

## STAFF RESPONSE TO THE EVALUATION BY THE INDEPENDENT EVALUATION OFFICE OF THE ROLE OF THE FUND IN ARGENTINA, 1991–2001

Executive Board Meeting  
July 26, 2004

1. We would like to commend the IEO for this thought-provoking report. By taking a careful look back at the experience, this report makes a valuable contribution to the learning culture of the Fund. In many respects, it also provides an independent confirmation of our own attempts to draw lessons from the crisis, although we do not agree with some of its interpretations and conclusions. We are in agreement with many of the recommendations and, indeed, are already acting on some.

2. We share the report's basic diagnosis of the crisis, which is very similar to our own assessment presented in the October 2003 staff paper on *Lessons from the Crisis in Argentina*.<sup>1</sup> The IEO report notes that "[t]he crisis resulted from the failure of Argentine policymakers to take necessary corrective measures sufficiently early, particularly in the consistency of fiscal policy with their choice of exchange rate regime" [page 3]. In order to avert the crisis, stronger fiscal adjustment would have been needed during the 1990s, when the economy was performing close to its potential, to ensure the sustainability of public debt. Strong, sustained structural reforms would have been needed to address the weaknesses in the labor markets and the fiscal system and to broaden and diversify the export base. Moreover, it would have been desirable to exit from the convertibility regime before the other problems had become insurmountable. The IEO report takes an important step beyond the staff paper in its detailed examination of how the Fund's decision-making processes contributed to the course of these events; by doing so, it provides a fresh perspective on the governance of the Fund.

3. The report concludes—also in line with our analysis—that the Fund erred by not pushing strongly enough for needed reforms and policy adjustments at a time when these could have helped prevent the crisis, and by providing financial support

for too long and when policies were increasingly weak and inconsistent. In particular, the Fund did not press the authorities to consider alternatives to its quasi-currency-board regime years before the collapse. Clearly, while strong country ownership of policies is important to ensure that they are implemented, ownership is not a sufficient basis for a Fund-supported program when the policies themselves are weak or inconsistent.

4. At the same time, we perceive some shortcomings of the IEO report. Some of its conclusions depend very much on hindsight. For instance, it offers Uruguay's 2002 debt restructuring as a model for Argentina (although it came later), but does not properly acknowledge that the success of the Uruguay program was due in part to the sobering effect of the Argentine experience on both private creditors and policymakers. As the report itself notes it does not examine external influences on the Fund's decisions, nor does it consider informal channels by which the Board may have been given information by the staff and management, and may therefore understate the information on which the Board's decisions were based.

5. Moreover, there is an internal inconsistency in the report's presentation of the Fund's decisions during late 2000 and early 2001: while the discussion in the body of the report takes the view that the catalytic approach had some chance of success—later impaired by the authorities' weak implementation—the lessons drawn appear to be based on the diagnosis of an irretrievably unsustainable situation that staff should have identified sooner. This inconsistency underscores the difficulty of making judgments on a program's viability. If, as suggested in the report, the Fund had drawn the line several months earlier by failing to complete the May 2001 review, the basic features of the crisis would have been the same: Argentina would not have avoided a wrenching default and a forced exchange rate regime change, with their deleterious effects on private and public balance sheets and the real economy. The main—but not in-

<sup>1</sup>See SM/03/345 and BUFF/03/206. [See PDR, 2003—Ed.]

consequential—difference is that the Fund would have avoided increasing its exposure to Argentina by about US\$9 billion, which in the event largely financed capital flight. To have ensured a qualitatively different outcome for Argentina, the Fund would have had to withhold its support at least another year or two earlier—but at that stage, it was less evident that the chosen strategy was unlikely to succeed.

6. An important theme of the report is that the Fund should have taken a step back from the program relationship with Argentina, to assess whether the economic policy strategy was on track to achieve its objectives. This is related to the need to strengthen surveillance in program countries, an issue stressed in the 2002 Biennial Surveillance Review. In light of that review, the Fund has taken steps to introduce greater freshness of perspective in Article IV surveillance in a program context<sup>2</sup>—taking greater care to ensure that Article IV consultations with program countries pay adequate attention to the issues that are most important from a medium-term standpoint. The 2004 Biennial Surveillance Review (SM/04/212), recently circulated to the Board, reviews the experience with implementation of these initiatives; it concludes that the quality of surveillance in program countries has risen, with the main improvement relating to taking stock of the economic policy strategy to date, but it notes that progress has been more limited with regard to the candid presentation of the short- and medium-term outlook and candid account of the policy dialogue. The IEO report's treatment of these issues in the Argentine context is thus particularly timely in view of the upcoming Board discussion of the 2004 Biennial Surveillance Review.

7. A key area in which a more candid assessment of the economic policy strategy would have been desirable in the case of Argentina is the exchange rate regime and its consistency with other policies. The Argentine experience indeed provides a graphic illustration of the need for a more pointed treatment of exchange rate issues in the context of surveillance—notably in staff reports, but also in staff discussions with the authorities and discussions in the Board. This issue was addressed in the more general context in the 2002 Biennial Surveillance Review. According to the 2004 Biennial Surveillance Review, it remains a significant challenge; the Board will have the opportunity to discuss the issue further in that context.

8. The assessment of exchange rate regimes inevitably involves some difficult choices for the authorities, staff, and the Board, particularly with re-

gard to institutionally pegged exchange rates. As noted in the IEO paper [page 20], the costliness of abandoning the peg was, to a considerable extent, by design, as it was key to its credibility: the costs of abandoning the regime included its legal foundation, the tangled pattern of currency mismatches on public and private balance sheets, and ultimately the strong degree of popular support for the regime. The authorities sought to entrench the convertibility regime still more deeply by treating any change in regime as not just undesirable, but unthinkable. While this was the logic of the regime, it was flawed because the authorities were unable to garner sufficient domestic support to implement the strong fiscal adjustment and structural reforms that would have been needed to make it viable. Thus, while an earlier exit—preferably in the calmer times of the mid-1990s—would indeed have been preferable, the costs of such an exit even under ideal conditions or the difficulty of engaging the authorities on the options should not be underestimated.

9. The report presents a number of recommendations in light of the Argentine experience. On the whole, these are reasonable. Indeed, as noted in the report, in many cases the proposed changes are in line with policy changes that the Fund has already initiated, partly in response to the Argentine experience, although in many instances the adequacy and implementation of these initiatives remain to be assessed.

10. *Recommendation 1* proposes that “[t]he IMF should have a contingency strategy from the outset of a crisis, including in particular ‘stop-loss rules’—a set of criteria to determine if the initial strategy is working and to signal whether a change in approach is needed.” The basic point, that the Fund should be ready to stop providing additional financing if the program is no longer on track to achieving its objectives, is a sound one. The need for close and candid scrutiny of a program is particularly pressing in cases of exceptional access. There is also some merit to the idea of formulating in advance how the Fund should react to certain contingencies, although experience suggests that it may be very difficult to engage the authorities on a contingent strategy, particularly at the outset of a crisis. (Indeed, the report itself notes that in the Argentine case, “there may well have been no feasible actions by the IMF that would have enabled the adoption of a meaningful Plan B.”) It is also desirable for the Fund to formulate where it would draw the line before providing further financing. At some level, providing such a stop-loss rule is precisely the purpose of the Fund's conditionality—more specifically, of performance criteria which specify conditions under which the member has access to the Fund's financing. There are, of course, questions of whether conditionality could be designed better to play this role in a crisis setting: for

<sup>2</sup>See also “Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps” (SM/03/96 and SUR/03/38); and “Strengthening Surveillance” (SM/03/249 and BUFF/03/157). See also “Operational Guidance Note for Staff Following the 2002 Biennial Surveillance Review.”

instance, should test dates be more frequent, should different indicators be used to monitor macroeconomic policies; could program reviews be used more effectively to assess the overall strategy; and so on. The proposed stop-loss rules would go further than the existing framework of conditionality by establishing other, perhaps less readily quantifiable criteria to indicate at what point the Fund should determine that the overall strategy is not working. But conditionality also has discretionary elements, related to the powers of the Executive Board, usually on the recommendation of management, to grant waivers for missed performance criteria and to complete reviews; these elements are necessary in view of the imperfect nature of any objective measures of policy performance and, moreover, provide an opportunity to reassess policies in relation to the overall program objectives and strategy. A stop-loss rule would either need to maintain this element of discretion—in which case, it could only serve as a guide, but would not prevent the Fund from continuing to provide financing when events turn out differently than expected—or it would imply that the Board would, *ex ante*, constrain its own power to grant waivers. We do not see the latter as appropriate, given that no quantitative indicator is likely to provide a one-dimensional test of viability—and it is unlikely that it would be acceptable to the Fund’s membership. However, it would be worth giving further consideration to establishing clearer guidelines indicating when the Fund should withdraw its support in the absence of a major change in strategy.

11. *Recommendation 2* is that when the sustainability of debt or the exchange rate is in question, the Fund’s support should be predicated on a meaningful shift in policy. This is certainly a valid point. In response to the experience of such cases, the Fund introduced new policies on exceptional access, requiring an assessment that the policy program of the member country provides a reasonably strong prospect of success, including not only the member’s adjustment plans but also its institutional and political capacity to deliver that adjustment; a detailed review of financing assurances including market access; and a rigorous and systematic analysis of debt sustainability.<sup>3</sup> The Board recently reviewed the initial experience with the application of this framework and did not see a need for any changes, but it would be desirable to give further consideration to this issue with the benefit of the light the IEO report

<sup>3</sup>See “Access Policy in Capital Account Crises” (SM/02/246), the related summing up (Buff/02/159), “Access Policy in Capital Account Crises—Modifications to the Supplemental Reserve Facility and Follow-Up Issues Related to Exceptional Access Policy” (SM/03/20; and SM/03/20, Supplement 1), and the related summing up (Buff/03/28).

sheds on the Fund’s decision-making process in a crisis situation.

12. *Recommendation 3* is that the Fund should systematize its practices for assessing medium-term exchange rate and debt sustainability. Exchange rates have been a major focus of analytical work by staff, as exemplified by the two papers on exchange rate regimes discussed by the Board in 2003. Fund staff has developed a macroeconomic balance approach to exchange rate assessments; while this approach is designed mainly for industrial countries, it has also been extended to developing countries.<sup>4</sup> At the same time, the 2004 Biennial Surveillance Review observes that, in practice, assessments of external competitiveness are often limited to an analysis of the evolution of a real exchange rate indicator; and exchange rate levels are usually found to be “about right” or in line with fundamentals. This is in line with the IEO’s recommendation that exchange rates should be assessed more systematically and more candid conclusions drawn—with both reports pointing to a need for fresh analytical work as well as greater candor in presenting the results.

13. As the IEO report notes, the debt sustainability framework was developed in 2002, in large part in response to the Argentine experience, although there is scope for further refinements.<sup>5</sup> In applying this framework, a key question is the debt level at which countries are likely to run into difficulties: the staff work accompanying the debt sustainability template, as well as the September 2003 *World Economic Outlook*, addressed this question by examining the debt levels at which problems have emerged in the past.<sup>6</sup> The work on “debt intolerance,” undertaken by IMF staff, implies that lower debt levels may be appropriate for countries that have defaulted in the past, and is part of the body of knowledge that informs the staff’s analysis of sustainability.<sup>7</sup> Beyond this, in crisis and near-crisis cases there is likely to be a need to go beyond the standard debt sustainability template, for instance by formulating

<sup>4</sup>See *Exchange Rate Assessment—Extensions of the Macroeconomic Balance Approach*, edited by Peter Isard and Hamid Faruqee, IMF Occasional Paper No. 167 (1998); and *Methodology for Current Account and Exchange Rate Assessments*, by Peter Isard, Hamid Faruqee, G. Russell Kincaid, and Martin Fetherston, IMF Occasional Paper No. 209 (2001).

<sup>5</sup>“Assessing Sustainability” (SM/02/166). It is also worth noting that staff undertook analysis of medium-term debt sustainability for Argentina, including extreme stress tests, beginning in 2000, prior to the introduction of the standardized debt sustainability template—although the results of this analysis were not fully shared with management and the Board.

<sup>6</sup>IMF, *World Economic Outlook, September 2003*, Chapter III.

<sup>7</sup>Carmen Reinhart, Kenneth Rogoff, and Miguel Savastano, “Debt Intolerance,” *Brookings Papers on Economic Activity:1* (2003), pp. 1–62.

more specific scenarios on the nature and magnitude of shocks that may occur, by making greater use of market indicators, and by undertaking a more comprehensive cash flow analysis to assess rollover risks.

14. *Recommendation 4* is that the Fund “should refrain from entering or maintaining a program relationship with a member country when there is no immediate balance of payments need and there are serious political obstacles to needed policy adjustment or structural reform.” We agree with the basic point that “[t]he markets may well do a better job of disciplining policy than a weak program that is being treated as precautionary.” At the same time, given that Argentina retained access to the financial markets, it is questionable whether following this recommendation would have made much difference to the way events unfolded there—although it is possible that the markets relied unduly on the Fund programs in lieu of their own due diligence. One important aspect of this issue is that a precautionary arrangement should be subject to the same standards as any other arrangement, given that it gives the member the same right to the use of Fund resources. The design and macroeconomic outcomes of precautionary arrangements will be examined in the forthcoming papers on program design.

15. *Recommendation 5* is that exceptional access should “entail a presumption of close cooperation between the authorities and the IMF.” We agree strongly with this principle, but have some doubts about the effectiveness of some of the specific steps

proposed. The report calls for mandatory disclosure to the Board of any issues/information that the authorities refuse to discuss/disclose—noting, for instance, the Argentine authorities’ reluctance to engage with the staff on exchange rate policy. We agree with the general argument: staff has the duty to inform the Board accurately on policy discussions (not just in exceptional access cases but in *all* cases) and this requires that when the authorities are not prepared to discuss key issues or provide key information staff should so inform the Board. But beyond this principle, it is not clear what purpose the proposed mandatory requirement would serve. With regard to the proposal that the Fund not endorse policies on which it was not consulted: while failing to consult is often an indication that the policy changes are not consistent with the program, and may raise questions about the authorities’ commitment to implement it—any staff assessment of policies still needs to be based on the merits of the policies and not solely on whether staff was consulted.

16. *Recommendation 6* is aimed at strengthening the role of the Executive Board. The procedures for exceptional access that were introduced after the Argentine crisis and reviewed this year do provide for a greater degree of Board scrutiny in cases of exceptional access—including the assessment of policies, debt sustainability, and financing assurances as already described.

17. Staff looks forward to Board discussion of this report and to working with the Board in following up on its recommendations.