The theoretical consequences of financial crises - the case of Argentina

The ideology of *laissez-fair* has dominated economic policy since the collapse of Bretton Woods in 1971. However, the increased frequency of financial crises has encouraged a prolific literature in which, progressively, the idea of the malfunctioning of the market is replacing the view that financial crises are provoked by state failures. As a consequence, policy prescriptions advice on the need for *appropriate institutions,* which should be able to correct market imperfections.

The aim of this paper is to present a review of the literature on financial crises and its applications to Argentina, as attempts to explain its crisis has spanned to whole scope of international macro-economic literature. This has been classified into two main groups: the orthodox perspective of the perfect functioning of the market and the alternative explanations of crises as triggered by market failures. It is argued here that these two broad perspectives have much in common. They both see the economy as synonymous with the market and have similar micro-foundations.

Furthermore, despite some novelty, the heterodox views pose that failures arise from some sort of asymmetries within the market participants. In these studies, the role of institutions then, is to put boundaries on the speculative and destabilising behaviour of economic agents. But how these institutions are formed and how they should pursue this specific tasks remain outside these theories. The important question here is the assumption that powerful financial interests and the tendency of the economy to monopolise would not have any influence in the process of creation and functioning of these institutions. As a consequence, two kinds of inconsistency develop: first, the state and the central bank are indicated as a panacea for every trouble experienced in the economy, but these institutions are supposed to be unconnected with the powerful interests individuated in the economy. Secondly how these institutions would have the ability and the means to act to limit these powerful interests remain unexplained.

However, the conventional literature shows important omissions with respect to a series of factors and relations about the economy. First, it does not consider distributional implications. Second, the relation between finance and the real economy is left aside. Third, the role of monetary policy in general and the exchange rate in particular with respect to Argentina, is considered to be technical one. Its political and distributional implications are overlooked. Fourth, there is not consideration of political factors and the role of the state is oversimplified. Fifth, this literature considers macro and micro as separated entities without consideration of their interaction. The inability of the conventional literature to provide a theoretical framework able to explain a series of issues opens the way for the analysis of two alternative perspectives rooted in the Marxist tradition. These see the Argentine crisis as a manifestation of intra-class and inter-class conflicts respectively.

This paper is organised as follows. The first section critically reviews the main orthodox explanations of the causes of financial and currency crisis as well as heterodox theories of financial fragilities endogenous to the market, including the Financial Instability Hypothesis, the Original Sin and the Sudden Stop. The next section analyses important omissions of the conventional literature and explains how the two radical perspectives on intra-class and inter-class conflicts see these factors and relations omitted in the rest of the literature. The conclusion outlines new avenues for research.

1. Examining theories of financial crises on Argentina

"It's Mostly Fiscal (IMF)"[1]

Free market ideology has dominated financial policy since the collapse of the Bretton Woods agreement in 1971. This neoclassical theoretical framework focuses on the market and on the assumption of its perfect functioning, as the best method for allocating resources. From this perspective, financial crises are caused by exogenous departures from its optimal functioning. A detailed list of such offences against the market, commonly cited by international macro-economists, would include inadequate regulation, lax fiscal policy, and inconsistency between monetary and fiscal policies.

Alternative explanations of financial crises refer to fragilities which are endogenous to the functioning of the market. Examples of such fragilities include Original Sin,[2] which is the inability of a country to borrow abroad in its own currency, and the idea of Sudden Stops, which is that financial crises are triggered by rapid reversal of capital outflows. Within the heterodox tradition, H.P. Minsky developed the Financial Instability Hypothesis (FIH) that encompasses a wide range of elements. The strong theoretical foundations of his work evokes the role of uncertainty and expectations in Keynes, the importance of innovation in Shumpeter, Kalecki's theory of profits, and the self-reinforcement dynamic of Fisher's debt deflation theory. Minsky has undergone a revival of interest since the Asian crises, mainly because of the increased frequency of financial disasters, and the need for perspectives different from the unconvincing orthodox view. According to his FIH, fragility is endogenous to the functioning of the market, which is inherently unstable and, if left unregulated, follows a cycle of booms and busts.
As the Argentine crisis deepened in 2002, economists put forward theories to explain the crisis that spanned the whole macro-economic literature. The purpose of this section is to review the main theories that were used in attempts to interpret that crisis. The intention is to open the way towards a number of critical considerations, which will be pursued in the next section. Although they differ in various respects, the theories reviewed here are based on similar assumptions and methodologies. This section concentrates on the internal consistency of those theories while the next one considers important omissions from most analyses of the crisis. The aim is to explain the theoretical foundations of the two broad perspectives, market failure vs. state failure, with specific references to academic works on the Argentine crisis. The aim is to demonstrate that the difference between the two views is less than it appears to be: the endogeneity of the financial fragility presented by proponents of the market failure view provide a rationale for state intervention. On the contrary, for the orthodox position, the state should have the minimum role of enabling the market to work. The terminology and the approach used in international macroeconomics are evocative of simple board game rules with little content in terms of references to the real economy. As a direct consequence, the whole literature on financial crises by Minsky (and the works based on his theory) and on the market failure paradigms in general, not only show important inconsistencies but they also prove to have crucial absences. These omissions will be the subject of the next section.

1.1 In search of a theory: market vs. state

The explanations of the crisis by the International Financial Institutions (IFIs) blame Argentina and its fiscal policy. Moreover, this explanation recalls the debate state failures vs. market failures, of which the following passage taken from an open letter from the Chief Economist of the IMF to the ex Chief Economist of the World Bank (Kenneth Rogoff and Joseph Stiglitz, respectively) is a good indication.

[1] Porzecansky (2002). This is to stress how the IMF economists were particularly keen on blaming the lax fiscal policy of the Argentine politicians as a main cause of the crisis.
[2] The creative denomination comes from the fact that the country's policy is not responsible for this problem.

> “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, p 1)

From the orthodox perspective, including the IMF, crises are provoked by exogenous factors. These may be an inadequate regulatory system, non-implementation of reforms or even wrong sequence of these reforms, corruption and wrong choice of exchange rate policy. The idea, as usual, is that state interventions have a distorting effect on the economy and move it away from equilibrium. Markets are able to allocate resources efficiently and optimally and state intervention causes a distortion on prices that send wrong signals to economic agents. Policy recommendations for Argentina, based on the assumption that markets are the best way to allocate resources, had included: import liberalization, domestic financial liberalisation, capital account liberalisation, fiscal contractionary policies.

The opening of the capital account is only one example of this perspective, according to which, financial globalisation should push to an efficient allocation of funds. International capital markets work by equalizing risk adjusted marginal products across countries. Capitals should leave capital-rich countries with low marginal product and invest in capital-poor countries that show high marginal product. Argentina had experienced a decade of capital account openness and financial liberalization thanks to which its private sector indebtedness had been rising uncontrollably.

The link between financial liberalization and growth has been questioned within the IMF as well. For example, recently, there have been a number of empirical studies to prove that the link between financial liberalization and growth is problematic (Prasad, Rogoff, Wei and Kose, 2003). Therefore, empirical evidence does not sustain the theoretical framework of the international financial institutions. But, instead of questioning the validity of their theories, they blame, when things go wrong, state failures of any sort such as corruption, weak institutions and any other government policy. In the case of Argentina, it is lax fiscal policy. In the end, the theories put forward by the IMF and orthodox economics are completely unconvincing from a theoretical viewpoint. Moreover, the whole debate of state vs. market is misleading since it is based on a categorisation that does not reflect the functioning of the economy and which misses out important considerations about the economy, as it will be discussed in the next section.

Following Kaminsky (2003), financial crises are classified into six varieties: fiscal deficit (first generation model), current account, self fulfilling pessimism (second generation models), financial excess (third generation model), Sudden Stops and sovereign debt.[3] This section is organised as follow: the first part reviews the wide-ranging literature on crises, particularly the three generations of models as applied to the Argentine crisis. The second part explains different theories based on endogenous sources of financial fragility. The third part focuses on the post Keynesian paradigm of Minsky. It concludes with some of the shortcomings of these theories. Although these two sets of theories of financial crises reflect state failure versus market failure perspectives, they are, in fact, based on similar assumptions and methodologies. In particular, they are internally inconsistent in their policy prescriptions, neoclassical in their methodology, and fail to consider country specific and historical details.

1.1 Three generations of crisis models applied to Argentina

It is important to consider the assumptions behind orthodox analyses of financial crises, as recent studies have began to question them without abandoning the neoclassical core of their theories. One of the most important assumptions is that all relevant information is available to all market participants at the same time and future outcomes exactly match current expectations. In other words, there is no

[3] According to Kaminsky (2003) the Argentine crisis of 2001-2002 is a current account and therefore a second generation crisis. The present paper does not share this view.

uncertainty. It also assumes that markets are “rational”; at any point in time they fully discount all relevant information. Prices reflect fundamental future values based on that information. This means that market price changes reflect new information relevant to determining future fundamental values. In addition, it assumes that all markets clear with balanced supply and demand, there are no transaction costs, and that there exists a static self-correcting long-run equilibrium (Eichner and Kregel 1975, Felix 1999). The standard international macroeconomic Mundell-Fleming framework is unable to explain financial crises. With fixed exchange rates, since there is perfect capital mobility, capital flows in when the central bank raises interest rates. So any change in monetary policy is undone by the private sector. With flexible exchange rates, since the monetary authority does not intervene in the foreign exchange market, private capital outflows and inflows correspond to balance of payment surpluses and deficits, respectively.

However, pervasive financial turmoil in Latin America at the end of the 1970s and the beginning of the 1980s gave the first impetus to a prolific literature on balance of payment crises. The seminal paper of Krugman (1979), now called the first generation model of currency crises,[4] was dusted off after the Argentine crisis of 2001-2002. The central focus of this model is the inconsistency between monetary and fiscal policies and the exchange rate commitment. Crises are triggered by an increasing current account deficit (indicating a trade deficit) or an expected monetisation of the fiscal deficit. When the country finances its fiscal deficit by printing money it leads to excessive credit growth and the eventual collapse of the fixed exchange rate regime. The IMF (Krueger, 2002; Mussa, 2002; Graham and Masson, 2002) explained the Argentine crisis in terms of lax fiscal policy and wrong choice of exchange rate, while Dominguez and Tesar (2005) consider this mechanism to be just one of the main causes of the crisis. In reality, data show that there was no increase in government *primary* expenditure (figure 2.1) but that *interest payments* increased dramatically during the 1990s as a proportion of both GDP (figure 2.2) and total government expenditure (figure 2.3).

Other theorists (Roubini, 2001; Kaminsky, 2003) interpreted the Argentine crisis in terms of the second generation crisis model (Obstfeld, 1996). These models were developed after the European Exchange Rate Mechanism (ERM) crisis which the first generation model failed to explain. They stress self-fulfilling expectations and herding behaviour in international capital markets, unrelated to market fundamentals. According to this theory, governments, especially in mature markets, are faced with two conflicting targets: employment and inflation. A fixed exchange rate may help to keep inflation under control at the cost of higher unemployment and reduced competitiveness. The government could improve employment by restoring competitiveness and abandoning the peg through a devaluation of the exchange rate. So a typical crisis might start with devaluation in one country, say country A. This affects the price level and hence the demand for money and the current account in the neighbouring country, say B, in which, as a result, devaluation becomes increasingly likely. This so-called contagion effect happens either because of similar macroeconomic fundamentals between the two countries, such as the level of employment and exchange rate arrangements, or because they are trading partners. The increased likelihood of a crisis after a crisis in a neighbouring country has even been measured (Eichengreen, Rose, and Wyplosz, 1997).

In an empirical work of reclassification of virtually all the crises in the world since 1970, Kaminsky (2003) classifies the crisis in Argentina in 2002 in the category of the second generation models. In particular, she found that a current account problem was associated with real appreciation fuelling loss in competitiveness and recession. For this kind of model then, the country does not need to exhibit particular forms of fragility. These are, in fact, defined as self-fulfilling crises and are associated with

[4] The Tequila and Asian crises have been at the root of a third generation of models (Krugman, 1999) focusing on fragility in the banking and financial sector, focus on moral hazard and imperfect information, with excessive booms and busts in international lending and asset bubbles. Here the banking sector plays a crucial role.

indicators such as term of trade, trade balance and interest rates. For Roubini (2001, p10) “spreads such as those experienced by Argentina have a component of self-fulfilling arbitrariness”.[5]
Still, the Mexican crisis of 1994-1995 first, and the Asian crises later, gave new creative impetus to international macroeconomics: a third generation model was developed (Krugman, 1999). This model concentrates on institutional weaknesses in the financial market which interact with the currency market and generate the so-called twin crises.[6] Models of this kind are based on moral hazard in financial markets.[7] Financial institutions are not as prudential as they should be since they expect to be bailed out by the central bank (or even IMF) as lender of last resort. A crash may be prompted by an excessive creation of money to save troubled financial institutions or also by an unregulated financial sector with deposit insurance. Capital inflows may lead to excessive lending with consequent bubbles in stock market and real estate. When a recession starts, the deterioration of the current account arouses concerns about possible default on foreign loans. Governments then face the choice between defending the banking sector and defending the pegged exchange rate.
The literature on the interaction between currency and banking crises in what are known as twin crises has become relatively large. Examples are Mishkin (1996) in which devaluation weakens the position of the banks if a large share of their liability is denominated in foreign currency. A related argument is presented by McKinnon and Pill (1998), in which a financial sector crisis is provoked by maturity and currency mismatches in the balance sheets of the financial institutions. Reinhart and Carlos A. Vegh (1996) review cases in which the two kinds of crises may have a common origin when countries implement exchange rate based stabilisation programmes such as Argentina in 2001-2002. The explanation is based on the fact that inflation converges only gradually to international levels and consequently the exchange rate appreciates. An initial boom in imports financed by borrowing abroad will fuel the turmoil. As the current account widens, financial market expect the stabilisation program to fail. The argument is considered to explain the Argentine crisis by Blejer (2002) who blames the banking sector and its lack of competition due to the resistance to closure of public banks. A detailed account of this mechanism in Argentina is given in Mondino (2002).
Indeed, although Argentina was congratulated for having a sturdy banking system, which was put in place after the Tequila crisis, there were concerns that the banking reforms were not as deep as they needed to be, given that the hard peg deprives the central bank of its role of national lender of last resort (Graham and Masson, 2002).[8] However, according to Dominguez and Tesar (2005) the balance sheets of the banking system did not show currency mismatches. Nevertheless, dollar denominated bank loans went to Argentine households and companies, which were earning in pesos. As a consequence, currency mismatches and risk of devaluation were completely transferred to the private non-banking sector. A large devaluation would have made repayment very difficult. Moreover, while the amount of these loans did not exceeding 23% GDP, it is estimated that over $100 billion were kept by Argentine residents in bank accounts outside the country (Basualdo, 2001).
Finally, it is worth mentioning that some commentators were concerned with structural features of the Argentine economy. The fight against corruption and ensuring property rights were seen as a priority over more technical macroeconomic policy choices such as the exchange rate mechanism (Caballero and Dornbush, 2002a, 2002b). Indeed, that Argentina had made significant reforms was recognised by many after the crisis, but the reform program was estimated to have been incomplete, in particular in the labour market and in the half privatised social security system (Edwards, 2002; Krueger, 2002).

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[5] Roubini gives a full account of these indicators supporting the view that Argentina was hit by one of these crises.
[6] These crises are named “twin” as they are both a currency and a financial system crises.
[7] Moral hazard is a concept of the theory of insurance according to which insured individuals or firms lower their prudence in the face of risk since they know that the insurance company will pay in the case of negative event.
[8] In reality the Convertibility Law allowed up to 33% of international reserves to be dollar denominated, internationally traded argentine bonds. Therefore, the country had a very limited role of lender of last-resort because it could provide the banking system with pesos in exchange for sovereign Argentine bond rather than dollars.

1.2 Endogenous fragilities

This second part examines alternative perspectives on financial crises. They are based on factors that are endogenous to the market. The first sub-section describes the theory of Sudden Stop and the problem of the Original Sin. The second sub-section explains the Financial Instability Hypothesis followed by its applications to an open economy and to the last crisis in Argentina.

1.2.1 Sudden Stops and Original Sin

More recently, the literature has opened the way to sources of fragility endogenous to the market. In particular, the question of capital flow reversals and the problem of Original Sin are seen as important components of market fragilities which can play a crucial role in triggering a crisis. The dogma of perfect functioning of the market is weakened in these two streams of study, but the flavour remains purely neoclassical, as will be discussed below. I shall explain briefly the two cases, starting with the work on capital flows and then turn to the problem of foreign debt connected with Original Sin.

The literature on Sudden Stops makes the case of severe capital flow reversals as an important source of instability.[9] In countries like Argentina, with a small proportion of tradable good output relative to domestic absorption of tradable goods, a Sudden Stop in capital inflows requires a sharp increase in the equilibrium exchange rate to push down the current account deficit.[10] With currency mismatches due to liability dollarisation, the real depreciation leads to weakening of the balance sheet of both the corporate sector and government. However, according to this view, the reversals of capital flows can be as dangerous as they have been in Argentina because they are combined with domestic financial fragilities. By comparison, Chile also experienced a similar Sudden Stop, but it was able to manage the situation without entering a devastating crisis. This was thanks to different currency composition of its corporate sector's liabilities and a different proportion of tradable goods (Calvo and Talvi, 2004). As shown in figure 2.4, the Russian default affected capital inflows into Argentina, which became negative in the last quarter of 1998. For Calvo et al. (2002), two factors represented the perfect cocktail for a disaster in the event of capital flow reversals in Argentina; firstly, the level of indebtedness, with currency denomination mismatches[11] such as a high level of domestic liability dollarisation; secondly, the dependence on financing from abroad to pay for imports. The Stop occurred with hikes in interest rate; although Argentina had little commercial relation with Russia, it experienced sudden difficulties in finding financing from external capital. It is worth mentioning that emerging economies were direct beneficiaries of the enormous increase in financial resources made available from the US stock market.[12]

Interest rate spreads rose from 450 basis points to 1,600 basis points in September 1998, more than tripling the cost of external financing in a period of weeks (Roubini, 2001). The central idea of this theory is that crises may be caused by "a sudden, *synchronized* and widespread increase in interest rates" as "*big players* in the *central* capital markets are subject to a liquidity crunch"(Calvo and Talvi,

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[9] A Sudden Stop is a sharp decline in capital flows. Dominguez and Tesar (2005) report detailed work on the exact definition/measurement of this kind of phenomenon in footnote 13. The main factors that trigger a crisis of Sudden Stop are interest rate increases and growth slow down, with highly dollarised debt concentrated in short maturity. A Sudden Stop crisis is more likely to happen in emerging economies.

[10]This mechanism is described in Domingues and Tesar (2005, p 9).

[11] Eichengreen, Hausmann and Panizza (2003) describe that the inability of emerging market economies to issue debt in local currency can be traced to two possible phenomena: "Original Sin" or "debt intolerance". Original Sin implies that the problem arises externally, with the structure of global portfolios and international financial markets, while debt intolerance implies that the problem arises internally, with weak institutions.

[12] Calvo and Talvi (2004) report that the Dow Jones multiplied by four and one half and the NASDAQ by fourteen between October 1990 and early 2000

2004, p. 9, italics added). Domestic fragilities can mitigate or accentuate the effects of a Sudden Stop, but they cannot be eliminated.

An additional source of endogenous fragility is known as Original Sin. This refers to the inability of a country to borrow in its own currency. This problem is directly linked to both foreign debt and exchange rate choice. In fact, the sustainability of the foreign debt is a recurrent concept in the literature on the Argentine crisis especially in connection with the exchange rate regime. Examples are abundant: Porzecansky (2002), Feldstein (2002) and Pou (2002) for whom a fixed exchange rate and an excessive borrowing from abroad was a devastating mix for the Argentine economy. Perry and Serven (2002) examine the vulnerabilities of deflationary adjustments to shocks under hard peg associated with high debt and lax fiscal policy. The Convertibility Plan was a bad exchange rate policy, although it is argued that it helped in fighting inflation, Perry and Serven (2002) estimated that the peso was overvalued by 40% in 2001.

Two questions related to the Argentine exchange rate regime are important. Firstly, to peg to the strong currency of a country which is not the main commercial partner (USA) was not wise; to keep the peg when the main commercial partner (Brazil) devalued its currency was disastrous. Secondly, Hausmann and Velasco (2002) associate the problem of Original Sin to the question of the exchange rate regime. A crucial consequence of the inability of a country to borrow abroad in its own currency is that currency mismatches in the balance sheets of financial institutions and corporate sector are unavoidable. Under these conditions, in fact, a country is unable to hedge the currency risk since it is impossible to find a mirror exposure in the market. In other words, Argentineans could not hedge their US dollar exposure because nobody in the US had to hedge a Peso exposure. At the macro level, then, full international financial integration will cause a country to lose control over its interest rates under a fixed exchange rate and hence, over its monetary policy completely. As a consequence, countries that cannot borrow abroad in their own currency are naturally more sensitive to real exchange rate and international interest rate movements. The currency hedge problem can be passed around between banks and firms but cannot be eliminated. This is clearly a market failure or, more precisely, a problem of missing markets. The literature on the argument is in its infancy, and it will be interesting to see its development. For now, the question remains why Argentina chose to (try to) stabilise the exchange rate instead of stabilising output. I shall discuss this point at the end of the next section.

1.2.2 Minsky' Financial Instability Hypothesis

Besides new theories that highlight vulnerabilities in the market mechanism, in recent times an older theory related to market fragility has undergone a revival of interest.

Following Keynes, Minsky developed a theory of endogenous financial crises that stresses uncertainty, speculation and expectations. Economic units can assume three different financial attitudes, hedge, speculative and Ponzi,[13] according to two dimensions: the unit’s cash flow prospects and the financial market conditions.

A speculative unit is forced to roll over its debts as the cash flows prospects are too low to pay for its debt in the short term; however, its expected cash receipts in the longer term exceed outstanding cash payment commitments. The speculative unit is close to the Ponzi finance structure in which cash receipts are lower than interest payments in both short and long run. As a result, the unit is forced to borrow simply to pay for interests on outstanding debt. In this circumstance, its debt increases rapidly and the risk of default becomes very high.

With increase in investment, growing profits secure the payment of cash commitment and optimistic expectations are pervasive. Hedge finance predominates in the economy. Credit is expanded. Profit maximiser agents invest in long-term assets using short-term finance: the balance sheets of any unit

[13] A Ponzi scheme takes its name from the Italian immigrant Carlo Ponzi who tried to run a pyramid scheme during the 1920s in Boston. Ponzi used the money from later investors to pay off his earlier obligations.

start to present maturity mismatches between assets and liabilities. The financial posture of economic units is transformed into speculation.[14] Prices and profits boost and the demand for finance increases. This leads to a raise in short-term interest rates and hence in long-term interest rates. If liabilities cannot be met by the cash flows generated by the asset side of the balance sheets, the roll over of debts will be refused. This will cause a domino effect on the interconnected balance sheets of household, businesses and financial institutions with the collapse of asset prices. The action of the central bank, acting as lender of last resort, is crucial in avoiding a financial crash. At the same time, the government should maintain effective demand through fiscal policy.

Two factors, besides the concept of uncertainty, play a crucial role in the Minskyian system, expectations and financial innovation. Firstly, changes in expectations on income and interest rates have important implications on stability since they affect directly what Minsky called margins of safety, which test i) the capacity of future cash flows to meet payment commitments and ii) whether payment commitments may be met by selling assets. But the role of expectations is also important indirectly, since capitalists have a view about what capitalists believe other capitalists' beliefs in financial markets (the Keynesian beauty contest). Moreover, the role of expectations reflects Fisher too: in the debt deflation theory, the turning point towards the down side of the cycle manifests itself when expected future profits are higher than the cost of capital. The process is inherently endogenous in the market mechanism and fundamentally unavoidable. The reason for the instability is that

> "The economic system contains innumerable variables-quantities ... Changes in any or all of this vast array of variables may be due to many causes. Only in imagination can all of these variables remain constant and be kept in equilibrium by the balanced forces of human desires, as manifested through "supply and demand"." (Fisher, 1933, p. 337)

As a result, the economy does not show self-equilibrating forces and times of stability are purely transitory and show the germs of a new crisis.

Secondly, financial innovation plays an important role as well. In fact, for Minsky, the very cause, the *primum mobile* of financial instability is the drive towards financial innovation: innovators look for profits in production, marketing and finance, and market instruments are created to exploit arbitrage opportunities. To illustrate this point, Minsky described how the relationship between commerce and finance evolved in the United States in a shift from big business to big finance: in colonial times, the use of bank credit was essentially for commercial transactions; on the contrary, in today's era of money-manager capitalism, institutional investors play an increasingly influential role in corporate decision making (Meherling, 1999). Minsky was clearly sharing with Kalecki (1954)[15] the idea that the economy has a tendency to monopolise and that financial conditions cause investment.

As a result, in terms of policy prescriptions, Minsky's concern was that big business was putting a distance from the ideal share of the fruits of growth: like Keynes, he believed that government and central bank were of paramount importance, to stimulate demand and to act as lender of last resort, respectively. In particular, since financial instability "does not rely upon exogenous shocks to generate business cycles of varying severity", Minsky's theory maintains that business cycles can be explained

[14] The difference then between speculators and entrepreneurs is that speculators are interested in foreseeing the price of assets in the future, while entrepreneurs are interested in the actual profitability of the investment, the prospective yield.

[15] Kalecki's idea that profits are largely determined by what firms themselves spend on investment was central, since it is with profits that debt is validated, supporting asset prices.

by a combination of the "internal dynamics of capitalist economy". A "system of interventions and regulations" is intended to "keep the economy operating within reasonable bounds" (Minsky, 1992, p 9).

1.2.3 Minsky applied to an open economy…

Minsky's research question was about the monetary system in a democratic, financially advanced economy. His theory was developed in the US context. To what extent it is applicable beyond the US in general, and to an emerging economy in particular, depends on a number of considerations. A more detailed critique of the applications of his theory will be discussed below. For now, it is important to consider that the idea behind his work has not been captured in the studies that have used the FIH to explain the Asian Crises (Arestis and Glickman, 2002) and the Argentine crisis (Kregel, 2002).

Minsky had a deep *specific* knowledge of the financial system of the US. But the above applications are *generic*, and their reasoning is intended to be applied to a variety of situations. Furthermore, the mechanism that triggers the crisis depends essentially on interest rate movements and their effects on balance sheets of the private sector. But in an open emerging economy, alternative sources of fragility such as Sudden Stops or Original Sin are indeed consistent with the Minsky's original work, but left unexplored by later applications. Certainly, the extension of the FIH to an open economy necessitates the consideration of additional sources of fragility. Firstly, debt might be due in a different currency; therefore the vulnerability to adverse changes in financial conditions experienced by a unit in a closed economy is augmented by both exchange rate risk and country credit risk. Secondly, as seen in 1.2.1, emerging economies usually experience the inability to borrow abroad in their own currency and therefore to hedge against currency risk. Thirdly, the risk of Sudden Stops and capital flow reversals is an additional font of fragility and raises the question of capital controls which is the focus of a wide debate in the field of international economics.[16]

1.2.4 …and to Argentina

Applications of the Financial Instability Hypothesis to the Argentine crisis have been extremely diverse: the FIH can be applied purely in terms of corporate finance at a micro level, analysing balance sheet data, as for example in Arza and Espanol (2005). Alternatively, it can be applied at a macro level (Arestis and Glickman, 2002) or even to the balance sheet of a sovereign borrower (Kregel, 2001 and 2004). In particular, the "balance sheet approach" has recently been very successful outside the academic environment and used as an analytical framework by Investment Banks around the world (i.e. Deutsche Bank,[17] Nomura[18]).

There are two cases in which Minsky has been specifically applied to the Argentine crisis: Arza and Espanol (2005) have applied it to a micro-economic context, while Kregel (2004) has used the FIH to explain the debt dynamic of the Government. I shall describe these two applications to highlight their major shortcomings.

According to Arza and Espanol (2005), Argentine firms showed speculative behavior during the 1990s. This increased their fragility at the balance sheet level and prevented firms from pursuing a strategy of longer-run productive investment. In particular, this behavior was made easier by the newly created and widely available financial opportunities after the liberalization of the financial institutions. Over a

[16] For a literature review and a discussion about capital and financial crises see Palma (2002)
[17] See for example [http://www.dbresearch.com/PROD/DBR_INTERNET_DE-PROD/PROD0000000000202011.pdf] and other results of Deutsce Bank research, Frankfurt
[18] Koo R. (2003), Balance Sheet Recession, Wiley. Koo is chief economist of Nomura Research Institute, http://www.nri.co.jp/english/

sample of 74 of the 104 Argentine firms listed on the Buenos Aires Stock Exchange, Arza and Espanol (2005) show that the median value of the ratio debt/net worth had doubled during the 1990s. In particular, hedge units went from a value of 0.2 of 1992 to a 0.8 in 2001, while speculative and Ponzi units went from 0.5 in 1992 to over 1 in 2000. Those units which were hedging at the beginning of the period, showed an increasing proportion of short-term debt over the total debt from below 0.4 to more than 0.6 (Arza-Espanol, 2005). These data clearly show how Argentine firms were in a Ponzi scheme. Unfortunately, this study does not take into account the financial posture of small and medium firms, which, by their very nature, might have been the weakest link of the payment chain and might have been the beginning of the domino effect that resulted in the crisis.

In a macroeconomic application of the Financial Instability Hypothesis, Kregel (2002) describes the Argentine debt dynamic as a Ponzi scheme: for firms, cash commitments are known with certainty but cash inflows might be volatile and subject to market fluctuations. On the contrary, sovereign borrowers face even harsher conditions, since both types of cash flows, those generated by the assets and those generated by the liabilities, are outside their control. In Argentina, growth was associated with the success of the Convertibility Law in beating inflation. Liberalization of trade and capital accounts and the reduction of the role of the government through privatization secured large capital inflows. But increasing capital inflows added pressure on the current account because of the rising share of interest payments. With an additional pressure on the current account due to the Brazilian devaluation, Argentina had to increase foreign borrowing in order to pay for interests on outstanding debt: a Ponzi scheme. This dynamic highlights an important point about the shift in Argentine policy and is clear evidence of the "transition to neo-liberalism" as applied during the 1990s. The liberalization of the capital account was supposed to increase efficiency in the allocation of capital. But this measure turned into the maintenance of a Ponzi scheme in which "deregulated open competitive markets and free international capital flows were seen as a necessary and sufficient conditions for a successful development strategy" (Kregel, 2004, p.15).

However, this application of the FIH to a sovereign borrower cannot be accepted as valid. Some shortcomings of the logic and methodology used in Minsky will be discussed below and more extensively in the next section. For now, it is important to highlight that the application of the FIH logic to a sovereign borrower is unsound. In fact, shifting the unit of analysis from a firm or financial institution to a sovereign borrower government seems flawed both theoretically (Kregel, 2002) and empirically (Kregel, 2004). It disregards completely the fundamental differences between a government and a firm, because it neglects the importance of the political and political economy dimensions of a country and the whole process of government policy formation.

1.3. Critical aspects of the literature on financial crises

1.3.1 On the Financial Instability Hypothesis

Firstly, there is an important assumption in Minsky's work that may be considered highly unrealistic and of questionable internal consistency. The credit market is considered to be homogeneous. As a result the micro-foundations of the FIH are based on a representative individual, which Minsky calls unit, and on a representative relationship between borrower and lender (Dymsky, 2005). This has two important consequences. On the one hand, we have an undifferentiated world of units. Thanks to this homogeneity; the economy can be treated as a simple aggregation of individuals. In reality, low-income "units" are likely to be affected by "financial exclusion"[19]; as a consequence the representative

[19] Dymsky (2005, p 440) describes financial exclusion as "the failure of the formal banking system to offer a full range of depositary and credit services, at competitive prices, to all household and/or businesses… on the base of race or ethnicity, geographic area, gender and so on-compromises their ability to participate fully in the economy and to accumulate wealth"

individual as unit of analysis is invalid. On the other hand, Minsky highlights how in the contemporary money manager capitalism, the largest share of the corporate sector‘s liabilities is in the hands of a few financial institutions (Minsky, 1996). This tendency of the economy to monopolise is inconsistent with the assumption of the homogenised world of a representative individual.

Secondly, Minsky was convinced that capitalism had to be regulated. Institutions had to be the solution to both the instability of the economy and the question of social issues. However, the way these institutions are formed remains outside his theory. The important question here is the assumption that powerful financial interests and the tendency of the economy to monopolise would not have any influence in the process of creation and functioning of institutions. These institutions, in turn, should put boundaries on the speculative and de-stabilising behavior of economic agents. In other words, those political elements which were present in the initial formulation of Minsky, like the tendency of the economy to monopolise are abandoned; the existence of some sort of economic power of the big finance is left aside in the normative part of Minsky’s work and in the later applications of his ideas. As a consequence, two kinds of inconsistency develop: firstly, the state and the central bank are indicated as a panacea for every trouble experienced in the economy, but the process of formation of these institutions is supposed to be unconnected with these powerful interests. Secondly, how institutions should have the ability and the means to act to limit these powerful interests remains unexplained. In this, Minsky is similar to other market failure views.

Later applications of FIH, completely overlook this aspect of his initial work: without bringing the social and political dimension back in, Minsky’s ideas risk becoming mechanical and partial as the embryonic socio-political dimension from Minsky’s original work is set aside.

1.3.2 On Market Imperfections

We can categorise the second set of the perspectives exposed as the market failure views. They encompass the theory of Sudden Stops, the Original Sin and the Financial Instability Hypothesis. This sub-section highlights some shortcomings of this broad approach mainly in terms of internal consistency.

Firstly, according to these perspectives, the idea that markets do not work perfectly allows for a re-design of the role of the government and the whole financial system. If there are interests and indeed economic and financial power in the economy, they are implicitly supposed to vanish in the formulation of the policies that should help a more egalitarian distribution of the fruits of growth. Implicitly then, the government is supposed to be above these interests and this power. However, the superiority of the “big government” remains a dogma precisely as the perfection of the market for the orthodoxy. Economic and political relations and the social structure in which they interact, which are themselves the results of previous interactions, are left aside. Minsky’s concerns about big businesses and big finance, for example, or even the re-design of the whole world financial architecture for Calvo and Talvi (2002, 2004), are seen to be resolved within an institutional framework of big government and big bank, as if this regulatory system was a *deus ex machina*. There is no explanation of the existence of neither these institutions nor, most importantly, the reason why such institutions should behave exactly in such a way as to avoid financial crises that, in turn, may have distributional implications. In other words, this view shows a contradictory logic: in the market failure paradigms the *primum mobile* for the market failure itself is an asymmetry between market participants in terms of access to information, market power and so on. Now, this position of power is supposed to vanish in the process of formation of institutions. Furthermore, once these institutions are formed, they are supposed to be benevolent and act in such a way as to correct market imperfections in a socially desirable way.

Secondly, these approaches remain essentially neoclassical in the sense that they abandon the analysis of the real side of the economy, apart from the subset that touches the financial side. Trade, consumption, and even production are left aside and this focus on market disregards other aspects of the economy.

Finally, the economy is somehow an aggregation of individuals on the base of common behaviour which may be a sort of imperfect information or probably simply a profit maximisation, or if we want, a rent seeking behaviour or an "irrational exuberance".[20] This approach shares some similarity with the methodology employed by the orthodoxy. Those who apply these ideas of market failures, do so irrespectively of country and historical specificity. The reason for omitting political economy elements, is because it would be impossible to encompass a wide range of crisis episodes under the one idea of "*it* did happen again".[21] Those ideas would force the researcher to look deeper into the country's history. But they would be able to explain a crisis in terms of different categories of analysis like inter-class or intra-class conflicts. A financial crisis then becomes a way to solve these conflicts. This will be the core of the last section.

2 The missing links of the conventional literature and a set of alternative perspectives

"!Qué se vayan todos!"[22]

This section is organised in two parts. The first one focuses on important absences that the conventional literature shows in analysing the Argentine crisis. Each of these sub-sub-sections will show how both market failure and state failure views disregard a set of particular factors and relations. Instead, alternative perspectives rooted in the Marxist tradition are able to encompass these factors. However, these viewpoints are diverse: a discussion on the main differences between these views is presented in the second part.

2.1 What is missing in the conventional literature

What I have defined as conventional literature, for lack of a better term, include market failure and state failure views. The present part shows how this literature lacks a social dimension. The omission of social consideration in the conventional literature is evident from: 1.the absence of any analysis of the distributional implications of the policies implemented in the period before the crisis; 2. the omission of the relation between the real economy and the financial sector; 3. a lack of investigation into the role played by the state and an exploration of the political factors; 4. no analysis of the instruments used in the implementation of certain policies; and finally 5. no consideration of the relationship between micro and macro and the separation between the two spheres.

2.1.1 Distributional implications

Financial crises are seen as purely monetary phenomena and described in terms of macroeconomic aggregates as if monetary policy was neutral to the distribution of income. This is true for the conventional analysis of the three generations of currency crises models and for the alternative perspectives of the Financial Instability Hypothesis. Theories of financial turbulence do not see the origins of crises within distributional struggles. It seems that the decision over the exchange rate regime is merely a technical macroeconomic issue, in the sense that implies only considerations of

[20] A. Greenspan 's speech, 5th December 1996 in http://www.federalreserve.gov/BoardDocs/speeches/1996/19961205.htm

[21] The reference here is to Kregel (1998) who refers to Minsky (1957) "Can it Happen Again?"

[22] "All of them out". This was the main slogan of the insurrection of December 2001. The interpretation of this sentence is exhaustively discussed in Dinerstein (2002) and Bonnet (2006). In short, it represents a scream against both the hypocrite (perceived as such) process of democratization and the violent character of the neo-liberal reforms which brought unemployment and job insecurity. Here it represents economic theories that do not care about the social dimension of the economy and have important missing links with the real world.

monetary variables. However, the distributional implications of the end of hyperinflation first, and of the end of the pegged exchange rate later, are never considered. In fact, economics textbooks teach us that distribution is an objective that belongs to fiscal policy which, by its very nature, is not distribution-neutral. Monetary policy is instead considered to be ineffective as far as distributional implications.

This is in part due to the conventional literature's focus on macroeconomic aggregates, with the disaggregation of income into wages and profits considered as uninteresting. Another reason for this important absence is that the theoretical framework of this literature describes an undifferentiated world of atomised entities, none of which is able to exercise any kind of power or to have any dominant position. Examples are abundant: the basic element of analysis of Minsky, for example, is the economic unit which can be a business, a household or a financial firm; standard modelling such as McKinnon-Pill (1998) considers the economy as formed by a large number of atomistic firms-households; the representative individual is the starting point of the Sudden Stop theory explained in chapter two (Calvo, 2003).

Even when dominant positions are assumed to exist, they are not fully analysed and explored within these frameworks. For example, a financial crisis is triggered by a sudden and widespread *synchronised* reversal of capital flows (Calvo and Talvi, 2003), but this synchronised character is seen as compatible with the assumption that the economy is a set of a large number of atomistic firms-households (Calvo, 2003).

A direct corollary of the fact that the economy does not consist of atomistic units with equally small market-shares, is that some have more power than others and different ways of exercising it. But this consequence has been ignored.

These examples of the literature on financial crises show that firms, households and banks of the same size/importance compose the economy. That is, market power, monopoly and monopsony, for example, simply do not exist. Or, alternatively, they show an implicit contradiction in their reasoning: on the one hand there is a market power like the tendency of the economy to monopolise in the Financial Instability Hypothesis or the synchronised character of the capital pull-outs in the Sudden Stop theory; on the other hand this inconvenience can simply be solved with the correctly designed institutional framework. The problem of how these institutions are created and why they should act as to avoid financial crises will be discussed in the following part. Now, it is important to highlight that some firms or household or financial institutions *are* in a dominant position and *do* use this dominant position in distributional terms, not only in the trivial sense of sharing the product between income and profit but also in a more dynamic sense: how to share the changes in value of the product.

With respect to the policies implemented during the decade before the Argentine financial crisis in 2001-2002, distributional implications have played a relevant role in triggering the crisis. In particular, privatisation, trade liberalization, capital account liberalization, exchange rate policy had important distributional consequences, which are neglected in the explanations of the crisis presented by both market failure and state failure paradigms. Instead, these distributional implications are considered to be at the root of the Argentine crisis for the Marxist literature. In spite of its diversity, in its historical, country specific approach, this literature examines the important structural changes of the Argentine economy during the 1990s in an effort to trace back the *real* origins of the crisis. I shall explain this point with three examples on the choice of the exchange rate regime, the privatisation programme and the trade liberalization respectively.

a. Exchange rate

With respect to the particular choice of the exchange rate policy, the mechanism adopted in the Convertibility Plan had clear distributional implications. The literature on the Argentine crisis explains the Convertibility in terms of successful anti-inflationary policy.[23] On the contrary, the choice of the

[23] Blejer M, Henke A, and Levy-Yeyati E, (2003); Dominguez KME and L. Tesar (2005), Krueger A. (2002).

exchange rate is explained by Basualdo (2001) and Basualdo et al.(2002) in terms of an intra-class conflict between two fractions of capital: one composed by financial groups of US origin and another linked to domestic groups and some foreign, mainly European, whose interests were essentially based on domestic production of tradable goods. The financial sector was supporting the full dollarisation of the economy, which had to become a financial instrument to guarantee the value of assets in dollars of the financial sector of North-American origin. The domestic capitalists were supporting the end of Convertibility and a devaluation of the currency, since they were mainly exporters representing the other faction. If these hypotheses are true, there have been considerable distributional implications during the 1990s from fixed asset capital mainly in the sectors of traditional comparative advantage like the agro-industry to the financial sector. According to Basualdo, the process of de-industrialisation of Argentina proves this point. In effect, the Convertibility Plan had important distributional implications also between for example, producers of tradable goods and non-tradable goods, and between capital and labour. The fixed exchange rate had an immediate effect on prices of tradable goods since domestic producers had to face tougher foreign competition. Non-tradable good producers, such as of public services, kept their dominant position and were rapidly privatised (Rodriguéz-Boetsch, 2005; Basualdo, 2001).

It is also argued that the fixed exchange rate increased the rate of exploitation of capital over labour, as the competitive pressure coming from importing cheap foreign products was transferred on labour via a rise in productivity. This resulted in an increase in unemployment. Moreover, the increase in productivity was not transferred to wages. This strategy included lowering real wages, increasing productivity and growing unemployment to create a reserve army of unemployed (Bonnet, 2006). The reduction in wages was the adjustment mechanism that had to restore international competition especially after the Brazilian devaluation in 1998. With an open economy, and without the possibility of devaluing the currency because of the Convertibility Law, Argentina used the lowering of labour costs to restore competitiveness. In particular, unemployment increased sharply from 5% in 1985 to 15% in 2000 (WDI, 2006) and a reduction of real average wages of 30% from 1985 to 1999 (Basualdo et al., 2001).

b. privatisation

Privatisation in Argentina has been a major source of redistribution.

Generally, state owned enterprises are a major source of employment. But after privatisation, unemployment increased owing to the surge in productivity. The increase in labour productivity among privatised firms was 16.9% per year between 1993 and 1998 (Rodriguéz-Boetsch, 2005).[24] At the same time, the largest 200 firms operating in Argentina generated nearly US$26 billion in profits. Of these, as much as 54 % went to only 26 privatised public service enterprises (PPSEs), resulting in average profits of US$2 billion per year. In the same period, the rate of profit among the top 200 firms was 10.8 % for PPSEs. Firms in the same group but with no ownership links to PPSEs registered an average rate of profit of only 1.6 % (Basualdo et al., 2002). The profitability of Argentine public service privatised firms is exceptional even with respect to similar companies in other countries. Aguas Argentina, for example, received an average profit on net asset of 23.3 % in the period 1994-1999. In France, the UK and the USA the net rate of profit on net asset of a water company is about 6-7%. Similar are the figures for gas transportation and telecom companies (Rodriguéz-Boetsch, 2005). These figures show that the privatisation programme has been highly distributional both in terms of labour-capital and within capital. This may have actually exacerbated pre-existing intra-class and inter-class conflicts.

c. trade liberalisation

[24] The benefit of this higher productivity were neither transferred to wage increases nor to price reductions.

An important component of the Convertibility Plan was the liberalisation of trade; foreign goods could enter the country without significant tariffs. The role of the fixed exchange rate became that of price anchor. Domestically produced goods had to have the same prices as the foreign goods. However, this measure has effects on tradable goods but not on prices of non-tradable such as the privatised public services like transports and utilities. As a result, while producers of tradable goods experienced the competitive pressure from abroad, the producers of public services did not face this pressure.
Moreover, the Convertibility Law had frozen automatic adjustments of prices and wages to eliminate inflation but this rule did not apply to the privatised companies since they claimed that inputs were to be purchased in the US, so price indexation should follow the US Consumer Price Index. When Argentina started to experience deflation and the US were having a low inflation, the inflation differential between the two countries had to be borne by Argentine consumers.

2.1.2 The relation between finance and the real economy

The conventional literature on financial crises focuses mainly on the market. Other non-market aspects of the economy are simply left aside. Dimensions such as production and the real economy in general are disregarded: the economy and the market coincide. Even those theories that see financial crises as triggered within the market are neutral as far as the nature of the markets. There is a missing link between finance and the real economy: an analysis of the structure of the real sector, for example, is absent. In reality, the impact on the real economy of the Argentine crisis has been devastating. Total unemployment reached 20% in 2002, and it was still above 15% in 2004, growth contracted to -11% in 2002, and per capita GDP shrunk to the level it was in 1980 (constant US$2000, WDI 2006)
Examples of these absences are abundant even for the theories of endogenous fragilities. The theory of Sudden Stop, for example, associates the reversal of capital flows with problems of macro aggregates but nothing is said about the real economy. Similarly, the Financial Instability Hypothesis gives a great preponderance to the financial side of the economy but leaves unquestioned the relation with the real economy. In reality, the Financial Instability Hypothesis is considered to bridge the real and the financial sector through the functioning of the interest rate (and of the exchange rate in an open economy) through their effects on the balance sheets of firms. But the theory is neutral as far as the nature of the markets in which the financial fragility explodes. The source of instability remains within the financial sphere; the triggering mechanisms and an analysis of what sectors or firms are involved remained unexplained.[25] The crisis prone character of the economy remains relegated into the financial sphere. The real accumulation of capital and how this in turn depends on political and economic power structured in the financial system and in the real sector is left aside (Itoh and Lapavitsas, 1999).
The role of the state in these triggering mechanisms is unquestioned as well. What are the effects not only of a particular monetary policy but also of a particular regulatory framework of the financial markets on the real sector are rarely addressed.[26] But how and if the state has the chance to intervene on the financial as on the real sector is unquestioned.
From the alternative perspective of Basualdo (2001) and Basualdo et al (2002), the understanding of the Argentine financial crisis depends on the analysis of the structural shift of the model of accumulation started under the military dictatorship with the reforms of 1977. These had changed the relation between the financial and the real sector tending to make foreign indebtedness profitable, while controls on financial activities and mobility of capital were eliminated. Full liberalization of financial

[25] In reality the triggering mechanisms are explained in terms of balance sheets of units. This however, does not add any explanatory potential to the framework as far as the nature of the markets.
[26] A clear exception, in some sense is the third generation models (McKinnon-Pill, 1998), although it sees crisis as a result of a regulatory failure.

transactions took place, and an absolute guarantee of the state for these operations was established.[27] This new model of accumulation is centred on what he defines as *financial valorisation* and its main expression has been a gradual and important shift from investment in fixed assets to investment in financial activities (Basualdo et al, 2002). Bonnet (2006, p.161), on the other hand, is in disagreement with this hypothesis as he claims it is against the labour theory of value.

To summarise, two points are relevant here:

a. Whether the financial system and the real economy are compatible to one another and whether the crisis was actually triggered by the incompatibility between the two sides. This hypothesis is explored by Basualdo (2001) who put forward the idea that financial valorisation has indeed broken down the capitalist alliance formed during the first years of Menem Administration. The financial crisis then would be related to this break of compatibility between these two sectors as they are represented by two different fractions of capital.

b. The necessity to look inside the real economy and the role of the state intervention within the real and the financial sectors. It would be interesting to explore whether the state has accommodated the needs of re-composition of profitability of the capitalists within a particular socio-political framework aimed at including vast sectors of population (i.e. *transformismo*).[28]

2.1.3 The role of the Convertibility Law

In the same way as the relationship between finance and the real economy, it is important to investigate the role of the (financial) instruments that have been used to serve certain interests. In particular, it is interesting to consider that the role of the exchange rate regime determined by the Convertibility Law has been extensively discussed in the literature. It is widely accepted by all the conventional literature reviewed that the fixed exchange rate regime had the merit to end hyperinflation and to gain stability from the long pain of hyperinflation that Argentina had suffered. Technically, the sustainability of the pegged exchange rate was guaranteed by the liberalization of trade and capital accounts, so that capital inflows were used to build up reserve to keep the exchange rate constant and to resume consumer credit (for the first time after hyperinflation), to pay for import of cheap tradable goods. According to this view, the higher interest rate offered by Argentina was functional to keep capital inflows in order to guarantee the exchange rate.[29] Similarly, the whole mechanism became unsustainable when trade balance started to deteriorate and the need for capital inflows pushed up interest rates in a vicious circle.

However, it is argued here that the peg of the exchange rate was not accountable for the end of inflation for a number of reasons. Firstly, the Convertibility Law took effect on April 1991. Inflation went definitely below 6% only in September 1993 (WDI, 2006). The mechanism of using a fixed exchange rate as a price anchor, in fact, is effective only for tradable goods not for non-tradable goods, such as

[27] The Financial Reforms of 1977 and 1979 furthermore established that the Central Bank could enjoy a mechanism whereby interest was to be paid on the funds immobilized by the banks by law, in accordance with declarations made by the banks, a factor that was thereafter subject to illegal claims (Basualdo, 2001)

[28] *Trasformismo* has its origins in Italy in 1876. It had a negative connotation inasmuch it served to describe a way to "buy" political consensus through corruption. Gramsci re-elaborated the concept. *Trasformismo* was not a sort of "original sin" of the Italian political system due to its polarisation. It was rather an accurately studied, specific strategy, implemented by dominant classes to absorb and accommodate the elites of other political forces in order to annihilate them and their representation. In this respect, Basualdo affirms that thanks to the Argentine *trasformismo*, the dominant classes replaced the physical annihilation of the dictatorship with the decapitation of the organised movements of the working class (Basualdo, p. 58). This process has then shaped the relation between the working class and the dominant classes in a way that has been fundamentally different to the experience of other democracies based on the alternation of two political parties for example.

[29] As seen in fig 1.7 interest rates have been permanently higher than the rest of the region for the whole period of the Convertibility Law.

public services. It was the liberalisation of imports of foreign cheap goods that had deflationary effects. This and the lack of an anti-dumping regulation put an incredible pressure on domestic producers of tradable goods (Basualdo et al., 2002). Secondly, the Convertibility Law established an important mechanism to reduce inflation by ending the automatic indexation of prices and wages, which was an important source of inflation.

Besides the more or less effective merits of the pegged exchange rate regime to bring down inflation, the problem here is to consider the role of the exchange rate as not merely a monetary instrument. The role of the exchange rate is instead seen by Basualdo et al.(2002) as an instrument to mediate between the interests of foreign creditors and domestic capitalists. In this respect, the debate that spread in Argentina before the crisis on whether to devalue the currency or completely dollarise the economy, represents the conflict between these two groups. Those who supported devaluation were domestic producers aiming at increasing the competitiveness of their products, while the foreign financial capital was supporting the full dollarisation of the economy aiming at preserving the value in dollars of their assets.

On the contrary, Bonefeld et al. (1995) consider the exchange rate as a mean to mediate between a national and a global dimension. In particular, capital accumulates globally while political constitutions are national: “Although exploitation conditions are standardised nationally, sovereign states, via the exchange rate mechanism, are interlocked internationally” (Bonefeld et al, p 28). This however, is not to say that crises are the result of a struggle between a global economy and a national political dimension. The crisis then is interpreted as the end of an exchange rate regime that has covered this mediating role in a particular time. Similarly, the Convertibility Law must be interpreted then, as a way to accommodate the necessities of capital. In other words, the pegged exchange rate was functional to the policies articulated around it, with the aim of increasing the level of exploitation of labour, namely privatisation, liberalisation of the capital account, liberalisation of imports.

The interpretation of the exchange rate regime in connection with these other measures is then completely overturned. There can be at least three examples of this difference. Firstly, Argentina’s rapid and unregulated privatisation for example, is a way to improve the efficiency of the productive activity for orthodox students (Krueger, 1974). For the alternative perspectives, instead, it is a way to re-establish profitability of the capitalist class as a whole and to exploit labour with increased unemployment, and extract value from rising labour productivity (Rodriguéz-Boetsch, 2005; Bonnet, 2006). Secondly, the tale of the liberalisation of the capital account that should move capital from low marginal productivity to high marginal productivity is instead seen as an instrument to increase external debt which is “the mechanism *par excellence* of the global command of money capital in indebted countries” (Bonnet, 2006. p161, italics original). Thirdly, liberalisation of import is seen, by the orthodox view, as a way to improve overall efficiency in the myth of comparative advantage, as domestic consumers are able to enjoy products produced more cheaply abroad. On the contrary, the actual effect of import liberalisation can be seen as a way to impose labour discipline by threatening working class with unemployment.

The differences between the two alternative interpretations of the Convertibility Law will be explored in the last part of this section. For now, it is necessary to add that, whether to serve an intra-class or an inter-class conflict, the exchange rate regime was instrumental to liberalization and privatisation and not the opposite as the conventional view argues. These policies were then wrapped in the Convertibility Law and presented to the world as a miraculous stabilisation.

2.1.4 Political factors and economic interventions

Another missing link in the diverse attempts to explain the Argentine crisis is a lack of consideration for political factors. In particular, questions related to the opportunity of a state intervention on both the

real and the financial side of the economy. Whether the state had an effective possibility of intervening or was it somehow limited.
This absence is consistent with the state failure paradigms. The market coincides with the economy and there is not rationale for state intervention. The only problems the economy may experience are the result of undue interferences of the state into the economy. However, this absence is remarkable in the market failure paradigms. These approaches recognise that certain asymmetries are pervasive in the economy and may be generated by a number of malfunctioning of the market, including excessive market share of certain financial institutions or the ability to act in a synchronised way. These imperfections provide legitimacy for state intervention; the state should step in whenever the market is unable to reach a particular outcome. But the logical consequence of the existence of these asymmetries should be that some groups or people have a certain degree of advantage (or power) over others. This inconsistency has been addressed in the previous section. Institutions are seen as a way to fix market imperfections then; there is not other rationale for state interventions other than to help the economy, to work better. The preferred solutions for financial and currency crises are offered by an international lender of last resort (role that should be played by the IMF) and a government operating a counter-cyclical tax policy.
There are two important implications of this view. Firstly, the role of state intervention on the economy other than on the market, such as production is completely neglected. Secondly, institutions are taken off-the- shelf and ready to use to fix whatever problem the economy may have. This shows an a-historical perspective on institutions. It should be a basic notion in social sciences that institutions are not just designed by policy makers and scholars and imposed from above to fix the market. Instead, they result from a much more complicated process which will depend on a number of variables and determined within a specific context.
On the contrary, the alternative explanations of the Argentine crisis see the role of the state in a completely different light. On the one side, besides the rhetoric of Menem's and De La Rua's administrations on *laissez-fair*, the government of Argentina, in fact, was actively intervening in different ways. For example, during periods of expansion the direct attack on labour was politically more viable, and it was pursued by reducing employers' contribution to social insurance, by making the labour market more flexible, by increasing the regressive character of taxation and donating high monopoly rents to foreign and domestic large conglomerates. It was more difficult during periods of recession during which it was pursued by allowing capitalists to reduce nominal wages and by threatening workers with unemployment (Bonnet, 2006; Basualdo, 2001; Rodriguéz-Boetsch, 2005).
On the other side, Basualdo sees the crisis as essentially a political crisis due to the exhaustion of a specific political process. The Argentine *transformismo* is seen at the base of the transition from military dictatorship to democracy. This crisis then can be interpreted, politically, as an inconsistency between *trasformismo* as a political project sustained by domestic capital, and the implementation of the neo-liberal policies sustained by foreign capital. According to this view, the working class increasingly perceived the state as a mere instrument in the hands of capital. Its main task was to ensure the flows of capital and the transfer of the control over a vast economic space through privatisation. In this respect the working class and the middle sectors (shop-keepers, professionals etc) realised that the political system had definitely abandoned the economic project underlying *trasformismo,* based on economic and social development with policies to sustain employment and re-distribution of income.

2.1.5 The relation between macro and micro

The literature on financial crisis in general, and on the Argentine crisis of 2001-2002 in particular, focuses mainly on macro aggregates and shows lack of consideration for any interactions between the two spheres of macro and micro. This separation has tended to assign variables to one or the other dimension with limited rationale. There are a number of consequences of this approach. Firstly, there are important methodological shortcomings. The literature on financial crisis is mainly macroeconomics. For that, it concentrates on macro aggregates. But this aggregation is operated through the sum of groups or sectors or, alternatively through the figure of the representative individual or firms. A fundamental assumption that allows the aggregation by sum is that these sectors and groups are essentially homogenous and act analogously in the maximization of a generic objective (utility, profit, rent). These micro-foundations of macroeconomics have been criticized on the base that individuals and sectors are not homogeneous and may show pattern of preferences (utility functions) that are very dissimilar. As a consequence, any aggregation by sum is actually flawed. Paradoxically, this way to proceed is proper of the market failure paradigms as well. In fact, in these paradigms, heterogeneity is recognised in the economy, since there may be missing markets (original sin) or asymmetries such as the tendency of the economy to monopolise. Nevertheless, the aggregation mechanism is the same.

Secondly, the focus on macro aggregates has left aside the interactions between macro and micro. In fact, the conventional literature concentrates exclusively on macro aggregates. It is important to notice that at first sight there are relevant exceptions: one is for example the third generation of currency crises models or the Minsky-type crisis where it is the interest rate that bridges micro and macro. These are important insights and have the advantage of showing that the two dimensions of micro and macro are not completely disconnected. A decision taken at a macro level may have important and direct consequences at a micro level. However, knock on effects of these macro policies or more complex interactions between the two dimensions of micro and macro are neglected precisely because the two spheres are kept separated. But this separation is arbitrary. Privatisation, for example, bridges the divide between micro and macro. It can be a major source of investment, demand, supply, fiscal revenues, as well as major employer. So it can be a major factor in macro in itself, and in its linkages an important factor in political and economic terms for the rest of the economy.

In conclusion, the separation between macro and micro is methodologically flawed, and presents serious problems in the application to real world situations, such as privatisation for example, because it is an arbitrary division that does not consider those interactions between the two spheres that are too complicated to be represented in the simple sum of individuals.

2.2 The Argentine crisis as a materialization of conflicts

There are two broad positions within the radical literature about the Argentine crisis. These two positions have been gradually introduced to emphasize their differences with the conventional interpretations of the crisis. This radical literature does not assume a separation between macro and micro, the exchange rate is not only a number that governments and central banks use to fix their Balance of Payments, the *real* economy and its distributional implications are the focus of its analysis.

The divergence between these two positions, however, is mainly on what kind of class conflicts played a major role in triggering the crisis. So, for example, Bonnet (2006) explains the crisis in terms of a "radicalisation of the social struggle" between capital and labour "that led to the financial crash and the fall of convertibility and the government" (Bonnet, 2006, p170). This struggle originated in the increasing level of exploitation of labour from neo-liberal policies. Two different social groups played a crucial role in the crisis. On the one hand, there were those who had been marginalized during the 1990s, having lost their jobs. On the other hand, the so-called "middle sectors"[30] who had sustained the

[30] The term sector is intentionally used to avoid the word "class". Since these groups "do not themselves constitute a class" but "share a certain standard of leaving and certain culture, ideological and political values (Bonnet, 2006, p175). Class is rather formed by a group of individuals who share the same relation with the means of production. These middle sectors were salaried skilled workers, but also shopkeepers, self-employed and independent professionals.

electoral alliance, had been those whose wage and social position had been mostly damaged. In particular, they suffered not only the austere policies of the last few years, like the increase of taxation over consumption and the wage cuts, but also the implementation of monetary policies (such as high interest rates and fixed exchange rate regime) which served to integrate the national exploitation conditions with the global character of capital accumulation (Bonnet, 2006; Bonefeld et al., 1995).
The second position within the radical literature interprets the crisis in a different way.
The Argentine crisis is one of accumulation of capital and involves a conflict between two fractions of capital operating in Argentina during the 1990s. These two fractions are represented on the one side by domestic producers of comparative advantage sectors and some foreign of European origin conglomerates, and, on the other side, by foreign capital of North American origins (Basualdo et al., 2002 ; Basualdo, 2001).
The crisis was definitely triggered by this conflict but it was exacerbated by a (failed) attempt by the government to manage the conflict, as if the Argentine economy had not undergone structural changes during the 1990s (in terms of unemployment, de-industrialisation and so on). In fact, the crisis took origin from a shift in a mode of accumulation from the Import Substitution Industrialisation (ISI) to the Financial Valorisation.[31] For Basualdo, the Argentine capital cannot be seen as homogeneous. Instead, there have been sharp contrasts within it since the ISI age. In fact, foreign conglomerates consider wages only as costs, as the demand for their products comes from high-income sectors. In contrast, the domestic firms are mainly producers of consumer goods. This is seen as the base for an alliance between domestic producers and working class. This alliance constituted a block against an alternative possible coalition between the foreign and the domestic capital. In particular, the domestic alliance was crucially dependent on manufacturing production and on the expansion of the internal market, which had to be sustained by the consumption of the working class. It would be of crucial interest to investigate the capacity of the state of organising and guiding the process of accumulation in relation to these phenomena.
According to Basualdo (2001), the military dictatorship interrupted this process and created a new process of accumulation based on the reduction of wages and the concentration of income, promoting the export of primary products and the import of luxury goods. The most brilliant phase of this new mode of accumulation was during the first years of the Menem administration. During this period, the dominant sectors were able to reach an agreement over the process of privatisation and at the same time the external debt increased the domestic credit financing domestic consumption, creating, in turn, an unprecedented political consensus for the administration and a social consensus for this new model of accumulation.
However, with the end of the process of privatisation and because of the increased volatility of growth from 1995, the contradictions within the capitalist class became more radicalised. The debate that took place during the years preceding the crisis over devaluing or dollarising is a manifested sign of the confrontation between these two fractions. But in 1999, following the shock of Brazil’s currency devaluation that slashed Argentina’s export trade, tax revenues plunged. The reaction of the working class to adjustment measures (mainly wage cuts and increased fiscal pressure on consumer goods) amplified the inability of the government to manage this conflict via a revitalised *trasformismo*.
The two views represented above, the intra-class conflict and the inter-class conflict, present many differences. Bonnet (2006) summarises them very neatly.

[31] Basualdo considers as financial valorisation as the allocation of the surplus of the majority of the big firms, in financial assets, in the domestic and foreign market. This process started to be dominant in Argentina since the end of 1970s and developed thanks to interest rates higher than the profitability of any other economic activity. It contributed to the increase of the external debt.

While for the position represented by Basualdo (2001) and Basulado et al.(2002), the crisis was the result of a long conflict between the two fractions of the bourgeoisie, Bonnet (2006) sees the crisis as the result of an offensive of capital against labour.

This distinction permeates the two interpretations on the whole recent history of Argentina, from the hyperinflation to the crisis, through the military dictatorship and the neo-liberal administration of Menem.

A striking example of this difference is the interpretation of the Convertibility Law. Bonnet (2006) assumes the existence of a *global capital* which is able to impose an exchange rate mechanism to a country as an instrument to exert pressure over the level of exploitation of labour. One the contrary, for Basualdo(2001) it is a question of re-distribution of surpluses between the two dominant fractions of capital.

The crisis itself then, assumes two completely different interpretations: for Bonnet it is a "crisis of neo-liberal policies through the limits set by the resistance of workers to the aforementioned capitalist offensive, which is based on the increase of the levels of exploitation" (Bonnet, 2006, p 162). On the contrary, Basualdo (2001) interprets the crisis as a conflict between different fractions of capital due to problems of domestic demand caused by a regressive distribution of income and rising unemployment.

3. Instead of a conclusion: new avenues for research

The ideology of *laissez-fair* has dominated economic policy since the collapse of Bretton Woods in 1971. However, the increased frequency of financial crises has encouraged a prolific literature in which, progressively, the idea of the malfunctioning of the market is replacing the view that financial crises are provoked by state failures.

This paper has presented a review of the literature on financial crises and its applications to Argentina, as attempts to explain its crisis has spanned to whole scope of international macro-economic literature. This has been classified into two main groups: the orthodox perspective of the perfect functioning of the market and the alternative explanations of crises as triggered by market failures. It is argued here that these two broad perspectives have much in common. They both see the economy as synonymous with the market and have similar micro-foundations.

Furthermore, despite some novelty, the heterodox views pose that failures arise from some sort of asymmetries within the market participants. In these studies, the role of institutions then, is to put boundaries on the speculative and destabilising behaviour of economic agents. But how these institutions are formed and how they should pursue this specific tasks remain outside these theories. The important question here is the assumption that powerful financial interests and the tendency of the economy to monopolise would not have any influence in the process of creation and functioning of these institutions. As a consequence, two kinds of inconsistency develop: first, the state and the central bank are indicated as a panacea for every trouble experienced in the economy, but these institutions are supposed to be unconnected with the powerful interests individuated in the economy. Secondly how these institutions would have the ability and the means to act to limit these powerful interests remain unexplained.

However, the conventional literature shows important omissions with respect to a series of factors and relations about the economy. First, it does not consider distributional implications. Second, the relation between finance and the real economy is left aside. Third, the role of monetary policy in general and the exchange rate in particular with respect to Argentina, is considered to be technical one. Its political and distributional implications are overlooked. Forth, there is not consideration of political factors and the role of the state is oversimplified. Fifth, this literature considers macro and micro as separated entities without consideration of their interaction. The inability of the conventional literature to provide a theoretical framework able to explain a series of issues opens the way for the analysis of two alternative perspectives rooted in the Marxist tradition. These see the Argentine crisis as a manifestation of intra-class and inter-class conflicts respectively.

In conclusion, the present paper has reviewed the literature on financial crises highlighting the inability of the conventional frameworks to account for a series of issues and relations.

However, this literature review has served to outline a number of hypotheses.

First, state intervention is crucial in intra-class and inter-class conflicts in both the national and international spheres. Its rationale is beyond the mere correction of market failures.

Second, distributional conflicts have played a major role in the Argentine financial-currency crisis.

Third, monetary policy is not non- neutral in distributional terms, within capitalist and between capital and labour. Instead, it is an instrument able to accommodate other policies that may have important distributional implications.