International capital flows in Argentina

Pedro Lacoste[1]

1. Capital flows and economic growth

Although there is some discussion as to whether international capital flows move as freely as they did during the heyday of the gold standard, there is general agreement that restrictions on capital flows have declined markedly since the 1970s. Although much of this new freedom of movement comes from more permissive attitudes towards foreign direct investment, it has also included substantially increased movements in short-term portfolio flows. It also seems to be associated with increased episodes of financial and banking difficulties.

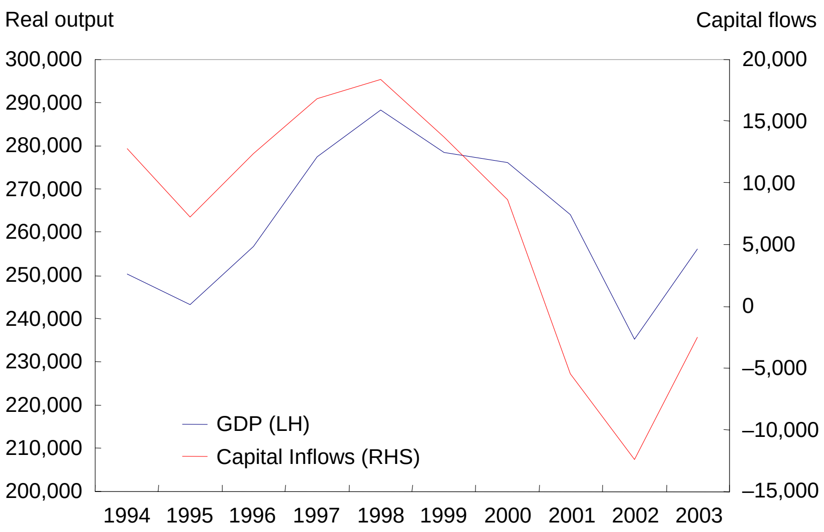
The evidence on foreign direct investment (FDI) is quite positive. FDI flows tend to be long lived, only slightly procyclical, and are strongly correlated with long-run growth. In addition, FDI tends to provide technological spillovers, especially in those cases where host country firms are taken on as intermediate input suppliers.

Short-term portfolio investments have been concentrated in a small number of middle income countries. These flows are highly procyclical and quite volatile. A number of countries, Chile for example, have had restrictions on short-term inflows. As a result, they have experienced less capital flow volatility than the regional average, and sustained growth. Rapid withdrawals of short-run portfolio investment have been accompanied by financial and banking crises and severe downturns in output.

The high correlation between international capital flows and recent movements in Argentina's real output seems clear in the data (see Graph 1). High real output growth in the early 1990s accompanied substantial capital inflows. Capital inflows declined substantially during the Tequila crisis of early 1995 and real output fell accordingly. Both output growth and capital inflows recovered in 1996 and remained strong until 1999, after which they declined precipitously through 2002.

Graph 1

Output and capital flows



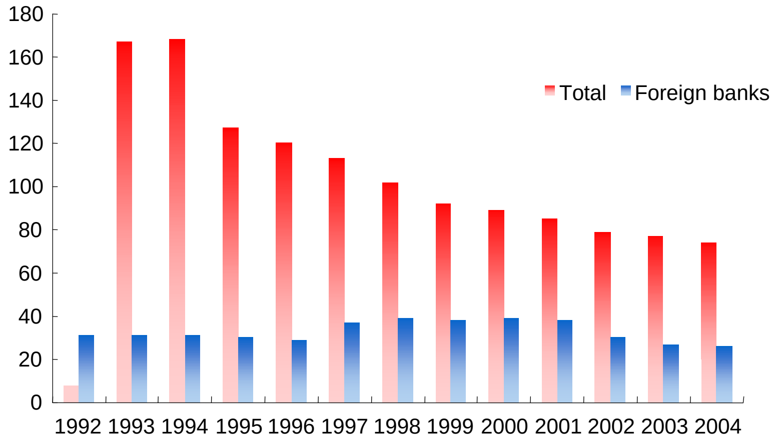
[1] First Vice President, Central Bank of Argentina.

The causal direction that underlies the preceding correlation is not easy to determine. There are good arguments for claiming that the Tequila crisis was an imported (something implied by the very name) or contagion-inspired event. In contrast, there seems to be sound evidence that the ultimate causes of the debt, currency and banking crisis that, strictly speaking, started in 1998 and exploded in 2001-02 were a combination of a rigid peg to the dollar and a persistent dollar appreciation (which undermined competitiveness and employment), along with other aggravating factors such as a sizable increase in the public debt in terms of GDP, the vulnerability of the banking system to a real depreciation due to the explicit decision to allow banks to freely lend in dollars to non-tradable sectors (including the public sector), and a reduction in the willingness of investors to finance emerging market economies in the aftermath of the Russian crisis.

The Mexican (Tequila) crisis of December 1994 had a profound effect on the Argentine banking system, which was reflected in a strong decline in the number of banks after the crisis (see Graph 2). Initially there was a flight to quality, with deposits flowing to the more solid domestic banks, to public banks, and to foreign banks. Later there was a flight from Argentina. Evidence from the period indicates that although most of the banks that suffered runs were less sound, a number of small banks with very high quality loan portfolios also experienced runs. Between the beginning of 1995 and the end of 1999 the number of banks fell from 168 to 92 as a result of closures and consolidations. Most closures occurred in 1995, when the number of banks fell to 127. However, closures in later years were also the result of prolonged financial difficulties caused by the Tequila shock from which the affected banks could not recover. The number of banks has continued to decline and, in mid-2003, there were 76 banks in the system.

Graph 2

Banks in Argentina



Foreign banks: foreign controlled local banks + branches of foreign banks

The Tequila crisis was triggered by the withdrawal of funds by large depositors from a number of wholesale banks. These banks failed and the panic spread to the rest of the banking sector, affecting mostly smaller banks and those with weaker portfolios. Although the portfolios of public banks were in bad shape compared to the private banks, the public banks were viewed as being backed by the government and did not suffer severe initial runs.

While the liquidity crisis exposed those banks with weak portfolios to runs, the process was satisfactorily managed. The reduction of comparatively large reserve requirements proved to be very useful in dealing with bank runs, and systemic liquidity regulations were substantially strengthened in the aftermath of the crisis. The successful resolution of the crisis enhanced the authorities' confidence in the basic underpinnings of the Convertibility (monetary and exchange) regime, but a much more severe test was only a few years ahead. The dollar started to appreciate against practically all currencies after mid-1995 (the aftermath of the Tequila crisis) and strong capital inflows to Argentina were restored, facilitating high growth rates. The Asian crisis of 1997 was hardly felt by Argentina, but the Russian crisis of August 1998, followed shortly afterwards by the currency devaluation in Brazil (Argentina's main trade partner), led the country into a protracted recession. The country's inability to restore growth and the absence of fundamental changes in macroeconomic policies gradually convinced international investors that the risk of default was sufficiently high to merit a significant reduction in exposure to Argentina. Increasing unemployment, generated by a lack of competitiveness, increased the probability of a new consensus towards a change in the monetary and exchange regime. At the same time, the fact that 93% of the government's public debt was denominated in foreign currency (while all of its income was peso denominated) and that 70% of bank loans were dollar denominated and a large fraction of that was granted to non-tradable sectors (including the public sector) implied that a devaluation would probably be accompanied by a government default and a severe banking crisis. As developed below, in those crisis episodes, which were indeed not very similar in nature, the behaviour of foreign banks was markedly different.

2. The banking system

During the later part of the Convertibility period in Argentina, and especially after the Tequila crisis, there was an effort to encourage foreign bank participation in the banking system. The view was that the capital, expertise and prestige of these foreign banks would help make the local financial system more stable. In the second half of the 1990's, British, Canadian, French, Mexican, and Spanish multinational banks purchased local banks. The fraction of banks owned by foreign capital rose substantially (see Graph 2), reaching 44% of total banks and 48% of deposits by December 2002. These figures understate the importance of this foreign incursion in retail banking since many of the local banks purchased by foreigners were among the largest. Nonetheless, after the devaluation of January 2002, a number of the newer foreign entries into the Argentine banking market decided to exit.

There is fairly wide agreement that the presence of foreign banks improves the transactions and payments technology, financial services, and banking efficiency. However, there are worries that foreign banks "cherry pick" the best firms, leaving the domestic banks with weakened loan portfolios that are concentrated in the non-tradable goods sector. In particular, it has been suggested that foreign banks concentrate on larger firms and leave the small and medium enterprises to the domestic banks.

One argument that has been used in favour of foreign owned banks is that the head office will act as a lender of last resort for its branch when there is a systemic liquidity banking crisis. However, a comparison of the short-run international capital flows of foreign and domestic banks in Argentina during the Tequila crisis and the most recent crises at the end of 2001 show important differences in head office responses. This can be seen by comparing total short-term foreign credit lines of foreign and domestic owned banks (see Graph 3). During the Tequila crisis, head offices transferred substantial (for this period) amounts of funds to their Argentine branches. For the first five months of 1995, during which most of the deposit withdrawals occurred, the transfers (which include foreign trade financing) totalled 7,802 million pesos.

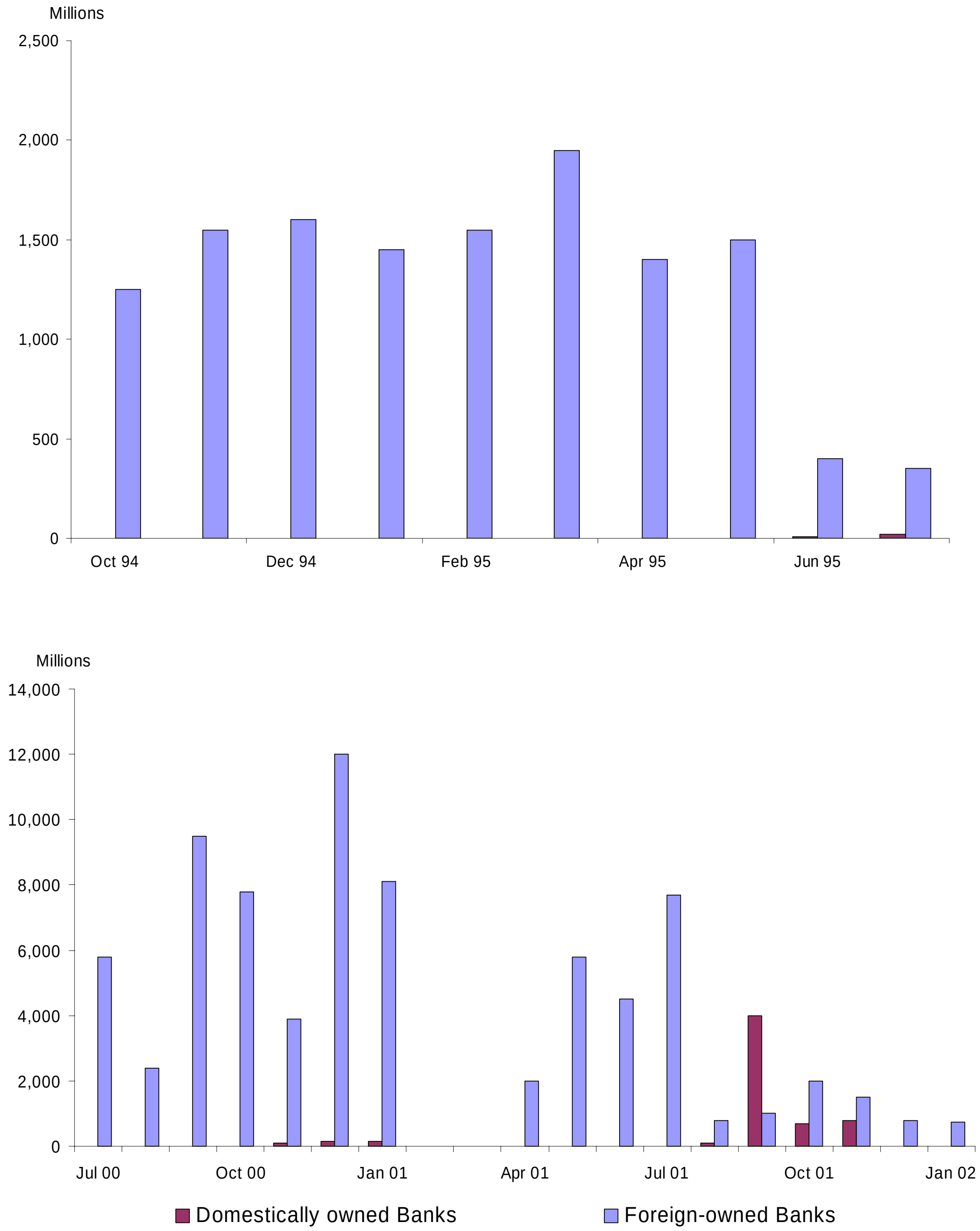
During the bank run leading up to the freezing of deposits in December 2001, the foreign banks took a different attitude. Although they had provided substantial credit lines to their branches in 2000, they began cutting them in 2001. By the end of the year these credit lines were fairly small, almost as if these banks had abandoned their branch offices. It could be argued that this behaviour was to be expected if the crisis under way was interpreted as much more than a systemic liquidity crisis. The bottom line was that the public did not receive the extra protection they expected from foreign banks.

3. Sudden stops of capital inflows

The increase in portfolio financing to emerging market economies in recent decades has increased vulnerability to sudden reversals of capital flows. There have been many instances of sudden stops in capital inflows precipitating a financial and/or banking crisis that, in the majority of cases, has led to a reduction in real output. Except for Korea, financial crises since 1990 have involved a nominal and real exchange rate depreciation (see Graphs 4 and 5). About half of the crises were followed by inflation of between 40% and 200% over two years. All but Brazil saw at least some real output decline shortly after the crisis, although for five out of nine countries, real output was above its starting level two years after the crisis.

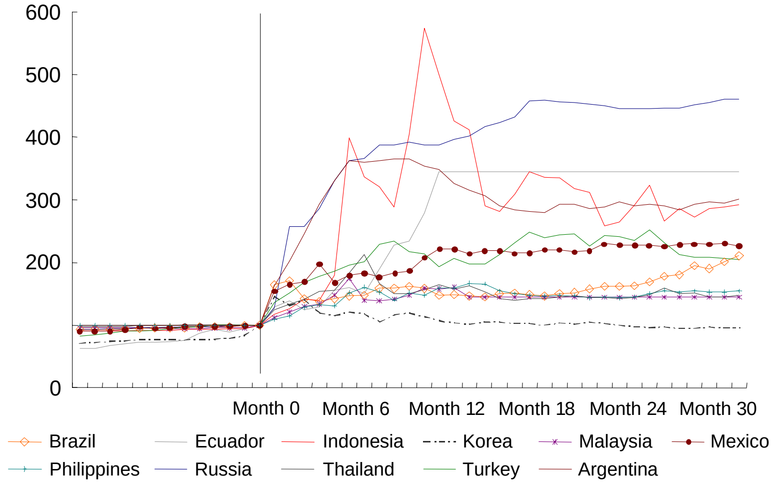
Graph 3

Foreign credit lines to banks in Argentina at times of crisis



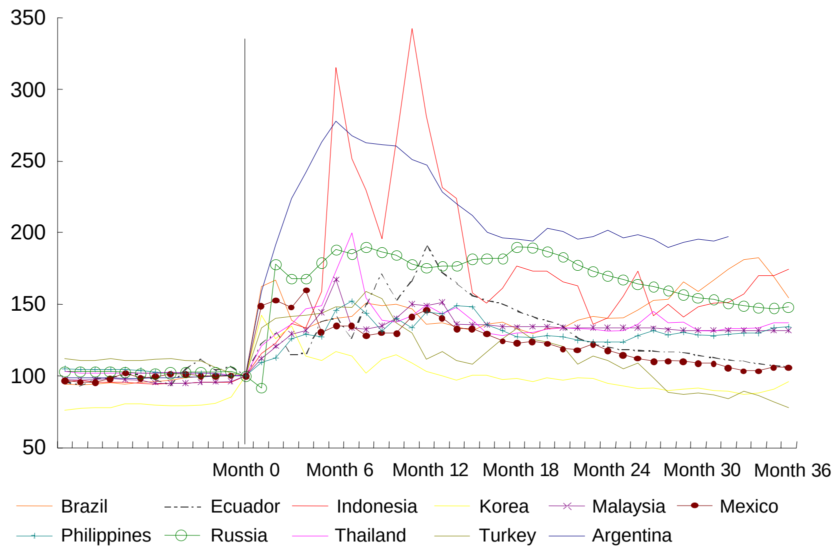
Graph 4

Nominal exchange rate



Graph 5

Real exchange rate



The real recovery has usually required a substantial restructuring of the debts of both the financial and corporate sectors, and the speed of the recovery has, in part, depended on the ability of the country to restructure these private debts. Several countries formed specific government agencies or courts which adjudicated debt restructuring. Many of these used newly issued government bonds as a form of compensation or for recapitalising banks (in a few countries, these bonds were exchanged for equity participation).

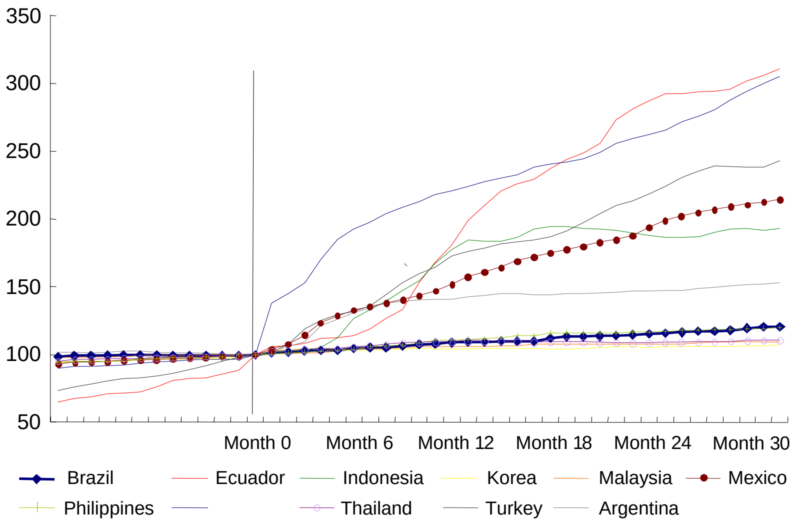
In Argentina, the sudden stop in the refinancing of maturing government debt accelerated a run on the banking system that had started around March 2001 and ultimately resulted in the suspension of convertibility of deposits to cash (the corralito), the default on most government debt, severe depreciation of the currency, and the compulsory conversion of the currency denomination (pesification) of dollar bank deposits (at 1.4 pesos per dollar) and debts (at one to one). Output in the first quarter of 2002 was 16% below that of the previous year and 28% below the peak of 1998, deposits fell more than 40% in real terms and credit plummeted from 16% to 8% of GDP. The BCRA initially tried to defend a moderate 40% increase in the peso/dollar rate but was unable to do so. The subsequent depreciation was considerably greater, with significant overshooting (Graph 4). After a few months of adverse expectations, the introduction of substantial foreign currency and capital controls plus severe monetary stringency was able to reverse expectations and a gradual appreciation of the peso followed. The process of monetary control was tightened when the BCRA began issuing its own short-term (one-week, initially) zero coupon bonds (LEBACs) in order to mop up excess liquidity. The LEBAC market later developed into a principal instrument of monetary control and the LEBAC interest rate has become a reference interest rate.

Twenty months after the crisis, the interest rate on one-month LEBACs was under 1% and that on the one-year bond at 12%. The volatility of the dollar/peso exchange rate was markedly reduced, and deposits in the banking system were growing slowly. Most of the restrictions on bank deposits have been lifted, and the banks are again regularly reporting their condition to the Central Bank. The real exchange rate remains very competitive in real terms compared to most other countries who have experienced crises (see Graph 5) and the accumulated change in the price level is closer to the countries with moderate crises than to those with more severe crises (see Graph 6). The path of output since the default has been very similar to the average of other crisis countries, except that the initial decline in output was deeper.

With respect to the recovery of the financial system, even though some shock strategies proved to be useful for solving financial crises in many emerging markets, they were neither necessary nor affordable for solving Argentina's recent crises. The explanation lies in the nature of the crises, and the role of International Financial Institutions (IFIs).

Graph 6

CPI



With respect to the first item, Argentina's crisis was not preceded by a credit boom. On the contrary, it was the corollary of a deep recession that started in 1998 and reflected a downsizing of the financial system, with a reduction of 12% in the number of bank branches between 1998 and 2002. With respect to official money, IFIs were net recipients of funds. Argentina has made net payments of more than $8 billion to IFIs, while Mexico for instance received $50 billion of foreign assistance to deal with its financial crisis in 1995 (see Table 1).

Table 1

Recent crises

Country	Crisis date	Real change in deposits %[1]	Change in real NW %[2]	Fiscal cost %	Net IMF disbursements (million US$)
Mexico	1994-95	–15	–64	19.3	10.67
Venezuela	1994-95	–43	–6	15.0	–0.66
South Korea	1997-2000	–6	15	31.2	6.07
Indonesia	1997-2000	13	–183	56.8	10.35
Thailand	1997-2000	–2	58	43.8	3.21
Ecuador	1998-2001	–24	–59	21.7	0.30
Turkey	2000-02	–27	97	30.5	13.42
Average		–19	–20	31	6.19
Argentina	2002-03	–41.8	–37	11.4	–16.00[3]

[1] From the start of the crisis to the trough in deposits. [2] Net worth, taking into account a period of two years after the crisis. [3] As of 31 July 2004.

Sources: BCRA from IFS data; Fiscal cost: "Managing Systemic Banking Crises" (IMF, 2003), except for Argentina.

Within this context of scarcity of resources and instruments, the Central Bank's strategy for the stabilisation of the financial system was based on two pillars: (1) providing institutions with time to absorb the losses caused by the crises and rebuild their capital base internally, and (2) changing regulations and prudential rules so that banks can expand their business, aiming for a financial system that is not only sound but flexible and profitable.

After several years of recession and profound multiple crises, the Argentine economy is well into the expansionary phase of the business cycle. At the time of writing, a number of problems remain: in particular, the central government has yet to come to an agreement with its foreign creditors, bank lending has been very slow to pick up, and the sharp relative price changes brought about by the devaluation have significantly reduced real incomes. Nevertheless, the economy is now growing briskly and there seems to be a recent broadening of the growth base, with investment expanding fast, albeit from extremely low levels. Capacity utilisation has been growing rapidly in manufacturing but is still very low in several service sectors. The change in relative prices has had a positive impact on the labour market. Although aggregate unemployment remains high, employment has been growing significantly for the first time in years. Tax collection, which had fallen sharply with the crisis, is rising steadily and the government is running a sizable and increasing primary surplus.

In the last 13 years, sudden stops in international capital flows have been very costly for countries in both Latin America, Asia, and eastern Europe. While some place all the blame for the sudden stops on international markets, every country that experienced from this event suffered weaknesses in either its banking system, its macroeconomic policy, or both. Strong prudential regulations, designed for the type of problems a developing country's financial system can encounter, along with sound macroeconomic policies are necessary conditions for a country to escape sudden stops. However, this might not be enough. Countries which are completely open to international capital, especially portfolio flows, seem to be particularly vulnerable. International investors seem to display, at least partially, herding behaviour in their willingness to take on risk. Changes in investor risk aversion can change international capital flows for even quite sound countries. Historically, those countries that imposed restrictions on international capital flows, such as Chile and Taiwan, seem to have been less affected by their experience with sudden stops. Some mild form of restrictions on portfolio capital flows may well be part of prudent financial policy.