

STATEMENT TO THE EXECUTIVE BOARD MEMBERS FROM THE GOVERNOR FOR ARGENTINA, HIS EXCELLENCY ROBERTO LAVAGNA, ON THE IEO EVALUATION OF THE ROLE OF THE FUND IN ARGENTINA, 1991–2001

Executive Board Meeting
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Introduction

We consider this to be a valuable and candid report that helps to form a more complete picture of the relationship of the Fund with Argentina during the 1991–2001 period when a currency board arrangement (CBA) was in place. The special nature of this exchange rate system implemented during the years of “irrational exuberance” and when the “first crisis of the twenty-first century” took place makes the Argentine case an interesting one to study. We should remind ourselves, however, that given the special circumstances that surrounded the case it is not possible to expect that the lessons to be drawn are all going to be equally useful to the Fund’s membership looking forward. The report also mentions the belief of the majority of the staff at the time that the “Argentine situation was so unique . . . as to make previous experience inapplicable.” We hope that this is not forgotten in the present dealings of the Fund with Argentina, since it is of the utmost importance to try to avoid to the extent possible the repetition of the same mistakes, as both the Fund and Argentina are suffering, albeit unequally, the consequences of misguided policies.

The value of the report is, in our view, not as much in the area of surveillance and program design, which to a large extent was covered by the November staff report (and its lessons already learned), as in the areas of crisis management and the decision-making process within the Fund, which can indeed offer lessons of a more general nature that may lead to improve the working of the institution in the future. The way the institution reacted to the unfolding of the crisis provided also an interesting practical example of the limitations of the exceptional access policy and of private sector involvement (PSI) in the particular circumstances of Argentina, which calls for further efforts in these areas.

Having said this, we would like to add some specific comments covering the three main conceptual topics of the report: (1) surveillance and program design, (2) crisis management, and (3) the decision-making process.

Surveillance and Program Design

On surveillance and program design we believe that some further comments to those presented in the report, including in its recommendations, are in order. The report rightly emphasizes the constraints imposed by the CBA and the consequent need to rely on a sound fiscal policy, as the only variable left for the authorities to influence macroeconomic conditions. The most significant period from the point of view of surveillance is the one that preceded the crisis. The surveillance weaknesses during that period were indeed many, mostly concentrated on the *fiscal area*: the asymmetric treatment of fiscal targets during times of vibrant growth and recessions, the successive granting of waivers for fiscal underperformance, the substantial privatization revenues considered as an item above the line, the insufficient attention to provincial finances, the off-budget debt issued, and the failure to properly assess the impact of the social security reform are partially highlighted in the report. In this respect it is worth noting that the report does not adequately assess the negative consequences stemming from the Fund’s endorsement of the social security reform, which was at the time hailed as a sound policy step in the right direction. The Fund, in spite of the very evident detrimental impact on fiscal revenues that this structural reform had, pointed it out as an example to be followed. It is therefore disappointing to see that the report, in spite of recognizing its negative fiscal consequences, still states that “the pension reform itself was [not] ill conceived.”

In our view, the report fails to assess the extent of *structural reforms implemented* during that period. The full-fledged program of privatizations, deregulations, trade and financial liberalization, and fiscal and social security reforms contributed to give Argentina the image of a stellar performer. Beyond the underlying fiscal slippages, which remained concealed for quite a long time, several other weaknesses were embodied in the structural reforms implemented in Argentina during the 1990s. The IEO report addresses, to a certain extent, the failures implicit in the social security reforms, but it says very little as regards the

flagship of Argentina's structural reforms, the overarching privatization process. In spite of receiving financial support by IFIs, privatizations were not duly monitored. It became evident from its earliest stages that the process was being carried out in a rather non-transparent manner and that its quality was at least questionable. Its proceeds were allowed to be counted as regular revenues, thus distorting the true nature of the structural fiscal situation. Perhaps more importantly, monopolistic market structures were allowed to remain, coupled with a blatantly inadequate regulatory framework; as a consequence, and notwithstanding the improved supply of some services, the high prices for their provision contributed to make Argentina an expensive place to do business. Equally important, the dealings of the government with the privatized companies throughout the period were obscure, and the enforcement of contracts was very weak. Nonetheless, as structural reforms implemented in Argentina during the 1990s and, very particularly the privatization of all its public services, were in line with the so-called "Washington consensus" recommendations, Argentina's policies were thus heralded by the Fund as an example to be followed. This was, quite evidently, an ideological prism of assessment. Also, it was—and regretfully still is—an ideological assessment unwarranted by conclusive evidence that all structural reforms would necessarily lead to increased growth. All this clearly blurred the capacity of the Fund to advance an objective assessment of Argentina's structural reforms, and we would have liked to see some more consideration of that in the IEO report.

In fact, we could conclude that *lesson 5* of the report should be indeed totally reversed. Rather than stating that a good macroeconomic performance when not accompanied by supporting structural reforms is not sustainable, Argentina's experience serves to support the opposite view that when apparently comprehensive structural reforms serve to conceal weak macroeconomic fundamentals, as it has happened in the Argentine case, in the end those weaknesses surface. Argentina is at present, for the first time in decades, including in particular the 1990s, obtaining a fiscal primary surplus that is unprecedented for its size and is committed to maintain it for the foreseeable future, yet in its relationship with the institution is now being pressed in a way absent during the 1990s to implement structural reforms under a schedule that is oblivious to the political realities of the country, lest the successful performance cannot be maintained, so runs the argument. The 1990s prove, however, that structural reforms are not a guarantee of sustainable macroeconomic performance when the political will to achieve it is not there.

The report highlights the importance of *labor market reforms* as a necessary adjustment mecha-

nism for an economy with a fixed exchange rate. This is an issue on which the staff from different departments presented a unified view, while management and the Board, at least on some occasions, overruled that view. In fact, a package of labor market reforms was also present during the first part of the 1990s and again in the Stand-By program of 2000. More than the regulatory framework, however, market pressures on the labor market forced substantial reductions in wages, particularly in the private sector. This is yet another instance of ideological bias. Labor market reforms were constantly pressed on, on the assumption that "labor market rigidities" were the main cause behind ever increasing unemployment rates, but, as we have seen, wage reduction, labor reforms, and even growth (in the early 1990s) were coupled with increasing unemployment rates. The report itself provides measurements of competitiveness based on unit labor costs that showed significant gains during the period under analysis. Thus, it could hardly be proposed that one relevant reason of the demise of the CBA has been labor market rigidities. The reason was indeed rooted in the fiscal front that represented a major failure of Fund surveillance.

The report raises the issue that the staff did not make an assessment on *how suitable the CBA was for Argentina*. The relevant consideration, however, is if the macroeconomic policies implemented were consistent with the CBA, which they were not. This is the most serious surveillance mistake. In addition, the handling of the Tequila crisis was presented as a proof of the strength of the CBA when in fact it only proved the shrewdness with which the authorities addressed the crisis. This enhanced credibility of the CBA, endorsed and strengthened by the IFIs through continued programs and explicit laudatory public statements, led to both abundant resources available to the authorities and to a consequent sense of self-complacency from all the interested parties—in particular from the IMF, which overlooked the risks involved in the continuous creeping up of the debt levels. The impact on market behavior during those years and the potential responsibilities for the Fund stemming from its reckless support for the CBA are not, in our view, duly stressed in the report.

Argentina's case during the 1990s offers a fertile ground to analyze the issue of *ownership*, a key component of our surveillance exercise in the Fund, on which the report also offers recommendations that we do not fully share. Practically all types of possible ownership scenarios were present in Argentina's relationship with the Fund throughout the period covered by the study. On the part of the Fund, the CBA was at the beginning tolerated, then accepted, then warmly supported to the extent that even at the end there was never an alternative scenario developed by the staff in

which a flexible exchange rate system was a constituent part.

Argentina's ownership of policies under the program, on the other hand, was for the most part unquestionable. The report highlights, however, the tension created when unquestionable ownership is at odds with what the staff considers appropriate policies. We believe, in this regard, that if we expanded the period analyzed by the report to the more recent past we could find quite contrasting responses on the part of the Fund to the same type of problem. In 2001 the authorities implemented policies without the consent of the Fund, and even with its opposition, while the program continued until the unsustainability of policies was impossible to hide any longer. Contrasting with the former experience, during the more recent experience of 2002 up until September of 2003 the authorities were unable to persuade the staff on an economic program that could be supported on a medium-term basis, despite strong evidence that their policies were producing stable and sustainable growth. Here we have two cases of full ownership not shared by the staff with two very different outcomes both in terms of Fund support and economic results.

Leaving aside these two extreme cases, hoping that they are truly exceptional, we are of the view that in general, where ownership is clearly present, the authorities should be given the benefit of the doubt since they are the ones who know all the facts impinging on a given issue and they are the ones who risk their own political future if they take the wrong decisions. In addition, the view that all policy recommendations issued by the staff are good and reasonable in all circumstances, and that the alternative views brought to the table by the authorities are in principle wrong, is unsupported by evidence and should be avoided. It is critical to gain acceptability of the Fund's policy advice, *inter alia*, by presenting it as an alternative, among others, to the authorities and not as the only reasonable one. Also, the social and macroeconomic costs associated with an eventual failure of the recommended policies should be assessed, disclosed, and evaluated. Thus, we do not see much merit in the report's *recommendation 4* that calls the Fund to withdraw support when the authorities are pursuing strongly owned policies that the Fund judges inadequate. We do not believe the more recent Argentine experience supports that claim.

Crisis Management

Turning now to crisis management, this is clearly the most difficult problem to address given the interplay of economic, political, and social factors involved. In the first place, and from a purely economic point of view, to make an assessment if a member is facing a *liquidity versus solvency* prob-

lem is never straightforward. At times, some doses of brinkmanship are needed to direct a situation towards the best possible outcome. On other occasions, as in the Argentine case, an early withdrawal of support could have diminished the consequences of a crisis. In fact, the earmarked funds of the 2001 packages should have been applied to finance a faster and more efficient exit from the CBA.

The IEO report is right in pointing out that even though the Fund faces probabilistic scenarios and developments could go as desired, when the risk is high it is important to have a *fallback strategy* in place if the preferred strategy fails. The lack of such an alternative plan was indeed a major failure of crisis management in the relationship of the Fund with Argentina. We should acknowledge, however, that it is not the practice of the institution to prepare fallback plans, and this could become an important lesson from the Argentine experience. In any event, each crisis has its distinctive characteristics, and it is not possible to pre-define a rigid set of rules to follow.

On the other hand, the Argentine crisis is not that peculiar from the point of view of the large amount of resources that the Fund disbursed; in fact, it is to be expected that in crisis situations the financial involvement of the Fund will be large and front-loaded, as it has happened in most cases. Under these circumstances, the *catalytic approach* to resolve a crisis used to justify the exceptional access policy loses part of its meaning. The question boils down to the initial and evolving judgment needed as to the liquidity versus solvency character of a crisis and the need in the case of the latter to involve the private sector in ways other than additional financing. The augmentation of the Fund program in late 2000 and September 2001 attempted to reassure markets that Argentina was facing a liquidity crisis, but both the markets' thought and the reality were otherwise, and the catalytic approach failed to materialize.

The September 2001 augmentation contained, however, an explicit earmarking of resources for debt restructuring. This was an unambiguous warning to markets that a restructuring involving a loss of NPV for creditors was in the offing. Notwithstanding the latter and the obvious risks for the Fund, fresh money was channeled to Argentina on that occasion. The report rightly relates the views of those, including from within the staff, that in fact those funds would facilitate the exit from Argentine exposure of the sophisticated investors that still remained rather than to actually support the Argentine program, increasing the already huge debt of Argentina to the Fund in the process. This is indeed very serious. As is evident, the Fund's 2001 policy towards Argentina of treating what clearly was a solvency crisis as if it were a mere liquidity crisis had not only the effect of importantly increasing the debt load,

and of aggravating the financial, economic, and social problems, but also of providing the means to facilitate an easily predictable capital flight.

It is noteworthy that even when the need for a debt reduction operation was publicly acknowledged by the Fund, *the need to make the exchange rate system flexible* was not fully incorporated. The fact is that in November 2001 the staff prepared a “preferred strategy” involving a package of further financial support that included a change of the exchange rate regime, but not in the direction of greater flexibility, as generally expected by markets, but in the direction of the extreme rigidity represented by the full dollarization of the economy. The package also involved debt restructuring representing a reduction of NPV of 40 percent.

The *dollarization* of the economy was a concept used by the Menem government early in 1999 to reassure markets during the critical months that followed the devaluation of the Brazilian real and that preceded the presidential elections in 1999. As the report states, this had a positive impact on expectations. However, when De La Rúa’s government took office it explicitly rejected the idea of dollarization, reflecting a widespread resistance within the country. Later on, the government expressed its willingness to go all the way, including full dollarization of the economy if necessary, but it was too late to reassure markets this time given the resistances mentioned. All of this points to the fact that the staff’s “preferred strategy” mentioned above was out of tune with political realities.

Political factors also serve to show the complexity and uniqueness of the Argentine case. Although the idea of full dollarization was rejected, the population at large remained largely in favor of the convertibility regime, to the extent that the presidential elections of 1999 were won by the alliance of parties that held the maintenance of the CBA as an essential ingredient of its economic program. On the other hand, a critical mass of political actors, including union leaders and some prominent leaders of the government that took office in December 1999, started to be outspokenly against the CBA exchange regime. Thus, the political backing was weakening. However, the complexity of the Argentine case, from the political point of view, becomes even more evident when observing the overwhelming support the government received in Congress to pass very demanding laws in the spring of 2001, including the granting of special taxation powers to the Executive branch and the zero deficit law that gave the government ample powers to take whatever measure was deemed necessary to revamp confidence and avoid the change of economic model. This was insufficient, nonetheless, to reverse the self-reinforcing dynamic unleashed during the whole of 2001, which,

as it is now clear, found its roots in the weaknesses of the model from its beginning in the early 1990s.

In closing these paragraphs on crisis management we have serious doubts that, notwithstanding the importance of having a fallback plan and of avoiding the assumption of excessive financial risks for the Fund, it would be feasible, or even beneficial, to develop *stop-loss rules* as suggested by *recommendation 1* that may guide decisions on when to support a program and when not. The staff should, however, continue refining their analytical tools so as to provide the Board with a varied set of indicators of the true nature of country problems, in particular if it is facing a liquidity or a solvency type of problem. In fact, we find in *lesson 9* of the report a quite encouraging statement as to crisis resolution in the framework of solvency problems when the relevant authorities are committed in an unprecedented fashion to fiscal responsibility and to taking a major shift from policies that caused such solvency problems. We quote: “Delaying the action required to resolve a crisis can significantly raise its eventual cost, as delayed action can inevitably lead to further output loss, additional capital flight, and erosion of asset quality in the banking system. To minimize the cost of any crisis, the IMF must take a proactive approach to crisis resolution, including providing financial support to a policy shift, which is bound to be costly regardless of when it is made.”

The Decision-Making Process

The *critical role played by management* throughout transpires from the report. There are several instances of the staff being overruled by management as for example in relation to labor market reforms, the many waivers granted in the fiscal area, the relaxation of fiscal targets at the time of the “*blindaje*,” entailing a loosening of the fiscal responsibility law signed by all political parties in 1999, the decision to continue supporting the program during most of 2001, as well as the decision to withdraw support in December 2001. These are all instances of the key role played by management. It seems only natural that this is the case. It is up to management to distill all the information it receives from the staff, from the authorities, from markets, and from civil society and come up with a proposal to the Board. What makes the job very difficult is that much of the information it receives is often conflicting, at times even the one coming from the staff, and the policy choices available are not always the first best. It goes without saying that management’s job is not merely that of objectively distilling information but also consists of handling political pressures.

Is there room for *the Board* to help management handle such difficult tasks? The report makes it evi-

dent that there has been not much opportunity for the Board, as a body, to have a meaningful participation in the main decisions taken regarding Argentina, which has also been the case in many other instances. Of course there is acknowledgment of the fact that major shareholders' authorities let their views be known to management. The report does not see in principle any objection to that but strongly advocates for making the Board the locus of decision making at the Fund, as it should be. The report calls for a broadening of the dialogue to the whole of the Board. This is commendable along with the call for a greater provision of information to the Board on all issues relevant to decision making. In fact, the practice by certain prominent shareholders of bypassing the Board raises serious transparency concerns in the decision-making process, not only as to the negative effect on the lack of proper and adequate debate in the Board as the natural "locus" for discussions, but also as to the "agenda"—other than finding the best possible alternative in specific crisis prevention or crisis resolution scenarios—that such shareholders might be advancing. As to the confidentiality concerns that would be raised in the framework of expanded Board discussions, we agree that the means to address them are already available through mechanisms similar to the use of side-letters for example. We have to note, however, that so far experience with the confidentiality of similar documents containing specific commitments has not been outstanding since it is not uncommon for these documents to leak, some way or the other, into the press.

It is important, however, to analyze the interesting observation in the report regarding the *behavior of developing countries* in the Board which, as the report says, as "potential borrowers," usually go along with management proposals to support a member country. Reality is more complex than this, and several other factors have a bearing on developing countries' behavior at the Board. For instance, given the limited available resources of the Fund (their relative importance vis-à-vis the international capital markets is ever shrinking), one would expect "potential borrower countries" to advocate limiting the granting of packages to relevant *competing* "fellow borrowers." Additionally, if the report's view were to be taken as a premise of the analysis, then much of the recommendation presented in the report on the need

for greater Board participation in the decision-making process would be inconsequential. The outcome would seldom be different since developing countries, according to the report, would always side with management, which in turn tries to incorporate the views of major shareholders. In our view, however, developing countries are quite capable of forming independent views from those of management, particularly when provided with relevant information, and we therefore see merits in the report's recommendations for a more participative decision-making process on the part of developing countries as well as others that may not have the same opportunities to present their views directly to management.

Beyond this, it should worry all of us that the IEO report points out shortcomings in governance and transparency in the handling of the Argentine crisis. These shortcomings are indeed compounded by the fact that representation at the Board does not adequately reflect the importance of emerging economies in the global economy.

Conclusions

As a way of conclusion, we would like to state that whereas the concept of *exceptional financing* applies fully to the Fund support received by Argentina during 2001, the financial assistance Argentina is currently receiving from the Fund under the present Stand-By program is of a completely different nature (despite that we are still calling it *exceptional financing*). In fact, as it transpires from the report, Argentina is not only paying for its own errors but also for those of the Fund. The report highlights the risks assumed by the Fund during the truly exceptional increase of exposure that took place in 2001. Indeed, neither the Fund nor Argentina was benefited by those misguided policies. The difference of course is that Argentina is the debtor and the Fund the creditor (a preferred creditor for that matter), which entails it to remain current on a huge debt for which Argentina is *not* solely responsible.

Finally, it should be recognized that this institution has the courage to expose and analyze its own mistakes. This should be commended. Recognizing errors is, however, just the first step in a healthy self-criticism exercise. The second step is bearing responsibility for failures, namely sharing the burden of redressing their consequences.