Argentina on the edge of blow-out

by Mark Sonnenblick

Argentina, whose classic monetarist policies have made it a model that many bankers recommend to other underdeveloped countries, is approaching a spectacular economic blowout. Bankers have been lending dollars to Argentina hand over fist at interest rates a full percentage point below those given to neighboring Brazil. However, half this "capital flow" is hot money sucked into Argentina to take advantage of short-term looting possibilities on the local loan market.

This cycle is nearing an abrupt end as the industrial and agricultural producers whose assets have been stripped in this loansharking operation slip into open and clandestine bankruptcy, leaving local banks loaded with nonperforming debt. Several of the country's biggest banks, including number-one Banco de Intercambio Regional, went under in the first round of the collapse process in March and April, but the Argentine bubble has since been puffed up larger than ever.

Rather than dealing with the crisis by funneling capital into productive activities utilizing the European-level skills of the Argentine workers and the Kansas-quality land of the vast pampas, the Argentina government is following Milton Friedman's prescriptions by allowing policy to be dictated by the money-market speculators. This has led to an accumulation of political pressures, which in a year of changes in the military dictatorship is likely to produce a panicky withdrawal of hot money, and pull down the house.

How the inflows work

International speculators regard Argentina as a paradise because of the success with which Economics Minister José Martínez de Hoz has deregulated the banking sector and allowed it to exact what the market will bear. De Hoz's policy of dismantling the tariff protection behind which Argentine industry had developed, and eliminating the subsidies that had sustained agribusiness, filled the money markets with desperate loan-seekers. At the same time, de Hoz, like his northern cothinkers Paul Volcker and Maggie Thatcher, turned off the credit spigots, driving up interest rates.

As Figure 1 shows, a substantial gap grew during 1977 between the level of monthly interest rates Argentine banks paid to depositors and the level of devaluation of the Argentine peso. This has provided the opportunity for financial speculators, multinational corporate treasurers, and Argentine international traders to bring in dollars and convert them into pesos to be lent for a few months at astronomical interest rates. Then the speculator reconverts his pesos into dollars and pockets the difference between the high interest rates and the lower devaluation rates, a difference that has varied from 4 to 7 percent per month. When annualized, the speculator's profit becomes 50 to 90 percent, which looks quite good next to the 10 to 15 percent provided by ordinary dollar investments.

Argentine inflation has consistently outpaced peso devaluation, however. Thus, the peso today has about 45 percent more buying power abroad than it did in April 1977. This tends to discourage speculators by holding over them the risk that at any moment, the Argentine government could "correct the overvalued peso" with a maxi-devaluation which would wipe away not only profits, but also part of capital invested in peso markets.

De Hoz removed all exchange risk in a Dec. 20, 1978 speech in which he announced that minuscule devaluations would continue daily, but the rate of devaluation would steadily decrease and, on his honor, there would be no big devaluations. With this guarantee, the big bucks started rolling in. The vaunted "savings rate" rose to 28 percent of GNP during 1979, but only 8 percent of the GNP was invested in productive activities.

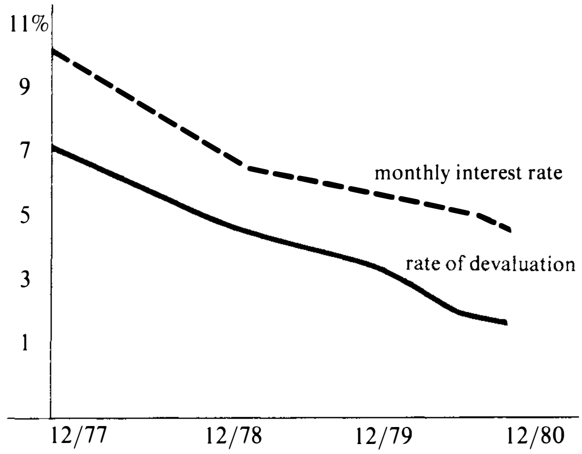
Bank clubs

Just as Perón's inflationary growth brought record profits to industries, de Hoz's monetarist "restructuring" has driven the capitalists out of business, "and I'm not just talking about Joe's meat market, but the major industrial and banking institutions," cautioned one frank banker. *El Economista* weekly of Buenos Aires estimates that the private banking system, capitalized at $6 billion, carries $2 billion in bad debts. In order to avoid declaring their own liquidation, the banks are now hiding most of the bad debts in "bank clubs," consortiums that disguise unpayable debts by rescheduling them over a long term, with de Hoz's blessing.

When the crash of several top banks became public knowledge in March, about $2 billion in hot money fled the country (see Figure 2). Desperate to restore Argentina's $10 billion reserve level so as to ward off devaluation rumors and keep the big bubble going, de Hoz on July 10 ended the requirement that dollar loans have a minimum term of one year and removed other controls and taxes on speculation. The success of his gambit is indicated in Figure 2 in the exceptional burst of dollars which followed his speech. During six weeks, Argentina's official short-term debt shot up from $950 million to $2.3 billion.

Figure 1

Argentina's hot money flows



This graph shows the differential between the monthly interest rates given by Argentine banks for 30-day peso deposits (top curve) and the devaluation of the peso in relation to the dollar (bottom curve) during the given month. The gap between the two curves illustrates the percentage profit made during the month by speculators bringing dollars into the Argentine money market. Their net profit in each month is obtained by subtracting the monthly cost of Eurodollar loans or of dollar zone inflation (say 1 percent) from the gap.

The jittery speculators are lending money for only 28, 60 or 90 days. As Figure 2 shows, when the rollover period began around Labor Day, there was a repatriation of funds even sharper than during the April crisis. Reality began to creep in: the overvalued peso has led to a 23 percent cut in the volume of meat exports, the announced closing of all four Argentine tractor plants and the elimination of 60 percent of textile capacity.

Deaf to the producers' complaints, de Hoz saw the foreign exchange flows as the only thermometer of Argentina's health. On Sept. 15, he guaranteed slow devaluations until the end of January. The hot money flew back for another two months. *El Economista* anticipates—with reason—that the hot-money boys will soon demand legally contracted government insurance against major devaluations—a strange plea for state intervention from the loud-mouthed champions of the "free market system."

On March 29, 1981, General Jorge Videla, who has run the country on behalf of de Hoz's liberal economics since the April 1976 coup against Isabela Perón, will hand over the reins to General Roberto Viola. The underlying economic crisis, as well as interservice rivalry, broke the surface when backroom combat between the dominant Army and the insurgent Navy forced Viola's presidency to be announced two days behind the military's precise timetable. The Navy—and Viola's replacement as Army Commander—has expressed misgivings about de Hoz's economic model.

Anything can happen. To stave off general bankruptcy, an about-face may be ordered on de Hoz's tight money policy and printing presses set in march in traditional Argentine fashion. Such policies would soon lead to a hyperinflationary blowout. Or, de Hoz could preempt a dollar flight by pulling a huge devaluation some midnight to "clear the decks" for his successor.

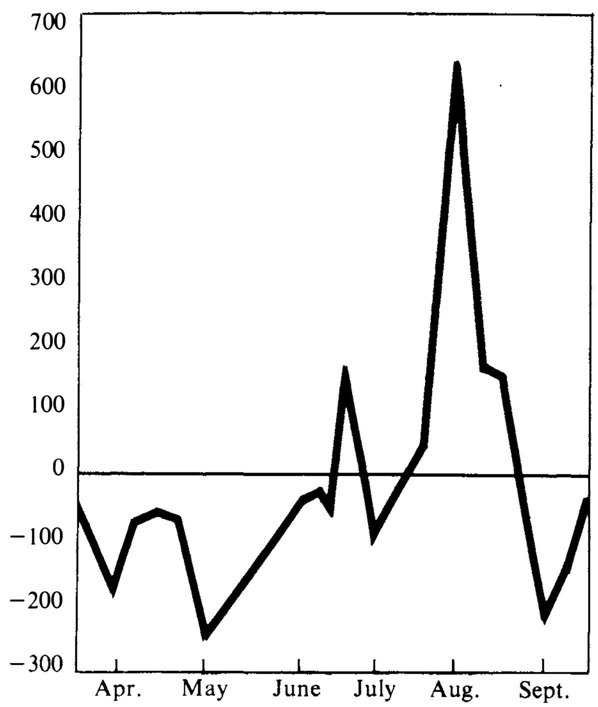
In any event, the "wizard" de Hoz and his protégés have trapped themselves on the exchange rate problem.

London's *International Currency Review* augurs, "Inevitably, a run on the currency would occur just before the transfer of power, since no one believes that an incoming Economics Minister would be able to start his term with a country suffering from excessive currency overvaluation. . . . Sr. Martínez de Hoz will be handing an extremely unstable situation over to his successors; and there appears to be a strong probability of a progressive or even sudden collapse of confidence overwhelming the government during its final months in power."

Figure 2

Weekly variation in foreign reserves

(millions of dollars)



The weekly change in Argentina's net foreign reserves is based on official Economic Ministry reports. The violent fluctuations reflect the March-April banking collapse, the July measures favoring hot money, and September devaluation fears.