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Fiscal Austerity in a Financial Trap: The Agonic Years of the Convertibility Regime in Argentina.

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ABSTRACT

This policy brief analyses fiscal policy in the final phase of Argentina's convertibility regime, which was implemented in early 1991 and collapsed with the 2001-02 economic crisis. The most popular interpretation of the Argentine crisis identifies fiscal profligacy as its main and largely preponderant cause. Assessing this interpretation is relevant in terms of economic history analysis, but more importantly, because it helps to inform a broader debate about the effects of fiscal austerity in highly indebted and depressed economies. This has become a hot topic stimulated by the debate on how to promote the recovery in the Eurozone countries and the US. In our interpretation, the roots of the Argentine breakdown have to be found in a completely different problem: the combination of an overvalued real exchange rate and the high levels of foreign debt, in great part inherited from the eighties.

RESUMEN

En este Policy Brief se analiza la política fiscal en la fase final del régimen de convertibilidad de Argentina, establecido a principios de 1991, que se derrumbó con la crisis económica de 2001-02. La interpretación más difundida de la crisis argentina identifica el despilfarro fiscal como su causa principal y ampliamente preponderante. La evaluación crítica de esa interpretación es relevante en términos de historia económica pero también, y más importante, porque ayuda a informar un debate más amplio sobre los efectos de la austeridad fiscal en economías altamente endeudadas y deprimidas. La discusión de este tema se ha visto estimulada por las dudas acerca de cómo promover la recuperación en los países de la eurozona y en los Estados Unidos. En nuestra interpretación, las raíces del colapso de la convertibilidad en la Argentina no son de naturaleza fiscal, sino que se hallan en un terreno completamente diferente: resultaron principalmente de la combinación de un tipo de cambio real sobrevaluado con altos niveles de deuda externa, heredados en gran parte de la historia previa.

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Introduction.

This policy brief analyses fiscal policy in the final phase of Argentina's convertibility regime, which was implemented in early 1991 and collapsed with the 2001-02 economic crisis. The most popular interpretation of the Argentine crisis identifies fiscal profligacy as its main and largely preponderant cause. Assessing this interpretation is relevant in terms of economic history analysis, but more importantly, because it helps to inform a broader debate about the effects of fiscal austerity in highly indebted and depressed economies. This has become a hot topic stimulated by the debate on how to promote the recovery in the Eurozone countries and the US.

An influential interpretation of the convertibility collapse is that by Michael Mussa (2002), former IMF's Research Department Director, who suggests that an excessively expansionary fiscal policy under a fixed exchange rate regime was the main cause behind the crisis. From this perspective, the experience clearly fits in the "first generation" type of currency crisis model, in which an expansionary fiscal policy, incompatible with a fixed exchange rate, leads to a run against the domestic currency and a balance of payments crisis (Krugman, 1979). This is one of the two main competing interpretations of the convertibility collapse.

The second one, to which we subscribe and have contributed with a series of papers, finds the roots of the breakdown in a completely different problem: the combination of an overvalued real exchange rate (RER) and the high levels of foreign debt. The former resulted from the stabilization program instrumented in 1991 in which a currency board was a central element. The latter was to a great extent inherited from the 1970s and 1980s: total foreign debt was equivalent to about 5 years of exports at the beginning of the 1990s and this ratio remained virtually unchanged all along the convertibility years (1991-2001). This combination of factors made the economy vulnerable to negative external shocks, because the currency board made impossible to absorb shocks via nominal exchange rate adjustments. Given this macroeconomic setting, the adjustment had to come via economic contraction and price and wage deflation.

In the wake of the South East Asian crises, the signs of external vulnerability made foreign credit substantially more expensive and scarce. This put the economy in what we call a "financial trap". Given the high level of foreign debt and the inability to correct RER overvaluation via nominal devaluation, capital inflows began to decelerate. This led to an increase in domestic interest rates and the contraction of credit and economic activity. Higher interest rates and a weakening aggregate demand, in turn, worsened the financial position of domestic agents with positive net debt, including the public sector. The deterioration of fiscal balance between 1998 and 2001 was an endogenous result rather than evidence of out-of-control fiscal policy. Moreover, fiscal balance worsened despite a series of efforts oriented towards cutting expenditures and rising taxes. The authorities were actually forced to act pro-cyclically due to the impossibility to adjust the exchange rate and escape from the financial trap.



There are three elements making the “fiscal view” of the Argentine crisis questionable. First, it tends to exaggerate the deterioration of the fiscal balance during the 1990s. This partly results from the practice of measuring fiscal deficits as the increase in the public debt (i.e., measured “below the line”). This fails to recognize the acknowledgment of debt accumulated before 1991 that the government converted into new bonds between 1991 and 1994. This new debt cannot be attached to the fiscal policy carried out during the convertibility period. Second, the “fiscal view” focuses on the behavior of total public expenditures and neglects the distinction between interest payments and primary expenditures, which is crucial for the understanding of the role of fiscal policy in an economy in a financial trap. Finally, it sees the evolution of sovereign risk premium as being determined mainly by fiscal policy and balance. This misses a key point. Because most of public debt was issued in US dollars, public sector’s ability to meet its financial obligations depended not only on the fiscal balance but also on the evolution of the balance of payments. Because of the RER overvaluation, Argentina ran persistent current account deficits during the 1990s (except in the depression years). Once in the financial trap since mid-1998, foreign credit also became scarce. Thus, the evolution of sovereign risk premium appears to have been mostly driven by the balance of payments rather than the fiscal balance.

It seems hard to argue in favor of the expansionary effects of fiscal austerity these days. Evidence suggests that its ability to stimulate private expenditures is, at best, very low. For an economy that is in a financial trap like Argentina was in the late 1990s, this argument is even harder to support. There were four defining elements of Argentina’s financial trap: RER overvaluation, high level of debt in foreign currency, very high sovereign risk premium and interest rates, and contracting economic activity. Fiscal austerity could do little to correct any of these problems. Certainly, the government lacked policy instruments. Modifying the exchange rate regime would have required the intervention of the Congress to revoke the law that institutionalized the currency board in 1992. This was not a political option. Beneath the lack of political will were the fact that the domestic financial system was highly dollarized and the conviction that, under these circumstances, a devaluation would generate a massive financial collapse. Re-scheduling debt payments of the public sector, on the other hand, was an option implemented twice in 2001. However, none of the voluntary debt restructuring in 2001 changed significantly the burden of debt services. As a result, further fiscal contractions had to be implemented.

Fiscal austerity only contributed to depress private animal spirits and to contract aggregate demand. The result was the acceleration of economic contraction and the worsening of fiscal balance. Despite these developments, the authorities were unwilling to get rid of such a rigid macroeconomic regime. Their view was that abandoning the currency board and devaluing the peso was similar to detonating a bomb; and none wanted the bomb exploding in their hands. Thus, the convertibility regime kept agonizing but alive for almost three years. In the meantime, the economy kept accumulating imbalances that only contributed to aggravate the final explosion.



In what follows, we provide evidence in support of our interpretation of role of fiscal policy in the Argentine convertibility collapse.

Fiscal performance under the convertibility regime and the public debt.

To evaluate the fiscal performance of Argentina in the 1990s, it may be convenient to start by adopting a long-term perspective. Table 1 presents several indicators of fiscal performance between 1960 and 2000. It shows that in the 1990s there was a substantial reduction of the fiscal deficit. Primary fiscal account was, on average, balanced during the convertibility years. This implies a sizable adjustment of more than 5 percentage points of GDP compared with the previous two decades in both primary and global balances. For the whole decade the global deficit was, on average, virtually equal to the interest payments on the public debt, for just above 2% of GDP.

Table 1
Fiscal Result of the consolidated public sector
(Nation plus provinces and the City of Buenos Aires)
Averages per period, as a percentage of GDP.

Period	Primary balance without privatization proceeds	Primary balance	Interest payments	Global balance without privatization proceeds	Global balance
1961-1970	-3.4	-3.4	0.7	-4.0	-4.0
1971-1980	-6.0	-6.0	1.0	-7.0	-7.0
1981-1990	-5.1	-5.1	2.0	-7.0	-7.0
1991-2000	-0.4	0.1	2.2	-2.6	-2.1

Source: Cetrángolo and Jiménez (2003), and Gaggero (2003).

A closer look at fiscal accounts in the 1990s.

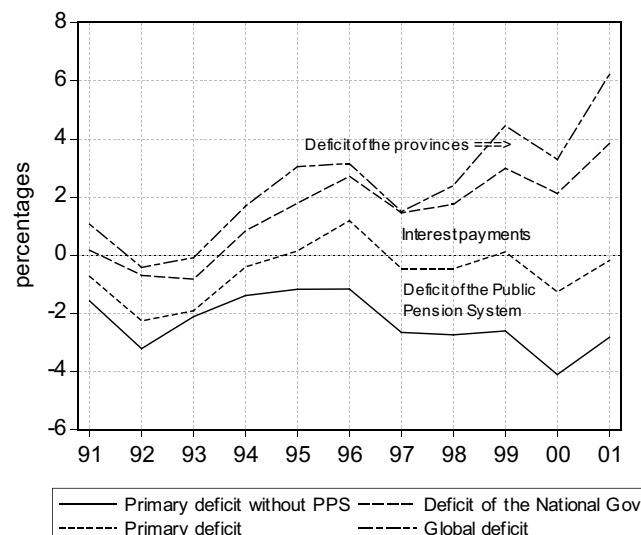
The average behavior during the 1990s hides, however, important differences within the decade. Three distinct phases can be identified: an initial phase (1991-94), followed by an interlude before the depression (1995-97), and the depression period that ended up in a crisis (1998-2001). The milestones that separate these phases are the pension reform of 1994 and the unfavorable change in the external environment resulting from the Asian and Russian crises of 1997-98. The first stage corresponds to the price stabilization phase, also characterized by a strong GDP growth and massive capital inflows. The second period starts with a brief recession in 1995 caused by the Mexican crisis (i.e., the so-called Tequila effect) and is followed by a rapid GDP expansion. The third phase is dominated by a deflationary process throughout the entire period.

The initial phase (1991-94).

The early 1990s witnessed a significant improvement in public accounts. The preceding stage, in which the economy had gone through several episodes of severe instability and hyperinflation, had eroded tax revenues in real terms. They recovered in the early 1990s thanks to significantly lower rates of inflation after the launch of the convertibility plan, as well as to the rapid economic recovery and expansion. On the other hand, macroeconomic stability facilitated the management of tax administration, an area in which significant improvements occurred during this period.

Graph 1 shows the evolution of the consolidated result of public sector. In 1992-93, it reached a balanced position. Table 2 shows that during this initial phase, the average result was negative, but only averaged 0.56% of GDP. It is important to bear in mind that in 1990 began a process of privatization of public-owned corporations. If revenues associated with privatizations are excluded from the analysis, the average deficit of the period amounts to 1.16% of GDP. Table 2 also shows that about half of this imbalance was due to the provinces (-0.69%), that the public pension system generated a deficit of 0.74% of GDP and that interest payments amounted 1.2% of GDP.

Graph 1
Fiscal deficit in the nineties
(on an accrual basis, in % of GDP)



Source: Authors' computation with data of the Ministry of Economy and from Cetrángolo et al. (2000) for the period 1991-1993.

Table 2
Fiscal balance in the 1990s
(Averages by period, on an accrual basis, as percentage of GDP).

Period	Primary balance excl. public pension system	Primary Balance	Interest payments	National Gov. Balance	Consolidated Pub. Sector Balance (1)	Privatization Proceeds (2)	Consolidated Pub. Sector Balance without Priv. Proceeds (3)
1991-94	2.07	1.33	1.20	0.13	-0.56	0.60	-1.16
1995-97	1.66	-0.29	1.70	-1.99	-2.56	0.49	-3.05
1998-01	3.07	0.45	3.13	-2.68	-4.09	0.37	-4.46
1991-01	2.32	0.57	2.04	-1.47	-2.39	0.49	-2.88

Note: the result of the public pension system (PPS) has been obtained as the difference between retirement and pension payments of the National Government and the own receipts of the public pension system, resulting from specific wage taxes and firms' contributions. However, the PPS also receives resources from other sources, like part of the income tax proceeds, etc..

(1) includes the aggregate results of the public sectors of the provinces and the City of Buenos Aires.

(3) = (1) - (2)

Source: Authors' computation based on data from the Ministry of Economy and Cetrángolo et al. (2000) for the period prior to 1994.

The reform of the pension system.

In 1994 the pension system hitherto consisting of a sort of pay-as-you-go system (but modified because of the existence of a legal link of the amount of pension benefits to the wages of the active workers) was replaced by a private capitalization system. In the new framework, the outstanding retirees remained in a residual public system, which was also opened to those active workers who rejected the option of the capitalization system.

We will not examine here the details of the reform. We will focus instead on its impact on fiscal performance. Since many workers, contributors of the pension system, moved (carrying with them their contributions) to the new private capitalization system, the revenues of the public social security system declined substantially. The increasing PPS financing needs since 1994 is clearly illustrated in Graph 1.

The intermediate phase (1994-1997).

A second phase began with the pension reform. It was also during this period that the authorities started to adopt what became to be known as "fiscal devaluation". These



consisted in a reduction of taxes on (mainly) tradable firms, aiming to offset the effects of RER overvaluation on tradable profitability and ability to compete internationally. As mentioned above, the RER overvaluation was a result of the stabilization program based on the fixation of the exchange rate through the currency board.

Because of the loss of revenues from both the PPS contributions and the “fiscal devaluation” measures, the fiscal deficit tended to widen. A rise in the value added tax (VAT) rate after the Mexican crisis in 1995 did not compensate for these revenue losses. Overall, the consolidated public sector balance fell by close to 2% of GDP, on average, compared to the previous phase. However, as is shown in Table 2, the primary surplus of the National Public Sector, without social security, declined only by 0.4% of GDP. The main factor explaining the deterioration of the consolidated balance was the increase in the deficit of the PPS, equivalent to 1.2% of GDP per year. This implies that around 60% of the rise in the fiscal deficit was explained by the PPS reform and another almost 25% corresponds to the increased burden of interest payments. It is worth noting as well that the imbalance of the provinces fell, reaching a balanced position in 1997, as shown in Graph 1.

The evolution of public debt before the economic depression.

The evolution of public debt completes the analysis of Argentina’s fiscal performance during these years. Between 1991 and 1994, consolidated public sector debt increased by about 22 billion US dollars. This figure goes beyond what could be explained by the consolidated public sector deficit. This occurred despite the netting out of liabilities via privatization (7.1 billion dollars) and the debt haircut due to the signing of the Brady Plan (2.3 billion dollars). As mentioned in the introduction, the bulk of the discrepancy between the increase in public debt and the accumulated fiscal deficit resulted from the recognition of financial obligations during the early years of the convertibility regime. This “new” debt was mostly with beneficiaries of the pension system and with suppliers of the public sector that had been accumulated in the late 1980s.

In summary, the 1991-1994 phase was characterized by a very strong improvement in the public accounts and a non-traumatic absorption of a large volume of debt generated largely in previous periods, i.e., normalization of liabilities. There were no signs of fiscal unsustainability by 1994, when the economy was hit by the spillover effects of the Mexican crisis.

In the second phase, the debt-output ratio gave a small jump up. But as is seen in Graph 2, the rise is concentrated in 1995. This is partly an effect of the economic contraction of 1995, but mainly reflects the increase in public debt originated in an assistance package articulated by the IMF, that helped the economy surf the effects of financial contagion and recover quickly afterwards. Graph 2 also shows that the rapid recovery and expansion that followed (1996-97) stabilized again the debt-to-GDP ratio at around 35%, a quite moderate level according to international standards. Moreover, public foreign debt as a percentage of GDP even fell, if not by much, in 1997.

Overall, despite the increased public deficit and the imbalance generated by the privatization of the public pension system, evidence is far from suggesting the existence of signs of fiscal unsustainability by 1997 at the given exchange rate. Again, the only way that one could argue about the possibility of fiscal insolvency at the end of 1997 was by suggesting that the exchange rate regime was unsustainable and a RER correction (i.e., a real devaluation) was necessary.

The depression period (1998-2001).

In almost all respects, the picture we have described so far changed substantially after 1997, and especially after the Russian crisis of August 1998, whose impact triggered an unusually long economic contraction. Graph 1 and Table 3 help to understand some key features of fiscal performance during this third and last phase of the convertibility regime. First, consolidated fiscal deficit entered a sharp upward trajectory reaching around 6% of GDP in 2001. This happened despite the several rounds of contractionary fiscal measures implemented in late 1998, late 1999 and all along 2001, which aimed to reverse this trend.

Table 3 explains the sources of the increase in the deficits by indicating the variation of several items of fiscal accounts between 1994 (the last year of the first phase) and the 1998-2001 average. Consolidated fiscal deficit increased by 7.112 billions of dollars from 4.346 billion in 1994 to an annual average of 11.458 billion in 1998-2001.

Where did this increase come from? Table 3 shows that the bulk of the increase is due to the interest payments (+6,784 billion), and secondly to the widening gap of the social security system (+4,867 billion). The provinces' deficit played a relatively minor role (+592 million), although it was following a growing trend as can be seen in Graph 1. Interestingly, the table also indicates that increase in primary budget by 5.131 billions generated by the austerity measures adopted during this period were insufficient to offset the increased burden of interest payments and the PPS imbalance.

(1) Variation of the global deficit	+ 7.112
(2) Variation of the deficit of the public pension subsystem	+ 4.867
(3) Variation of the primary deficit of the National Government	- 5.131
(4) Variation of the primary deficit of the provinces	+ 0.592
(5) Variation of interest payments of the consolidated public sector	+ 6.784

(2) See definition in Table 2.

(3) Without considering the public pension subsystem.

Source: Authors' computation based on data from the Ministry of Economy and Cetrángolo et al. (2000).

The explosive behavior of interest payments can clearly be seen in Table 4. The interest payments to tax revenues ratio, which had increased somewhat after 1994, accelerated markedly since 1998. In 2000, before the crisis, the ratio got close to 19%, twice as much the value of 1995. This evolution is explained partly due to the reduction in tax revenues as a consequence of the recession and the “fiscal devaluation”, but mainly due to the rise in the average interest rate on the outstanding public debt. This rate –calculated in Table 4 as the ratio of annual interest payments and the stock of total debt at the end of previous year– rose from 5.8% in 1996 to 9.4% in 2001. It should be noted that a significant proportion of the debt was contracted at a fixed rate, thus the rise in interest rates on variable-rate segment was extremely strong.

Driven by the rise in the country risk premium –with which it correlates very closely in the period 1997-2001– the upward trend of the interest rate on the public debt was the main determinant of the increase in consolidated fiscal deficit, which in turn explains the rise in the stock of public obligations (Graph 2). As mentioned above, in 1997, before the impact of the Russian crisis, total public debt did not exceed 35% of GDP. In 2001, the ratio of the consolidated public sector debt and the product surpassed 55%. It had risen by 20 percentage points of GDP in just 4 years. The increasingly difficult access to external financing as a consequence of the unfavorable international context, forced the government to find domestic sources of finance (mostly the PPS and domestic banks) to place its new debt. Meanwhile, the external debt tended to stabilize, although the external debt-to-output ratio continued to rise moderately, mainly because of the decline of GDP. These trends are observed in Graph 2.

Table 4
Consolidated tax burden and interest payments on public debt (in percentages).

Year	Global tax burden (% of GDP) (1)	Average interest rate on the public debt (%) (2)	Ratio of interest payments to tax receipts (%) (3)
1991	18.8	NA	5.6
1992	20.8	6.6	8.3
1993	21.3	5.0	6.0
1994	21.1	5.5	6.9
1995	20.9	6.1	9.2
1996	19.6	5.8	9.7
1997	21.0	6.7	10.9
1998	21.4	7.6	12.2
1999	21.4	8.3	15.9
2000	21.9	8.9	18.5
2001	21.1	9.4	23.4

(1) On a cash basis. It includes contributions to the PPS.

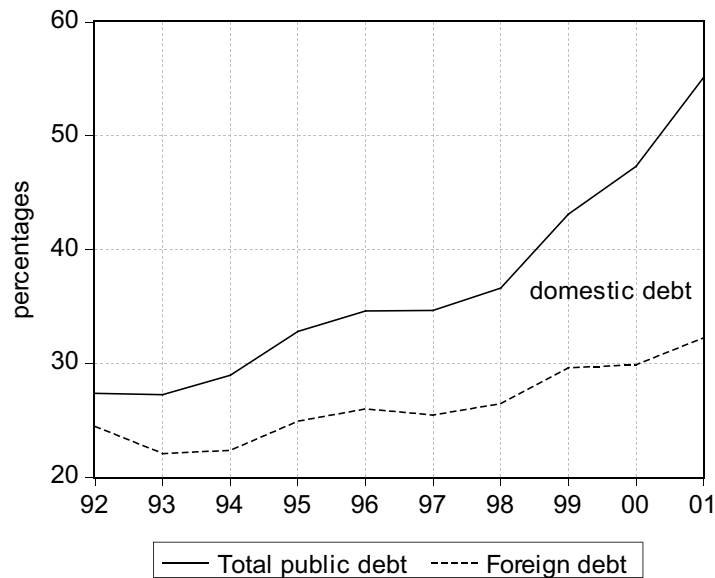
(2) Estimated as the ratio between interest payments of every year and the outstanding public debt at the end of the previous year.

(3) Tax receipts include contributions to the PPS.

Source: Authors’ computations based on data from the Ministry of Economy and Gaggero (2003).



Graph 2
Evolution of the public debt
in % of GDP



Source: Authors' computations based on data from the Ministry of Economy.
Note: Observations correspond to the average between the debt at the beginning and the end of each year, divided by GDP at current prices.

Fiscal account performance and the crisis: final thoughts.

In many crisis episodes in developing countries, both in the 1980s and in the 1990s, fiscal unsustainability had either no role or a secondary one. Certainly, a rapidly growing public debt, which ends up being considered unsustainable by market participants can precede and even be the trigger of an episode of this kind. But the sources of these crises have been related to the inconsistency between overvalued RERs, excessive external debt accumulation (mostly carried out by the private sector) and some sort of fixed exchange rate arrangement.

Argentina's crisis of 2001-02 was not an exception. Certainly, in this case the public sector was the main issuer of foreign debt and the increase of fiscal deficits since 1995 was important. However, as we described above, the deterioration of fiscal balance began with the privatization of the public pension system. On the one hand, with the reform of late 1994 much of the PPS revenues moved to the recently created private pension administrators (AFJPs), without a similar change in the flow of pension payments, which was kept in hands of the public sector. Moreover, the government ordered the reduction of employer contributions to the PPS in an attempt to improve tradable sector's competitiveness, threatened by RER overvaluation.



Since 1998, the rise in interest payments of the public debt additionally contributed to the deterioration of public finances. The increase in interest rates –typical of a cyclical downturn– had a direct effect public debt growth, contributing to a perverse dynamic of rising debt and mounting risk premia (Damill, Frenkel and Juvenal, 2003). In these circumstances, the sustainability analysis of an investor would detect multiple sources of concern. On the one hand, it could detect some common features of dynamics that typically lead to crises: a) Increasing current account deficits and foreign debt accumulation, b) growing needs of capital inflows, and c) increasing likelihood of abandonment of the exchange rate rule and the associated potential balance-sheets effects. On the other hand, in parallel with this process, the investor could also observe the increasing trend in the public debt and the growing financial needs of the public sector.

The observed increase increased country risk premium and interest rates since 1998 may have been associated with either the situation of the Argentina's external accounts or the evolution of public finances. Or with both of them, as the reports of investment funds and rating agencies expressed at that time.

However, even when the concerns associated with the sustainability of public debt have weighed heavily on the investors' assessments of risk, this should not obscure the original source of the deficit and the public sector debt. The main cause was not fiscal profligacy, but the combined effect of the external fragility and the contagion of the critical events in Asia, Russia and Brazil.

Again, Argentina's crisis of 2001-2002 is not an exceptional case. Occam's razor suggests giving privilege to the stylized facts that this experience shares with other crises in emerging market economies.

The IMF and some analysts –prominently, the former Chief Economist of the IMF (Mussa, 2002)– are emphatic in attributing the crisis to fiscal deficit and the dynamic of public debt, without regarding its origins. There is an implicit suggestion that the experience would have been sustainable and the crisis had not happened with a different fiscal policy.

Recognizing that the growth of public debt was largely an endogenous result of the increase in country risk premium would put the IMF in an awkward position and would force it to some self-criticism. In the first half of the 1990s, the institution gave intellectual support and devoted resources to support macroeconomic policies characterized by fixed exchange rate and real appreciation, including among these the currency board regime adopted by Argentina in 1991. Later, when the Mexican crisis made evident the shortcomings of these exchange rate policies, the IMF changed its diagnosis. The new approach recognized the volatility of capital flows and moved to recommend floating exchange rate policies. But the new direction reserved a favorable qualification for fixed exchange rates when they were supported by legal and institutional rigidity, as in regimes of currency board or dollarization. This category became one of the "corner solutions" accepted by the new orthodoxy (Fischer, 2001). The umbrella of the new orthodoxy was wide enough to cover the Argentine convertibility regime.

The IMF's commitment to the convertibility regime had its maximum expression in the emergency package agreed to Argentina in late 2000. In the opportunity, the



conditionality did not incorporate any significant change in the ruling policy regime. The support was clearly intended to extend the survival of it, when there were clear indications that it was unsustainable. Multilateral resources were actually employed to finance, in part, the capital flight that was a prelude to the crisis. The IMF agreed to a payment in August 2001, when the Argentine authorities alone seemed to think it was still possible to sustain the regime.

It is understandable that the IMF would prefer not to remember that story. The diagnosis that attributes the problems and the crisis in Argentina exclusively to fiscal variables is convenient because the IMF may thus discharge any responsibility for the events and their disastrous consequences - including not only those that fell on the population, but also the capital losses suffered from outside investors. Less understandable is that from then on, after the crisis, the IMF had refused for a long time the least support to policies that attempted to manage the consequences of the crisis caused in part by policies previously supported by the institution. Paradoxically, IMF officials justified such reticence with obscure references to "the mistakes we made with Argentina in the past."

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