment. This is an expected result given the direct relationship between unemployment and government spending. Increases in government spending and job guarantee programmes boost the demand for labour and decrease unemployment. The responses of our explanatory variables to changes in the level of debt servicing between strategic and orderly defaults are very different. Changes in debt repayments during the 1982 default had some clearly adverse and very complex effects.
on the economy. On the other hand, changes in the debt servicing after the 2001 default had straightforward and positive effects.

5.7 Conclusion

This chapter has made use of the theoretical arguments developed in the previous chapters to refine my assumptions over the effects of sovereign default. At the beginning of this study, my contention was that there are different forms of sovereign debt and different types of sovereign defaults. I criticized the mainstream literature on debt for ignoring this crucial aspect of sovereign debt and the historical analysis emphasized those distinctions. We detected key themes and tactics that altered the impact of sovereign defaults in Argentina depending on the type of debt borrowed and the stance of the government towards its debt. We explored possible causal mechanisms that created a difference; like the identity of creditor, the general monetary and fiscal targets of the defaulting government, so on and so forth. However, we could not make clear cut causal links nor precisely measure how different these defaults were relying only on historical process tracing.

This chapter moved from the historical analysis to the contemporary investigation of modern Argentina, using the more readily available economic data since the mid-20th century. That is why I could complement the historical study with a quantitative analysis and substantiate my previous claims. The empirical findings presented in this chapter are consistent with the theoretical assumptions underlying this study; an orderly sovereign default decreases government and public spending and increases unemployment, while a strategic default has the exact opposite effects. In the long run, a strategic default during a debt crisis was and is the most sustainable path Argentina can take. Overall, the findings of this chapter represent the essence of what we have been trying to capture since the beginning of this study.

Although the econometric results came out very clearly in support of my theoretical expectations, I am not arguing that we rely solely on a quantitative tool to define the form and trace the effects of default. That is beyond the scope of this project. Without the comprehensive historical review of Argentina between 1955 and 2000 I conducted before the empirical analysis, the econometric results would be hollow. Although the focus was solely on Argentina, there are areas of this research that can be generalized to all developing countries that face a sovereign debt crisis.

The next, and last, section concludes the thesis by summarizing the findings of this research on the last 200 years of Argentina debt and defaulting history.
Chapter 6

Conclusion

“In economics, the majority is always wrong.”

John K. Galbraith

This thesis set out to examine the determinants of sovereign defaults, and their differential consequences, in Argentina between 1827 and 2010. While it is not the first study to focus on Argentina’s history of debt and default, this historical and political economy study sheds a new light on the so-called ‘serial-defaulter’. It does so by building and elaborating on MMT theory which provides a different lens on debt and sovereign default, namely: sovereign default is not a problem *per se*, but a symptom of an underlying problem that needs addressing. The problem lies not only on the side of the debtor. It is a symptom of inefficiency of both creditors and debtors. Creditors are inefficient with their capital spending when they extend credit to an apparently risky venture, and hence will have to bear the loss incurred by such short-sighted behaviour. Debtors are inefficient when they fail to utilize the credit to increase broad-based total-factor productivity. Defaults are not to be taken lightly, but not because they reflect the presumed inabilities of debtors to pay what is due. Rather, they deserve our attention because of what they reveal about the actual problems underlying the debit and credit sides of balance sheets. A sovereign default is a valuable indicator of a deep and structural problem in an economy and political economists should appreciate it as such.

This lens on debt and defaulting is distinct from that adopted in both mainstream and critical political economy research that focus on, and take as their starting point the destructive dimensions of debt and default. This literature sees default as extremely costly events that countries should preferably avoid. In Chapter 2, for example, we discussed how economists, like Hébert and Schreger (2017), use complex econometry to reveal how costly defaults have been to Argentina. Then again, lawyers, like Panizza, Sturzenegger, and Zettelmeyer (2009), have looked at the process of litigation over sovereign debt in Argentina and concluded that it is not legal enforcement mechanisms but the high domestic cost of default that prevents countries from repudiating their debt and enter into a default. In turn, political scientists, like
Hershberg (2003), have linked the ‘crushing’ defaults suffered by Argentina to the failure of the political system in the country. The more critical, left-leaning literature also shares this understanding of sovereign debt as an evil to be avoided. Scholars in this stream have described public debt as “a dangerous obsession” (Blot, 2018), and credit as a “tool of oppression” (Millet & Toussaint, 2004, p. 47) that has been deliberately employed by the financial centres against the periphery, that is, countries in the developing world (Barnes & Sheldon, 2010). Argentina is portrayed as yet another example of such an attack (Petras, 1982).

In the same chapter we outlined our theoretical departure from both the mainstream and the so-called critical perspectives. We established how credit plays an important role in every economy as an apparatus that accelerates production and exchange while decreasing the cost of circulation of money. Furthermore, we discussed how credit and debt are two sides of the same coin since every debt stock generates an equal amount of credit. This approach does not ignore the asymmetrical power relations that blatantly exist between debtor and creditor countries. On the contrary, we have emphasised the significance of these asymmetrical relationships throughout the thesis. We have shed light on how different people and classes are disproportionately affected by sovereign debt crises, and also how creditor nations can exert power and influence over debtor nations like Argentina. Nevertheless, we pointed out that this asymmetry is not an inherent part of debt, and demonstrated that reducing debt will not necessarily solve inequality of which debt may be a symptom. In fact, by trying to address debt per se, one might be contributing to more inequality, both in terms of power but also in terms of the income distribution within indebted states.

The theoretical perspective adopted here reminds us that for every dollar an indebted country owes, there is a dollar invested into that country. This implies that reducing the amount of credit/debt in circulation is neither a good nor a bad result in itself, and should not be the macroeconomic target of a country. Debt is a tool that can aid development, and is not a goal in itself. As we have seen in the analysis, policies designed to reduce debt levels at all costs tend to result in perverse and tragic outcomes such as even more debt and worsening living standards in an economy. A stark example of this problem is the Paris Club’s so-called ‘treatments’ of Argentina, which introduced a chronic and eventually fruitless fight against debt over a number of decades. As the country renegotiated its debt, it had to borrow more to meet its payments and avoid a default. This is not unique to Argentina, however. Many nations have suffered such increases in debt during periods of restructuring (Das, Papaioannou, & Trebesch, 2012). While progressive economists have long highlighted these inconsistencies in austerity programmes prescribed by neoclassical economics (Weeks, 2012), the aftermath of the most recent global
financial crisis (GFC) has led even the IMF to examine these perverse outcomes (Bahal, Raissi, & Tulin, 2018) and to acknowledge the ineptitude of these programmes (Furceri, Loungani, & Ostry, 2016).

Then again, such revelations by the IMF or similar critiques by progressive and left-leaning scholars and politicians usually fail to bring any decisive change to the pattern of macroeconomic management. The reason is to be found in the deeper underlying assumptions that are embedded in all leading economic schools and in the popular understanding of governmental economics. Regardless of their ideological positions, all dominant schools of thought have embraced the idea that the state has a limited amount of spending power; governments collect taxes, spend what is available and borrow when they are short of funds. This view limits the discussion on the global debt problem by framing it in a very restricted and myopic fashion. For example, the discussion on sovereign debt has resurfaced multiple times over the last ten years since the GFC and over the four years it took to conduct this study. In most of these, the myopic approach dominates. In various elections in the last three years, candidates who promised more social security, universal healthcare and lower unemployment have been repeatedly queried about their budgetary plans to fulfil these objectives. Progressive politicians were questioned for the ‘black holes’ in their budgets in New Zealand (Stuff, 2018), whether they believed in a ‘magic money tree’ in the UK (Dearden, 2017), and numerous calculations were made on how much it would cost governments to establish welfare programs in the US (Mangan, 2016; Riedl, 2018) since 2014. In Latin America, the ‘pink tide’ has receded in the course of writing this thesis and a new right has emerged. Kirchner in Argentina was attacked for wasting government resources and causing inflation (B. Alejandro, 2015) and a neoliberal government won the elections in Argentina in 2015. The questions on the source of money and accusations of inflationary policies are very tough to answer if one accepts that sovereigns are revenue-constrained. The current and popular solution of progressive politicians is usually to resort to ‘Robin Hood’ taxes (Mitchell & Fazi, 2017, p. 260) on the rich to pay for public services. This fiscal approach, however, is often curtailed by fiscal loopholes and strategies enabling the upper-class to evade taxes, and therefore fails to support large social programmes. Furthermore, budget forecasts usually do not add up and, at least in the long-run, deficits or increasing private indebtedness become inevitable. Thus, the myopic view of government constraints usually end up in policies that protect the rich and powerful, but deny the broad mass of people the opportunity to develop.

This study rejects this myopic view of the constraints faced by sovereigns. Accepting fiat money as a restraint on government spending creates a paradigm where debt sustainability is only
possible through austerity. If the state has a limited amount of financial resources, saving ‘money’ would be, by design, more sustainable than spending it. Using MMT as the basis of the theoretical framework elaborated in this study releases one from the disease of myopia. Overall, I have argued and shown throughout this historical and political economic case study of 200 years of debt and default history in Argentina that a currency-issuing sovereign government has no imperative to fund its spending: it can buy anything that is for sale within its borders at any given time. In the preceding chapters, evidence have been amassed that not only confirm the theoretical liberation that MMT implies, but that also adds to its armoury of insights. In particular, this thesis makes the following contributions:

- The first contribution of this thesis has been to advance the small body of MMT scholarship by employing it to analyse debt and defaulting in a developing country. MMT is a new school of economics and only few case studies of debt and defaulting have used it as a theoretical lens. Moreover, most of these studies focus on developed economies. The emphasis on sovereignty and strong state renders MMT’s arguments weak for developing economies. Developed countries with strong currencies and low debt-to-GDP ratios, like Australia and Canada, can employ expansionary fiscal policies without encountering serious balance of payments constraints. But the ensuing current account deterioration can be very harmful for developing countries that depend on imports for production. Countries like Argentina do not have the option to not use US dollars to buy energy, medicine and other essential items for the daily functioning of their economy. This is potentially one of the most damning critiques of MMT (Palley, 2015), and the school’s current exclusive focus on high-income countries is preventing it from developing an adequate response. The necessity of credit in foreign currency for developing countries has not yet been thoroughly addressed in MMT literature. The only coherent policy recommendation related to this issue is that the government should not sell bonds or accrue debt in foreign currency (Wray, 2012). This obviously does not apply to heavily-indebted developing countries. I have contributed to filling this gap in MMT by conducting a case study analysis of Argentina, a country that struggled with debt since its independence. The main finding in this regard is that developing countries do have policy options to restrict the potential negatives associated with dependence on debt dominated in foreign currencies, including the ability to rely on fiat money and to avoid exposure to foreign-currency fluctuations.

Nineteenth century Argentina has proven an ideal case to show how the state apparatus works when it comes to monetary and fiscal operations. In Chapter 3, we focused on the first 100 years
of Argentina’s pendulum-like history of defaulting; we analysed the differences between the 1827 and 1890 defaults and the two major exchange rate regimes, fixed and fiat, that characterised the country’s responses to the crises. The 1827 default occurred in Buenos Aires province shortly after its independence during a widespread wave of defaults that hit the newly independent Latin American countries. Argentina was one of the first to default and it took decades for the parties to resolve this default. The crisis forced the provincial government to suspend the gold standard and to start an experiment with fiat currency. Since fiat money was more flexible and efficient in mobilizing the workforce and in creating employment than the gold standard used in other provinces, Buenos Aires attracted more migrants and emerged as the leading province. Although Argentina was a newly independent nation struggling with internal conflicts that consumed precious resources, the GDP-per-capita increased on par with that of continental Europe. Moreover, even before the unification, regional governments easily switched between different exchange rate regimes.

The 1890 default hit the country after a banking crisis in 1873. The crisis uncontrollably spread over the world and engulfed most Latin American countries, which defaulted on their debt within four years (Kaminsky & Vega-García, 2014). Exceptionally, Argentina resisted the crisis and continued with its repayments until it eventually defaulted in 1890. Unlike the 1827 default, the 1890 default was resolved fairly quickly, in less than eight years.

Yet, despite these differences, neither of these two default waves had a significantly negative impact on the growth rate of Latin American countries, and the flow of capital to defaulters was not substantially affected by the crises. This suggests that neither the external conditions surrounding a default nor the length of the renegotiation period necessarily determine how impactful a default will be. What is more, the rapid growth of Argentina during these defaults is an effective argument for MMT in that external constraints do not cause complications if domestic demand and production keeps expanding. Instead of merely recommending “do not borrow in foreign currency”, MMT theorists can also endorse defaults as a way to restore a country’s full sovereignty and encourage it to focus on expanding its domestic market.

- Secondly, this study contributes to the surprisingly small literature (in English, at least) on the historical political economy of Argentina. There is a clear need for more study on the long-run political economic analysis of debt, evident from the success that met the book ‘This time is different’ from C. Reinhart and K. Rogoff (2009). Although the book was riddled with spreadsheet mistakes and over-simplistic generalizations, it won numerous awards, remained a best-seller for years and significantly influenced policy discussions. If only we had more
nuanced studies of the real effects of sovereign defaults available, it is unlikely that public opinion would succumb so easily to the conclusions of the Reinhardt and Rogoff volume. Furthermore, Argentina holds a special place in the history of debt. It was a pioneer in trialling a new solution to deal with its debt - i.e. it was the first country to grant full independence to its central bank, and the first to restructure its debt via a former institution, the Paris Club. It is a unique defaulter country - i.e. it is the only country that lost its high-income country category, and it is the country that went through the largest default in history. It is therefore enigmatic that there is not an abundance of studies on the history of Argentine political economy. There are many individual case studies of Argentine defaults, but there are very few complete historical analyses of debt and default in this country. The limited critical literature that engages with the two centuries of Argentine history in its entirety (e.g. Boonman, 2017; Della Paolera & Taylor, 2003) does not challenge the postulates of neoclassical economics; surplus running governments are seen as stable, while debt repayments are interpreted as successes for Argentina. Those perspectives cloud these studies’ explanations of crises.

In this study, I examined most of the unique dimensions of Argentina’s history of debt and defaulting. The country’s most distinctive decision was its resolution to pay its debt in full after the 1930 Great Depression. As the only major country that did not default in the 1930s, Argentina, once again, presented the perfect case study to evaluate the impact of defaulting and not defaulting. I used this unique experience to test the hypothesis that emerged in Chapter 3: Sovereign defaults do not have lasting negative impacts. The non-existence of default in the 1930s enabled a direct comparison between Argentina and its neighbours. We did not find any significant advantage of not defaulting. On the contrary, debt repayments reduced Argentina’s stocks of gold to very low levels and forced it to take a new direction in relation to domestic politics. As we observed, this decision to not default saw the rise of authoritarian tendencies in the government. Instead of investing in and utilizing its workforce, Argentina adopted a different paradigm that undermined labour and its economy by placing them both at the service of increasing the country’s competitiveness and growing its export sector. As domestic demand was curbed to augment trade surpluses, Argentina became increasingly dependent on external demand for its products to replenish its gold and foreign exchange reserves disregarding the dire costs this approach had on both its domestic market and labour. As we analysed in Chapter 4, this new objective was buttressed by frequent coups.

- The third contribution of this thesis consists in having developed an analytical lens to re-evaluate existing categories used to classify debt and default. The current understanding of
debt as a (lump of) stock does not pay sufficient attention to what constitutes government debt. As this study has argued by elaborating on MMT, we should distinguish between debt in foreign currency and debt in domestic currency. As MMT explains, debt in domestic currency can never be the cause of insolvency since the government can create it out of thin air. This means that the debt-to-GDP ratio of today’s Greece and Argentina, for example, cannot be directly compared. Greek debt is denominated entirely in a ‘foreign’ currency because it cannot create it. On the other hand, the bulk of Argentine debt today is denominated in pesos. Another example is Japan. Although it is broadly accepted that Japan has a very strong economy (BBH, 2018), this country not only has the highest net government debt as a percentage of GDP, it also has extremely low government bond yields. Simply put, this is because Japan’s debt is in Yen, and the markets are aware that this debt stock does not pose any threat to the country.

An additional missing distinction in the literature is that between types of defaults. As the econometric analysis in Chapter 5 demonstrated, not every default has the same determinants, nor do defaults always have the same consequences. I focused on the difference in sovereign defaults caused by insolvency (orderly default) and defaults initiated by the government as a strategic decision. It was shown that these two types of default have completely opposite implications. If a government defaults due to insolvency, this means that the country ran out of foreign reserves after making large repayments on its debt. This indicates a prolonged period of stagnation that ended with the country exhausting its assets, and a distressed state that ran out of options. All these elements were visible in Argentina in the 1980s; years of deepening austerity policies had deprived the domestic markets of liquidity and buying power, and weakened political control over monetary and fiscal apparatuses. Although it had the strong support of supranational institutions after the 1982 default, the crisis intensified with every major adjustment in debt repayments leading to higher unemployment and increasing private sector debt. The crisis ended with a radical change in the economy eight years later, which tied it to the US economy by fixed exchange rates. The 2001 default started just like the 1982 one, but took a different path after the elections at the end of 2002. The new government stopped repayments altogether and decisively chose to allocate its resources to Argentinians. After the collapse of the fixed exchange rates, it increased its spending and created new employment programs. Even without the support of the IMF or major creditor nations, the crisis became an opportunity for transformation. This time, whenever there was a large change in the amount of debt repaid (positive or negative), unemployment fell along with the debt levels of firms and households. This is also true for the sudden drop in debt repayments, the effect remained the same even when Argentina decided to pay portions of its debt after 2005.
Whenever there was a large repayment, domestic and foreign investors would applaud the decision and increasingly large investments followed (Schaick, 2007). The implication is that a country does not have to cut its ties with the rest of the world after a strategic default, it only needs to restore its ties with its own population. This conceptual distinction has significant implications for scholarship on default. First, we cannot understand a default without looking into the political process that produced it and the one that follows the default. Sovereign defaults are not purely economic incidents, they are very deeply embedded into the political structure. Second, such a distinction between types of defaults means econometric analyses needs to differentiate between them. There are very few studies that use econometrics and also account for the type of default (e.g., Buiter & Rahbari, 2013).

However, since this study only analysed two Argentine defaults to construct the conceptual distinctions between two orderly and strategic defaults, I cannot claim that every strategic default will have effects similar to those highlighted here. I was careful not to make any such claims on the previous Argentine defaults, as there is not enough data to support such claims. This problem of generalization is not a dilemma with the types of defaults we explained here; every argument I put together is, technically, only applicable to Argentina. Furthermore, historical single case studies, such as the one conducted here, do not aim necessarily at generalizability. They serve the purpose of critically reconsidering existing theories and building alternative theoretical frameworks to better understand complex political economic phenomena and processes.

Telling a story as complex as Argentina’s struggle with its debt over a 200-year time-span that consists of numerous different regimes and ever changing economic structure, was a challenge within a single, coherent study. There is much more to tell, elaborate and particularize in this story. For instance, this study did not delve into many major incidents, like coups and important elections, and avoided using names of influential figures in Argentine history in order to rather focus on the already ambitious aim of developing a new perspective on sovereign debt that can explain not only the current crisis, but also historic ones. There is no dataset that distinguish between types of default, and developing one is a necessary step in understanding the nature of defaults. Therefore, there is a need for further research into the types of defaults occurring in various other countries to test the hypotheses advanced in this study and expand its theoretical framework. Single case studies as this one would advance the field by providing more specific investigations on individual defaulting countries that could be compared to develop more generalized analyses on the process of default.
MMT provides an alternative vantage point for this fast-developing field of research and is capable of serving different and multiple approaches to better conceptualize debt. Popular works on sovereign debt crises could be emulated from more critical perspectives to focus on the capabilities of the sovereign and the importance of domestic demand. Such research would offer an alternative view on what can be done by governments and would complement the current narrow discussions on taxation and government spending. Another important research avenue would be to develop a full economic model of Argentine defaults. Such model would comprise enough equations to provide accurate clues about how each and every agent behave during a crisis. This would be a valuable addition to extant econometric studies on defaults as they are predominantly conducted from a neoclassical approach. While building full economic model of Argentina was beyond the scope of this study, I used a reduced form of IRF with four variables to explore the potential of this method and lay the ground for such model. In doing so, I contributed to open a space for critical research that pays attention to and account for the complex historical and political economic factors and processes that underlie debt, credit, and default.

* * *


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Appendix

Figure A. 1 Percentage of developing countries in default weighted by their share of income

This graph complements Figure 5.8. There are noteworthy differences between the two. The first difference is that the decline of sovereign defaults appears slower and more gradual in this A.1. I explained this with the defaults of Russia and Germany in the late 1940s, considering that these countries’ share of income is rather high, it explains the slow decline in defaults after the 1930s crisis. Still, both graphs show how another large wave of default did not follow the Great Depression after the foundation of Paris Club. However, A.1 does not show the large default wave of early-1980s, while Figure 5.8 clearly did. This is due to the absence of defaults in developed nations within this period, contrary to the evidence which suggests that 35% of all developing economies fell into default in the same period. There is a lot to unpack here in terms of the first wave of defaults which only hit developing economies. This segregation and isolation of defaults requires an in-depth discussion and the complex mechanics involved requires further analysis in future research.
The Impulse Response Function used in sections 5.4 and 5.6 traced the response of several macroeconomic indicators for the Argentine economy to shocks in debt repayments. These macro indicators include Argentina’s debt service on external debt in current US dollars ($D_t$), general government final consumption expenditure in current US dollars ($C_t$), unemployment level ($U_t$), and domestic credit to private sector by banks as a percentage of GDP ($PD_t$). The matrices, randomly ordered, are represented following the Cholesky decomposition as shown below:

\[
\begin{pmatrix}
D_t \\
C_t \\
U_t \\
PD_t
\end{pmatrix} \equiv \begin{pmatrix}
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0 \\
0 & 0 & 0 & 0
\end{pmatrix} \begin{pmatrix}
D_t \\
C_t \\
U_t \\
PD_t
\end{pmatrix} + \begin{pmatrix}
1 & 0 & 0 & 0 \\
b1 & 1 & 0 & 0 \\
c1 & c2 & 1 & 0 \\
d1 & d2 & d3 & 1
\end{pmatrix} \begin{pmatrix}
\mu D_t \\
\mu C_t \\
\mu U_t \\
\mu PD_t
\end{pmatrix}
\]

This ordering includes both positive and negative changes in $D_t$. Annual data is employed in this analysis. The data used for the 1982 default is collected from 1980 to 1990, and from 2000 to 2010 for the 2001 default. The reason I included the short period before the default is to capture the impact of debt repayments during the crisis too. Also, this enabled us to focus on the respective decades where the defaults occurred. Alternatively, it is possible to choose different cut-off dates, but such a change should create no distortions in our overall results.

The major limitation of VAR is that, unlike building a full model and running regressions, we only use a limited number of variables and the effects of omitted variables are captured in the residuals. In any case, given the plausibility of our results and the reliability of the technique employed, there is sufficient rational to infer structural interpretations from the VAR estimates. Following Nishi (2012), I computed confidence intervals directly from the standard errors of the estimated coefficients, abating the need for Monte Carlo simulations.

While quarterly data may have been more suitable in this analysis, because it multiplies the number of data available by four, data availability for Argentina constrains our choice to annual data. Given the limited data available for this complex VAR modelling, several issues relating to data occurrence and effectively capturing the effects are mitigated against by following the framework and outputs by Pesaran and Shin (1998), Nishi (2012) and Lütkepohl (2018). For this study, the methods of Pesaran and Shin (1998), Nishi (2012) and Lütkepohl (2018) are reorganized to suit this specific case study.