Financial Crisis as a Struggle for Economic Theory
The case of Argentina

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Presented to IX Encuentro Internacional de Economistas Sobre Globalización y Problemas del Desarollo, La Habana, 7 February 2007

How Financial Crises are seen in Economic Theory
State Vs. Market Dichotomy

This paper presents a critical review of the explanations on financial crises and in particular the applications to the case of Argentina as it has spanned the whole scope of international macro-economic literature

"We do not believe that markets are always perfect, as you accuse. But we do believe there are many instances of government failure as well and that, on the whole, government failure is a far bigger problem than market failure in the developing world"

(Rogoff, 2002, Open Letter to Joseph Stiglitz)

1. **First Generation Models (Krugman, 1979)**
2. **Second Generation Models (Obstfeld, 1996)**
3. **Third Generation Models (Krugman, 1999)**
4. **Original Sin (Eichengrren et al, 2003)**
5. **Sudden Stop Theory (Calvo et al., 2002)**
6. **Minsky's Financial Fragility Hypothesis(Minsky,1992)**

Mainstream Motivations, Assessments, and Policy Proposals Related to Financial Crises – Three Generations of Models

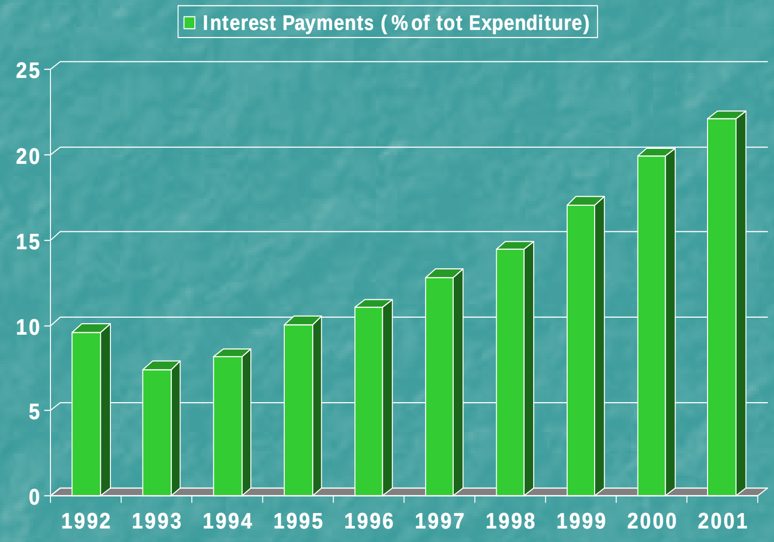
1. Macro-Economic Inconsistency between Monetary and Fiscal Policy

Krueger (2002), Mussa (2002), Graham and Masson (2002)

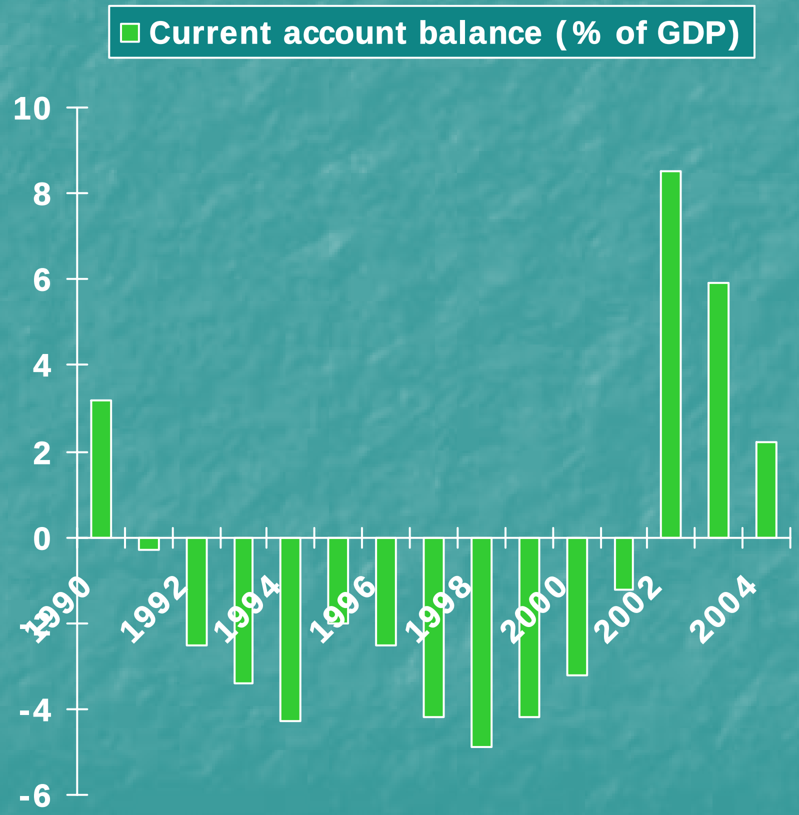
1. **Macro-Economic Inconsistency between Monetary and Fiscal Policy**

Krueger (2002), Mussa (2002), Graham and Masson (2002)

But evidence: Primary expenditure does not show incresing pattern, rather it is the interest payments that show an increasing pattern



2. Second Generation Models
-self fulfilling expectations and Hearding behaviour: contagion effects
Roubini (2001), Kaminsky(2003)



- Current Account deficit associated with real appreciation of the exchange rate fuelling loss of competitiveness and recession
- Contagion effect from neighbour and/ or with similar fundamentals country (i.e. Brazil)

But evidence:

- The current account shows an inconsistent pattern
- Contagion effect conditions are prior to the crisis (Brazil'devaluation)

3. Third Generation Models –Twin Crises

Blejer (2002), Mondino(2002) Institutional weaknesses in the financial markets which interact with the currency market and generates the crisis. Financial institutions are not as prudential as they should be since they expect to be bailed out by the Central Bank and/or the IMF acting as lender of last resource

But evidence:

- **1. Dominguez-Tesar (2005) Balance sheets of financial institutions do not show currency mismatches but dollar denominated loans went to households and companies which were earning in pesos. The risk was transferred to the private non banking sector**
- **2. Arza (2005) shows how balance sheets problems are, in fact, in the corporate sector**

Alternative Perspectives on Financial Crises
Cases of Endogenous Fragilities

1. Sudden Stops Theory: Severe capital flow reversals. The stop occurs with hikes in interest rates. "A sudden, *synchronised* and widespread increase in interest rates" as "*big players* in the *central capital markets* are subject to a liquidity crunch" (Calvo and Talvi, 2004, p9)

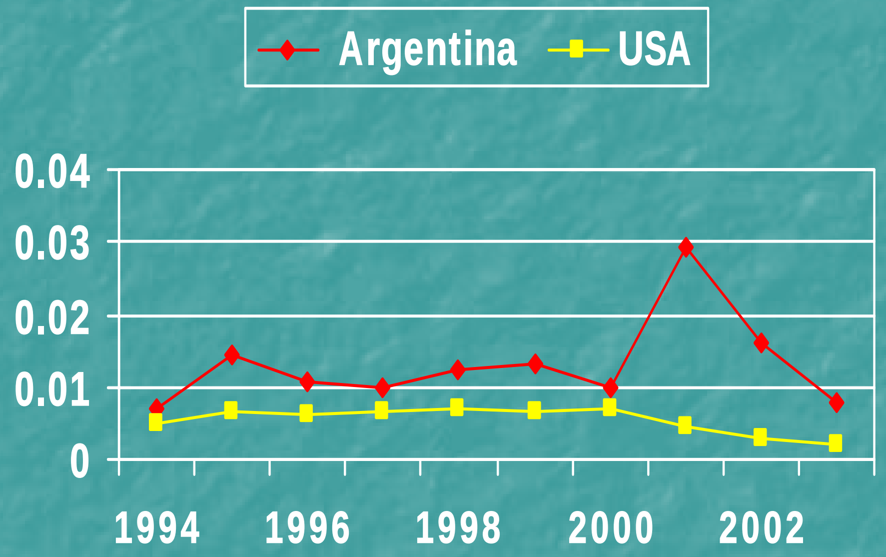


Figure: 13 Credit risk Stabdard & Poor		
Argentina		
Foreign Currency Long Term Debt		
RATING	EFFECTIVE	
B-	01/06/2005	up
SD	06/11/2001	down
CC	30/10/2001	down
CCC+	09/10/2001	down
B-	12/07/2001	down
B	06/06/2001	up
B	08/05/2001	down
B+	26/03/2001	down
BB-	19/03/2001	down
BB-	14/11/2000	down
BB	01/11/2000	down
BB	02/04/1997	up
BB-	25/08/1993	Neutral
Source: S&P		

Alternative Perspectives on Financial Crises
Cases of Endogenous Fragilities

- **2. Original Sin: Difficulty of the country to borrow in its own currency**

  A case of missing market

  Loss of control over monetary policy in case of fixed exchange rate and full financial integration

The responsibility of the Convertibility Law (overvaluation of 40%)

a. To fix the currency to a country which is not the man commercial partner is never a good idea
b. To Keep the peg when the main commercial partner (Brazil) devalues is devastating

Alternative Perspectives on Financial Crises
Cases of Endogenous Fragilities

3. The Financial Fragility Hypothesis

When an economic unit is in a speculative position its cash receipts are lower than interest payments. With an external shock the unit is then forced to borrow simply to pay for interests on outstanding debt. This can be explained by a combination of "*the internal dynamics of capitalist economy*" and "*a system of intervention and regulations*" is intended to "*keep the economy operating within reasonable bounds*" (Minsky, 1992, p9)

However, this logic CANNOT be automatically applied to a sovereign country as it would neglect the political aspects of the formation and action of Governments.

Missing elements and problems associated with the “conventional literature” both Orthodox and Heterodox

1. Distributional implications (i.e. monetary policies)
2. The Relation between Finance and the Real Economy
3. Political factors
4. Macro-Micro separation: for example privatization
5. The role of the Convertibility Law

The Need to Consider Conflicts

- Intra-Capital Conflicts

  The exchange rate becomes an instrument to mediate between the interests of foreign creditors and domestic capitalists (with links abroad) Devaluation Vs. Dollarisation

- Inter-Class Conflicts

  The exchange rate is an instrument to mediate between a global dimension and a domestic reality and serves to accommodate the interest of an international capital which accumulates globally but attacks labour nationally as conditions of exploitations are defined nationally (i.e. State intervention)