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Latin american debt crisis – World Economic History Part 7

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- Latin american debt crisis - Mexico, brazil and argentina -

Latin American debt crisis occurred a number of times, in fact 8 major continental crisis occurred in its 200-year history. The first Latin American debt crisis taking place in 1826-1828, followed by crisis in 1873, 1890 and 1931. In the 20th century, Latin America witnessed a major crisis in 1982 – Mexico's default, 1994/ 95 – the Tequila crisis, in 2001/02 Argentina's default, 1999/03 – Brazil's crisis and 2008/09 Global Financial Crisis. Latin America's crisis filled history is invaluable for studying financial crisis.

In February 1995, Mexico approached the IMF for a US $ 17.8 billion stand-by arrangement for an 18-month program. This was the largest ever financing package approved by the IMF for any member country. The exceptional action was necessary to provide an adequate international response to Mexico's financial crisis and giving confidence to the international financial system. Mexico had achieved a remarkable economic transformation in 1980s on the basis of far reaching structural reforms. The Government's program had resulted in a sharp reduction in fiscal imbalances, a reduction in the role of the State in the economy, a lowering of inflation to close to international levels. During 1994, investors' concerns about the sustainability of the current account deficit began to increase, against the background of dramatic adverse political events in Mexico. To stem capital outflows, the authorities raised interest rates and depreciated the peso. Nevertheless, there was a significant loss of external reserves and there was tremendous pressure on foreign exchange and financial markets precipitated a financial crisis. The Mexican financial crisis contributed to serious pressures in financial and exchange markets in a number of other Latin American countries.

In 1998, Brazil came under significant pressure in the aftermath of the East Asian crisis, as contagion resulted in a dramatic worsening of the international financial environment. Brazilian authorities took emergency fiscal and monetary policy measures–revenue raising and expenditure cuts equivalent to 2½ percent of GDP and doubling the domestic lending rates to 43½ percent. By August 1998, the capital account came under serious pressure in the aftermath of the Russian crisis, necessitating additional expenditure cuts and fiscal tightening measures. Despite these measures, foreign exchange reserves declined from US $ 70 billion to US $ 45 billion in 3 months from July to October 1998, and Brazil was in need of a major economic restructuring program. Brazil approached the IMF for an US $ 18 billion stand-by arrangement for 36 months. The program was largely preventive in nature with the objective to assist Brazil face a period of deep uncertainty in the international financial markets.

In 2001-02 Argentina experienced one of the worst economic crisis in its history. GDP fell by 20 percent over 3 years, inflation reignited, Argentina defaulted on its sovereign debt, the banking system was paralyzed and the Argentine Peso which was pegged to the US Dollar reached lows of Arg $ 3.90 to US dollar in June 2002. Less than a year earlier Argentina was cited as a model of successful economic reform, inflation was in single digits, GDP growth was impressive, and the economy had successfully weathered the storm of the Tequila crisis. Argentina was considered a model reformer of the 21st century economic governance. The 2002 Argentina crisis was not driven by large money financed deficits and hyper-inflation but by fragility in the public sector debt dynamics. The currency board arrangement precluded direct money financing of budget deficits. In the run-up to the crisis there was price deflation and banking system appeared sound and well capitalized.

The currency board arrangement played a central role between Argentina's transformation from a star performer to a crisis country. Initially the currency board played a role in achieving disinflation, once Argentina slid into recession, the currency board arrangement limited Argentina's ability to prevent a tightening of monetary policy and the public debt dynamics ruled out loosening of fiscal policy. The entire onus of macroeconomic stabilization was on fiscal policy, and Argentina seemed trapped in a monetary policy regime that constrained policy choices. Rising fiscal deficits, government's high off budget activities and extensive transfers of over 30 percent to provinces from Federal budgets and interest repayments severely constrained Argentina's policy options. The share of exports in Argentina's economy was limited and the country could not export its way out of the crisis. Debt service payments were absorbing 3/4th of the exports earnings. Amidst dramatically mounting debt, given the currency's free fall, Argentina defaulted on government debt and the currency board collapsed.

Argentina crisis required an IMF Stand-By Arrangement of US $ 14 billion and an international support package of US $ 40 billion. The macroeconomic stabilization program sought to bring public sector surplus to 1 ½ percent of GDP from ½ percent of GDP and reduce fiscal deficit from (–) 6.4 percent to 3 percent of GDP. Despite these interventions, GDP growth continued to decline, falling by 11 percent in 2002 and unemployment rose above 20 percent with significant inflation. Argentina passed a zero deficit law, and made radical policy changes as it ran out of funding options.

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