CHAPTER 2 Surveillance and Program Design, 1991–2000

This chapter reviews the IMF's prolonged involvement in Argentina from the introduction of the convertibility regime in 1991 until the onset of crisis in late 2000. The purpose is to determine the extent to which IMF surveillance helped to identify the vulnerabilities that led to the crisis and how effectively the IMF used the program relationship with Argentina during much of the period to address these vulnerabilities. We focus on three areas of critical relevance to the IMF: (i) exchange rate policy; (ii) fiscal policy; and (iii) macro-critical structural reforms in the fiscal system, the labor market, the social security system, and the financial system. For each of these areas, two sets of issues will be addressed: first, whether the IMF's diagnosis of what needed to be done at various stages was correct, and whether it could have been improved; second, the IMF's impact on the policies actually chosen, and what determined the strength or weakness of that impact.

Exchange Rate Policy

Argentina was one of the handful of countries that maintained a "hard peg" in the 1990s and early 2000s (Box 2.1). It is well known that the sustainability of such an exchange rate regime critically depends on certain stringent conditions being fulfilled. One of the central issues in evaluating surveillance and program design in this area during the precrisis phase is how the IMF perceived the convertibility regime's medium-term viability over time; how effectively it advocated the requisite supporting policies; and whether it provided timely advice on exit strategy if and when supporting policies were judged to be insufficient.

Early success of the convertibility regime

As pointed out in Chapter 1, the convertibility regime, with a rigid peg to the U.S. dollar, was initially adopted as an instrument of price stabilization, and this objective was achieved. The IMF was initially reluctant to support the system (see Cavallo and Cottani, 1997), and remained for some time concerned that it might not deliver the permanent stabilization that was needed. The staff report that accompanied Argentina's request for a new SBA in July 1991 commented: "The convertibility scheme can assist the authorities in their search for a rapid deceleration of inflation, but it is also evident that inflation must decline quickly and stay at very low levels if the economy's competitiveness is not to be impaired. This in turn requires that the fiscal objectives of the program be fully met."

Because convertibility was initially viewed as a stabilization device, little attention was paid to whether the arrangement was appropriate as a basis for long-term growth. There was little analysis of whether the exchange rate regime was viable over the medium term, including the issue of whether the United States and Argentina formed an optimum currency area in terms of synchronization of business cycles, geographical trade structure, or common exposure to external shocks. Instead, attention was focused on whether the fixed rate was overvalued at the moment the peg was introduced and whether the peg might lead to a real appreciation in the near future.

Once the economy had stabilized and started to grow, the focus of the IMF shifted to the risk of overheating. Partly because the rate of inflation initially remained higher than that in the United States, the Argentine currency appreciated in real effective terms by over 50 percent from March 1991 through 1993 (Figure 2.1). Concerns were expressed over the current account deficit, which widened to 3 percent of GDP in 1992 (Figure 2.2). Internal staff documents occasionally expressed concern that the deteriorating current account might undermine the sustainability of the exchange rate regime and suggested that fiscal policy be moved toward surplus and reserve requirements on banks be tightened. The authorities generally disagreed with this assessment, though the fiscal balance improved in 1992–93 and reserve requirements were tightened somewhat in August 1993.

The worries over the current account deficit subsided in early 1994, as inflation continued to fall and the real effective exchange rate (REER) began to de-

Box 2.1. Economic Characteristics of Hard Peg Economies

Argentina was one of the handful of countries that maintained a "hard peg" during the 1990s and early 2000s. Other economies with hard pegs during some or all of this period included Bulgaria, Hong Kong SAR, Estonia, Lithuania, Ecuador, and Panama. Of these, the first four economies maintained currency-board-like arrangements, while the other two were dollarized economies in which the U.S. dollar functioned as legal tender.

Comparison of Argentina with the other economies in some pertinent economic characteristics reveals three important facts (see table below):

- Argentina's external debt was particularly large relative to the value of exports, with the debt-to-exports ratio at 438 percent for 1992–2001.
- Argentina had a particularly small external sector. Total trade accounted for only 16 percent of GDP during 1992–2001, far smaller than the average of 96 percent for the group.
- Along with Hong Kong SAR, Argentina had only a small share of its total trade (about 15 percent) accounted for by the anchor currency country (that is, the United States), whereas the other countries conducted at least 33 percent of their trade with anchor currency countries.

In terms of other macroeconomic characteristics, Argentina did not differ much from, or perform much worse than, its comparators. Argentina's government debt did not seem particularly high relative to that of other countries, indicating that debt became an issue largely because it was mostly foreign currency denominated and the country had a small export base. As measured by general government balance relative to GDP, Argentina's fiscal policy was worse than most, but better than Lithuania's.

Economic Characteristics of Selected Hard Peg Economies

(In percent; period averages)

	Argentina 1992–2001	Bulgaria 1998–2003	Hong Kong SAR 1990–2003	Ecuador[1] 2000–03	Estonia 1993–2003	Lithuania 1995–2003	Panama 1990–2003	Average
Total external debt/exports of goods and services	438.4	150.6	. . .	240.7	52.2	77.1	80.9	173.3
Current account balance/GDP	–3.3	–5.0	3.0	–1.1	–7.6	–7.8	–3.6	–3.6
International reserves/central bank reserve money	120.1	195.7	472.4	136.6	127.8	136.2	. . .	198.1
Total trade/GDP	16.4	84.3	239.2	53.4	144.5	90.4	45.6	96.3
Share of trade with anchor currency country[2]	15.2	51.4	14.6	33.0	57.6	43.3	34.2	35.6
General government balance/GDP	–2.5	–0.4	0.2	0.8	–0.3	–3.6	–0.9	–1.0
General government net debt/GDP[3]	42.3	74.2	. . .	68.8	2.4	23.0	64.6	45.9

Sources: IMF database, and Bankscope.

[1]Total external debt/exports of goods and services is the average between 2000 and 2002.

[2]Anchor currency economies are the EU for Estonia and Lithuania and the United States for the rest of the economies.

[3]Gross debt for Ecuador.

preciate, reflecting the U.S. dollar's depreciation against Argentina's main trading partners. The staff, while still advocating fiscal adjustment, no longer expressed strong concerns over the sustainability of the exchange rate regime. In retrospect, this might have been an opportune time to exit the peg, although the memory of hyperinflation was still fresh and argued against such a possibility at that time. Some Board members did raise the issue, but the staff hardly discussed it with the authorities and appears to have accepted their view that a significant portion of the real appreciation had been offset by improvements in competitiveness resulting from deregulation and privatization.

The Mexican crisis and subsequent recovery

The Mexican crisis of 1994–95 represented a turning point in the IMF staff's view of the peg. Earlier reports had noted the effectiveness of the peg in controlling inflation, and had outlined the policies that staff judged to be necessary for sustaining the peg. Not until 1995 did a formal staff report state a position as to whether the peg *should* be maintained. The staff report of March 1995 took a clear position in favor of the peg:

> The pegging of the Argentine peso to the U.S. dollar since April 1991 has been critical to the successful performance of the economy in recent years, providing the necessary discipline to keep inflation under control. . . . Argentina's economic history during the 1980s suggests that it would be very difficult to keep inflation expectations under control in the event that exchange rate discipline were to be lost. For this reason, and in view of the strengthening of policies by the Argentine authorities, the staff supports the maintenance of the fixed exchange rate.

These views were echoed in public statements. The press release following the Board approval of the extension request, dated April 6, 1995, said: "The decisive measures taken by the authorities, shortly ahead of national elections, demonstrate their full commitment to the basic objective of maintaining the Convertibility Plan that has served the country well."

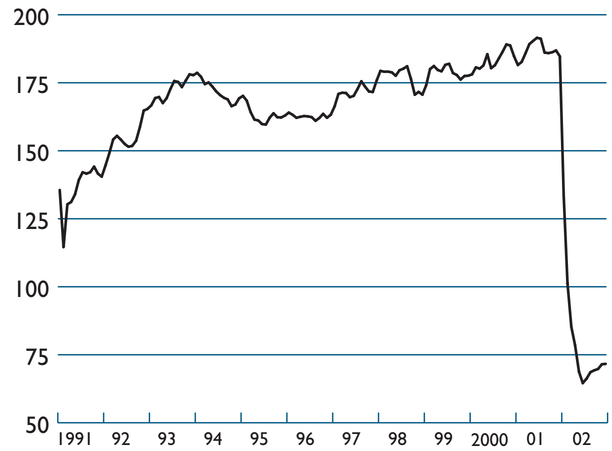
The staff was impressed by Argentina's ability to withstand the pressures that followed the Mexican crisis, and particularly the authorities' willingness to take tough measures in support of the peg.[1] These included a fiscal adjustment of some 2 percent of GDP (mostly through an increase in the value-added tax (VAT) rate from 18 percent to 21 percent and a reduction in public sector wages) and a set of structural reforms, most notably measures to improve labor market flexibility for small and medium-sized enterprises. The fact that these politically painful decisions were taken on the eve of presidential elections was especially notable.

Subsequent staff reports and public statements reiterated the IMF's support for the peg. In a speech in Buenos Aires in May 1996, the Managing Director commented:

> The recovery in output, which is just now beginning to take hold, depends mainly on continued strengthening of private sector confidence, and continued macroeconomic policy discipline is essential to achieve this. In this regard, the Convertibility Law has served an essential function over the last five years in reinforcing Argentina's commitment to fiscal discipline and price stability; accordingly, it is continuing to play a critical role in restoring confidence.

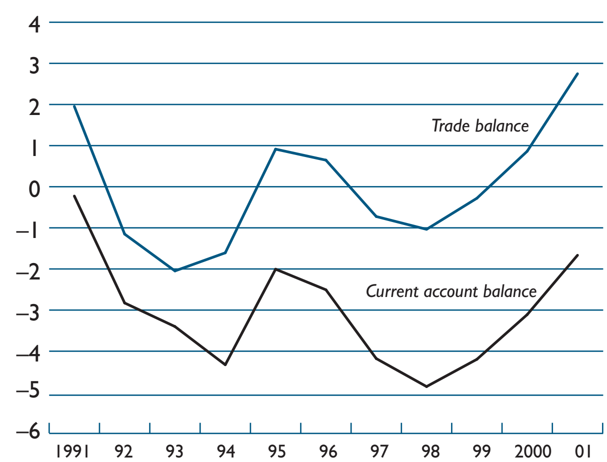
There were, however, some internal differences in perception. While IMF management and staff in the

Figure 2.1. Monthly Real Effective Exchange Rate
(1990 = 100)



Source: IMF database.

Figure 2.2. Trade and Current Account Balances
(In percent of GDP)



Source: IMF database.

Western Hemisphere Department (WHD) moved toward a more explicit stance in support of the exchange rate peg, other departments and some Executive Directors started to wonder if the peg should be reexamined. Given the "very weak growth prospect" envisaged for Argentina, a memorandum by the Policy Development and Review Department (PDR) in January 1996 questioned the appropriateness of the

[1]How the markets reacted to some of the actions of the authorities taken in early 1995 is analyzed in Ganapolsky and Schmukler (1998).

exchange rate arrangement in view of the need to stimulate domestic demand. While some Executive Directors had raised this issue from time to time, the questions became more frequent in the aftermath of the Mexican crisis. Nevertheless, management consistently supported WHD's position in favor of the peg, and whenever the issue was raised at Board meetings, the majority of Executive Directors also concluded that grounds for encouraging an exit were lacking.

From mid-1996 through 1998, there was virtually no substantive discussion of the peg within the staff or between the staff and the Argentine authorities, although the issue was raised from time to time at Board meetings. The topic did not seem especially pressing, largely because the REER based on consumer or wholesale prices showed only mild appreciation, if any, over most of this period. Concerns about competitiveness were never far from the surface, but staff reports dismissed these by citing the rapid growth of exports (exports grew over 30 percent annually in volume terms and 11 percent in value terms from 1995 through 1999). As evidence of the positive impact of structural reforms on labor costs, the staff produced an estimate of the real peso-dollar exchange rate based on unit labor costs, which showed a steady cumulative "depreciation" of almost 50 percent from 1991 through the third quarter of 1998.

In retrospect, the years 1996–97 may well have been the last opportunity for Argentina to exit from the peg without facing very high costs. Spreads, if any, between peso and dollar interest rates were small, suggesting that the market did not expect any break in the peg to involve a large depreciation.[2] Moreover, the strength of capital flows to emerging markets in that period and the widespread optimism about Argentina's growth potential would have acted to stabilize the currency. The authorities' strong response to the Mexican crisis had produced a great deal of confidence in the ability of the Argentine political system to keep the country's debt under control and to implement a new wave of structural reforms, all of which created favorable circumstances for exit.

It should be noted, however, that exit was never an easy option, either politically or economically. In the first place, the design of the convertibility regime made any exit costly, a feature that was necessary as part of the strategy of ensuring its initial credibility, and the costs increased over time as the fixed peg determined behavior that was reflected in balance sheets and other aspects of economic life. Moreover, President Menem's prestige was closely linked to the convertibility regime, which commanded wide public support. The legal consequences of any exit would also have been just as significant, given the extensive dollarization of contracts and the fact that it would have meant the breach of a social contract between the state and the public. Nevertheless, the IMF could have played a valuable role in encouraging serious consideration of the exit option through policy advice and an offer of financial support if the authorities were interested.

Staff clearly believed that a strong program based on fiscal consolidation and structural reform would facilitate a possible switch to a floating exchange rate in the future. A briefing paper prepared in April 1997 stated: "the discussions on a program to be supported by an extended arrangement will be based on the assumption that convertibility will be maintained, . . . with the expectation that successful implementation of the program may create the conditions for orderly exit from this strategy, if such exit were to be desired." Unfortunately, this idea was not developed, and no further effort was made to determine more precisely what "the conditions for orderly exit" might be. From 1995 to 1999, the staff devoted few analytical resources to the question and hardly raised the issue with the authorities.

Responses to adverse shocks

From 1998 to 2000, Argentina underwent a series of adverse shocks and, in consequence, unfavorable economic developments. These included: (i) a sharp reduction of capital flows to emerging markets after the East Asian and Russian crises of 1997–98; (ii) a corresponding increase in the risk aversion of international investors; (iii) a terms of trade shock deriving from the fall in the relative price of commodities exported by Argentina; (iv) the Brazilian devaluation of early 1999 and the ensuing loss of market share in Brazil; (v) a secular appreciation of the U.S. dollar relative to the euro that eroded the competitiveness of Argentina in third markets; (vi) a sharp increase—by 175 basis points—in the U.S. federal funds rate between mid-1999 and mid-2000; (vii) prolonged recession in Argentina; and (viii) the structural and worsening current account deficit. As pointed out by Calvo and others (2002), under these circumstances, Argentina's relatively small tradable goods sector would have required a large real exchange rate adjustment to restore external balance.

The evolving crisis in Brazil toward the end of 1998 should have presented an occasion for staff to resume internal discussion of the convertibility regime, but this did not happen. The staff report of

[2]Spreads between peso and dollar interest rates on similar domestic instruments began to decline substantially in late 1995 and remained relatively small from early 1996 to the third quarter of 1997, ranging from near zero (or even negative in some cases) to less than 200 basis points.

September 1998 did not mention the risks to Argentina of a possible devaluation of the Brazilian real.[3] A briefing paper in November included a footnote suggesting that a worsening of the situation in Brazil might lead to lower capital market access and "slightly negative" growth in 1999, but did not even discuss its implications for the convertibility regime. When Brazil abandoned its crawling peg in January 1999, causing a sharp appreciation in the REER of the Argentine peso, the staff responded by reaffirming its support. The staff report for the 1999 Article IV consultation, written shortly after Brazil's devaluation, declared:

> The authorities and the staff agree that the most appropriate response to recent events in Brazil is to reaffirm, indeed reinforce, the strong commitment to the policy framework that has served Argentina well, including the automatic adjustment mechanism implied by the currency board, prudent fiscal and debt policies cast in a medium term framework, and significant structural reform to bolster banking soundness and flexibility in the economy.

The staff's positive appraisal of the "automatic adjustment mechanism" was new.[4] In late 1997, the authorities had offered this argument to justify their position that strong action to address the current account deficit was not necessary. While not explicitly rejecting this view, the staff had been careful not to make the same argument in its own appraisal. Instead of relying on any automatic adjustment mechanism, the staff had urged that the current account gap be reduced through fiscal adjustment combined with structural reforms to improve competitiveness. In early 1999, however, it apparently shifted to a position more accommodating of the automatic adjustment view, while continuing to emphasize the need for prudent fiscal policies and structural reform. By August 1999, however, the staff again emphasized the need for aggressive action without mentioning the automatic adjustment mechanism, suggesting that skepticism about the efficacy of "automatic adjustment" had returned.

The initial response of the Argentine authorities to the Brazilian devaluation was to announce their intention to pursue full dollarization of the economy, that is, moving to an even harder peg. Technical discussions on this matter with the U.S. authorities had started in 1998. The issue assumed a higher profile in 1999, but the discussions slowed ahead of the October 1999 elections. The new De La Rúa administration that took office in December 1999 did not pursue the matter. The mere announcement in early 1999 that the Argentine authorities were seriously considering full dollarization had a positive impact of reassuring investors that the authorities were not considering a break in the peg.

Despite being aware of the authorities' interest in full dollarization and of their discussions with the United States, and despite the urging of management and reviewing departments, WHD did not take a strong position on the dollarization issue. The report prepared for the May 1999 review noted that the staff shared the authorities' view that full dollarization would improve growth prospects by reducing the high interest rates paid by Argentine borrowers. The report, however, provided no supporting analysis, beyond noting that full dollarization would need to be supported by "further reforms to increase the flexibility of the economy and its resilience to asymmetric shocks within the dollar area."[5] Within the staff, as well as in the wider policymaking community, there was an understandable lack of consensus on the benefits of full dollarization, particularly for an economy like Argentina with a relatively diversified geographical pattern of trade.

When the recession deepened in the course of 1999, and prospects for a rapid recovery in 2000 faded, WHD staff began to engage in a comprehensive analysis of the issues surrounding possible exit strategies. A memorandum prepared for management in August 1999 outlined two scenarios for 2000. In one scenario, the "current" policies were assumed to be maintained despite falling tax revenue, resulting in a sharp rise in the fiscal deficit, a fall in confidence, and a tightening of external financing conditions, as a result of which unemployment was projected to rise and the sustainability of the convertibility regime to come into question. The second scenario identified "a set of policies that could help restore confidence and ensure the sustainability of the convertibility regime over time," including a sharp fiscal adjustment of up to 1.5 percent of GDP and structural reforms designed to shore up competitiveness, possibly with augmented official support. Dollarization is men-

[3]The issue was raised, however, at the Board discussion of the review. In response to questions from a few Executive Directors, the staff representative downplayed the risks to Argentina of a crisis in Brazil, noting the diversification of Argentina's exports in 1998, its ability to resist an outflow of deposits as demonstrated during the Mexican crisis, the strength of the banking system, and the contingent repurchase agreements with commercial banks.

[4]According to this view, any balance of payments difficulties under a currency board arrangement would result in a contraction of base money, leading to a rise in domestic interest rates and a fall in domestic prices. These developments are in turn expected to bring about the needed adjustment of the balance of payments through a combination of a fall in domestic demand, a real exchange rate depreciation, and an increase in capital inflows.

[5]The Argentine proposal, however, did lead to further research within the IMF into issues related to full dollarization in the general case. See Berg and Borensztein (2000).

tioned as a measure that might further boost confidence, provided that it is accompanied by firm policies such as those described.

The staff noted that, if a package of the type described in the second scenario did not prove to be feasible, then "[a]n exit strategy would need to be considered." But exit "would be extremely difficult, if not chaotic," for a number of reasons, including the memory of hyperinflation, the likelihood of capital flight, and the impact on the banking system. The memorandum concluded that, while a move to a floating regime "could lead to a stronger economic performance over the medium term" because it would enable a more rapid adjustment of relative prices, the risks of a return to the pre-1991 instability and the costs of the transition "are too high to allow contemplation of such a possibility on a voluntary basis." Staff therefore recommended implementing the fiscal adjustment and structural reforms needed "to restore viability to convertibility."

The August 1999 memorandum proved to be only the start of a lengthy process of analysis by staff of the costs, benefits, and modalities of an exit from the peg. The different analyses all reached the same conclusion: that an exit would be extremely costly and would bear a high risk of leading to hyperinflation, a severe shock to the banking system, and a sovereign default. Subsequent decisions by the IMF can be understood in the light of the assessment that, given the large up-front costs, it was not appropriate to force an exit from the peg. But this was valid only on the assumption that appropriate corrective steps would be taken to preserve the peg.

The political environment after 2000 was particularly unfavorable to considering an exit from the peg as a policy option. The De La Rúa administration had been elected on a pledge to maintain the convertibility regime, and needed to demonstrate that it would not repeat the hyperinflation of the late 1980s that had brought down the Radical government. The authorities were highly reluctant even to discuss the issue, given the risk that news or rumors that such discussions were under way would lead to a market panic, but they were receptive to the staff's advice on the need for policy action to support the exchange rate regime. Measures to this end were built into the SBA approved in March 2000, although they proved to be largely ineffective.

The IMF and exchange rate policy: an assessment

In assessing the effectiveness of IMF advice in this area, it is important to recognize that the choice of exchange rate regime is a member country's prerogative. However, the IMF has an obligation to exercise firm surveillance over members' exchange rate policies, and this is normally understood to mean that the IMF must examine the consistency of the authorities' choice of exchange rate regime with other policy choices, given the institutional constraints. The views of the Executive Board reiterating this broad understanding were clearly expressed during a discussion on "Exchange Rate Regimes in an Increasingly Integrated World Economy" held on September 31, 1999.[6] Yet, IMF staff devoted only limited resources to determining whether the exchange rate regime adopted in Argentina was consistent with other policies and institutional constraints and, if not, what possible exit strategies Argentina should consider. Until the very last minute, management and staff did not discuss alternatives to Argentina's exchange rate policy at the Executive Board, even though the issue was raised on occasion by Executive Directors.

The reluctance to analyze and discuss fundamental issues of the convertibility regime can be explained by four factors:

- First and perhaps most important, there was a fear that discussion of the convertibility regime, particularly when markets were jittery, might undermine its viability in a self-fulfilling manner. But even if this was a legitimate consideration constraining the scope of discussion in the Board, it does not explain the failure to discuss the issue with the authorities.
- Second, the IMF lacked objective tools to evaluate the appropriateness or sustainability of a country's exchange rate arrangement. In large part, this reflected the absence of consensus within the economics profession (Box 2.2), but available analytical tools were also not sufficiently deployed. The exchange rate was typically analyzed in terms of historical movements of the REER, but such analysis was not based on the forward-looking concept of sustainability.
- Third, there was an institutional culture that discouraged open discussion of such issues, based on a particular (and in our view incorrect) interpretation of the Articles of Agreement. It is true that IMF staff quickly learned that the authori-

[6]The Chair's Summing Up of the Board discussion stated that "the Fund should offer its own views to assist national authorities in their policy deliberations [on exchange rate policy]. In particular, the Fund should seek to ensure that countries' policies and circumstances are consistent with their choice of exchange rate regime. In some cases where the issue arose, this would require the Fund to offer advice on an appropriate strategy for exiting a fixed exchange rate regime." It further stated: "Directors agreed that the Fund should not provide large scale assistance to countries intervening heavily to support an exchange rate if this peg is inconsistent with the underlying policies."

ties were not interested in discussing alternatives, which is understandable in view of the centrality of the peg to their overall economic strategy. However, the prerogative of a member country to choose an exchange rate regime of its liking, and even its unwillingness to discuss the issue, did not exonerate the IMF from its obligation to exercise firm surveillance over members' exchange rate policies.

- Fourth, repeated public statements by the IMF supportive of Argentina's convertibility regime subsequently made it difficult for management and staff to credibly propose alternatives to the Executive Board and to the Argentine authorities.

Whatever the reason may be, the IMF's failure to address the viability of the exchange rate system early in the process must be read as a weakness of its surveillance over exchange rate arrangements, as mandated by the Articles of Agreement and reaffirmed by subsequent Executive Board statements and policy guidelines. In the event, very little analysis was done, let alone discussed with the authorities. By the time staff and management began to consider substantive issues related to the convertibility regime, the cost of any exit was already so high that it could only be implemented with strong political leadership, something that would prove lacking in Argentina.

Fiscal Policy

Fiscal policy was the single most prominent topic of discussion between the IMF and the Argentine authorities for virtually the entire period of convertibility. While fiscal policy often dominates the IMF's interactions with member countries, it assumed a particular importance in the case of Argentina. For one thing, there was a history of fiscal irresponsibility that had in the past contributed to repeated cycles of defaults and hyperinflation.[7] Moreover, the choice of the convertibility regime made fiscal policy especially important.

There were three reasons why convertibility made fiscal policy especially important. First, fiscal policy was effectively the only tool of macroeconomic management, because the reserve backing rule of the currency-board-like regime imposed restrictions on the use of monetary policy. For fiscal policy to perform this role, debt needed to be kept low enough to allow deficit financing during a downturn without creating fears of insolvency. Second, the same restrictions on monetary policy deprived the central bank of the ability to act as the lender of last resort in the event of a banking crisis. This reinforced the need to maintain a sufficiently low level of public debt to ensure that the government had adequate borrowing capacity to support the banking sector, if necessary.[8] Third, the long-run viability of the convertibility regime depended

Box 2.2. Measuring the Equilibrium Real Exchange Rate

There is now a consensus that the Argentine peso was increasingly overvalued during the immediate precrisis period, but assessing the degree of overvaluation is not easy.

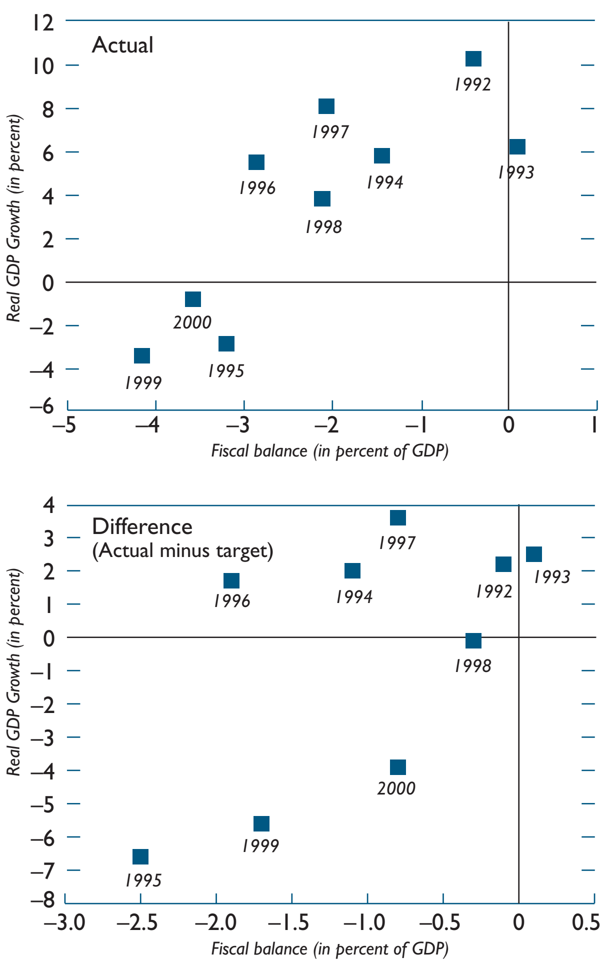
A wide range of views exist even today on whether the peso was overvalued before the series of external shocks hit Argentina during 1998–2000. Some consider that the improvement in productivity in the 1990s was sufficient to compensate for (a substantial portion of) any nominal effective appreciation of the peso (e.g., PDR, 2003). Others challenge this view by appealing to the fact that the surge in productivity had tapered off in the second half of the 1990s (e.g., Perry and Servén, 2002). Argentina's export growth in the 1990s is difficult to interpret, given the low initial base, the elimination of export taxes and other trade liberalization measures, and the impact of trade diversion associated with MERCOSUR. The fact that imports grew much faster (at 25 percent a year) than exports (at 8 percent) during 1990–98 may have indicated a loss of competitiveness.

In the spring of 2000, before the further worsening of economic and financial conditions in Argentina and before the further weakening of the euro relative to the U.S. dollar, there were equally divided views of the peso's overvaluation. For example, the overvaluation was estimated to be 7 percent by Goldman Sachs, 13 percent by JP Morgan, and 17 percent by Deutsche Bank. There were many other estimates, ranging from a single digit to over 20 percent. Irrespective of the difficulty of quantifying the exact amount of overvaluation, however, the series of adverse shocks within the context of Argentina's economic characteristics should have led to an unambiguous qualitative judgment that the peso was significantly overvalued as the country entered the second year of recession.

[7]In July 1991, the Argentine representative at the Executive Board noted: "The chronic fiscal imbalance is recognized as the main contributing factor to the past stagnation and price instability."

[8]In a heavily dollarized economy, however, there is a limit to the public sector's ability to perform this role regardless of the choice of exchange rate regime.

Figure 2.3. Comparison of Fiscal Targets and Actuals



Source: IMF staff reports.

on the credibility of the government guarantee that local currency would be exchanged for U.S. dollars at par. This credibility required that the markets did not question the ability of the government to borrow in foreign currencies, which in turn depended on fiscal solvency.

The convertibility regime, coupled with central bank independence, was expected to contribute to fiscal discipline by eliminating money creation as a source of deficit financing. This strategy seemed to work in the first few years, when the authorities succeeded in substantially reducing fiscal deficits and there was even a small surplus in 1993. The early achievements in fiscal consolidation were interpreted by the IMF (as well as others) as a vindication of the disciplining role of a currency-board-like arrangement.[9] Yet, Argentina still regularly fell short of the targets agreed under the IMF-supported programs. The fiscal balance remained in deficit (except in 1993) even when growth was high (Figure 2.3). Relative to the program targets set at the beginning of the year, annual targets were missed every year from 1994 through 2001. The margins were sometimes substantial, amounting to as much as 2 percent of GDP. The shortfalls are especially notable considering that GDP growth exceeded forecasts in several of these years. Despite this poor record, the IMF maintained financing arrangements with Argentina by relaxing targets or replacing the existing arrangement with a new one.

The IMF's analysis of fiscal policy

The IMF's analysis of fiscal policy, particularly during the second half of the 1990s, can be faulted on three grounds. It focused too much on the flow aspect reflected in the fiscal deficit and not enough on the stock aspect reflected in the size of public debt, which was arguably critical for market confidence. It also underplayed the role of provincial finances, which were an important source of fiscal weakness. Finally, it overestimated the sustainable level of debt for a country with Argentina's economic characteristics.

Focus on flow variables

The focus of the staff's analysis and discussion with the authorities was primarily on the fiscal deficit as a flow variable. Although total public sector debt was included as a performance criterion from the beginning, an assumption of overdue obligations was routinely accommodated. The staff did not produce a table providing a convincing connection between fiscal flow variables and the year-to-year change in the debt stock until July 1997. The debt stock per se became the main focus of briefing papers and policy discussions only in late 1999 or early 2000, when the debt-to-GDP ratio began to approach 50 percent. By then, the economy was in recession, and efforts to reduce the debt by running a fiscal surplus were difficult and possibly also counterproductive.

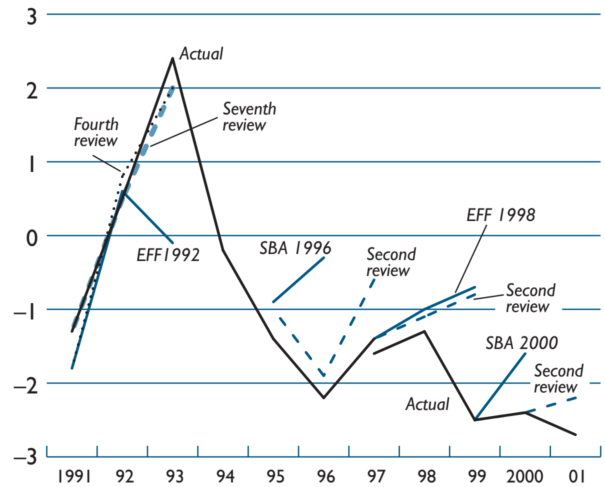
The focus on the deficit had two consequences. First, a failure to meet fiscal targets in a given year was followed merely by a renewed insistence that the authorities meet the flow targets for the follow-

[9]For example, a staff study published in 1997 concluded that, in Argentina, the "[currency board arrangement] contributed in an important way to enforcing fiscal discipline (at the federal level)." Baliño and others (1997), p. 7.

ing year; the targets were never recalibrated to correct for the deviation of the debt stock from the desired path as a result of earlier underperformance (Figure 2.4). A full compensation for a shortfall in the previous year may not have been appropriate, but fiscal deficits should have been explicitly related to the objective of reducing debt ratios over time. Second, the focus on flow variables weakened the fiscal position over time because of asymmetric response to growth shocks. There was a tendency to loosen fiscal targets and grant waivers for the nonobservance of performance criteria when growth fell below forecasts (for example, in 1995, 1999, or 2000), but not to strengthen targets when growth exceeded forecasts (for example, in 1993 or 1997).[10]

The need for a tighter fiscal policy in Argentina was not fully appreciated within the IMF during much of the precrisis period. Despite the tendency to relax targets in years of weak economic performance, WHD's fiscal policy stance was at times criticized for being too contractionary, both by review departments and by some Executive Directors. For example, PDR remarked in August 1996 that, given the high level of unemployment, the delay in recovery, the lack of inflationary pressure, the government's waning political support, and the fact that fiscal policy was still tight in a cyclically adjusted sense, "the wisdom of pushing too hard for significantly more stringent fiscal measures is subject to question."[11] As late as February 1999, the Research Department (RES) warned that caution "should be taken not to aggravate the economic downturn through a further tightening of the fiscal position. Given Argentina's low fiscal deficit, the sound track record of fiscal responsibility established in recent years, and the experience following the Mexican crisis, the 'market confidence' effects of a policy response of fiscal tightening are likely to be modest."

Figure 2.4. Projected Overall Fiscal Balances and Their Outturns
(In percent of GDP)



Source: IMF staff reports.

The emphasis on the deficit as a flow variable served to understate the seriousness of Argentina's fiscal position, because sovereign debt was growing much more quickly than would be expected from the year-to-year deficit figures (see Appendix 3 for details). One reason for this was the (often court-ordered) assumption of old debts, including overdue obligations to pensioners, government suppliers, and provincial governments. The authorities were also prone to issue off-budget debt to settle government obligations, through such means as the capitalization of interest payments.[12] While such increases in debt were not given due recognition, the deficit-related performance criteria for the program supported by the 1992–94 extended arrangement included privatization receipts.[13] In other words, the performance criteria could be met with nonrecurring debt-reducing operations but were unaffected by nonrecurring debt-increasing operations.

The emphasis on flows in part reflected the fact that the IMF's financial programming was based on flow relationships. A similar approach informed the authorities' attempt to legislate fiscal discipline through the enactment of a "Fiscal Responsibility Law" in September 1999. This law set a timetable

[10]This tendency was noted in the IEO's evaluation of fiscal adjustment in IMF-supported programs (IEO, 2003b). When growth was robust, staff did sometimes try to argue for tightening the fiscal targets, but to no avail. In March 1993, for example, the staff advised the authorities "that a strengthening of the public finances, perhaps even beyond the programmed level, would restrain absorption and reduce the risks to the program." The authorities responded that, in their view, demand pressures were subsiding and additional restraint was not necessary. In the end, the targets that had been set at the beginning of the year were not adjusted and were met only with a small margin. Likewise in April 1998, senior staff wrote a letter to the authorities stressing the need to tighten fiscal policy in view of a large current account deficit. It should be noted, however, that the staff's approach to fiscal policy in these instances was motivated by cyclical demand management considerations, and not by debt sustainability concerns.

[11]A *Wall Street Journal* commentary written around this time by a prominent academic expert took a position even more lenient toward fiscal policy than that of the IMF, by recommending that a new IMF-supported program should focus on structural reforms rather than short-term fiscal targets. See Edwards (1996).

[12]An unofficial estimate by Teijeiro (2001) puts the figure at $31 billion during the 1990s.

[13]Privatization revenues, however, were later treated as financing.

under which the federal deficit would be reduced gradually and then eliminated entirely by 2003, and limited the growth rate of real expenditures to that of real GDP. The accumulation of a small "fiscal stabilization fund" was envisaged, which would smooth cyclical fluctuations in the fiscal accounts, but debt reduction per se was not a primary goal of the law. In internal discussions and in discussions with the authorities, staff did not consider the pace of fiscal consolidation specified in the law to be fast enough, and was disappointed that the law covered only the federal government (attempts were made in 2000 to enact similar laws in the provinces). Nevertheless, the IMF publicly endorsed the law as providing an important signal of the authorities' commitment to sound fiscal policies, and urged the presidential candidates to declare their support for it. In the event, even the relatively weak prescriptions of the law could not be met in the recessionary climate of 2000.

Insufficient attention to provincial finances

The provincial governments constitute a significant component of the public sector in Argentina, with a combined spending comparable to that of the federal government once transfers to the provinces are excluded from federal expenditures (see Appendix 3, Table A3.5). From the very beginning, the IMF was well aware that poor tax administration and weak fiscal control at the provincial level had contributed to the country's historically poor fiscal performance, and this posed challenges for strengthening the overall fiscal discipline of the public sector. As a result, the reform of the provincial finances, including the revenue-sharing arrangements, was rightly made an area of structural reform under the successive financing arrangements with Argentina (see the section "Structural fiscal reforms"). Yet, the focus of formal fiscal conditionality in the earlier years remained exclusively on the federal government budget, and it was only in 1998 that the combined federal and provincial deficits were explicitly included as an indicative target in the EFF (see Appendix 4).

An attempt to address weaknesses in provincial finances was made in response to the Mexican crisis. One-time revenue sources that had financed provincial deficits, such as privatization receipts and the settlement of the federal government's earlier obligations to the provinces, had fallen sharply from their levels of the early 1990s, and there was a danger that the provincial deficits would rise very quickly. The strategy adopted then was for Argentina's Treasury and central bank to restrict borrowing by the provinces in order to encourage a return to fiscal discipline. However, the ability and the willingness of the federal authorities to control provincial borrowing proved limited, with some of the provinces successfully floating large bond issues (which required at least tacit approval at the federal level) on international capital markets.

The effort to get the authorities to focus on the need for greater fiscal discipline at the provincial level was clearly not successful. The federal authorities on their part cited constitutional limitations on their ability to make commitments on behalf of the provinces. To make matters worse, the ability even to monitor the provincial finances was constrained initially by the lack of reliable and timely data, although staff efforts did help to improve the capacity to monitor these developments over time. Nevertheless, the federal government's repeated attempts to bail out provincial governments or programs meant that much of the provincial deficits ended up being explicitly recognized as federal deficits.[14] Moreover, part of the provincial deficit reflected the transfers of some of the responsibility for spending programs from the federal government to the provinces that took place throughout the 1990s.

Overestimating the sustainable level of debt

One reason why there was less focus on debt than necessary was that the public debt-to-GDP ratio (in the range of 30 percent during much of the 1990s) did not seem excessive for quite some time, and Argentina had little difficulty financing its deficits through foreign borrowing. In retrospect, it is evident that the staff's analysis missed a number of important economic characteristics of Argentina that made the situation especially vulnerable (see Appendix 5). First, Argentina's public debt was almost entirely denominated in foreign currencies, reflecting its limited ability to issue long-term debt in its own currency, itself a reflection of the fact that the convertibility regime tended to encourage dollar-denominated debt. The apparent public debt-to-GDP ratio was therefore potentially understated because a depreciation of the peso, a possibility that was ignored because of the assumed stability of the exchange rate regime, would immediately translate into a jump in the debt ratio. Second, much of the debt was held by external creditors (who tend to be much more susceptible to swings in market sentiment than domestic creditors), making debt servicing conditional on export receipts, and Argentina had a relatively small ratio of exports to GDP. This

[14]For example, a briefing paper expressed concern over the fiscal pact negotiated between the federal and provincial governments in August 1993, in which the federal government took over a number of heavily indebted provincial pension systems and increased revenue transfers in exchange for the provinces' agreement to support social security reform and to implement deregulation and tax reform at the provincial level.

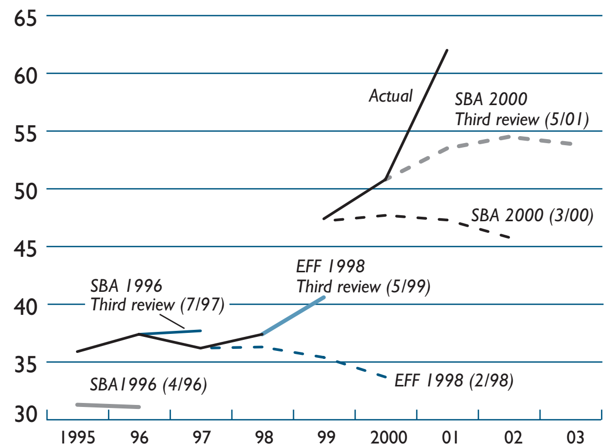
meant a large external debt-service ratio, which could trigger a run on the currency. Third, Argentina suffered from weak tax administration, and revenue collection did not show an improvement commensurate with economic growth (see the section "Structural fiscal reforms"). Fourth, as with other emerging market economies, Argentina could borrow only at sizable spreads over U.S. treasuries, and a shift in market sentiment could lead to very high interest rates, creating potentially explosive debt dynamics.

These problems did not surface as long as growth was robust and capital market conditions were relatively favorable, as in the 1990s. The rise in the debt ratio was modest during much of the 1990s and, in 1992 and 1997, the ratio even declined because of strong GDP growth. Staff projections assumed that this outturn would be the norm in future years, but after 1997 debt accumulation consistently exceeded GDP growth, which was compounded by a jump in the stock of debt associated with the election-driven increase in public spending in 1999 (Figure 2.5). As noted by the staff's recent analysis of the Argentine crisis (PDR, 2003), overoptimistic growth projections led to an overestimation of Argentina's ability to accumulate a larger stock of debt. Nor did the staff explore the implications of less optimistic projections. While staff reports regularly mentioned the risks faced by Argentina, and particularly the risk that a fall in confidence would lead to a temporary loss of market access, little was done in the way of rigorously exploring the implications of these risks for fiscal solvency.[15]

It is relevant to ask whether diagnostic tools developed in the IMF since the Argentine crisis would have generated stronger warning signals, had they been available earlier. Our analysis shows that debt sustainability analysis would have consistently projected the external debt-to-GDP ratio to exceed the suggested benchmark of 40 percent during 1998–2000 even in the baseline scenario (see Appendix 6).[16] In this sense, external debt sustainability would clearly have been questioned by 1998. The public debt-to-GDP ratio, however, would have been projected to exceed 50 percent only in 2001 even under the most extreme scenario. It is not clear if staff would have taken this as a sufficiently alarming signal. As noted by Krueger (2002), even with the best available methodology, debt sustainability analysis remains "fundamentally a matter of judgment." To trace what actually happened, debt sustainability analysis would have required unusually adverse assumptions on the exchange rate.[17]

Figure 2.5. Public Sector Debt Targets and Actuals

(In percent of GDP)



Source: IMF documents.

Note: There was a break of actual data series in 1999 owing to a change of the GDP definition.

The IMF and fiscal policy: an assessment

Our assessment of Argentine fiscal policy is that it was too weak given the exceptional standards required by the convertibility regime.[18] While the IMF

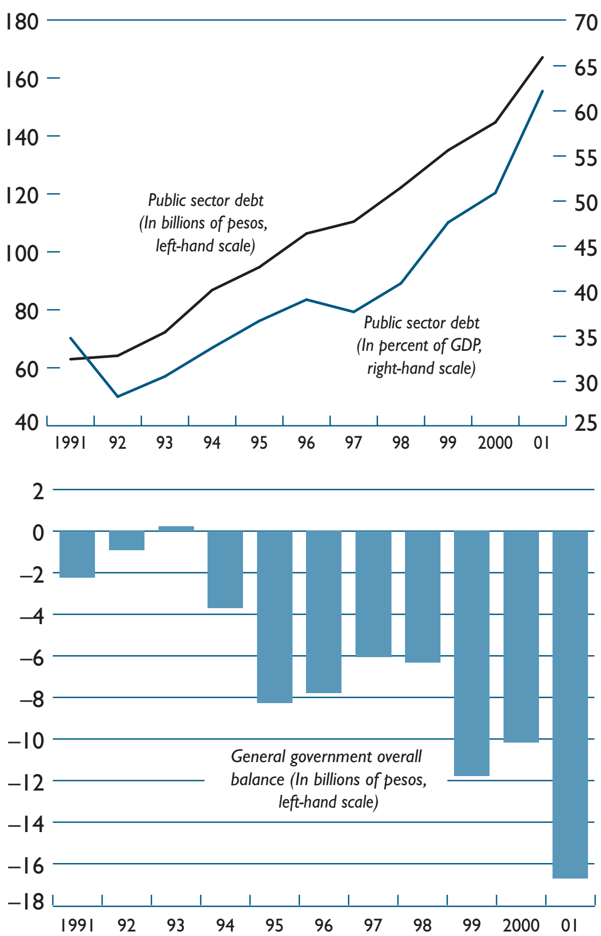
[15]The staff's analyses typically assumed relatively mild shocks, such as slower export growth or a rise in global interest rates. For example, the staff report of January 1998 forecast growth of 4 percent, followed by a gradual return to potential growth of 5 percent by 2000. The consolidated public sector deficit was projected to narrow from 1.4 percent of GDP in 1998 to 0.4 percent in 2000 and 0.1 percent by 2004, while the public sector debt-to-GDP ratio would steadily fall by one or two percentage points a year from 36.3 percent at end-1997.

[16]PDR suggests the 40 percent benchmark as implying the conditional crisis probability of about 15–20 percent. "Sustainability Assessments—Review of Applications and Methodological Refinements," SM/03/206, June 2003. Reinhart and others (2003), however, suggest a much smaller threshold (of perhaps as low as 15–20 percent) for some highly debt-intolerant emerging market economies. Recent RES analysis argues that the sustainable public debt level for a typical emerging market economy may be about 25 percent of GDP. See IMF (2003), p. 142.

[17]Empirical evidence suggests that, if a currency crisis does occur, short-run real depreciation is typically far in excess of any initial fundamental real overvaluation and, in most cases, lasts for two years (Cavallo and others, 2003).

[18]We are not making a judgment on the relative size of the public sector compared with other countries, but on the country's willingness to generate tax revenues on a sustainable basis to support choices on the level of public expenditures. However, Krueger (2002) notes that the average Argentine federal employee was paid much more than the average Argentine private sector employee (as much as 45 percent in 1998) and that Argentina's size of the public sector was large by international standards, with its public sector employment comparable to that of some industrial countries.

Figure 2.6. Public Sector Debt and General Government Overall Balances



Source: IMF database.

was always aware of fiscal weaknesses and called for corrective steps, it did not anticipate the extraordinary vulnerability that could arise from these weaknesses. Argentina did achieve greater fiscal discipline in the 1990s, compared with previous decades, but the fiscal balance remained weaker than necessary, and the numbers hid the true picture. With occasional bailouts of provincial liabilities, recognition of off-budget obligations, and the unintended fiscal consequence of social security reform, debt accumulated steadily throughout the period (Figure 2.6). While the deficiencies in the IMF's analysis of fiscal policy were understandable, given the existing professional knowledge, available analytical tools and data limitations, the IMF's high stake in Argentina should have prompted the staff to explore in greater depth the risks that might arise from considerably less favorable economic developments.

Not only did fiscal policy remain weak, structural obstacles to effecting a rapid turnaround in the fiscal balance (such as the federal-provincial revenue-sharing rules) were not removed. As a result, when growth slowed in 1999–2001, the authorities were unable to respond with a fiscal stimulus; to the contrary, the government's solvency had deteriorated and its borrowing needs had grown to such an extent that a fiscal contraction was thought necessary to restore market confidence. This created adverse debt dynamics—a process in which an excessive fiscal contraction caused the recession to deepen, the sovereign borrowing spread to widen, and debt to increase still further. This is not to say that the authorities had an alternative course of action available at the time. The restrictions imposed by the convertibility regime made it impossible to resort to expansionary fiscal policy once the markets had closed. Such procyclical fiscal policy and vulnerability to self-reinforcing debt dynamics are typical of heavily indebted countries, particularly in Latin America, but in the case of Argentina, the convertibility regime compounded these problems.

Despite its awareness of the steady increase in debt, the IMF did not adequately incorporate debt dynamics into conditionality. The IMF's approach was based on a belief that, if the deficit was consistently small and declining, the market would be willing to finance both the deficits and the investment needed to generate high levels of growth. This approach, however, ignored the very real possibility that conditions would at some point deteriorate—growth would falter, the terms of trade would shift, or capital flows would reverse. At each point, deviations may have seemed small or well justified, and each decision to accommodate the deviation involved a judgment call. But a series of these marginal decisions, when combined and accumulated, proved fatal for Argentina during the crisis of 2000–01, when the combination of high interest payments, low growth, and worsening credit quality created "debt dynamics" that caused the country's debt ratios to spiral out of control.

In sum, the IMF's fiscal analysis underestimated the vulnerabilities created by Argentina's particular combination of economic policy choices in three areas. First, the convertibility regime, in an environment of limited wage flexibility, meant that any needed adjustment in the real exchange rate in response to an adverse shock was likely to involve prolonged periods of recession, which would make it difficult to achieve fiscal discipline. Second, the heavy reliance on external borrowing in foreign currencies increased the exposure to swings in market sentiment and hence pressures on the balance of payments and the real exchange rate. While under a fixed exchange rate all domestic financial assets could in principle be the source of similar pressures if domestic agents sought to exit during a crisis, in practice external creditors are much more susceptible to such swings. Third, fiscal policy was weak, given the exchange rate regime and the reliance on external borrowing, and the political ability to deliver the required fiscal discipline weakened further in the late 1990s against the background of electoral politics. This left the economy vulnerable to adverse debt dynamics and limited the scope for countercyclical fiscal policy. These three elements proved highly toxic when the country faced a series of adverse external shocks.

Structural Reforms in Macro-Critical Areas

Starting in 1990, the Argentine authorities embarked on a program of comprehensive market-oriented reforms, reversing a decades-long policy of heavy state intervention. The reforms consisted of privatization of state-owned enterprises, deregulation of product and labor markets, and liberalization of foreign trade. Of the many reforms implemented, this section does not deal with the efficiency-oriented reforms in the real economy. It focuses instead on the "macro-critical" areas of structural reform that were of particular relevance to the IMF, namely, structural fiscal reforms, labor market reform, social security reform, and measures to improve financial system soundness. The implementation of reform in these areas was seen as critical to the success of the convertibility regime, by promoting fiscal discipline, flexibility of the economy, and national savings. In many of these areas, the IMF worked side by side with the World Bank and the IDB.[19] (Details of the structural reforms associated with each program, whether in the form of performance criteria or structural benchmarks, are given in Appendix 4.)

Structural fiscal reforms

Structural fiscal reforms were rightly considered critical to improving fiscal discipline, and covered federal-provincial fiscal relations, tax policy, and tax administration. We review below reforms in each of these areas and assess the role the IMF played.

Federal-provincial fiscal relations

The importance of reforming the provincial finances, including the federal-provincial revenue-sharing arrangements, was well recognized by IMF staff from the very beginning.[20] Argentina had a complex revenue-sharing *("coparticipation")* scheme which generated perverse incentives. An increase in shared federal taxes implemented for fiscal adjustment purposes at the federal level, for example, would create a new provincial revenue entitlement and lead to a permanent increase in provincial spending. Provinces had an incentive to press for new transfers, rather than generating their own revenues or reallocating existing spending.[21]

Following the Mexican crisis, successive IMF arrangements sought to promote reform of the provincial finances, while the World Bank and the IDB provided financing and technical assistance to assist in reforming provincial administrations and privatizing provincial banks. Progress was made in some areas, but a permanent reform of the *coparticipation* scheme was extensively discussed but never concluded. This reflected the largely "zero-sum" nature of any reform, given the conflicting interests of the federal and provincial governments. In the past, revenue-sharing rules were often changed as a quid pro quo between the two parties, but the federal government's ability to strike a compromise became increasingly limited by tightening constraints on fiscal resources and by the political gridlock of the late 1990s.[22]

Subsequently, the fiscal compulsions of the federal government necessitated temporary changes in the *coparticipation* scheme. The 1998 tax reform (see below), which increased shared taxes, compensated the federal government for the lost revenue share by allowing a fixed deduction (of up to Arg$2,154 million a year) from the collected revenue until the end of 2000. The fiscal pact of December 2000 extended the validity of this deduction for the federal government until 2005. At the same time, it replaced revenue-based transfers by a fixed transfer of Arg$1,364 million a month for 2001–02

[19]The World Bank made financial commitments to Argentina totaling $12.6 billion during FY1991–99 and provided technical assistance in such areas as public sector reform (increasingly targeted at the provinces), privatization, labor market and financial sector reforms, and the social sectors. See OED (1996, 2000).

[20]See Schwartz and Liuksila (1997) and Cuevas (2003) for a comprehensive analysis of fiscal federalism in Argentina.

[21]The unusual degree of complexity, under which different sharing rules applied to different taxes, was an outcome of political bargaining. Likewise, rigidity reflected the provincial governments' preference for a set of agreed rules as a protection against possible acts of federal opportunism (such as unilateral cuts in transfers). See Tommasi (2002).

[22]The constitution stipulated that a new tax-sharing agreement be sanctioned by Congress by the end of 1996. However, the provision that any new revenue-sharing law be also authorized by each provincial legislature ensured that no such law would be enacted (Tommasi, 2002).

and, for 2003–05, by a predetermined but increasing amount of transfers. Additional changes were introduced during the crisis in early 2002, but a permanent reform of the revenue-sharing scheme was not made.[23]

Tax reform

Tax reform efforts in the 1990s aimed at reducing the distortionary impact of the tax system on employment and investment, improving its flexibility and effectiveness as a fiscal policy tool, and improving tax compliance (see below). There were two major phases of tax reform at the federal level. In the early 1990s, some 21 distortionary federal taxes were abolished; the bases of the VAT, corporate, and personal income taxes were broadened; and the payroll tax for employer contributions to the social security system was reduced for certain provinces and sectors. Tax reform enacted in 1992 fulfilled a structural performance criterion of the program supported by the 1992 EFF—in fact, this was one of the only two structural performance criteria included in any IMF-supported program during the precrisis period.

Various tax reform measures were included as structural benchmarks under the program supported by the 1998 EFF (see Appendix 4). In 1997, at the request of the authorities, the IMF had dispatched a mission to prepare a blueprint for tax reform that could be submitted to Congress after the October elections. Many of the mission's recommendations found their way into the reform of 1998. It reduced employer social security contributions further in exchange for an increase in existing taxes and the introduction of new ones. The bases of the VAT and income taxes were broadened further, taxes were introduced on interest payments and on the gross assets of businesses, some excise taxes were increased, and a "single presumptive tax" was introduced to cover the business tax obligations for small enterprises and self-employed individuals. An overriding concern of the IMF throughout this period was that any tax reform be at least revenue-neutral, and preferably revenue-enhancing. In 1998, IMF missions consistently stressed the link between reducing the payroll tax and increasing the yield of other taxes.[24]

Tax compliance

Widespread tax evasion and noncompliance, and the ineffectiveness of the judicial system that encourages such behavior, lie at the roots of Argentina's chronic fiscal problems. The IMF was well aware of this, and improvement of tax administration received focused attention during the 1990s. The IMF staffed a number of technical assistance missions on tax administration with some of the best qualified experts, complementing parallel efforts by other international financial institutions (IFIs). Three full-fledged technical assistance missions were sent by the Fiscal Affairs Department (FAD) to cover all aspects of tax administration, while many short and follow-up visits addressed specific areas, including customs administration.

Efforts to improve tax compliance involved computerizing the operations of the tax-collection agency, systematizing the audit process, applying special scrutiny to the returns of large taxpayers, and requiring retailers to use cash registers that would facilitate VAT enforcement. From 1992, IMF technical assistance helped formulate work plans and track progress in such areas as the monitoring of large taxpayers and improving the audit process. In 1995, a mission stressed the need to intensify VAT audit programs and to improve control of basic VAT filing and payment obligations. A technical assistance mission on tax administration even visited the Province of Buenos Aires in 1996, in what the staff described at the time as "one of the first instances in which technical assistance has been provided to a subnational level of government by the Fund."[25] These measures should have been supported by reform of the judicial system, but this area received much less attention than it deserved.

Despite these efforts, tax compliance in Argentina did not improve noticeably. Successive FAD missions noted that weak revenue administration was associated with frequent changes in tax law and senior management in tax administration, politicization of the tax administration, lack of a computer-based accounting system that consolidates different payments and tax liabilities of each taxpayer into a single account, insufficient audit coverage, numerous payment facilitation schemes, frequent use of tax amnesties, and lengthy and inefficient appeals procedures. As a tangible reflection of these weaknesses, from 1993–96 to 1997–2000, total net tax collection remained essentially unchanged at 21 percent of GDP. Notably, there was no change in net receipts from the VAT (at 6.8 percent of GDP), despite

[23]In view of the federal government's inability to pay the guaranteed levels of transfers to the provinces, the pact of February 2002 abolished the deduction of Arg$2,154 million and made 30 percent of revenues collected from the financial transactions tax subject to revenue sharing.

[24]The provisions of the reform were to be phased in such a way that the revenue-increasing aspects would take effect before the reductions in the payroll tax, so that the revenue yield in 1999 would be (temporarily) enhanced.

[25]Another mission visited the Province of Cordoba in late 1999 to give advice on tax administration.

the fact that the VAT rate was raised to 21 percent from 18 percent in 1995.[26]

The role of the IMF

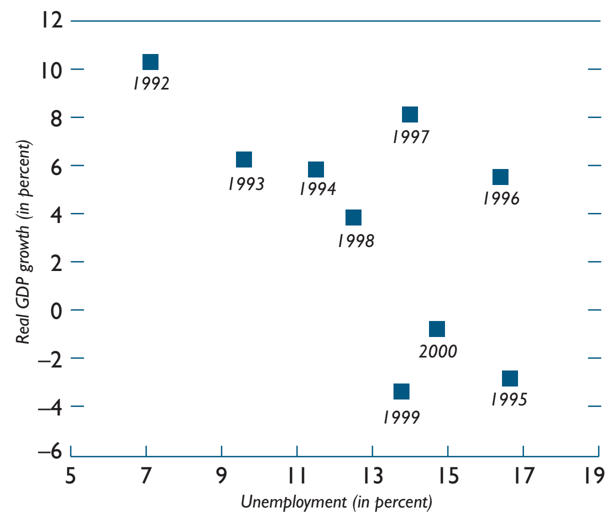
The IMF understood from the very beginning that structural fiscal reforms were critical for ensuring fiscal discipline and thereby contributing to the medium-term viability of the convertibility regime. It consistently raised the issue with the authorities and included some specific measures in successive programs. It also frequently provided technical assistance to give advice on tax reform and improving tax compliance. However, its overall impact was disappointing.

The inability of the IMF to have a meaningful impact on changing Argentina's federal-provincial fiscal relations is understandable, given political realities. Likewise, the deep-rooted culture of tax evasion made it difficult for the IMF to single-handedly force a dramatic improvement in compliance, however competent and sound the technical advice might have been.[27] That said, it can be argued that the IMF did not employ all the available tools to bring about reforms in some critical areas. Despite the rhetoric about the importance of structural fiscal reforms, there was only one structural performance criterion (on tax reform) included in all of the successive IMF-supported programs in this area. More binding conditionality may not have yielded the desired result, but it would have at least forced a more substantive debate and possibly also allowed the IMF to disengage itself more easily when it saw that meaningful reforms were not forthcoming. The threat of disengagement may well have been the most effective leverage that the IMF had.

Labor market reform

In the early 1990s, the IMF, the Argentine authorities, and most outside observers were in broad agreement that, for convertibility to remain viable, the restrictive labor market practices that had evolved over the previous half-century would have to be revised. For one thing, the rigidity of the nominal exchange rate meant that, in the event of a large shock, a rapid adjustment of the REER to a new

Figure 2.7. Real GDP Growth and Unemployment



Source: IMF staff reports.

equilibrium level could only be achieved if nominal prices in Argentina, including wages, were flexible enough. The privatization and deregulation programs of the early 1990s, and particularly the set of deregulation measures enacted in November 1991, ensured that prices of most goods and services were reasonably flexible, but downward price flexibility could only be achieved if wages were flexible downward. Labor market reforms would have helped in this process. It was also hoped that increased labor market flexibility would help to increase productivity and reduce unemployment at a time when the Argentine economy was undergoing rapid structural change.

The links between labor market reform and the exchange rate regime were clearly drawn by a staff report in early 1998, which stated: "The authorities agreed with the staff that, especially in view of the exchange rate regime, labor market flexibility is crucial to ensure the simultaneous achievement of a steady improvement in competitiveness and a further sustained decline in unemployment." However, progress in this critical area was negligible. The fact that rapid growth in Argentina did not translate into reduced unemployment in the 1990s suggested that labor market inefficiencies remained (Figure 2.7).

The principal reason for limited progress, despite the authorities' repeated commitment to labor market reform, both in their public statements and in their letters of intent (LOIs), was the lack of political support, given the labor union base of the Peronist party. Labor reform was intended to be a central element of

[26]These figures come from Fiscal Affairs Department, "Argentina: Identifying Priorities for Comprehensive Tax Reform," August 2003, Table 2, p. 22. VAT efficiency, defined as the sum of gross collection and nominal consumption divided by the VAT rate, would show that tax compliance significantly deteriorated from the early 1990s to the late 1990s.

[27]The experience in this area is another example of the difficulty of addressing fundamental distortions through a series of short-term programs, as noted by the IEO's evaluation of fiscal adjustment in IMF-supported programs (IEO, 2003b).

the program supported by the extended arrangement of 1992, but no action was taken that year. In the policy memorandum setting forth their commitments under the program for the year 1993, the authorities indicated their intention to introduce measures in the first half of that year to decentralize collective bargaining agreements, liberalize conditions for temporary employment, and allow more flexible working hours. This agenda broadly coincided with what IMF staff thought was necessary. A draft labor market reform bill was duly submitted to Congress in November, but faced strong political opposition.

Under the pressure of the Mexican crisis in early 1995, a relatively limited labor reform bill was introduced and passed by Congress. The legislation exempted small and medium-sized enterprises from many restrictions on the use of temporary contracts and flexible working hours. Though limited, this initiative, along with the simultaneous fiscal adjustment, gave a significant boost to market confidence, because it was seen as a signal that the Argentine political system was capable of supporting the politically painful policies that were necessary for convertibility to remain viable under adverse shocks. However, as with the fiscal measures, its significance lay in the fact that it could be viewed as a credible signal that more substantial action was imminent. As it happened, efforts at labor market reform faltered over the next several years.

The IMF pressed the economic team that took office in July 1996 to submit legislation to reform collective bargaining agreements as a prior action for the approval of the revised SBA. This set off what staff characterized as a "national debate" over labor reform issues. In May 1997, the government reached agreement with labor unions on a legislative package that, in the view of the staff, represented only a limited improvement on existing legislation and even a reversal of some earlier reforms. While the package included a reduction in severance payments and the gradual elimination of the automatic extension of collective bargaining agreements (a practice giving excessive bargaining power to labor unions), it also discouraged temporary labor contracts by eliminating their exemption from social charges. The latter steps seemed to go against the authorities' stated goal of reducing unemployment, especially given that temporary positions had been an important component of recent job growth. Furthermore, the package did not eliminate restrictive aspects of the labor market, such as the predominance of sectoral collective bargaining agreements over those reached at the enterprise level, the favored status enjoyed by some workers under "special labor statutes," and the sheltering of union-run health plans from competition.

A staff mission that visited Buenos Aires shortly after the May 1997 agreement "indicated to the authorities that, in its view, the proposed reforms fall well short of what is needed to ensure adequate flexibility in the labor market, and would not appear, in their present form, to deserve support" under the extended arrangement then being negotiated. Review departments strongly supported WHD's position. In September 1997, however, the staff agreed with the authorities on a formula under which further labor reform at least comparable to the May 1997 agreement would be a structural benchmark for the first review of the extended arrangement in mid-1998. This commitment was included in the LOI signed in December, but even this weak package failed to clear Congress.

In February 1998, the government proposed a labor reform package that staff judged to be even weaker than that agreed with the unions the previous May. The plan to phase out the automatic extension of collective bargaining agreements had been dropped, and the centralization of collective bargaining was actually to be increased. In July, during a mission to prepare the first review of the program, the staff proposed three specific changes to the draft labor law—a longer probation period for new employees; further reductions in severance pay; and a limited decentralization of collective bargaining—and "made it clear that they would recommend the conclusion of this review only after they had been introduced into the bill and approved by Congress." The government proposed a modified law, but could not get congressional approval.

Staff continued to raise labor reform issues in 1999, but the authorities chose not to take action ahead of the elections. Enactment of labor reform was a structural benchmark for the first review of the SBA negotiated in early 2000 with the *Alianza* government, and the new authorities duly secured the passage of a labor reform law by Congress in May 2000. This law finally enacted several of the measures that the IMF had been urging since the mid-1990s, including extending the probation period of new workers, limiting the automatic extension of collective bargaining agreements, and decentralizing the collective bargaining process. The controversy surrounding this law, however, revealed deep fissures in the ruling coalition and raised doubts as to whether the substance of the law would indeed be put into practice.[28]

The role of the IMF

Our evaluation suggests that the IMF rightly emphasized labor market reforms, particularly in the early years of the convertibility regime, but when political obstacles surfaced, it was reluctant to jeop-

[28]It was later alleged that bribes had been paid to opposition politicians to secure the passage of the legislation by Congress.

ardize its relationship with Argentina over labor market matters. Internal memorandums suggest that the softening of the WHD's position from May to September 1997 was a response to management's perceptions. In the fall of 1998, following the congressional rejection of a labor reform law, the staff took a position that the Board discussion of the review be postponed until the authorities had taken appropriate measures, such as implementing the law by decree. This position, however, was overruled by management and, in its report to the Board, the staff only stated its "regret" at the outcome. It should be noted that most Executive Directors, when they met on September 23, 1998, did not share the staff's concerns; some accepted the arguments of the authorities that the new law was not as regressive as alleged, while others merely encouraged the authorities to follow through on their promises of introducing complementary legislation.

The turbulence in world financial markets in 1997 and 1998 undoubtedly weighed heavily on the minds of management and Executive Directors. These considerations argued against disrupting the IMF's relationship with Argentina at a time when the country was one of the few major emerging market economies that seemed relatively unscathed by the global flight to safety. Understandably, any concerns the IMF may have had were not aired publicly. A two-sentence press release issued after the September 1998 meeting simply stated: "substantial progress has been made in the implementation of the structural reforms included in the program." However, this forbearance on an issue that was ultimately central to the viability of the convertibility regime had its costs, because policies that a few months earlier were meant to be at the core of the IMF-supported program would be delayed to the point where they would have little impact on the economy's ability to respond to the shocks of 1999–2000.

Social security reform

The pay-as-you-go (PAYG) social security system of Argentina was reformed in 1994 with a partial "privatization" that created a fully funded pillar in the system. Younger workers were allowed to choose between the state-run system and approved private pension funds. IMF staff had long recognized that the existing PAYG system was headed for insolvency and that a serious reform of some kind was needed. Social security reform was made a structural performance criterion for the program supported by the extended arrangement approved in March 1992. The policy memorandum specified that the reform would involve "[f]inancial equilibrium of the existing pay-as-you-go system on both a cost and accrual basis" as well as "a new mandatory, capitalized, privately administered system, and a voluntary private supplementary system." The reform was to be completed by the end of 1992 but was delayed until late 1993 by the protracted political debate, which resulted in a compromise that allowed participation in the funded, privately administered system to be voluntary.

In principle, the switch from a PAYG system to one that is fully funded can lead to a higher level of national savings and investment, higher capital accumulation, and higher long-run per capita income. This follows from the fact that, instead of payments from contributors to the system going directly to beneficiaries, contributors invest in a mix of public and private assets (usually through privately run, publicly regulated pension funds), while retirees draw on the income from the assets they had accumulated during their working lives to pay for their retirement. If the population is growing and the pension funds are well run, this creates a pool of savings entrusted to private managers who compete in search of high returns, a setup which should improve the efficiency of capital allocation.

For these long-run benefits to obtain, however, the transition costs from one regime to the other must be financed through taxation rather than public borrowing.[29] Tax on the "old" generation (the current beneficiaries and those who have accumulated substantial rights under the old system)—either through an explicit tax, an increase in contributions, or a cut in benefits—would seem unfair, since this generation already has made contributions under the old system, which went to support the previous generation of retirees. But if instead the transition is financed via a tax on the current "young" generation (those whose pensions will be based on rights accumulated under the new system), the young will be taxed twice: once for their contributions to the new regime and once for the transition payments to the current beneficiaries. Because taxing either the old or the young is politically costly, some countries have tried to smooth the transition costs by issuing debt. But debt-financed privatization is no different from taxing the young.[30]

[29]The staff was aware of the importance of how the transition from a PAYG system to a funded one is financed in determining the effect on saving. A staff study published in 1997 stated that "the public sector deficit created as workers stop paying payroll taxes and start making contributions to the new system should be financed as much as possible through fiscal consolidation" if the impact on saving was to be maximized (Mackenzie and others, 1997).

[30]If debt is issued at the time of the reform to cover the implicit pension wealth of the current beneficiaries, this would require raising taxes equal to the interest costs required to service this debt. If new debt is issued each year to cover the annual revenue loss from contributions now going to the privatized accounts, this too would lead to an accumulation over time of public debt that needs to be financed. For this reason, Kotlikoff (2001) has called debt-financed privatization a "shell game."

The strategy chosen in Argentina resembled the second, debt-financed model. Political resistance to reform resulted in a compromise that allowed the public system to coexist side by side with the private, funded system. Not only were the contributions of those who moved to the private system transferred out of the public system, the payroll tax that was designated as the employer's contribution to the pension system, was progressively lowered as a way to reduce labor costs and improve competitiveness. Additional liabilities were created when the federal system took over the obligations of some of the bankrupt provincial systems. Both the year-to-year loss of revenues from reduced contributions to the PAYG system and the increased liabilities from the takeover of the provincial systems were financed with debt, which contributed to the growing fiscal imbalance.[31]

The fiscal imbalance created by the social security reform was significant. From 1994 on, government revenues from social security payroll taxes gradually declined, with the revenue gap in 2001 estimated at 2.9 percent of GDP. Of this, 1.5 percent was due to the transfer of workers' contributions from the social security system to individual accounts in the new private pension funds, a direct effect of the reform, and the remaining 1.4 percent resulted from the reductions in payroll tax rates. On top of this, the federal assumption of the liabilities of the provincial systems added another 0.9 percent of GDP annually to expenditures by 2001. Against this, there were offsetting reductions in social security expenditures as a result of the reform; an estimate by Rofman (2002), which may be optimistic, is that annual expenditures were smaller by 1.1 percent of GDP in 2001. Taken together, the reform and accompanying policy changes worsened the annual overall fiscal balance of the federal government by at least 2.7 percent of GDP.[32]

The role of the IMF

The social security reform was initiated and in large part designed by the Argentine authorities, with the World Bank providing some technical assistance. In retrospect, most observers (the IMF, the World Bank, local commentators, and the administrators of the new private funds) overemphasized the potential benefits of the new system and failed fully to anticipate its severe fiscal consequences.[33] Part of the problem was that it overestimated the self-financing component of the reform, without recognizing the imperfections of capital markets that would create an immediate burden on the government's borrowing requirements.[34] The increase in fiscal deficits arising from the reform was considered simply as an explicit recognition of already existing implicit debt, which the markets should be willing to finance.[35] This was perfectly true, but for a country subject to severe financing constraints, the consequence of the reform on the government's cash position should have received greater consideration, and should have argued for a transition financed by either taxes or expenditure cuts. To achieve the desired impact on saving, moreover, much of that burden needed to fall on the old.

Initially, staff tried to press for a transition financed by taxes or expenditure cuts. In May 1993, when the reform passed by Congress incorporated a compromise that allowed participation in the privatized system to be voluntary, the staff secured a commitment from the authorities that the contributions of workers who chose to remain in the state system would be treated as if they were part of a fully privatized system, and not be applicable to fiscal performance criteria. Unfortunately, the commitment to exclude social security contributions when assessing fiscal performance was rapidly weakened and then dropped.[36] After 1994, program documents did not identify the share of the primary surplus accounted

[31]Some authors (e.g., Hausmann and Velasco, 2002) have underplayed the role of the social security reform in exacerbating the fiscal problems of Argentina in the 1990s. According to their interpretation, the reform only made explicit the implicit pension liabilities of the PAYG system and reduced long-term social security wealth by partially phasing out the PAYG system. But the reform and related policy changes did not just make explicit implicit liabilities; they rather sharply increased the flow and stock imbalance of the regime.

[32]All the figures in this paragraph come from Rofman (2002), Table 1, p. 1. See also Table A3.4 in Appendix 3 for the estimates of social security balances by Cetrángolo and Jiménez (2003). Comparison of the two sets of figures suggests that almost all of the social security deficits during 1994–2001 resulted from the reform and the associated changes.

[33]The staff report for the 1994 Article IV consultation, for example, commented: "Structural reforms such as ... reform of the social security system ... have helped to reduce domestic costs and promote higher saving and investment."

[34]Based on Latin American experience, Artana and others (2003) argue that the financing of the transition cost is not guaranteed in an emerging market economy "simply because the actuarial balance has improved with reform."

[35]In the words of an October 1996 background paper, the transition costs, then estimated at about 1 percent of GDP annually, were "an investment in an improved pension system."

[36]In August 1993, staff pressed for a primary surplus target of 2.7 percent of GDP in 1994, a figure based on the assumption that social security contributions of 1 percent of GDP would be made to the public system. After negotiations with the authorities, the program targeted a primary surplus of 2 percent of GDP, or 1 percent if social security contributions were excluded. In the staff report outlining the 1994 program, this 2 percent figure was described as an *improvement* over the 1.7 percent outturn from 1993, implying that the staff no longer favored excluding employee contributions to the state system from fiscal targets. The primary surplus actually achieved in 1994 was 0.8 percent of GDP.

for by contributions to the public system. The steady reduction in employer contribution rates may well have been a desirable public policy measure, as they were meant to reduce unemployment and increase competitiveness by cutting labor costs. The problem was that there was no compensating effort to ensure that the overall fiscal position was *strengthened* to finance the transition.[37] The IMF, among others, did not fully grasp early on the conceptual weaknesses of the way the transition to the new system was financed, which together with other accompanying policy changes implied a flawed reform with serious long-term consequences.

Financial system soundness

The convertibility regime called for an especially strong financial system because restrictions on monetary policy prevented the central bank from acting as a lender of last resort through money creation. The Argentine authorities, understanding this imperative, took several initiatives—particularly after the Mexican crisis—to foster the development of a liberalized financial system with extensive involvement by foreign institutions and strong prudential safeguards. By the end of the 1990s, Argentina was considered a model for other emerging market economies in the area of banking supervision and prudential policy.[38] Banking system assets grew from a post-hyperinflation level of 20 percent of GDP in 1991 to 40 percent of GDP in 1999. Capital adequacy, measured according to the standards of the Basel Committee on Banking Supervision, stood at 21 percent in 1999.

The banking system was strong enough to withstand for many months the impact of the deepening crisis during 2000–01, but the crisis revealed that the system had contained vulnerabilities that were not fully recognized. For one thing, holdings of government debt became a serious risk factor when the government developed solvency problems, leading to bank runs and capital flight in 2001.[39] This vulnerability resulted directly from the government's deliberate policy to seize the banking system's liquidity in a desperate attempt to finance its deficits when there was no other source.[40]

The banking system was also heavily exposed to a devaluation of the peso against the U.S. dollar. While most of banks' assets and liabilities were matched in terms of their currency of denomination, many dollar-denominated bank loans went to Argentine companies and households that had earnings in pesos, and devaluation would compromise these loans. The authorities were reluctant even to measure this risk, in keeping with their policy of portraying devaluation as unthinkable.[41]

The large public sector banks were particularly vulnerable to a crisis of confidence in the government. In particular, the federally owned Banco de la Nación, the Banco de la Provincia de Buenos Aires, and several other provincial banks remained in state hands, despite the privatization efforts. In 2001, the perception that these institutions had weak balance sheets because of politically motivated lending decisions (particularly large public debt holding) would shake public confidence in the banking system as a whole and thereby help trigger the banking crisis.

The role of the IMF

The initiatives for financial sector reform came from the Argentine authorities themselves, with some financial and technical support from the World Bank and the IDB. The IMF's role in the financial sector was limited, though the Monetary and Exchange Affairs Department (MAE) provided technical assistance on a few occasions, in such areas as the central bank's accounting system, payments system reform, and risk-based supervision. It was only in March 2001 (when the crisis was already under way) that, at the request of the Argentine authorities, the IMF became deeply involved in an assessment of the Argentine banking system as part of joint IMF/World Bank Financial Sector Assessment Program missions. At this time, the missions found that the most serious short-term risk came, not from institutional or regulatory weaknesses, but from the macroeconomic environment characterized by three years of recession and high interest rates.[42]

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[37]In August 1997, a FAD technical assistance team advised the authorities "that the abolition of the employer contribution to the pension component of the social security tax should, *pari passu* with it, involve an alternative financing mechanism for the pension scheme given the existence of a social contract." But this recommendation was not included in the staff reports.

[38]The World Bank (1998) ranked Argentina second, after Singapore and tied with Hong Kong SAR, in the quality of its regulatory environment.

[39]There are several estimates. According to Lagos (2002), the banking sector's exposure to the public sector rose from 17.9 percent of total assets at end-2000 to 27.2 percent at end-2001. Exposure had been less than 10 percent at end-1994.

[40]A historical analysis of how the banking system succumbed to government pressure in 2001 is offered by Della Paolera and Taylor (2003).

[41]The banking system was equally exposed to a fall in the equilibrium *real* exchange rate, because likely deflationary adjustment would have forced some borrowers with earnings in nontradable goods and services into bankruptcy through what Irving Fisher (1933) called "debt-deflation."

[42]The missions identified the banking sector's exposure to the public sector only as a "medium-term vulnerability." The IMF maintained close monitoring of the banking sector throughout 2001, but the Financial Sector Assessment Program for Argentina was not formally completed.

The IMF staff was very well aware of the extensive liability dollarization of the financial system and hence its exposure to a devaluation. However, it was only when economic conditions began to worsen toward the end of 1999 that the staff began to analyze these vulnerabilities in detail. Until then, the staff deferred to the authorities' insistence that there was no point in contemplating a devaluation, even at a purely analytical level. By the time the vulnerabilities began to be examined, and it became clear that a devaluation would cause significant damage to the financial system, there was not much anyone could do to avert or minimize such damage.

The weaknesses of the state-owned portions of the financial system were never an important theme of staff documents or Board discussions. The IMF supported the privatization of the remaining state-owned financial institutions, just as it supported privatization in other sectors, and staff raised the issue from time to time in consultations with the authorities. The staff was conscious of the political constraints involved and chose not to press the matter strongly. The conversion of the Banco de la Nación from a public agency to a publicly owned corporation, which would facilitate its eventual privatization, was a structural benchmark under the program supported by the 1998–99 extended arrangement and, after it failed to be achieved in that program, under the 2000 SBA. Congress rejected a formal conversion in 2000 but it approved measures to increase the bank's autonomy and transparency, steps that the staff viewed as having met "the intent of the original proposal."

The IMF and structural reforms: an assessment

Until 1998, the IMF rightly focused on a very narrow range of structural issues. Performance criteria (covering tax and social security reforms) were included only in the EFF of 1992. The IMF pressed the authorities for labor market reform and reforms of provincial finances (including intergovernmental fiscal relations), but this was done without formal structural conditionality in a program context. In financial sector reforms, the key decisions were taken by the authorities themselves with little or no prodding from the IMF.

This approach changed somewhat from 1998. A number of benchmarks began to be set in such areas as labor reform, tax reform, reform of tax administration, social security and health care reforms, the conversion of the Banco de la Nación from a state agency to a state-owned enterprise, and even the leasing of airports and telecommunications frequencies. However, in all these cases conditionality took the form of structural benchmarks (which do not govern disbursement), and no performance criteria were included. Staff's discussions with the authorities and Executive Board discussions continued to focus on a small number of areas, labor reform in particular. Many other reforms were repeatedly postponed or quietly dropped, perhaps in an implicit acknowledgment of the obstacles that hindered effective action by the federal authorities.

As noted by Allen (2003), the remarkable feature of the programs with Argentina was the paucity of formal structural conditionality, particularly in the form of performance criteria. Internal documents suggest that staff in review departments was often critical of the weak structural content of the programs, particularly those supported by extended arrangements, but management consistently overruled such objections. This may have reflected, particularly after 1998, the institution's response to the increasing criticism of the excessive structural conditionality it had allegedly imposed on the East Asian crisis countries.

What little conditionality the programs contained was not vigorously enforced. Delays were allowed in meeting the performance criteria; repeated slippages in meeting the benchmarks were a rule. Even in the area of labor reform, where the IMF's involvement was direct and persistent, the measures ultimately enacted either were limited in nature, reversed earlier reforms, or came too late to help moderate the impact of the 1998–2001 recession on unemployment. Undoubtedly, the required reforms faced enormous political obstacles and, in the case of measures to improve tax compliance, went against the deep-rooted culture of evasion. Stronger conditionality would be unlikely to have brought about greater change in the absence of domestic ownership, but the IMF did not adequately identify the structural measures that were key to longer-term success and then make adequate progress in those areas a prerequisite for its continued program relationship with the country.

The Manner of Engagement with Argentina

The IMF rightly supported Argentina's broad program of stabilization and structural reform in the early 1990s, but by late 1993, policy differences with the authorities had emerged in a number of areas, particularly fiscal policy and the slow pace of structural reform. By the end of 1994, Argentina had ceased to draw under the extended arrangement, and it appeared unlikely that the arrangement would be renewed. However, the IMF's relationship with Argentina underwent a fundamental shift with the Mexican crisis in 1995, when it added a year to the extended arrangement that was off track. This proved to be the beginning of a prolonged involvement with some special features.

Two aspects of this engagement of the IMF after the Mexican crisis deserve particular note:

- First, the IMF in its public statements and internal reports moved from a stance of evaluating the authorities' policies *given* their choice of a specific exchange rate regime to one of *endorsing* that regime. Interviews with staff indicate that the IMF was sometimes pressed by the authorities to express such endorsements, with support from major shareholders. The credibility of the IMF became closely linked to the survival of the exchange rate regime, at least in international public opinion.

- Second, the IMF continued to provide access to its resources even though the balance of payments need was no longer as pressing, and even after it had become clear that the political ability to implement policies needed to sustain the exchange rate regime was breaking down. The IMF repeatedly accommodated Argentina's slippages in meeting fiscal performance criteria from mid-1996 onwards, either to give the authorities credibility or in view of their good-faith efforts in the face of political constraints.

As it happened, Argentina enjoyed reasonably low-cost access to international capital markets in the post-Mexican-crisis period, and this had two effects on the IMF's ability to influence policy in the desired direction. First, the availability of private sector finance was seen as weakening the IMF's leverage with the authorities, particularly when the arrangement was being treated as precautionary.[43] Second, easy market access reduced the sense of urgency concerning the policy adjustment that was judged to be necessary, reflecting a misjudgment about the persistence of capital inflows. The general buoyancy of portfolio flows to emerging market economies in the mid-1990s turned out to be a reversible phenomenon, but while it lasted, it created a great deal of complacency.

There were differences of view between management and staff on policy toward Argentina, particularly regarding the extended arrangement that was approved in February 1998. As early as the fall of 1996, staff was surprised to learn that management had "acquiesced" to a request by the Argentine authorities to have the SBA succeeded by an EFF. WHD's misgivings about the arrangement, given the authorities' backsliding on labor market reform, have already been mentioned. From mid-1997 through the end of the year, internal staff memorandums were almost unanimous in opposing the proposed EFF with Argentina, at least on the terms being finalized. In October, for example, the Treasurer's Department (TRE) questioned the authorities' ability to achieve the required structural reforms, given their past performance and the present political environment. Likewise, in November, RES commented on the draft LOI: "We maintain the view that the program outlined in this . . . letter of intent is not ambitious enough to warrant Fund support in the form of a high-access extended arrangement." However, these concerns were downplayed or absent from the staff report on the 1998 EFF-supported program presented to the Executive Board.

The lack of candor in staff reports might have been a factor influencing the Executive Board's assessment, but the record suggests that the staff's generally upbeat public assessments were shared by most on the Executive Board. For example, the decision not to discuss Argentina in a formal setting from October 1996 to February 1998 (two program reviews in 1997 were approved on a "lapse of time" basis) indicates that Executive Directors were broadly satisfied with developments during that period and no Director considered formal discussion necessary. Although Directors, when they did choose to discuss Argentina, expressed a range of views as to whether they found the authorities' actions to be cause for concern, there was almost universal confidence expressed in the authorities' ability and willingness to implement the appropriate policies. Voices expressing serious doubt about the overall logic of the actions of the IMF or the authorities became rarer as the decade wore on.

In retrospect, the rationale for maintaining a program relationship with Argentina appears questionable. From at least 1994 until early 2000, except during the immediate aftermath of the Mexican crisis, Argentina was able to raise large amounts of financing at relatively low cost. During this period, and particularly after 1999, the earlier political consensus in support of fiscal adjustment and structural reforms weakened considerably and the authorities were unable to deliver on their commitments in IMF-supported programs. Nevertheless, the IMF continued to remain engaged even after Argentina had recovered from the impact of the Mexican crisis. The information available at the time—the authorities' poor com-

[43] A deeper analysis, however, would have suggested a contrary view. First, the exposure of the World Bank to Argentina during this period was sharply increasing, so that the declining exposure of the IMF was simply the reflection of a shift in burden sharing between the two institutions, not of a successful reduction in Argentina's borrowing needs. Second, Argentina critically needed the IMF's seal of approval in order to receive World Bank loans and to enjoy large access to the international capital markets, so that the IMF did in fact maintain considerable leverage, had it been willing to exercise it.

pliance record with earlier programs, the unraveling of the political consensus that had backed the reform program of the early 1990s, the absence of a clear balance of payments need—would have been sufficient reason to end the program relationship. The decision to approve an EFF in early 1998—despite strong staff misgivings—effectively weakened market discipline on Argentina's economic policies. This said, it has to be recognized that even at this time market pressure on Argentina to modify its policies may not have been very strong, since the market perception of the sustainability of policies was initially favorable and reacted only slowly to events. It is not possible to say whether a stronger signal from the IMF, in the form of refusal to approve the EFF, would have made a fundamental difference.